Report by the Government Actuary on the drafts of the Social Security Benefits Up-rating Order 2006 and the Social Security (Contributions) (Re-rating and National Insurance Funds Payments) Order 2006

Government Actuary's Department
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REPORT BY THE GOVERNMENT ACTUARY ON THE DRAFTS OF THE SOCIAL SECURITY BENEFITS UP-RATING ORDER 2006 AND THE SOCIAL SECURITY (CONTRIBUTIONS) (RE-RATING AND NATIONAL INSURANCE FUNDS PAYMENTS) ORDER 2006

Presented to Parliament by the
Secretary of State for Work and Pensions and the Paymaster General
by Command of Her Majesty
January 2006

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To: The Right Hon. John Hutton 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 2006 AND THE SOCIAL SECURITY (CONTRIBUTIONS) (RE-RATING AND NATIONAL INSURANCE FUNDS PAYMENTS) ORDER 2006

Sir and Madam,

I attach a report on the likely effects on the National Insurance Fund of the *Social Security Benefits Up-rating Order 2006* and the *Social Security (Contributions) (Re-rating and National Insurance Funds Payments) Order 2006*. 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 2005-06 to 2010-11. The economic assumptions used correspond with those prepared by Her Majesty's Treasury at the time of the Pre-Budget Report in December 2005.

On the basis of the estimates in the report, the level of the National Insurance Fund at 31st March 2007 will be greater than one-sixth of benefit payments in 2006-07. 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 2006-07.

Christopher Daykin
Government Actuary
January 2006

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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 2006* (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 2006* (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 2006* and the *Social Security Pensions (Low Earnings Threshold) Order 2006.* 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 2005-06 and 2006-07. 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 2005 (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 2006 the rates at which many benefits are paid, and which is estimated to result in extra benefit payments in 2006-07 of £1,618 million;
- the proposed Re-rating Order, which alters the rate of 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 act in opposite directions and there will be no net change in the receipts to the National Insurance Fund in 2006-07;
- the proposed *Social Security (Contributions) (Amendment) Regulations 2006*, 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 2006-07 by £396 million. This includes the effects of the *Social Security Pensions (Low Earnings Threshold) Order 2006* on contracted-out rebates.

4. On the basis of the estimates in this report, no Treasury grant is required in 2006-07, as the balance in the fund at 31st March 2007 is estimated to be £37,328 million (60.1% of estimated benefit payments), and so significantly exceeds one-sixth of estimated benefit payments in 2006-07.

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 10th April 2006, by the increase in the retail prices index in the year to September 2005 (2.7%), except for contribution-based jobseeker's allowance which is increased by the increase in the ROSSI index over the same period (2.2%). 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 2005-06	Proposed increase in weekly rate	Weekly rate proposed from 10th April 2006
Retirement pension - person claiming on their own or their deceased spouse's NI contributions - standard rate	£82.05	£2.20	£84.25
Retirement pension – person claiming on their spouse's NI contributions - standard rate	£49.15	£1.35	£50.50
Contribution-based jobseeker's allowance single person over 25	£56.20	£1.25	£57.45
Incapacity benefit long-term main rate	£76.45	£2.05	£78.50

6. Earnings-related additional pensions of retirement pensioners and bereavement benefit beneficiaries who qualified for these pensions before 6th April 2006 will be increased by 2.7%. 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 2.7% 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 £7.35 to £7.55. 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 £4,345 to £4,465 a year. The Class 2 weekly contribution rate will remain unchanged. 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 2006* will increase the lower and upper earnings limits (LEL and UEL) for Class 1 contributions to £84 (from £82) a week and £645 (from £630) 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 2005. 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 2005. This will increase the thresholds to £97 (from £94) a week for weekly-paid employees and £420 (from £408) 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 2006* will increase the Low Earnings Threshold (LET) from £12,100 to £12,500 in 2006-07. The LET 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. Consequently, the upper limit of Band 2 accrual for the State Second Pension will be £28,800 in 2006-07, compared with £27,800 in 2005-06. 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 2004-05. 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 26.8 million in 2005-06 and 26.9 million in 2006-07, the increase in average earnings is assumed to be 4.0% over the year to 2005-06 and 4.3% over the year to 2006-07, and the numbers unemployed and claiming benefit in Great Britain are assumed to be 0.84 million on average in 2005-06 and 0.89 million in 2006-07. 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 2006-07 (with the estimates for 2005-06 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	2005-06		2006-07	
Receipts				
Contributions (as given in App 6)	67,153		69,078	
Less recoveries of SSP	80		83	
Less recoveries of SMP, SPP and SAP (and abatements)	1,324		1,355	
Net contribution receipts		65,748		67,640
Treasury grant		0		0
Compensation from Consolidated Fund for SSP, SMP, SPP and SAP recoveries		1,378		1,411
Income from investments		1,374		1,556
State scheme premiums		133		137
Other receipts (4)		67		69
Total receipts		68,700		70,813
Payments				
Benefits At present rates (as given in App 4)		59,905		60,233
Increase due to proposed changes				1,618
Personal and stakeholder pensions contracted-out rebates (as given in App 6)		2,408		2,479
Age-related rebates for contracted-out money purchase schemes (as given in App 6)		154		180
Administration costs (4)		1,421		1,458
Redundancy fund payments (net) (4)		252		245
Transfer to Northern Ireland		185		630
Other payments		31		32
Total payments		64,356		66,875
Statement of balances				
Balance at beginning of year	(1)	29,046		33,390
Excess of receipts over Payments		4,344		3,938
Balance at end of year		33,390		37,328
Balance at end of year as percentage of benefit payments (2)		55.5		60.1

(1) The balance in the National Insurance Fund at 31st March 2005 has been taken from draft accounts of the fund for the year 2004-05.

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

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

(4) The figures for 2005-06 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 2006-07. 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.

Estimates for 2005-06

15. The estimates shown above for 2005-06 may be compared with the estimates made a year ago, and published in my report in February 2005 (Cm 6457). The estimated surplus of £4,344 million for 2005-06 shown above differs from the surplus of £3,407 million estimated in that report. The change is the result of three main factors: benefit estimates have been reduced for the reasons explained in paragraphs 16 and 17 below, the contracted-out rebates paid for personal and stakeholder pensions has been much lower than was expected at this time last due to advice by some insurance companies that their policyholders should contract back into the State Second Pension and contribution income is estimated to be £466 million less than was projected last year for the reasons outlined in the rest of this paragraph. The proportion of employers paying PAYE electronically is increasing and it is expected that eventually almost all PAYE payments will be made in this way. The electronic payments system has been set up such that the tax and National Insurance contributions (NICs) are not differentiated, though these amounts have to be calculated separately by employers and are still shown separately when payments are made manually. The result of this is that the amounts paid over to the National Insurance Fund (NIF) are based on estimates made by HM Revenue & Customs (HMRC) and the true amounts of NICs paid is not known until some time after the end of the financial year. It is therefore impossible to distinguish real trends in the payment of NICs from the errors in the estimating process. The effect on our projections is two-fold. Firstly, information on NIC liability will be delayed by almost a year since contributions shown as received by HMRC data can give little idea of true contribution liability: these latter amounts will not be known until all end-of-year returns are processed (when the amounts are reconciled). Secondly, it is not possible to estimate amounts paid over to the NIF in a particular year, since these have to be decided by HMRC without the benefit of knowing the true amounts of NICs paid over by employers. In these circumstances, differences between actual and estimated receipts are inevitable.

16. When preparing estimates for National Insurance Fund benefits for this report in the past, 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 NIF accounts are based on the final cash IMBE for each year and the differences between the IMBE data and the final Accounts is small. For this reason it has been in the past the cash IMBE that has been used to align the benefits for the up-rating 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. In recent years, however, the difference has been larger than can be explained by the delay in cashing the benefit and has been very variable. We therefore altered our method of alignment last year and amended it again this year in the light of more recent experience, causing a significant change in the benefit estimates since Cm 6457. This is explained in more detail in Appendix 3.

Estimates for 2006-07

18. The extra benefit payments in 2006-07 as a result of the proposed increases in benefit rates from April 2006 are estimated to be £1,618 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 £396 million. Other changes in contribution receipts from 2005-06 to 2006-07 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 2006-07 is again nil. At this stage, the estimate of the balance in the National Insurance Fund at 31st March 2007 substantially exceeds one-sixth of estimated benefit payments in 2006-07. 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 2010-11. 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) and the update published on the GAD website in December 2004.

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 2006 in view of the changes taking place in pension provision by employers (see paragraph 27).

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 2006-07 of variations in economic assumptions

Great Britain, £ million

Variation compared to assumptions given in Appendix 3 paragraph 24	Effect on receipts in 2006-07	Effect on payments in 2006-07
GB number of employees–in–employment lower by 200,000 in 2006-07	-440	
GB number of employees-in–employment higher by 200,000 in 2006-07	+440	
Earnings increases 1% lower over the year to 2005-06 and 2% lower over the year to 2006-07	-2,070	
Earnings increases 1% higher over the year to 2005-06 and 2% higher over the year to 2006-07	+2,080	
GB unemployment higher by 200,000 in 2006-07		+100
GB unemployment lower by 200,000 in 2006-07		-100

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 2005-06 and 2% lower over the year to 2006-07 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 2006-07 would be a loss of approximately £2.6 billion, which would still not necessitate a Treasury grant in 2006-07.

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 2006-07. Amounts of APP and stakeholder pension rebates for 2006-07, and COMPS rebates for 2006-07 above those deducted from contributions received in 2006-07, 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 2006

Great Britain, £ million

Variation in assumptions	Effect on rebates for 2006-07	Effect on rebates paid or deducted from contributions paid in 2006-07
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	+80	+40
100,000 more members of APPs or stakeholder pensions with same sex, age and earnings profile as assumed APP and stakeholder pension membership	+120	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 2007-08 to 2010-11 as well as for the surplus in 2006-07.

Conclusion

29. Table 2 of the report shows that the balance in the National Insurance Fund at 31st March 2006 is likely to be substantially above the recommended minimum level of one-sixth (16.7%) of benefit payments. The level is likely to be lower than estimated in the report on the changes in February 2005 (Cm 6457). Appendix 8 shows that the Fund is projected to remain above this level at least up to 31st March 2011.

30. It is estimated that no Treasury grant is needed in 2006-07 for the balance in the fund at 31st March 2007 to be at least one-sixth of estimated benefit payments in 2006-07. It is also projected that no Treasury grant will be needed in the period to 31st March 2011.

31. If economic conditions differ from the assumptions given in paragraph 24 of Appendix 3, then the balance in the Fund at 31st March 2007 will be different from that given above. This is also true for the figure shown in Appendix 8 up to 31st March 2011. 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.

Government Actuary CHRISTOPHER DAYKIN

Fellow of the Institute of Actuaries
January 2006

APPENDIX 1

MAIN RATES OF BENEFIT

	Weekly rate in 2005-06 £	Weekly rate proposed from 10th April 2006 £
Retirement pension, bereavement allowance, widow's pension and widowed parent's allowance		
Personal benefit (basic pension)	82.05	84.25
Wife or other adult dependant (retirement pension only)	49.15	50.50
Graduated retirement benefit (unit)	0.0993	0.1020
Bereavement payment (1)	2,000	2,000
Incapacity benefit long-term rate (2)		
Personal benefit	76.45	78.50
Transitional invalidity allowance higher rate	16.05	16.50
Transitional invalidity allowance middle rate	10.30	10.60
Transitional invalidity allowance lower rate	5.15	5.30
Wife or other adult dependant	45.70	46.95
Age increase higher rate	16.05	16.50
Age increase lower rate	8.05	8.25
Incapacity benefit short-term		
Personal benefit higher rate	68.20	70.05
Personal benefit lower rate	57.65	59.20
Wife or other adult dependant	35.65	36.60
Statutory sick pay	68.20	70.05
Jobseeker's allowance (contribution-based)		
Personal benefit for those aged 18 to 24	44.50	45.50
Personal benefit for those aged 25 and over	56.20	57.45
Maternity allowance (3)	106.00	108.85
Statutory maternity pay		
Standard rate (3)	106.00	108.85
Guardian's allowance		
First child	12.20	12.50
Other children	12.20	12.50
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	9.40	9.25
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) The weekly rate for maternity allowance and statutory maternity pay is the amount shown or 90% of the woman's average weekly earnings if this calculation results in a figure which is less. 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 2005-06	Rate proposed from April 2006
Class 1			
Lower earnings limit (LEL)		£82 a week	£84 a week
Upper earnings limit (UEL)		£630 a week	£645 a week
Primary threshold		£94 a week or £408 a month	£97 a week or £420 a month
Secondary threshold		£94 a week or £408 a month	£97 a week or £420 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		£2.10 a week	£2.10 a week
Small earnings exception		£4,345 a year	£4,465 a year
NHS allocation included in above (percentage of contribution)		15.5%	15.5%
Class 3			
Flat rate contribution		£7.35 a week	£7.55 a week
NHS allocation included in above (percentage of contribution)		15.5%	15.5%
Class 4			
Lower profits limit (LPL)		£4,895 a year	£5,035 a year
Upper profits limit (UPL)		£32,760 a year	£33,540 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 2005-06 and 2006-07 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 2005-06 and 2006-07 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 HM Revenue & Customs 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 HM Revenue & Customs 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 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 based on the new Lifetime Labour Market Database and allowing for the continuation of the trend in the proportions of employees contracted out into occupational schemes observed in recent years. The rebate rates used from 2007-08 are those recommended in my recent consultation document ('Rebates and reduced rates of National Insurance contributions for members of contracted-out pension schemes') dated 19 September 2005, as amended by the supplementary note dated 10 November 2005. This is similar to the assumption made for the benefit estimates included in the recent Long-Term Public Finance Report (which used the figures before the amendments in the supplementary note) but not with the estimates of contribution income for the Pre-Budget Report (PBR). The Treasury decided that the PBR projections should continue to use the rebate rates that were used for the Budget estimates.

3. Other classes of contributions are estimated using simpler models. Class 1A and Class 1B contributions are estimated using data provided by HM Revenue & Customs (HMRC) on contributions paid in previous years. Estimates of Class 2 and Class 4 contributions are estimated using data on the earnings of the self-employed received from HMRC, 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 were 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 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) are estimated in a similar way. There are still substantial problems relating to the data on statutory payments. Investigations are continuing but the problem appears to be systemic and therefore difficult to solve. The figures for statutory payments might, therefore, be substantially amended in the future. Full allowance has been made for the recent policy changes on duration and entitlements.

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 2006-07 is estimated as that amount needed to ensure that the estimate of the fund balance at 31st March 2007 is at least one-sixth of benefit payments (including redundancy fund payments) in 2006-07.

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 the Cross-Cutting Strategy and Analysis Directorate 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 of state pensions 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 2004-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. A review of the assumptions used in the model has been carried out incorporating data from the new Lifetime Labour Market Database to provide an indication of future entitlements to basic retirement pension. In addition, allowances have been made for the cost of the abolition of the hospital in-patient down-rating 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 2004-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-2003 based adjusted); termination and transfer rates by single age and type of benefit are derived from recent data. A full review of all the assumptions used in the model has been made incorporating data post 2001. This has enabled appropriate assumptions to be made for widowers based on actual data.

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. The awards of bereavement allowance have been unusually low in recent statistics. There are no external factors that would explain a drop of the size that has been observed and so the probability that the data is incorrect is significant. In the absence of any other information, this data has been used but it has led to a drop in the estimates previously made.

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 benefit 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 2005-06 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 paydays 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. Following my report last year (Appendix 3, paragraph 21) an investigation was carried out and it appears that some of the volatility in the cash IMBE figures for 2004/05 was due to the switch to Direct Payments during the year. Towards the end of the year the differences reduced, but the final figures for 2004/05 still showed cash to be slightly higher than accruals which is unusual.

22. It is generally thought that the accruals data better reflect the true liability of the NIF and we have therefore used accruals to align our estimates with IMBE. For all years benefit estimates have been alignment to the December accruals IMBE, with an adjustment reflecting the fact that December accruals tend to be higher than the final, and a further factor to adjust to encashments based on the outturn data observed over the period 2000-01 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 HMRC for 2005-06. The costs for 2006-07 and later have been estimated as the 2005-06 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 2005. These are given below:

Assumptions used for estimates

	2005-06	**2006-07**
Number of employment jobs (UK), million (including HM Forces, excluding self-employed)	26.8	26.9
Increase in average earnings on one year earlier, %	4.0	4.3
Average number of unemployed (GB), million	0.84	0.89

The assumptions for 2005-06 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 2006-07

Great Britain £ million	Estimated total payments in 2005-06	Estimated total payments in 2006-07	Extra payments in 2006-07 as a result of up-rating
Retirement pensions – basic	43,304	44,568	1,094
Retirement pensions – additional pensions	8,282	8,994	337
Widows' / bereavement benefits – basic	672	613	12
Widows' / bereavement benefits – additional pensions	184	161	5
Incapacity benefit – basic	6,410	6,471	156
Incapacity benefit – additional pensions	303	258	0
Contribution-based jobseeker's allowance	461	496	10
Maternity allowance	162	163	4
Guardian's allowance	2	2	0
Christmas bonus	125	126	0
Total (1)	59,905	61,852	1,618
Redundancy payments (net) (1)	252	245	0

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

APPENDIX 5

ANALYSIS OF THE CHANGES IN CONTRIBUTION RECEIPTS FOR 2006-07 AS A RESULT OF THE CONTRIBUTION RE-RATING ORDER AND OTHER MEASURES

Great Britain, £ million **National Insurance Fund effects**	**Contributions for 2006-07**		**Contributions received in 2006-07 (1)**	
Social Security (Contributions) (Re-rating and National Insurance Funds Payments) Order 2006				
Increase in Class 2 rate	0		0	
Increase in Class 2 small earnings exception – indexation effect	-2		-1	
Increase in Class 3 rate	+2		0	
Increase in Class 4 profits limits – indexation effect	+1		+1	
Total		+1		0
Proposed Social Security (Contributions) (Amendment) Regulations 2006				
Increase in Class 1 primary and secondary thresholds, and lower and upper earnings limits – indexation effect				
Effect on contribution receipts from gross contributions (2)	-409		-360	
Effect on contribution receipts from contracted-out rebates (4)	-72		-36	
Total		-482		-396
Total, all measures		-480		-396

(1) The balance of contributions for 2006-07 will not be received until after 31st March 2007.
(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 2006.

APPENDIX 6

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

Great Britain, £ million			**2005-06**		**2006-07**	
National Insurance Fund						
Class 1 (1)	Primary	Gross	27,822		28,464	
		Contracted-out rebate (2)	2,315		2,340	
		Net		25,508		26,124
	Secondary	Gross	43,477		44,817	
		Contracted-out rebate (2)	4,823		4,878	
		Net		38,654		39,938
	Total	Gross	71,299		73,281	
		Contracted-out rebate (2)	7,137		7,218	
		Net		64,161		66,063
Classes 1A and 1B				953		927
Class 2				219		222
Class 3 (3)				79		76
Class 4				1,740		1,790
Total National Insurance Fund Contributions (4)				67,153		69,078
National Health Service						
Class 1	Primary			7,382		7,578
	Secondary			9,857		10,132
	Total			17,240		17,710
Classes 1A and 1B				166		162
Class 2				40		41
Class 3 (3)				15		14
Class 4				811		838
Total National Health Service Contributions				18,272		18,764
All contributions						
Class 1 (1)	Primary	Gross	35,205		36,042	
		Contracted-out rebate (2)	2,315		2,340	
		Net		32,890		33,702
	Secondary	Gross	53,334		54,949	
		Contracted-out rebate (2)	4,823		4,878	
		Net		48,511		50,071
	Total	Gross	88,539		90,991	
		Contracted-out rebate (2)	7,137		7,218	
		Net		81,401		83,773
Classes 1A and 1B				1,119		1,088
Class 2				259		263
Class 3 (3)				94		90
Class 4				2,552		2,628
Total contributions				**85,425**		**87,842**

(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 HM REVENUE AND CUSTOMS

Great Britain, £ million	**2005-06**		**2006-07**	
Personal and Stakeholder pension rebates				
Primary contracted-out rebates	547		562	
Secondary contracted-out rebates	1,861		1,917	
Total (1)		2,408		2,479
Age-related rebates for members of contracted-out money-purchase schemes (1)		154		180
All payments in respect of personal pensions and age-related rebates to contracted-out money purchase schemes		2,562		2,658

(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 2005-06 MADE NOW AND IN Cm 6457 (FEBRUARY 2005)

Great Britain, £ million	2005-06 estimates made now		2005-06 estimates given in Cm 6457	
Receipts				
Contributions	67,153		67,619	
Less recoveries of SSP	80		80	
Less recoveries of SMP, SPP and SAP and SMP, SPP and SAP abatement	1,324		1,344	
Net contribution receipts		65,748		66,195
Treasury grant		0		0
Compensation from Consolidated Fund for SSP and SMP recoveries		1,378		1,397
Income from investments		1,374		1,605
State scheme premiums		133		137
Other receipts		67		68
Total receipts		68,700		69,403
Payments				
Benefits		59,905		60,332
Personal and stakeholder pensions contracted-out rebates		2,408		3,347
Age-related rebates for contracted-out money purchase schemes		154		290
Administration costs		1,421		1,515
Redundancy fund payments (net)		252		267
Transfer to Northern Ireland		185		225
Other payments		31		20
Total payments		64,356		65,996

Figures may not sum to totals due to rounding.

REASONS FOR CHANGES IN ESTIMATES

1. The estimates of Class 1 contributions are lower than last year in total, with most of the difference relating to primary contributions. This is the result of several factors. It has been possible for the first time this year to make an adjustment to the earnings distribution for the type of bonuses that is not picked-up particularly well in the Annual Survey of Hours and Earnings. This has caused a shift from primary to secondary contributions. Also for the first time has been the receipt of full data on Class 1B, which has shown this class of contributions to be much larger than previously thought. Class 1B is collected with Class 1 and so, whilst the total remains the same, any change in Class 1B means an equal but opposite change in Class 1. Finally, there is the problem explained in paragraph 15 of the main report, which has made it very difficult to estimate the receipts of the National Insurance Fund in any one year.

2. Receipts of Class 2 contributions are now estimated to be lower than was estimated last year. This is partly due to lower numbers assumed to be self-employed and partly due to a decrease in the proportion of the self-employed who are paying contributions.

3. Estimates of Class 4 contributions are lower than the estimates produced last year. This is due to the same factors that reduced the estimates of Class 2.

4. Estimates of Classes 1A and 1B are higher following the receipt of full data on Class 1B for the first time. This data showed that Class 1B was much higher than had been previously thought. Class 1A was little changed from last year.

5. The estimate for Class 3 contributions is little changed from last year.

6. Estimates of SSP, SMP, SPP and SAP are little changed from last year. 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 2004-05, which resulted from the delayed payment of Class 1 contributions to the National Insurance Fund (see paragraph 15 of the main report).

8. The estimate of total benefit payments for 2005-06 is lower than that shown in last year's report. The main reason for the difference in retirement pension is the linking of our estimates to IMBE (in-year monitoring of benefit expenditure). Retirement pension has also been affected by a change in the pre / post up-rating split (the proportion of payments that relate to the small period between the start of the financial year and the date of the up-rating). 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 differences in the other benefits are caused by the incorporation of more recent data. All benefits have been affected by a change in the 'benefit year length' (the number of payments that are due to be made in the year) which has been increased since last year.

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. There were delays in the payment of these amounts this year and the current estimates for 2005-06 are more uncertain than is usual at this time of the year.

10. Estimates of the administration costs that will be charged to the National Insurance Fund have been supplied by HM Revenue & Customs. These estimates are a little lower than those for 2004-05, mainly because of improved efficiency. It is possible, however, that the final figure will be higher since the costs payable to the Department of Constitutional Affairs have not yet been finalised. 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.

	2005-06 estimates made now	**2005-06 estimates given in Cm 6457**
Number of employees in employment (UK), million (including HM Forces, excluding self-employed)	26.8	26.7
Increase in average earnings on one year earlier, %	4.0	4.8
Average number of unemployed (GB), million	0.84	0.82

APPENDIX 8

PROJECTED RECEIPTS, PAYMENTS AND FUND BALANCES FOR THE NATIONAL INSURANCE FUND UP TO 2010-11

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

Great Britain, £ million	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Receipts	64,384	68,700	70,813	74,689	79,007	83,773	88,524
Payments	62.420	64,356	66,875	69,758	73,749	77,744	81,423
Excess of receipts over payments	1,964	4,344	3,938	4,931	5,258	6,029	7,101
Balance in Fund at end of year	29,046	33,390	37,328	42,259	47,517	53,546	60,647
Balance at end of year as a percentage of benefit payments	(1) 50.8	55.5	60.1	64.6	68.8	73.5	79.5

(1) From the draft accounts for 2004-05.
(2) This uses the book value of the fund as at 31 March 2005 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 2007-08 and later years are based on the economic assumptions used for the Pre-Budget Report in December 2005.
(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.

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GOVERNMENT ACTUARY'S DEPARTMENT

Finlaison House 15-17 Furnival Street London EC4A 1AB

Fax (GTN): 020 72112630/2640

Switchboard: +44 (0)20 7211 2600

Direct (GTN): 020 7211 plus extension number

E mail enquiries: enquiries@gad.gov.uk

E mail: firstname.secondname@gad.gov.uk

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