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Richard Wilson.

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- Miss Dudley APS/S of S

From: Mr S G Hewitt C1
Date: 4 December 1989

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	Mrs Firth	SS (C)
	Mrs Woods	FD
	Mr Clark	FD1C
	Mr Epsom	C1A

NI FUND

I attach:

- * A revised draft paper
- * A draft letter to the private secretaries to the Chancellor of the Exchequer and the Secretary of State for Health

As we discussed, you will hold on to this material until Mr Partridge has discussed the matter again with colleagues in the Cabinet Office.

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CONFIDENTIALIntroduction

1. On 23 November, the Committee considered my memorandum E(A)(89)(31) about the management of the National Insurance Fund. I was asked to consult with the Chancellor of the Exchequer and the Secretary of State for Health and provide a further paper on options for managing the Fund.

The National Insurance Fund

2. The structure of the Fund is described at Annex 1. Because contributions are earnings related and benefits (except SERPS) are price indexed, a surplus has hitherto built up in the Fund allowing us to reduce, and eventually to abolish, the Treasury Supplement; gradually to increase the NHS allocation; and, at the last Budget, to decrease contributions for employees. But the unexpectedly high take up of personal pensions and the costs of rebates and incentives associated with the initiative means that the Fund will be exhausted by 1991/92 unless remedial action is taken.
3. Forecasts on the state of the Fund are produced by the Government Actuary using economic assumptions provided by the Treasury. By law, the Fund must not be allowed to go into deficit. In addition, the Actuary recommends that a minimum balance (currently 16.7% or sufficient to meet about 2 months' benefit) should be maintained at all times. The Fund has no borrowing powers: nor can contribution rates be increased quickly. Moreover, the Treasury Supplement has been abolished. The minimum balance is therefore essential to cope with short term fluctuations in income and/or expenditure. It would be imprudent to reduce this minimum balance and given current uncertainties about the future number of personal pensions the Actuary would, if anything, be likely to recommend an increase in the current level. This would, of course, exacerbate our present difficulties.

Options

4. This paper examines the scope for solving the Fund's problems through a reduction in outgoings or an increase in income.

Outgoings

5. Expenditure from the Fund includes three items which are non-contributory namely industrial injuries benefits (IIB), statutory sick pay and maternity pay (SSP/SMP) and the NHS allocation.

Industrial Injuries Benefits

6. Industrial injuries benefits are not statutorily contributory since they do not have specific contribution conditions. However recipients are required to have been in employment. II Benefits are currently financed from the NI Fund; being non-contributory however it might be more appropriate to make them and associated administrative costs a charge on the Consolidated Fund. This would reduce expenditure from the NI Fund by about £500 million a year.

SSP/SMP

7. The same considerations apply to SSP/SMP although the practical arrangements for paying these benefits makes their treatment rather different. At the moment, employers are responsible for meeting these benefits but they recoup their costs by adjusting their monthly national insurance contribution payments. It would be administratively difficult both for employers and the Inland Revenue and undesirable in principle (because that would be hypothecation of tax) to change to a system whereby the costs of these benefits were recouped through reductions in PAYE tax. But the burden could be shifted on to the Consolidated Fund by the introduction of a

special vote to the NI Fund. This would be worth more than £1 billion a year. It could however be portrayed by the Opposition as a revival of the Treasury Supplement.

Administrative Costs

8. The Fund traditionally bears the administrative costs relating to the NI contributions received and benefits paid out. Expenditure from the fund could be reduced by about £1 billion a year by transferring these costs to the Consolidated Fund. This would require primary legislation and could be presentationally difficult because it would undermine the status of the Fund as a self sufficient source of finance for the relevant payments. I do not find such an approach to be attractive.

NHS Allocation

9. The extent of the NHS allocation in recent years is shown at Annex 2. The allocation is currently about £4 billion or 16% of NHS spending.
10. Colleagues have decided that the allocation should be retained. It is the one device which allows us to vary the Fund's balance without changing contribution or benefit rates. For presentational reasons, it would be extremely difficult to reduce the allocation to zero. At present, the size of the allocation can only be altered by 0.1% each year. An increase in the permitted level of annual variations from 0.1% to 0.2% would give greater flexibility in the management of the Fund. This would, of course, require primary legislation.

National Insurance Contributions

11. The only other possibility is to increase contribution rates. To eliminate the projected deficit, it would be

necessary to increase primary and secondary contributions by about 0.5% from April 1991 and, again, by a similar margin in April 1992. A small reduction might be necessary the following year but the rates for 1993/94 would still be higher than now. Such increases would be unpopular especially as they could only be justified as a way of paying for some peoples' personal pensions. And there could be an indirect effect on inflation with employers trying to pass on their increased costs to consumers and employees pressing for higher wage settlements.

12. At present, the main contribution rates can only be varied by 0.25% a year by way of secondary legislation. New powers could be taken to increase this margin to, say, 0.5%. As with the NHS allocation, this would provide greater flexibility although we would need to be ready to defend the change.

Discussion

13. If we are looking for a single measure to cure the Fund's problems it will be necessary either to increase contributions progressively by around 1%; or reduce the NHS allocation to zero. Both would have considerable presentational drawbacks.

14. An alternative would be to remove expenditure on IIB and SSP/SMP. This would improve the balance in the Fund to the point where only limited additional action would be necessary on contribution rates and the NHS allocation. Such additional action could be taken within existing legislative provision. Nevertheless, new powers on contribution rates and the allocation - even if they were not used in full - would greatly increase our flexibility in further years and help to put the Fund on a sounder footing.

Conclusion

15. I propose to include a package of measures in my next Bill aimed at solving the Fund's present difficulties and providing much greater room for manoeuvre. This package would include the removal of expenditure on IIB and SSP/SMP; and powers to vary contribution rates by up to 0.5% a year, and the NHS allocation by 0.2% a year. I believe this could be presented as a logical and acceptable reform of the NI Fund.
16. Colleagues are invited to agree such an approach.

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DRAFT LETTER TO THE PRIVATE SECRETARY TO THE CHANCELLOR OF THE EXCHEQUER

NI FUND

At the meeting of E(A) on 23 November, my Secretary of State was asked to produce a further paper on options for managing the NI Fund. I attach a draft of such a paper and should be grateful to know whether the Chancellor of the Exchequer is content with the conclusions it reaches.

From the DSS point of view, there is now some urgency in this matter, since any new measures designed to cure the Fund's problems will have to be included in our forthcoming Bill. We therefore need to circulate an agreed paper as quickly as possible.

A copy of this letter goes to [] at the Department of Health. I should be grateful if he could let me have any comments on the draft which his Secretary of State would care to make.

THE NATIONAL INSURANCE FUND

GENERAL

1. The National Insurance Scheme operates on a contributory principle whereby contributions paid by employers and employees are compulsory and go towards the cost of benefits which are paid subject only to the fulfilment of qualifying conditions. This principle is reflected by the existence of a separate Fund where contributions and benefits are set out quite separately from general tax income and Consolidated Fund expenditure.

The National Insurance Fund has effectively never been financed on an actuarial, but on a pay-as-you-go, basis from contributions, now mainly earnings-related, and interest on investments. This means that current contributions pay for current benefits.

THE NATIONAL INSURANCE FUND

2. A working balance is provided

a. to finance advances, mainly to the Post Office and Girobank, to meet benefit expenditure; and

b. to cushion against changes in the forecast levels of income and expenditure.

and thus ensure that sufficient money is always available to meet the cost of benefits. This is essential because the Fund has no borrowing powers from which to meet any shortfall.

3. The Government Actuary has considered what risk margins it would be prudent to allow for the various items of income and outgo in the light of recent experience of the operation of the Fund. These risk margins reflect variations both in the actuarially estimated factors and in the working economic assumptions. On balance, the Actuary has recommended a minimum working balance of one-sixth of the year's estimated benefit expenditure.

THE ROLE OF THE GOVERNMENT ACTUARY

4. The Social Security Act 1975 (sections 121(1) and 124(3)) provide that whenever the Secretary of State lays before Parliament the draft of any Order which proposes a re-rating of contributions or an increase in benefit rates, he must simultaneously lay before the House a copy of a report by the Government Actuary which shows the Actuary's opinion of the likely effects on the National Insurance Fund. These opinions are published as House of Commons Command Papers.

MANAGEMENT OF THE FUND

5. Under section 133(3) of the 1975 Act, the assets of the Fund are invested by the National Debt Commissioners. The Commissioners are required by statute to invest in Government stocks. Some £1.5 to £2 billion is held in liquid funds to meet current needs and the remainder in a range of stock maturing over the next 20 years.

6. In the final analysis after taking account of interest on investments the Government must ensure that contribution rates are set at a level to finance projected outgoings from the Fund and to maintain the prudent balance as recommended by the Government Actuary.

7. The Government has recently taken steps to reduce future liabilities by encouraging contributors to opt out of the State Earnings Related Pension Scheme (SERPS) and by making changes in that scheme to reduce its future costs. However, the immediate effect of these changes has been to reduce the income of the Fund in short-term.

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ANNEX 2

NHS Allocation from NI Fund

Year	Percentage Employee*	Allocation Employer*	Amount Allocated to NHS £ million	Percentage of total NHS Finance
79/80	0.4%	0.6%	877	9.6%
80/81	0.4%	0.6%	989	8.2%
81/82	0.65%	0.6%	1,257	9.4%
82/83	0.75%	0.6%	1,662	11.3%
83/84	0.75%	0.6%	1,708	11.0%
84/85	0.75%	0.6%	1,848	11.1%
85/86	0.75%	0.6%	1,945	11.0%
86/87	0.75%	0.6%	2,220	11.7%
87/88	0.85%	0.7%	2,471	13.0%
88/89	0.95%	0.8%	3,372	14.5%
89/90	1.05%	0.9%	4,068	16.2%

* The NHS allocation is a percentage of the relevant earnings - eg if the NI Contribution rate is 9% of earnings, and the allocation rate is 1.05%, 7.95% goes to the NI Fund and 1.05% to the NHS.