Towards a Citizen’s Pension: Interim Report December 2004

Appendix Two: How contracting-out works, and more detail on how National Insurance contributions could change, as described in Chapter 2

These appendices should be read together with the main report

Produced by the Pensions Policy Institute
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Appendix 2: How contracting-out works, and more detail on how National Insurance contributions could change, as described in Chapter 2

The current contracting-out system is complex
Contributory pensions in the current state pension system (the Basic State Pension (BSP) and State Second Pension (S2P)) are administered through the National Insurance fund. National Insurance contributions (NICs) are paid by:

- Anyone who is employed, aged between 16 and SPA and earning more than £4,732 a year (£91 a week)[1], to accrue entitlement to BSP and S2P,
- Employers who employ anyone paying NICs, and,
- The self-employed, who pay lower NICs to accrue entitlement to the BSP, but not S2P.

It is possible to contract-out of S2P, if an individual is a member of an approved occupational pension scheme, or has an approved personal pension.

- An individual who contracts-out will accrue lower S2P entitlement.
- In return he or she pays a lower NIC (as does his or her employer), or at the end of the year has part of his or her NIC paid directly into a private pension scheme in the form of an rebate, that depends upon the age and earnings of the individual.
- The exact combination of S2P received, lower NICs and rebate paid direct to a pension fund depends on the type of pension arrangement the individual has, and how much the individual earns (Table 1).
  - If an individual is contracted-out into a Defined Benefit occupational pension scheme, both the employer and employee pay lower NICs. If the individual earns more than £26,500 a year (£511 a week), the occupational pension scheme provides all second tier pension benefits. If earnings are less than £26,500 a year, a residual amount of S2P would be accrued, which would be paid by the state after state pension age.
  - If an individual is contracted-out into a Defined Contribution occupational pension scheme, the individual and the employer payer lower NICs, and the pension scheme receives a rebate at the end of the year direct from the NI fund, depending on the age and earnings of the individual. This is called an Age Related Rebate. If the individual earns more than £11,600 a year (£223 a week), the occupational pension scheme provides all second tier pension benefits. If earnings are less than £11,600 a year, a residual amount of S2P would be accrued, which would be paid by the state after state pension age.
  - If an individual is contracted-out into a personal pension, the individual and employee make full rate NICs. At the end of the year the personal pension fund receives an Age Related Rebate direct from the NI fund. If the individual earns more than £11,600 a year, the personal pension scheme provides all second tier pension benefits. If earnings are less than £11,600 a year, a residual amount of S2P would be accrued, which would be paid by the state after state pension age.

[1] Entitlement to BSP and S2P begins at the Lower Earnings Limit of £79 a week, but National Insurance contributions are only paid on earnings of £91 a week or more

Table A2.1: 2004/5 NI contribution and rebate levels by contracted-out status[2]

	NIC rates – employee	NIC rates - employer	Minimum Employer/ Employee contribution to private pension scheme	Government rebate paid to private pension scheme	State benefit entitlement
Not paying National Insurance Contributions *(8.5 million people)*	None	None	None	None	None
Contracted-in *(9 million people)*	11% on earnings between £91 and £610 a week 1% on earnings above £610 a week	12.8% on earnings above £91 a week	None	None	S2P
Contracted-out in a Defined Benefit occupational pension scheme *(4.5 million people public sector, 3.5 million private sector)*	9.4% on earnings between £91 and £610 a week **(1.6% reduction)** 1% on earnings above £610 a week	9.3% on earnings between £91 and £610 a week **(3.5% reduction)** 1% on earnings above £610 a week	**5.1%** of earnings between £91 and £610 a week, equivalent to the combined employer and employee NIC reduction[3]	None	If earnings are above £511 a week, no S2P is accrued. For earnings between £91 and £511, contracting-out only partially replaces S2P, so some S2P benefit is accrued[4]
Contracted-out in a Defined Contribution occupational pension scheme *(Less than 0.5 million people)*	9.4% on earnings between £91 and £610 a week **(1.6% reduction)** 1% on earnings above £610 a week	11.8% on earnings between £91 and £610 a week **(1% reduction)** 1% on earnings above £610 a week	**2.6%** of earnings between £91 and £610 a week, equivalent to the combined employer and employee NIC reduction	Age related rebate ranging from **2.1%** for a 16 year old to **10.5%** for anyone aged 54 or older. Rebates are doubled on earnings between £91 and £223 a week, and halved on earnings between £223 and £511	If earnings are above £223 a week, no S2P is accrued. For earnings between £91 and £223 contracting-out only partially replaces S2P, so some S2P benefit is accrued[5]
Contracted-out into an approved personal pension (APP) *(6 million people)*	The same as for a contracted-in employee	The same as for a contracted-in employee	None	Age related rebate ranging from **2.6%** for a 16 year old to **10.5%** for anyone aged 54 or older. Rebates are doubled on earnings between £91 and £223, and halved on earnings between £223 and £511	If earnings are above £223 a week, no S2P is accrued. For earnings between £91 and £223, contracting-out only partially replaces S2P, so some S2P benefit is accrued[6]
Self-employed *(2.5 million people)*	Flat-rate of £2.05 a week 8% on 'profit' between £4,745 and £31,720 a year **(3% reduction)** 1% on 'profit' above £31,720 a year	None	None	None	BSP only – no S2P

[2] PPI calculations based on 2004/5 rate and rebate levels
[3] In practice this does not have to be paid in every year, and depends on the scheme funding position. If the scheme is well funded, less may be paid in.
[4] See PPI (2004) *The Pensions Primer* for more details
[5] See PPI (2004) *The Pensions Primer* for more details
[6] See PPI (2004) *The Pensions Primer* for more details

- Rebates on NICs are only available on earnings below the Upper Earnings Limit, which is £31,720 a year in 2004/5.

The impact of removing contracting-out
With the introduction of a Citizen's Pension, there would be no further accruals of BSP or S2P. There would also be no more contracting-out, as there would no longer be anything to contract-out of.

Despite the different structures of NICs that exist for different contracting-out vehicles, the amount that individuals and employers have to contribute to the NI fund and contracted-out pension schemes is theoretically the same for each vehicle. For example, the sum of contributions paid to the NI fund and contracted-out pension schemes by the employer and employee for an employee earning £400 a week is £74 a week for employees who are contracted-in, or contracted-out into an occupational pension scheme or personal pension (Chart A2.1).

Chart A2.1[7]

The contracting-out landscape

Weekly contributions and rebates illustrated for a person earning £400pw 2004/5

Contracted in or out status	Number of people of working age of each status	Contributions to NI fund		Employer/ employee contribution to pension fund in lieu of S2P	Total contribution	NI rebate paid direct to pension fund
		Employee	Employer			
Not making NI contributions	8.5m	None	None	None	None	None
Contracted-in to S2P	9m	£34	£40	None	£74	None
In a contracted-out Defined Benefit scheme	4.5m public 3.5m private sector	£29	£29	£16	£74	None
In a contracted-out Defined Contribution scheme	Fewer than 0.5m	£29	£36	£8	£74	From £10 to £40 depending on age
In a contracted-out Personal Pension	6m	£34	£40	None	£74	From £16 to £40 depending on age
Self-employed	2.5m	£27	None	None	£27	None

This means that, in theory, removing contracting-out should not change the level of total contributions to the NI fund and contracted-out pension schemes faced by any employer or employee. Rather than some contributions being directed towards private pension arrangements, all contributions would be made to the state. Although contributions would not directly guarantee any state pension (as this would be based on residency), the Citizen's Pension would be more generous than existing state pension provision.

[7] PPI calculations based on 2004/5 rate and rebate levels

There are some circumstances in which total contributions may be changed by abolishing contracting-out:

- In Defined Benefit occupational pension schemes contributions may not be directly related to the benefit accruing of the individual, but to the requirements of all scheme members. Actual contributions by employers and employees to the pension scheme may not be the same as those implied by the NI rebate. If the scheme is well-funded, contributions may be lower than the NI Rebate. If it is poorly funded, contributions may be higher.
- The Age Related Rebates paid to personal and occupational money purchase pension schemes are not paid for directly by the employee or employer, but are paid by the NI fund. In the absence of S2P and contracting-out, there appears to be no rationale for continuing to pay age-related rebates from the NI fund. This has no impact on what individuals see as cash flow, but will mean a smaller contribution to money purchase pension funds.
  - The rebate – up to £56[8] pw - to personal pensions used for contracting-out would be removed. In return, the personal pension would not have to accumulate the S2P-equivalent benefit.
  - 6 million individuals would need to decide whether to continue with the same level of voluntary saving into their personal pension (because with the new Citizen's Pension as their future state pension, they believe their total pension is enough) or whether they wish to supplement their personal pension.

There are options for change for NICs

There are a number of different options for National Insurance contributions and rebates after the introduction of a Citizen's Pension. For example:

- Leave NIC rates unchanged
- Align NIC rates at the contracted-in rate
- Increase the amount paid by the self-employed
- Redesign the NIC system

These changes would impact on:

- The NICs paid by employees, employers and the self-employed; and
- The contributions paid by employers and employees to (currently) contracted-out pension schemes

Unchanged NI rates

This would mean no change in the amount of NI contributions paid by any individual or employer. The Government would collect the same amount of revenue in National Insurance Contributions as in the current system.
Advantages of this approach include:

- No increase in NI contributions for anybody.
- There would be minimal disruption to employees, employers and private pension schemes.
- The NI fund would still balance as it is currently running at a surplus.

[8] For someone earning above the Upper Earnings Limit of £610 a week and receiving the maximum age related rebate of 10.5%

Disadvantages include:

- Some previously contracted-out employers (including Government) and employees would be paying a lower NICs for no obvious reason.
- The National Insurance fund would be subsidising occupational pension schemes and their members.
- No money would be released to fund additional spending on current pensioners.

Align NIC rates at the contracted-in rate
In the absence of S2P to contract-out of, there would no longer be a rationale for contracting-out rebates to remain in payment. One option would be to abolish all contracted-out rebates, and re-align NIC rates at the current contracted-in levels (Charts A2.2, A2.3 and A2.4). This would mean:

- The majority of individuals would face unchanged NI rates.
- The 8.5 million members of contracted-out occupational pension schemes would face an increase in NICs. Over half of the individuals affected belong to public service pension schemes.
- Employers running contracted-out salary related occupational pension schemes would pay higher NICs.
- Employers running contracted-out money purchase occupational pension schemes would pay higher NICs.
- Employers running occupational pension schemes would have to decide future contribution levels to schemes. They could:
  - Continue with existing employer and employee contribution levels. This would represent an increase in total (state and private) pension provision.
  - Reduce employer and employee contribution levels to reflect the increase in NICs. Under these circumstances, the net impact on total pension provision is neutral, and the combined NIC and pension contributions faced by the employer and employee could be the same as in the contracted-out system.
  - Employers with a contracted-in DB scheme face a more complicated choice which depends on the current funding level and maturity of the scheme.
  - The employer has to ensure that over the long-term the scheme can deliver S2P-equivalent benefits, and would be expected to be putting in a contribution for this. From C-day[9], this expectation will cease for future accruals, but the employer will still have to ensure that accrued rights will be delivered, which may or may not require future contribution increases.
  - In addition, the employer has to decide how the level of future accruals should reflect the new Citizen's Pension. For example, a contracted-out 1/60ths scheme may provide a similar total (state and private) pension to a 1/80ths scheme. This might mean a change in the long-term contribution (which would reflect the change in NICs), but it is unlikely to mean an immediate change in contributions, especially if the scheme is mature so that future accruals are of less significance than past accruals.
  - A particular case arises for ex-public sector schemes with active members who were employees at the time of privatisation. Protected Persons Regulations require that each employer has to continue to provide as good a pension as before privatisations, unless members accepted a reduction. This would affect still active ex British Coal, Rail and Electricity employees.

[9] The day of transition to a Citizen's Pension

- Employees in contracted-out non-contributory schemes would not be able to offset high NICs against lower occupational pension contributions. This may be particularly important in some public service occupational pension schemes.

Advantages of this approach include:

- A level playing field, as all employees and employers face the same NI rates
- It provides an opportunity for employers to re-design occupational pension provision consistent with the introduction of a Citizen's Pension.
- It would free all of the £12bn currently spent on rebates to pay for a higher Citizen's Pension for current pensioners.

Disadvantages include:

- Higher NI contributions for 8.5 million employees and their employers.
- A reduction in the resources that employers could devote to occupational pension schemes, which could lead to a reduction in employer pension provision more than the change to a Citizen's Pension would warrant.

Chart A2.2[10]

Align NI contributions at the contracted-in rate
Earning £300 a week

	NI contributions		Employer/ employee contribution to pension fund (assumed)	Overall change in NI and assumed pension contributions	Age-related rebate no longer paid	Pension benefit being accrued in state system
	Employee	Employer				
Not making NI contributions	None	None	None	None	N/A	Higher, earnings-linked CP replaces partial entitlement to BSP and S2P
Contracted-in to S2P	No change	No change	None	None	N/A	Higher earnings-linked CP instead of BSP and S2P
In a contracted-out Defined Benefit scheme	Increased by £3	Increased by £7	Reduced by £10	None	N/A	Higher earnings-linked CP instead of price-linked BSP
In a contracted-out Defined Contribution Scheme	Increased by £3	Increased by £2	Reduced by £5	None	£8 to £34	Higher earnings-linked CP instead of price-linked BSP
In a contracted-out Personal Pension	No change	No change	None	None	£14 to £34	Higher earnings-linked CP instead of price-linked BSP
Self-employed	No change	No change	None	None	N/A	Higher earnings-linked CP instead of price-linked BSP

Chart A2.3[11]

Align NI contributions at the contracted-in rate
Earning £400 a week

	NI contributions		Employer/ employee contribution to pension fund (assumed)	Overall change in NI and assumed pension contributions	Age-related rebate no longer paid	Pension benefit being accrued in state system
	Employee	Employer				
Not making NI contributions	None	None	None	None	N/A	Higher, earnings-linked CP replaces partial entitlement to BSP and S2P
Contracted-in to S2P	No change	No change	None	None	N/A	Higher earnings-linked CP instead of BSP and S2P
In a contracted-out Defined Benefit scheme	Increased by £5	Increased by £11	Reduced by £16	None	N/A	Higher earnings-linked CP instead of price-linked BSP
In a contracted-out Defined Contribution scheme	Increased by £5	Increased by £3	Reduced by £8	None	£10 to £40	Higher earnings-linked CP instead of price-linked BSP
In a contracted-out Personal Pension	No change	No change	None	None	£16 to £40	Higher earnings-linked CP instead of price-linked BSP
Self-employed	No change	No change	None	None	N/A	Higher earnings-linked CP instead of price-linked BSP

[10] PPI calculations based on 2004/5 rate and rebate levels
[11] PPI calculations based on 2004/5 rate and rebate levels

Chart A2.4[12]

Align NI contributions at the contracted-in rate Earning £600 a week

	NI contributions		Employer/ employee contribution to pension fund (assumed)	Overall change in NI and assumed pension contributions	Age-related rebate no longer paid	Pension benefit being accrued in state system
	Employee	Employer				
Not making NI contributions	None	None	None	**None**	N/A	Higher, earnings-linked CP replaces partial entitlement to BSP and S2P
Contracted-in to S2P	No change	No change	None	**None**	N/A	Higher earnings-linked CP instead of BSP and S2P
In a contracted-out Defined Benefit scheme	Increased by £8	Increased by £18	Reduced by £26	**None**	N/A	Higher earnings-linked CP instead of price-linked BSP
In a contracted-out Defined Contribution Scheme	Increased by £8	Increased by £5	Reduced by £13	**None**	£14 to £55	Higher earnings-linked CP instead of price-linked BSP
In a contracted-out Personal Pension	No change	No change	None	**None**	£22 to £55	Higher earnings-linked CP instead of price-linked BSP
Self-employed	No change	No change	No change	**None**	N/A	Higher earnings-linked CP instead of price-linked BSP

Increase the amount paid by the self-employed
A Citizen's Pension would represent an increase in state pension coverage for the self-employed, as they are currently not covered by the State Second Pension. Although a Citizen's Pension is not based on contributions, the contribution paid by the self-employed could be increased to reflect this increased coverage.

Currently, self-employed individuals pay a flat rate payment (£2.05 pw), which covers entitlement to the Basic State Pension. The self-employed also pay class 4 contributions (covering the same range of earnings as for employees) at a lower NIC rate of 8%. This does not give any entitlement to S2P.

Advantages of bringing the self-employed fully in to the NIC system include:
- Consistency of treatment (for contributions and benefits) for employees and the self-employed.
- Increasing the amount collected from the self-employed may allow for a reduction / smaller increase in the amount collected from employees and employers.

Disadvantages of this approach include:
- Potentially increases the NICs of up to 2.6 million self-employed people.
- Fully aligning with the employees' rate of NICs would see a large increase in payments. This could be an extra £14 pw for someone with profits of more than £31,720 a year[13].

[12] PPI calculations based on 2004/5 rate and rebate levels
[13] PPI calculation based on 2004/5 rates and allowances. Assumes an increase on class 4 contribution rate from 8% to 11%, offset by not paying class 2 contributions of £2.05 a week.

Re-design the NIC system
This represents a compromise between realising all of the money spent on contracted-out rebates, protecting employees and employers from large increases in NICs, and increasing the coverage of the self-employed. NIC rates could be set somewhere between the existing contracted-in and contracted-out levels.

Employers and employees would face similar choices as outlined above with regard to contributions to occupational pension schemes where NIC rates are higher than the current system. This is likely to be on a more limited scale than if rates were aligned at the contracted-in level. Lower NIC increases would mean that some level of private pension contribution could still be maintained without increasing overall state and private contributions (Charts A2.5, A2.6 and A2.7).

For example, aligning all employee (and self-employed[14]) contribution rates at 10.3% and all employer rates at 12.1% would, alongside the abolition of Age Related Rebates, would give an additional amount collected in NICs that broadly matches the total additional first year costs of a Citizen's Pension set at £105 a week.

Advantages of this approach are:
- Lower NIC contributions for employers and employees currently paying the contracted-in NIC rate.
- A smaller increase in NIC contributions for employers and employees currently with contracted-out occupational pension schemes than aligning at the contracted-in rate.
- Lower overall contributions for all employees and employers.
- A smaller impact on contributions to occupational pension schemes, as this reduction in total contributions would mean that any employers and employees who adjust contributions to maintain them at current levels are in effect increasing voluntary saving.

Disadvantages of this approach are:
- More disruption to NICs, than, for example, aligning at the current contracted-in rates – rates would change for all NI payers.

[14] This example also assumes that the Class 2 contributions are set to zero, so there is no flat-rate contribution from the self-employed. This means that low paid self-employed people (earning less than £9,400) would pay lower NICs than today.

Chart A2.5[15]

Align NI contributions at the contracted-in rate Earning £300 a week

	NI contributions		Employer/ employee contribution to pension fund (assumed)	Overall change in NI and assumed pension contributions	Age-related rebate no longer paid	Pension benefit being accrued in state system
	Employee	Employer				
Not making NI contributions	None	None	None	**None**	N/A	Higher, earnings-linked CP replaces partial entitlement to BSP and S2P
Contracted-in to S2P	No change	No change	None	**None**	N/A	Higher earnings-linked CP instead of BSP and S2P
In a contracted-out Defined Benefit scheme	Increased by £3	Increased by £7	Reduced by £10	**None**	N/A	Higher earnings-linked CP instead of price-linked BSP
In a contracted-out Defined Contribution Scheme	Increased by £3	Increased by £2	Reduced by £5	**None**	£8 to £34	Higher earnings-linked CP instead of price-linked BSP
In a contracted-out Personal Pension	No change	No change	None	**None**	£14 to £34	Higher earnings-linked CP instead of price-linked BSP
Self-employed	No change	No change	None	**None**	N/A	Higher earnings-linked CP instead of price-linked BSP

Chart A2.6[16]

Align NI contributions at the contracted-in rate Earning £400 a week

	NI contributions		Employer/ employee contribution to pension fund (assumed)	Overall change in NI and assumed pension contributions	Age-related rebate no longer paid	Pension benefit being accrued in state system
	Employee	Employer				
Not making NI contributions	None	None	None	**None**	N/A	Higher, earnings-linked CP replaces partial entitlement to BSP and S2P
Contracted-in to S2P	No change	No change	None	**None**	N/A	Higher earnings-linked CP instead of BSP and S2P
In a contracted-out Defined Benefit scheme	Increased by £5	Increased by £11	Reduced by £16	**None**	N/A	Higher earnings-linked CP instead of price-linked BSP
In a contracted-out Defined Contribution scheme	Increased by £5	Increased by £3	Reduced by £8	**None**	£10 to £40	Higher earnings-linked CP instead of price-linked BSP
In a contracted-out Personal Pension	No change	No change	None	**None**	£16 to £40	Higher earnings-linked CP instead of price-linked BSP
Self-employed	No change	No change	None	**None**	N/A	Higher earnings-linked CP instead of price-linked BSP

15 PPI calculations based on 2004/5 rate and rebate levels
16 PPI calculations based on 2004/5 rate and rebate levels

Chart A2.7[17]

Align NI contributions at the contracted-in rate Earning £600 a week

	NI contributions		Employer/ employee contribution to pension fund (assumed)	Overall change in NI and assumed pension contributions	Age-related rebate no longer paid	Pension benefit being accrued in state system
	Employee	Employer				
Not making NI contributions	None	None	None	**None**	N/A	Higher, earnings-linked CP replaces partial entitlement to BSP and S2P
Contracted-in to S2P	No change	No change	None	**None**	N/A	Higher earnings-linked CP instead of BSP and S2P
In a contracted-out Defined Benefit scheme	Increased by £8	Increased by £18	Reduced by £26	**None**	N/A	Higher earnings-linked CP instead of price-linked BSP
In a contracted-out Defined Contribution Scheme	Increased by £8	Increased by £5	Reduced by £13	**None**	£14 to £55	Higher earnings-linked CP instead of price-linked BSP
In a contracted-out Personal Pension	No change	No change	None	**None**	£22 to £55	Higher earnings-linked CP instead of price-linked BSP
Self-employed	No change	No change	No change	**None**	N/A	Higher earnings-linked CP instead of price-linked BSP

There is only a weak link between contributions and benefits in the National Insurance fund.
The fund works on a Pay-As-You-Go basis (PAYG), so the contributions paid in any year are then used to pay benefits to pensioners in the same year.

In theory, the NI fund is 'hypothecated' – that is, contributions paid in to the fund are only used to pay for specific contributory benefits[18]. In reality, there are a number of disjoints between the contributions made and the benefits paid:

- In recent years more has been paid in to the NI fund in contributions than has been paid out in benefits. This has resulted in the NI fund having assets of almost £30 billion above the amount paid out annually in benefits. The Government Actuary[19] recommends that £10bn of assets should be reserved in this way. Consequently there is a surplus of £20bn in the NI fund[20].
- Employers and employees can contract-out of the NI fund for part of their pension provision. Less money is collected from contracted-out employees and employers in contributions, and Age Related Rebates are paid directly from the NI fund to private pension schemes.

[17] PPI calculations based on 2004/5 rate and rebate levels
[18] Excluding contributions specifically allocated to the NHS
[19] The Government Actuary views a surplus of 1/6 of annual benefit expenditure to be a 'reasonable working balance' for the NIF (Paul Flynn MP in the Westminster Hall debate on the National Insurance Fund, House of Commons *Hansard* 21 October 2003 column 217WH)
[20] Paul Flynn MP in the Westminster Hall debate on the National Insurance Fund, House of Commons *Hansard* 21 October 2003 column 217WH

- The NI fund also contributes to private pension schemes indirectly. Employer contributions to private pension schemes are not subject to NICs, resulting in employers making lower NICs than if the same amount of money were paid directly to employees. This relief amounted to more than £6bn in 2003/4[21].
- A link between contributions paid in and benefits paid out has been further weakened by a series of reductions made to employer NICs as direct offsets to taxes that encourage environmentally friendly behaviour, or 'Green Taxes'. These include the landfill tax, aggregates levy and the climate change levy. Taken together, these have reduced employer NICs by more than £2 billion a year[22].

NICs could be integrated with the income tax system
A more radical approach to reforming NICs would be to integrate them further with the tax system. The Citizen's Pension in New Zealand - the closest comparison to the proposals for the UK - is paid for from general taxation.

There are some possible advantages in switching state pension funding from National Insurance to general taxation:

- It would continue an existing trend. Contributory pension benefits are already becoming less important as a source of pension income as reliance on means-tested benefits increases. Today, 90% of pension benefit expenditure is through contributory pensions. Over the next 50 years, this is projected to fall to 75%[23].
- It would be more progressive as, for example, income tax is based on all income rather than just earnings, is not capped at the upper earnings limit and covers all adults, not just those of working age.
- It may also fit much better with the idea of citizenship. Within social insurance there is a difference between those who can pay contributions and are part of the system, and those who cannot afford contributions but arguably need the most support[24]. Because of this, a system of credits for 'worthy' non-contributors has been added to the system over time, but even this still leaves certain groups with lower pension entitlements[25].

There are however, advantages in retaining the existing structure of National Insurance:

- While a switch from NICs to general taxation is logical, it is not necessary. The NI fund would still have a role to play even in the absence of contributory pensions. Other contributory benefits would still need to be funded and paid, and payments would still be made to the NHS. If the National Insurance fund was left to cover this expenditure, contributions could be much lower than current levels.

[21] Inland Revenue statistics, www.inlandrevenue.gov.uk/stats/tax_expenditure/table1-5.pdf
[22] Paul Flynn MP in the Westminster Hall debate on the National Insurance Fund, House of Commons *Hansard* 21 October 2003 column 217WH
[23] PPI calculations based on DWP long-term projections
[24] Howell T. (1975) *Changing a Winning Scheme* A Nuffield Fellowship Study of New Zealand's Social Security Cash Benefits Department of Health and Social Security London
[25] Curry (2003) *The Under-Pensioned* Pensions Policy Institute

- There are problems involved in abolishing (or reducing the role of) the NI fund, not least political difficulties in seeming to increase other levels of taxation (such as income tax) even if the overall tax burden is unchanged. Making some groups pay for pensions through taxation who currently do not pay NICs (such as pensioners, even though they would be the better off fifth of pensioners[26]) might not be popular.
- The balance of contributions between employers and employees may also change if NICs were abolished. Other employer taxes would need to increase, and employers would not be able to offset pension contributions to private pensions against NICs. This would be likely to reduce private pension contributions.
- There is still some public commitment to paying 'contributions' for pensions, even if there is little link between the actual contributions paid in and the benefits received[27].

The decision to pay for a Citizen's Pension through the NI fund or general taxation is likely to be based on political and administrative grounds. There is no fundamental reason why a Citizen's Pension would not be workable with the current NI arrangements, even if there were no relationship at all between contributions and benefits.

An alternative to abolishing the NI fund would be to change its purpose, so it was used to pay for social expenditures other than pensions and benefits. For example, the whole of the NI fund could be allocated to the NHS (and / or education, depending on the relative size of existing budgets), while pensions are funded through general taxation. The net effect on the relative balance between general taxation and the NI fund could be minimised. The same amounts of money would be raised through each method, but it could be allocated in a different way from today.

As it is not necessary to switch paying for state pensions from National Insurance to taxation, it was not considered for the main report.

[26] PPI (2004) *State Pension Reform: Managing Transition*
[27] Hills J. (2004), *Heading for Retiement? National Insurance, State Pensions and the Future of the Contributory Principle in the UK* in the Journal of Social Policy 33, 3 pages 347-371 Cambridge University Press