

**REPORT BY THE GOVERNMENT ACTUARY ON THE DRAFTS
OF THE SOCIAL SECURITY BENEFITS UP-RATING ORDER
2005 AND THE SOCIAL SECURITY (CONTRIBUTIONS) (RE-
RATING AND NATIONAL INSURANCE FUNDS PAYMENTS)
ORDER 2005**

*Presented to Parliament by the Secretary of State for Work and Pensions and the Paymaster General
by Command of Her Majesty
February 2005*

Cm 6457

To: The Right Hon. Alan Johnson MP, Secretary of State for Work and Pensions

The Right Hon. Dawn Primarolo MP, Paymaster General

REPORT BY THE GOVERNMENT ACTUARY ON THE DRAFTS OF THE SOCIAL SECURITY BENEFITS UP-RATING ORDER 2005 AND THE SOCIAL SECURITY (CONTRIBUTIONS) (RE-RATING AND NATIONAL INSURANCE FUNDS PAYMENTS) ORDER 2005

Sir and Madam,

I attach a report on the likely effects on the National Insurance Fund of the *Social Security Benefits Up-rating Order 2005* and the *Social Security (Contributions) (Re-rating and National Insurance Funds Payments) Order 2005*. This report is made in accordance with sections 142(1), 147(2) and 150(8) of *the Social Security Administration Act 1992*, as amended by the *Social Security Contributions (Transfer of Functions, etc.) Act 1999*.

The report estimates the receipts of and payments from the National Insurance Fund for the years 2004-05 to 2009-10. The economic assumptions used correspond with those prepared by Her Majesty's Treasury at the time of the Pre-Budget Report in December 2004.

On the basis of the estimates in the report, the level of the National Insurance Fund at 31st March 2006 will be greater than one-sixth of benefit payments in 2005-06. Thus it exceeds the minimum level that I recommend to ensure that a reasonable working balance is maintained. It will not therefore be necessary for any Treasury grant to be made to the National Insurance Fund in 2005-06.

Christopher Daykin
Government Actuary
February 2005

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Summary

1. This report is on the likely effects on the Great Britain National Insurance Fund of:
 - (i) the *Social Security Benefits Up-rating Order 2005* (the Up-rating Order). Section 150(8) of the Social Security Administration Act 1992 requires the Secretary of State for Work and Pensions to lay a report by the Government Actuary before Parliament with drafts of any orders which alter the rates of benefits made under that section of the Act, and
 - (ii) the *Social Security (Contributions) (Re-rating and National Insurance Funds Payments) Order 2005* (the Re-rating Order). Sections 142(1), and 147(2) of the Social Security Administration Act 1992, as amended by the Social Security Contributions (Transfer of Functions, etc.) Act 1999, require the Treasury to lay a report by the Government Actuary before Parliament with drafts of any orders which alter the rates of contributions made under those sections of that Act.

The report also sets out the effects on the National Insurance Fund of changes which will be made by the *Social Security (Contributions) (Amendment) Regulations 2005* and the *Social Security Pensions (Low Earnings Threshold) Order 2005*. This report does not consider the separate Northern Ireland National Insurance Fund, nor the effects of the orders on that Fund.

2. The report shows estimates of the receipts of and payments from the National Insurance Fund for 2004-05 and 2005-06. The receipts from contributions and the payments on benefits in these years will depend, among other things, upon the levels of unemployment and employment, and the rate of increase in earnings. The estimates have been made using assumptions about the levels of unemployment, employment and earnings increases which correspond with those prepared by Her Majesty's Treasury at the time of the Pre-Budget Report in December 2004 (see paragraph 12 and Appendix 3, paragraph 28).
3. The orders and regulations covered and the financial effects are as follows:
 - the proposed Up-rating Order, which increases from April 2005 the rates at which many benefits are paid, and which is estimated to result in extra benefit payments in 2005-06 of £1,802 million;
 - the proposed Re-rating Order, which alters the rate of Class 2 and Class 3 contributions, alters the small earnings exception for Class 2 and adjusts the band of earnings on which Class 4 contributions are paid. It is estimated that these changes will increase receipts to the National Insurance Fund in 2005-06 by £5 million;
 - the proposed *Social Security (Contributions) (Amendment) Regulations 2005*, which increase the lower and upper earnings limits and the primary and secondary thresholds for Class 1 National Insurance contributions. It is estimated that these changes will decrease receipts to the National Insurance Fund in 2005-06 by £325 million. This includes the effects of the *Social Security Pensions (Low Earnings Threshold) Order 2005* on contracted-out rebates.

4. On the basis of the estimates in this report, no Treasury grant is required in 2005-06, as the balance in the fund at 31st March 2006 is estimated to be £34,605 million (57.1% of estimated benefit payments), and so significantly exceeds one-sixth of estimated benefit payments in 2005-06.

Description of the changes to benefits and contributions

5. The Up-rating Order increases the rates of social security benefits paid from the National Insurance Fund, from the week beginning 11th April 2005, by the increase in the retail prices index in the year to September 2004 (3.1%), except for contribution-based jobseeker's allowance which is increased by the increase in the ROSSI index over the same period (1.0%). Table 1 shows the changes to the major benefit rates. A more complete summary of the principal rates of benefit before and after the proposed changes is given in Appendix 1.

Table 1 – Changes to the major benefits rates

	Weekly rate in 2004-05	Proposed increase in weekly rate	Weekly rate proposed from 11th April 2005
Retirement pension - person claiming on their own or their deceased spouse's NI contributions - standard rate	£79.60	£2.45	£82.05
Retirement pension – person claiming on their spouse's NI contributions - standard rate	£47.65	£1.50	£49.15
Contribution-based jobseeker's allowance single person over 25	£55.65	£0.55	£56.20
Incapacity benefit long-term main rate	£74.15	£2.30	£76.45

6. Earnings-related additional pensions of retirement pensioners and bereavement benefit beneficiaries who qualified for these pensions before 6th April 2005 will be increased by 3.1%. There is no increase in additional pension for those on incapacity benefit. The increase applies to additional pensions before abatement for any contracted out deduction where the pensioner has been contracted-out before 6th April 1997. However, where a contracted out deduction in payment includes an amount arising from earnings between 6th April 1988 and 5th April 1997, such amount is deemed to be increased by 3.0% by the contracted-out pension scheme, and the increase in additional pension is correspondingly reduced.

7. The Re-rating Order will increase the Class 3 weekly contribution rate from £7.15 to £7.35 It will also increase the Class 2 rate payable by the self employed from £2.05 to £2.10 per week. There is a liability for Class 2 contributions for self employed people with profits or gains above the small earnings exception, which will be increased from £4,215 to £4,345 a year. Self employed people with profits below

the small earnings exception may still pay Class 2 to protect benefit entitlement. For Class 4, the lower profits limit and the upper profits limit will be altered to maintain their alignment with the income tax personal allowance and the upper earnings limit for Class 1 contributions respectively.

8. The proposed *Social Security (Contributions) (Amendment) Regulations 2005* will increase the lower and upper earnings limits for Class 1 contributions to £82 (from £79) a week and £630 (from £610) a week respectively. The increase to the LEL is in line with the increase to the basic retirement pension while the increase to the UEL is in line with the increase in the retail prices index to September 2004. The regulations continue to align the primary and secondary thresholds with the income tax personal allowance, which has been increased in line with the increase in the retail prices index in the year to September 2004. This will increase the thresholds to £94 (from £91) a week for weekly-paid employees and £408 (from £395) a month for other employees.

9. The changes described in paragraphs 7 and 8 are shown in Appendix 2. The financial effects of these changes are shown in Appendix 5. The effects of the orders on the Northern Ireland National Insurance Fund have not been included in this report.

10. The proposed *Social Security Pensions (Low Earnings Threshold) Order 2005* will increase the Low Earnings Threshold from £11,600 to £12,100 in 2005-06. The Low Earnings Threshold affects the amount of State Second Pension being accrued and the level of contracted-out rebates for people in Appropriate Personal Pensions and contracted-out stakeholder pensions. Consequentially, the upper limit of Band 2 accrual for the State Second Pension will be £27,800 in 2005-06, compared with £26,600 in 2004-05. The effects of this proposed Order have been allowed for in this report.

Methods and assumptions used to project receipts and payments

11. Each significant item of receipts and payments of the National Insurance Fund is estimated separately. The results are laid out in a format similar to the accounts for the National Insurance Fund for the year 2003-04. Redundancy receipts are not shown as a separate item, but redundancy payments are shown net of receipts.

12. The main economic assumptions which have been used are based on those which were, in part, set out in Annexes A and B of the Chancellor of the Exchequer's Pre-Budget Report. The important assumptions are that the number of jobs in the UK, including the armed forces and excluding the self-employed, is assumed to be 26.5 million in 2004-05 and 26.7 million in 2005-06, the increase in average earnings is assumed to be 4.6% over the year to 2004-05 and 4.8% over the year to 2005-06, and the numbers unemployed and claiming benefit in GB are assumed to be 0.81 million on average in 2004-05 and 0.82 million in 2005-06. Details of the methods used to estimate contribution income and benefit expenditure are given in Appendix 3.

Estimates of receipts and payments and balance in the fund

13. The estimates of receipts and payments for 2005-06 (with the estimates for 2004-05 shown for comparison) are given in Table 2.

Table 2 – Estimated receipts and payments and statement of balances of the National Insurance Fund

Great Britain, £ million	2004-05	2005-06
Receipts		
Contributions (as given in App 6)	64,846	67,619
Less recoveries of SSP	77	80
Less recoveries of SMP, SPP and SAP (and abatements)	1,284	1,344
Net contribution receipts	63,484	66,195
Treasury grant	0	0
Compensation from Consolidated Fund for SSP And SMP recoveries	1,335	1,397
Income from investments	1,421	1,605
State scheme premiums	129	137
Other receipts (4)	68	68
Total receipts	66,438	69,403
Payments		
Benefits At present rates (as given in App 4)	56,837	58,530
Increase due to proposed changes		1,802
Personal and stakeholder pensions contracted-out rebates (as given in App 6)	3,214	3,347
Age-related rebates for contracted-out money purchase schemes (as given in App 6)	292	290
Administration costs (4)	1,480	1,515
Redundancy fund payments (net) (4)	248	267
Transfer to Northern Ireland	230	225
Other payments	20	20
Total payments	62,321	65,996
Statement of balances		
Balance at beginning of year	(1) 27,082	31,198
Excess of receipts over Payments	4,117	3,407
Balance at end of year	31,198	34,605
Balance at end of year as percentage of benefit payments (2)	54.7	57.1

(1) The balance in the National Insurance Fund at 31st March 2004 has been taken from audited accounts of the fund for the year 2003-04.

(2) Percentages of benefit payments including net redundancy payments.

(3) Figures may not sum to totals shown due to rounding.

(4) The figures for 2004-05 are provisional estimates supplied by other government departments on the basis of amounts received or paid so far this year.

(5) SSP, SMP, SPP and SAP stand for statutory sick pay, statutory maternity pay,

statutory paternity pay and statutory adoption pay respectively.

14. Table 2 shows that the balance in the Fund is projected to grow as a percentage of benefit payments in 2004-05. It should be emphasised that there is uncertainty around such projections as the surplus generated each year is the difference between two large numbers and so quite small percentage changes in either of them could result in a large percentage change in the surplus income, and hence in the projected fund balance. However, the general trend is upwards.

Estimates for 2004-05

15. The estimates shown above for 2004-05 may be compared with the estimates made a year ago, and published in my report in February 2004 (Cm 6117). The estimated surplus of £4,117 million for 2004-05 shown above differs from the surplus of £2,369 million estimated in that report. This increase results mainly from contribution income being higher than expected at this time last year, principally because more contributions relating to liability in 2003-04 have been received in 2004-05 than was expected at this time last year. Payments made electronically by employers do not distinguish between income tax and National Insurance contributions (these amounts are calculated separately by employers and could be supplied with their electronic payments as easily as with manual payments, but Inland Revenue have decided to collect them without differentiation). Inland Revenue have been estimating the split between tax and National Insurance contributions for electronic payments but the part that was tax was overestimated in 2003-04, leading to an underpayment to the National Insurance Fund, a lower surplus in 2003-04 and a lower Fund at the end of 2003-04 than there should have been. The underpayment in 2003-04 has been rectified by additional payments in 2004-05, resulting in higher contributions and a higher surplus in 2004-05 than was estimated in Cm 6117.

16. When preparing estimates for National Insurance fund benefits for this report in previous years, it has been the practice to align the estimates produced by the benefit models to estimated expenditure for the current year produced by DWP's In Year Monitoring of Benefit Expenditure (IMBE). Two sets of benefit expenditure figures are produced by IMBE, accruals (resource) and cash (encashments). The NI Fund accounts are based on the final cash IMBE for each year and the differences between the IMBE data and the final Accounts is extremely small. For this reason it is the cash IMBE that has been used to align the benefits for the uprating report. However, for most other purposes, such as the estimates supplied by DWP for the Pre-Budget report, the accruals estimates are used.

17. For National Insurance Fund benefits it would be expected that there should be fairly close agreement between accruals and cash. The main reason for differences would be the lag in actually cashing the benefit (or it being paid into a bank account); the effect of this would generally be small in any year, mainly relating to the annual increase in benefit rates – leading to more of the encashments being paid at the previous year's rates. However, the difference during most of 2004-05 is larger than can be explained by the delay in cashing the benefit and has been very variable. We have therefore altered our method of alignment and this is explained in more detail in Appendix 3. This difference between accruals and cash IMBE has been brought to the

attention of DWP on several occasions over the past year, but they have been unable to explain it so far. We understand that DWP are now intending to undertake an investigation into the discrepancies, in co-operation with us.

Estimates for 2005-06

18. The extra benefit payments in 2005-06 as a result of the proposed increases in benefit rates from April 2005 are estimated to be £1,802 million. Particulars of the extra cost and of the payments for individual benefits are given in Appendix 4.

19. The financial effects on contribution receipts and contracted-out rebates of the proposed changes set out in paragraphs 7, 8 and 10 are given in Appendix 5. The total effect of the changes is estimated to be a loss in revenue to the National Insurance Fund of £320 million. Other changes in contribution receipts from 2004-05 to 2005-06 arise largely as a result of forecast increases in earnings between the two years.

20. Table 2 shows that the amount of Treasury grant estimated to be needed in 2005-06 is again nil. At this stage, the estimate of the balance in the National Insurance Fund at 31st March 2006 substantially exceeds one-sixth of estimated benefit payments in 2005-06. My recommendation is that the level of one-sixth of benefit payments is the minimum level needed to ensure the maintenance of a reasonable working balance in the fund.

21. Appendix 8 shows the projected development of the Fund up to 2009-10. It shows that the Fund (as a proportion of annual expenditure) is expected to increase slightly over this period and so to improve its position as a buffer fund. The projected development of the Fund over the longer term is shown in the Government Actuary's Quinquennial Review of the National Insurance Fund (Cm 6008).

Composition of benefit payments and contribution receipts

22. Appendix 4 shows that retirement pension accounts for the major part of benefit payments. Short-term projections indicate that the costs of retirement pension (including additional pension) as a proportion of benefit payments will increase slightly since the amount of additional pension is still growing rapidly.

23. Appendix 6 shows an analysis of contribution receipts. The changes to National Insurance contributions described in paragraphs 7, 8 and 10 above do not greatly affect the overall expected pattern of contribution receipts to the National Insurance Fund.

Effect of different assumptions about employment, unemployment, earnings and contracting out

24. Different assumptions about unemployment would affect the estimates of benefit payments. Different assumed levels of employment would change the estimates of contributions. The estimates of contributions are also critically dependent on assumptions about the level of earnings increases. Thus it is appropriate to consider the effect on National Insurance Fund receipts and payments of different

values for these economic assumptions. It is also appropriate to consider the effects of alternative assumptions for the numbers contracted out by different methods after April 2005 in view of the changes taking place in pension provision by employers (see paragraph 26).

25. The effect of different assumed numbers of employees does not depend greatly on the assumptions used for earnings increases, nor does the effect of different earnings increase assumptions depend greatly on the number of employees assumed. Hence these factors have been considered separately, and the two effects can be treated as additive. The results of varying the economic assumptions are given in Table 3 below.

Table 3 – Effect on receipts and payments of the National Insurance Fund in 2005-06 of variations in economic assumptions

Great Britain, £ million		
Variation compared to assumptions given in Appendix 3 paragraph 24	Effect on receipts in 2005-06	Effect on payments in 2005-06
GB number of employees-in-employment lower by 200,000 in 2005-06	-440	
GB number of employees-in-employment higher by 200,000 in 2005-06	+440	
Earnings increases 1% lower over the year to 2004-05 and 2% lower over the year to 2005-06	-2,010	
Earnings increases 1% higher over the year to 2004-05 and 2% higher over the year to 2005-06	+2,020	
GB unemployment higher by 200,000 in 2005-06		+110
GB unemployment lower by 200,000 in 2005-06		-110

26. Using the figures in Table 3 it is possible to estimate the likely contribution receipts, benefit payments and, most importantly, fund balance, under different sets of assumptions. For example, if earnings increases were 1% lower over the year to 2004-05 and 2% lower over the year to 2005-06 and the number of employees were 200,000 lower and the number unemployed 200,000 higher, then the total effect on the receipts net of payments of the National Insurance Fund in 2005-06 would be a loss of approximately £2.6 billion, which would still not necessitate a Treasury grant in 2005-06. It would, however, reduce the surplus for that year.

27. Different levels or patterns of contracting out could have a material effect on the cash flows of the National Insurance Fund. Table 4 shows the effect of different assumptions on the amounts of rebates paid (or, in the case of COSRS and the flat-rate part of COMPS rebates, deducted from contributions received) in 2005-06. Amounts of APP and stakeholder pension rebates for 2005-06, and COMPS rebates for 2005-06 above those deducted from contributions received in 2005-06, will generally be paid by the National Insurance Contributions Office after the end of the financial year direct to personal pension providers or the pension scheme.

Table 4 – Effect on receipts and payments of the National Insurance Fund of variations in assumptions on contracting out from April 2005

Great Britain, £ million

Variation in assumptions	Effect on rebates for 2005-06	Effect on rebates paid or deducted from contributions paid in 2005-06
100,000 more members of COSRS, with same sex, age and earnings profile as assumed COSRS membership	+100	+90
100,000 more members of COMPS with same sex and earnings profile as assumed COMPS membership	+100	+50
100,000 more members of APPs or stakeholder pensions with same sex, age and earnings profile as assumed APP and stakeholder pension membership	+110	0

For different assumptions for changes to the numbers of people contracting-out, these amounts can be scaled pro-rata.

28. The surplus generated in a year is the difference between two much larger numbers and comparatively small changes in these numbers will produce a large change in the surplus. This is true for the surpluses in the years 2006-07 to 2009-10 as well as for the surplus in 2005-06.

Conclusion

29. Table 2 of the report shows that the balance in the National Insurance Fund at 31st March 2005 is likely to be substantially above the recommended minimum level of one-sixth (16.7%) of benefit payments. The level is likely to be higher than estimated in the report on the changes in February 2004 (Cm 6117). Appendix 8 shows that the Fund is projected to remain above this level at least up to 31st March 2010.

30. It is estimated that no Treasury grant is needed in 2005-06 for the balance in the fund at 31st March 2006 to be at least one-sixth of estimated benefit payments in 2005-06. It is also projected that no Treasury grant will be needed in the period to 31st March 2010.

31. If economic conditions differ from the assumptions given in paragraph 24 of Appendix 3, then the balance in the Fund at 31st March 2006 will be different from that given above. This is also true for the figure shown in Appendix 8 up to 31st March 2010. However, even quite substantial alterations in economic conditions in future years should not cause the balance in the fund to fall significantly below its current level, although the rise shown for future years might not occur.

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January 2005

APPENDIX 1

MAIN RATES OF BENEFIT

	Weekly rate in 2004-05 £	Weekly rate proposed from 11 th April 2005 £
Retirement pension, bereavement allowance, widows pension and widowed parent's allowance		
Personal benefit (basic pension)	79.60	82.05
Wife or other adult dependant (retirement pension only)	47.65	49.15
Graduated retirement benefit (unit)	0.0963	0.0993
Bereavement payment (1)	2,000	2,000
Incapacity benefit long-term rate (2)		
Personal benefit	74.15	76.45
Transitional invalidity allowance higher rate	15.55	16.05
Transitional invalidity allowance middle rate	10.00	10.30
Transitional invalidity allowance lower rate	5.00	5.15
Wife or other adult dependant	44.35	45.70
Age increase higher rate	15.55	16.05
Age increase lower rate	7.80	8.05
Incapacity benefit short-term		
Personal benefit higher rate	66.15	68.20
Personal benefit lower rate	55.90	57.65
Wife or other adult dependant	34.60	35.65
Statutory sick pay	66.15	68.20
Jobseeker's allowance (contribution-based)		
Personal benefit for those aged 18 to 24	44.05	44.50
Personal benefit for those aged 25 and over	55.65	56.20
Maternity allowance (3)	102.80	106.00
Statutory maternity pay		
Standard rate (3)	102.80	106.00
Guardian's allowance		
First child	11.85	12.20
Other children	11.85	12.20
Increases for the children of widows, widowers, retirement pensioners and those on long-term rate and higher short-term rate of incapacity benefit and recipients of incapacity benefit over pension age		
First child	9.55	9.40
Other children	11.35	11.35
Christmas bonus to pensioners	10.00	10.00

(1) Lump sum benefit.

(2) The threshold for Incapacity Benefit offset for occupational pensions is £85 a week for both years.

(3) From April 2005 the weekly rate for maternity allowance and statutory maternity pay will be £106.00 or 90% of the woman's average weekly earnings if this calculation results in a figure which is less than £106.00. Self-employed women who hold a certificate of small earnings exception receive maternity allowance equal to 90% of the maternity allowance threshold (£30 a week).

APPENDIX 2

MAIN FEATURES OF THE CONTRIBUTION SYSTEM

	Rate in 2004-05	Rate proposed from April 2005
Class 1		
Lower earnings limit (LEL)	£79 a week	£82 a week
Upper earnings limit (UEL)	£610 a week	£630 a week
Primary threshold	£91 a week or £395 a month	£94 a week or £408 a month
Secondary threshold	£91 a week or £395 a month	£94 a week or £408 a month
Contribution rates (NI Fund and NHS combined)		
Primary		
(employee) On earnings between the primary threshold and UEL	(1) 11.0%	(1) 11.0%
On earnings above the UEL	1.0%	1.0%
Reduced rate on earnings between the primary threshold and UEL, for married women and widow optants	(2) 4.85%	(2) 4.85%
NHS allocation included in above		
- percentage of earnings between the primary threshold and UEL	2.05%	2.05%
- percentage of earnings above the UEL	1.0%	1.0%
Secondary		
(employer) On all earnings above the secondary threshold	(3) 12.8%	(3) 12.8%
NHS allocation included in above		
(percentage of all earnings for employees earning above the secondary threshold)	1.9%	1.9%
Class 1A and Class 1B		
Contribution rate	12.8%	12.8%
NHS allocation included in above	1.9%	1.9%
Class 2		
Flat rate contribution	£2.05 a week	£2.10 a week
Small earnings exception	£4,215 a year	£4,345 a year
NHS allocation included in above (percentage of contribution)	15.5%	15.5%
Class 3		
Flat rate contribution	£7.15 a week	£7.35 a week
NHS allocation included in above (percentage of contribution)	15.5%	15.5%
Class 4		
Lower profits limit (LPL)	£4,745 a year	£4,895 a year
Upper profits limit (UPL)	£31,720 a year	£32,760 a year
Contribution rate		
On profits between the LPL and UPL	8.0%	8.0%
On profits above the UPL	1.0%	1.0%
NHS allocation included in above		
Percentage of profits between the LPL and UPL	2.15%	2.15%
Percentage of profits above the UPL	1.0%	1.0%

- (1) The contracted-out rebate for primary contributions in 2004-05 and 2005-06 is 1.6% of earnings between the LEL and UEL for contracted-out salary-related schemes (COSRS) and contracted-out money purchase schemes (COMPS).
- (2) Married women opting to pay contributions at the reduced rate earn no entitlement to contributory National Insurance benefits as a result of these contributions. No women have been allowed to exercise this option since 1977.
- (3) The contracted-out rebate for secondary contributions in 2004-05 and 2005-06 is 3.5% of earnings between the LEL and UEL for COSRS and 1% for COMPS.
- (4). Members of COMPS also receive an age-related rebate (a rebate which increases with age) which is paid by the Inland Revenue direct to the scheme on receipt of the employer's end of year return. For holders of an appropriate personal pension or a stakeholder pension, the whole of the rebate is age-related and, like that for a COMPS, is paid by the Inland Revenue direct to the scheme on receipt of the employer's end of year return. The employee's share of the rebate is 1.6%.

APPENDIX 3

DETAILED METHODS AND ASSUMPTIONS USED

Contributions

1. Contributions are estimated separately for each class. Actual known receipts in recent years are used to adjust modelled estimates for future years.
2. Estimates of Class 1 contributions are made separately for gross contributions and amounts of contracted-out rebates. Estimates of gross contributions and rebates are made using an earnings distribution based on the New Earnings Survey (now replaced by the Annual Survey of Hours and Earnings), projected in line with the earnings increases shown in paragraph 24 below. The gross contribution results are scaled in line with the assumed number of employees which are also given in paragraph 24. The estimates of amounts of contracted-out rebates are made in a similar way, using an assumption of the numbers contracted out which allows for the continuation of the trend in the proportions of employees contracted out into occupational schemes observed in recent years.
3. Other classes of contributions are estimated using simpler models. Class 1A and Class 1B contributions are estimated using data provided by the Inland Revenue and information on Class 1A contributions paid in previous years. It should be noted that we have not been able to find a source of data on Class 1B contributions paid. Estimates of Class 2 and Class 4 contributions are estimated using data on the earnings of the self-employed received from the Inland Revenue, adjusted for earnings increases. This data is combined with information on contributions received in the past, the assumed numbers of self-employed in the future, and the rates of Class 2 and Class 4 in order to estimate the contributions paid. Class 3 contributions are estimated by adjusting the contributions paid in earlier years for the changes in the contribution rate and allowing for the extra payments made after the delayed deficiency notices are sent out.
4. Statutory sick pay (SSP) and statutory maternity pay (SMP) recovered by employers are estimated by adjusting amounts recovered in the latest year for which data are available broadly in line with changes in numbers of employees, rates of benefit, and, for earnings-related statutory maternity pay, the average earnings of women. The additional amount in excess of 100% of SMP paid which can be reclaimed by small employers (SMP abatement) is estimated in a similar way. The reliability of the data on actual amounts of SSP and SMP reclaimed by employers is no better than at this time last year. The amount of the payment from the Consolidated Fund is estimated as the amounts of SSP and SMP recovered, with adjustments in the current year arising from revisions to estimates of amounts recovered in prior years. Statutory paternity pay (SPP) and statutory adoption pay (SAP) is estimated in a similar way.

Other receipts

5. The estimates given for receipts from state scheme premiums are based on data from the National Insurance Contributions Office on the receipts of these amounts in the recent past.
6. The investment return on the National Insurance Fund is estimated by applying an assumed rate of return to the average balance in the Fund during the year.
7. The amount of the Treasury grant for 2005-06 is estimated as that amount needed to ensure that the estimate of the fund balance at 31st March 2006 is at least one-sixth of benefit payments (including redundancy fund payments) in 2005-06.
8. Estimates for the item called "Other receipts" in the accounts of the National Insurance Fund (mainly recoveries of damages in tort from benefit paid) are provided by Analytical Services Division of the Department for Work and Pensions.

Benefits

9. Benefits are estimated separately for each of the contributory benefits, and separately for the basic, flat-rate elements and for additional pensions (SERPS and S2P).
10. In general, for flat-rate benefits, numbers are estimated by taking the most recent data on beneficiaries and projecting these with allowance for awards and cessations in future years based on past experience and taking into account demographic factors. The average rate of benefit is calculated, making allowance for dependency and average amounts of benefit, based on past data and observed trends.
11. Estimates of basic retirement pension, by far the largest benefit, use the 2003-based population projection as a basis for the numbers over pensionable age. They allow for gradual changes in the proportion of that population receiving basic retirement pension, as well as for an increasing trend in the numbers of overseas residents receiving pension. Allowance is made for trends in the average amounts of benefit and the changing mix in categories of retirement pension for women arising from the increasing trend for women to have entitlement on their own contributions. In addition, allowances have been made for the cost of the deferral package contained in the Pensions Act 2004, for the effects on retirement pension of extra contributions being paid in response to delayed deficiency notices being sent out and for the effects on benefits of the Civil Partnerships Act 2004.
12. Estimates of amounts of additional pension paid with retirement pension are derived from age-specific data on past earnings. For future years, earnings factors are derived by adjusting these for earnings increases, for the introduction of different accrual rates on different bands of earnings in the State Second Pension (S2P), and for demographic and economic activity rate changes under pensionable age. Allowance is also made for accruals of S2P credited earnings from 2002-03 onwards. Accrued earnings are survived to pensionable age using adjusted population mortality rates. At

pensionable age the accrued survived earnings are converted to amounts of additional pension awarded, and survived using the mortality rates from the 2003-based projection. Allowance is made for additional pension which is inherited by surviving widows and widowers after the death of a pensioner. A similar method is used for guaranteed minimum pensions and contracted-out deductions, with adjustment to the mortality rates to allow for generally lighter mortality for those contracted-out.

13. Estimates of graduated retirement pension are based on the numbers of graduated units earned between 1961 and April 1975. An estimated adjustment was made to allow for units of deceased men inherited by their widows who were under pensionable age at April 1975 and which would not come into payment until the widow reached pensionable age. The units at April 1975 are survived using population mortality rates. Allowance is made for inheritance of graduated units by widows and, from 1979, by widowers. Units in respect of people under pension age are assumed to be put into payment on reaching pensionable age. The appropriate graduated rate is applied to the survived units over pensionable age.

14. Estimates of widows' benefits and bereavement benefits are based on an awards and survivorship model. This model is split between projecting the remaining pre-1988 widows who have full transitional protection and are subject to the pre-1988 rules for widows' benefit, projecting a build-up and run-off of widows widowed between 1988 and 2001, and projecting a build up of widows and widowers post 2001 who are subject to the rules for widows' benefits and bereavement benefits introduced by the Welfare Reform and Pensions Act 1999. Allowance is made for widowers with children who were widowed before April 2001 and who have received widowed parent's allowance since April 2001. Awards are based on recent data and are projected using numbers of new widows and widowers from the latest marital condition projection (mid-1996 based adjusted); termination and transfer rates by single age and type of benefit are derived from recent data. For widowers, due to the paucity of data, assumptions are based on those for widows, with adjustments to allow approximately for age differentials and entitlement.

15. There has been no firm data on the lump sum widows payment / bereavement payment since 1996-97. Estimates for this are derived from numbers of awards of bereavement benefit, combined with assumptions on those cases who are not awarded bereavement benefit based on the old data. Efforts are being made to re-instate the collection of data.

16. Estimates of the amount of additional pension paid with widows' benefits and bereavement benefits are derived from the retirement pension additional pension model. Accrued additional pension to people dying under pensionable age, and actual additional pension in payment to those dying over pensionable age are converted to give amounts of widows' and widowers' additional pension using assumptions on marital status and age of surviving spouse. The amount is split by type of benefit and survived using the main basic widows' benefit model. Allowance is made for the changes which have applied since April 2001, under which additional pension will only be paid to widows and widowers under pensionable age who receive widowed parents allowance. Amounts of survived additional pension are transferred back to the main retirement pension model in respect of widows and widowers who reach

pensionable age, including amounts which are not actually paid under pension age. A similar method is used for contracted-out deductions.

17. Trends in awards and survival for incapacity are based on recent data. Additional pension with incapacity benefit ceased for new awards from April 1995, although after 1995 cases still retain the benefit at the existing rate. The estimates are now based on data which includes the effects of changes that were introduced from April 2001 under the Welfare Reform and Pensions Act 1999.

18. The estimate of the cost of contribution-based jobseeker's allowance is based on the assumptions for the number of unemployed set out in paragraph 28 of this appendix. It takes account of the estimated proportion of those unemployed who are entitled to the contributory element of jobseeker's allowance. The proportion entitled is derived from recent data on contributory jobseeker's allowance analysed by duration of unemployment. The model takes recent data on duration-specific proportions entitled and applies these to a durational split of the numbers unemployed based on durational profiles determined from ONS data on unemployment by age and duration.

19. Estimates for maternity allowance are based on recent data on awards and benefits in receipt varied in line with numbers of births from the latest population projection. Full allowance has been made for the recent policy changes on duration and entitlements. Estimates for guardian's allowance are derived from recent data, varied in line with numbers of children in the population and with an allowance for recent trends. Estimates for the lump sum Christmas bonus are derived from numbers assumed entitled to the qualifying benefits (retirement pension, widows pension, widowed parent's allowance and long-term incapacity benefit) with allowance for those cases not entitled to the Christmas bonus.

20. The underlying Government Actuary's Department estimates of payments for all benefits are aligned to recent data on payments for 2004-05 to ensure that account is taken of more recent changes in factors affecting benefit payments than are incorporated in data on numbers of beneficiaries. As was explained in paragraphs 16 and 17 of the main report, the difference between the cash and accruals produced by DWP is now much larger than can be accounted for by the delay in cashing benefits. General trends in benefit case load would also affect the relationship; for some benefits, such as Retirement Pension, this is increasing, whilst for others, such as Bereavement Benefits, it is decreasing. There are also differences that arise from the number of payday's in the year, which can be allowed for when making comparisons. On balance it is to be expected that encashment expenditure would be somewhat less than accruals, but not much, as benefits are usually paid soon after entitlement arises.

21. Data for the period from 1999-00 to 2002-03 appeared to confirm this. The overall differences between cash and accruals was relatively small, with cash being around £100-£150 million lower than accruals. For 2003-04 the difference increased, as was noted in my report last year (appendix 7, paragraph 7), and the final difference for the year was £250 million. During 2004-05 the differences between cash and accruals has increased substantially and the latest figures for December shows this to

be around £600 million. This difference mainly arises on Retirement Pension; for other benefits differences are similar to previous years.

22. This difference between accruals and cash IMBE has been brought to the attention of DWP on several occasions over the past year, but they have been unable to explain it so far. Some recent adjustments to the cash IMBE reduced the difference, but they nevertheless remain very large. It is generally thought that the accruals data better reflect the true liability of the NI fund. In the absence of any good reason being forthcoming to account for the differences between the cash and accruals IMBE, adjustments have been made to the methodology for aligned benefit expenditure. For the current year, 2004-05, benefits are aligned to the December cash IMBE, with an allowance to reflect the fact that December cash tends to be lower than the final cash IMBE (on which the NI Fund Accounts will be based). For 2005-06 and later years benefit estimates have been alignment to the December accruals IMBE, with an adjustment reflecting the fact that December accruals tends to be higher than the final, and a further factor to adjust to encashments based on the outturn data observed over the period 1999-00 to 2003-04.

Other payments

23. Redundancy payments estimates (net of redundancy receipts) are provided by the Department of Trade and Industry, and are based on the same economic assumptions as the other estimates.

24. Estimates of payments to providers of appropriate personal pensions (APPs) and stakeholder pensions are made using the method for calculating contracted-out rebates which was described in paragraph 2 of this appendix. Virtually all the rebates in respect of contributions paid in one financial year are paid in the following financial year.

25. Transfers from the Great Britain National Insurance Fund to the Northern Ireland National Insurance Fund are made in order to keep the balance in the Northern Ireland National Insurance Fund at 2.66% of the combined balance in the two funds. Estimates of transfers to Northern Ireland are made on this basis.

26. The estimates for administration costs are provided by the Inland Revenue for 2004-05. The costs for 2005-06 and later have been estimated as the 2004-05 costs increased in line with inflation.

27. The figures for “Other payments” are based on an extrapolation of amounts shown in the accounts of the National Insurance Fund for this item in previous years.

Economic assumptions

28. The estimates for contribution receipts are sensitive to the assumptions used about the numbers of employees and the numbers of self-employed workers, and to the assumptions used for earnings increases. The estimates of benefit payments depend, among other things, on assumptions about the numbers unemployed. In

accordance with normal practice, working assumptions have been given by the Government in regard to these factors. The economic assumptions which have been used are those which underlie the estimates of the contributory social security benefits as given in the Pre-Budget Report in December 2004. These are given below:

Assumptions used for estimates	2004-05	2005-06
Number of employment jobs (UK), million (including HMF, excluding self-employed)	26.5	26.7
Increase in average earnings on one year earlier, %	4.6	4.8
Average number of unemployed (GB), million	0.81	0.82

The assumptions for 2004-05 differ from those used in making last year's report.

29. The effects of variations in these assumptions are given in paragraphs 26 and 27 of the main report.

APPENDIX 4

ESTIMATED PAYMENTS FROM THE NATIONAL INSURANCE FUND FOR BENEFITS, AND EFFECT OF BENEFIT UP-RATING ON PAYMENTS IN 2005-06

Great Britain £ million	Estimated total payments in 2004-05	Estimated total payments in 2005-06	Extra payments in 2005-06 as a result of up-rating
Retirement pensions – basic	41,184	43,457	1,227
Retirement pensions – additional pensions	7,405	8,380	363
Widows' / bereavement benefits – basic	704	675	15
Widows' / bereavement benefits – additional pensions	193	174	6
Incapacity benefit – basic	6,294	6,611	182
Incapacity benefit – additional pensions	354	313	0
Contribution-based jobseeker's allowance	432	442	4
Maternity allowance	145	152	4
Guardian's allowance	2	2	0
Christmas bonus	124	125	0
Total (1)	56,837	60,332	1,802
Redundancy payments (net) (1)	248	267	0

(1) Figures from these lines appear in Table 2 in the main report.

APPENDIX 5

ANALYSIS OF THE CHANGES IN CONTRIBUTION RECEIPTS FOR 2005-06 AS A RESULT OF THE CONTRIBUTION RE-RATING ORDER AND OTHER MEASURES

Great Britain, £ million	Contributions for 2005-06	Contributions received in 2005-06 (1)
National Insurance Fund effects		
Social Security (Contributions) (Re-rating and National Insurance Funds Payments) Order 2005		
Increase in Class 2 rate	+6	+4
Increase in Class 2 small earnings exception – indexation effect	-2	-1
Increase in Class 3 rate	+2	+1
Increase in Class 4 profits limits – indexation effect	+8	+2
Total	<u>+14</u>	<u>+5</u>
Proposed Social Security (Contributions) (Amendment) Regulations 2005		
Increase in Class 1 primary and secondary thresholds, and lower and upper earnings limits – indexation effect		
Effect on contribution receipts from gross contributions (2)	-324	-287
Effect on contribution receipts from contracted-out rebates (4)	-104	-39
Total	<u>-429</u>	<u>-325</u>
Total, all measures	-414	-320

- (1) The balance of contributions for 2005-06 will not be received until after 31st March 2006.
- (2) Figures are gross of statutory sick pay, statutory maternity pay, statutory paternity pay and statutory adoption pay.
- (3) Figures may not sum to totals shown due to rounding.
- (4) This line also includes the effects of the proposed Social Security Pensions (Low Earnings Threshold) Order 2005.

APPENDIX 6

ANALYSIS OF CONTRIBUTION RECEIPTS BY FUND AND CLASS OF CONTRIBUTOR, AND ANALYSIS OF OCCUPATIONAL PENSION SCHEME CONTRACTED-OUT REBATES

Great Britain, £ million			2004-05	2005-06
National Insurance Fund				
Class 1 (1)	Primary	Gross	28,267	29,346
		Contracted-out rebate (2)	2,318	2,380
		Net	25,949	26,966
	Secondary	Gross	40,606	42,565
		Contracted-out rebate (2)	4,767	4,896
		Net	35,839	37,669
Total		Gross	68,872	71,911
		Contracted-out rebate (2)	7,085	7,277
		Net	61,788	64,635
Classes 1A and 1B			855	825
Class 2			237	238
Class 3 (3)			101	76
Class 4			1,866	1,846
Total National Insurance Fund Contributions (4)			64,846	67,619
National Health Service				
Class 1	Primary		7,169	7,474
		Secondary	9,336	9,746
		Total	16,505	17,221
Classes 1A and 1B			149	144
Class 2			43	44
Class 3 (3)			18	14
Class 4			837	852
Total National Health Service Contributions			17,553	18,274
All contributions				
Class 1 (1)	Primary	Gross	35,435	36,821
		Contracted-out rebate (2)	2,318	2,380
		Net	33,117	34,440
	Secondary	Gross	49,942	52,311
		Contracted-out rebate (2)	4,767	4,896
		Net	45,175	47,415
Total		Gross	85,377	89,132
		Contracted-out rebate (2)	7,085	7,277
		Net	78,292	81,855
Classes 1A and 1B			1,004	968
Class 2			280	282
Class 3 (3)			119	89
Class 4			2,703	2,698
Total contributions			82,398	85,893

(1) All figures are gross of recoveries by employers of statutory sick pay, statutory maternity pay, statutory paternity pay and statutory adoption pay.

(2) Contracted-out rebates in respect of contracted-out occupational pension schemes

deducted from contributions paid in year only.

(3) These figures include an allowance for extra payments made after the delayed deficiency notices are sent out.

(4) These figures appear in Table 2 in the main report.

(5) Figures may not sum to totals shown due to rounding.

APPENDIX 6 (cont)

ANALYSIS OF PAYMENTS IN RESPECT OF APPROPRIATE PERSONAL PENSIONS AND AGE-RELATED REBATES IN RESPECT OF CONTRACTED-OUT MONEY PURCHASE SCHEMES MADE BY THE INLAND REVENUE

Great Britain, £ million	2004-05	2005-06
Personal and Stakeholder pension rebates		
Primary contracted-out rebates	730	761
Secondary contracted-out rebates	2,484	2,586
Total (1)	3,214	3,347
Age-related rebates for members of contracted-out money-purchase schemes (1)	292	290
All payments in respect of personal pensions and age-related rebates to contracted-out money purchase schemes	<u>3,506</u>	<u>3,637</u>

- (1) The figures from these lines appear in Table 2 in the main report.
(2) Figures may not sum to totals shown due to rounding.

APPENDIX 7

COMPARISON OF ESTIMATES FOR 2004-05 MADE NOW AND IN Cm 6117 (FEBRUARY 2004)

Great Britain, £ million	2004-05 estimates made now	2004-05 estimates given in Cm 6117
Receipts		
Contributions	64,846	63,547
Less recoveries of SSP	77	74
Less recoveries of SMP, SPP and SAP and SMP, SPP and SAP abatement	1,284	1,233
Net contribution receipts	63,484	62,239
Treasury grant	0	0
Compensation from Consolidated Fund for SSP and SMP recoveries	1,335	1,284
Income from investments	1,421	1,388
State scheme premiums	129	149
Other receipts	68	68
Total receipts	<u>66,438</u>	<u>65,128</u>
Payments		
Benefits	56,837	56,826
Personal and stakeholder pensions contracted-out rebates	3,214	3,793
Age-related rebates for contracted-out money purchase schemes	292	295
Administration costs	1,480	1,321
Redundancy fund payments (net)	248	248
Transfer to Northern Ireland	230	255
Other payments	20	20
Total payments	<u>62,321</u>	<u>62,759</u>

Figures may not sum to totals due to rounding.

REASONS FOR CHANGES IN ESTIMATES

1. The estimates of Class 1 contributions are higher than last year for both primary and secondary contributions. This is largely because the underpayment of contributions to the National Insurance Fund by Inland Revenue in 2003-04 (explained in paragraph 15 of the main report) is being repaid in 2004-05.
2. Receipts of Class 2 contributions are now estimated to be slightly lower than was estimated last year. This is due to changes in the numbers assumed to be self-employed.
3. Estimates of Class 4 contributions are higher than the estimates produced last year. This is because we have changed from using average earnings to self-employed earnings when estimating Class 4 contributions.
4. Estimates of Classes 1A and 1B are lower following a downward revision by Inland Revenue in their estimates of Class 1A liability.
5. The estimate for Class 3 contributions is little changed from last year.
6. Estimates of SSP, SMP, SPP and SAP are higher than was estimated last year because we have taken account of the latest data on these benefits. There are still some unresolved questions in relation to this data and therefore there is the possibility of revisions in the future when these problems are resolved.
7. Income from investments is estimated to be lower than was estimated at this time last year. This is largely due to the lower balance in the fund at the end of 2003-04, which resulted from the underpayment of Class 1 contributions.
8. The estimate of total benefit payments for 2004-05 is little different to that shown in last year's report although the differences for individual benefits are greater. The main reason for the difference in retirement pension is the linking of our estimates to IMBE (in-year monitoring of benefit expenditure). This is explained in more detail in Appendix 3, paragraphs 20 to 22. Contribution based jobseeker's allowance has altered mainly because the unemployment level is different to that assumed at this time last year, and the differences in the other benefits are caused by the incorporation of more recent data.
9. Payments of minimum contributions to appropriate personal pension (APP) providers (including stakeholder pensions) are now estimated to be lower than was estimated last year. This is in line with more recent data on the amounts that have been paid.
10. Estimates of the administration costs that will be charged to the National Insurance Fund have been supplied by the Inland Revenue. These estimates are a little higher than those given last year but the difference is within the normal range. This item of expenditure is always fairly variable and the underpayments and exceptional items of expenditure in the last few years have made it more difficult to project than

usual.

11. The assumptions used in making the two sets of estimates are compared in the table below.

	2004-05 estimates made now	2004-05 estimates given in Cm 6117
Number of employees in employment (UK), million (including HMF, excluding self-employed)	26.5	26.3
Increase in average earnings on one year earlier, %	4.6	4.6
Average number of unemployed (GB), million	0.81	0.91

APPENDIX 8

PROJECTED RECEIPTS, PAYMENTS AND FUND BALANCES FOR THE NATIONAL INSURANCE FUND UP TO 2009-10

Balance in National Insurance Fund at the end of successive financial years

Great Britain, £ million	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Receipts	61,379	66,438	69,403	73,542	78,187	82,578	87,168
Payments	60,827	62,321	65,996	68,284	71,953	75,827	79,809
Excess of receipts over payments	552	4,117	3,407	5,258	6,235	6,751	7,360
Balance in Fund at end of year	27,082	31,198	34,605	39,863	46,098	52,849	60,209
Balance at end of year as a percentage of benefit payments	(1) 49.2	54.7	57.1	63.6	69.7	75.7	81.8

(1) From the accounts for 2003-04.

(2) This uses the book value of the fund as at 31 March 2004 and is in accordance both with the accounts and with past practice. However, it is not consistent with the fund projections made in my latest Quinquennial Review of the National Insurance Fund, which used market values.

(3) Projections for 2006-07 and later years are based on the economic assumptions used for the Pre-Budget Report in December 2004.

(4) The excess of income over expenditure each year is the difference between two large numbers and so quite small percentage changes in either of them could result in a large percentage change in the surplus income. This, in turn, could have a significant effect on the fund balances.