Abolish NICs

Towards a more honest, fairer and simpler system

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SUMMARY

- In 2009/10, National Insurance Contributions (NICs) raised about £74 billion for the National Insurance Fund. NICs also raised another £20 billion for the NHS. In total, NICs represented 20% of total government receipts.

- Of the money raised by NICs, £61 billion was paid in the state pension. A further £7 billion was paid in Incapacity Benefit.

- Recent announcements indicate that the contributory principle behind the state pension is to be scrapped. In its place, a state pension of £140 a week, based on residence criteria, has been proposed by the Coalition Government. In addition, expenditure on contributory Employment Support Allowance is likely to be substantially lower than on Incapacity Benefit, which is being phased out.

- These reforms effectively remove the last justification for the continuation of NICs.

The problems with NICs

- NICs are riddled with anomalies, complexity and a lack of cohesion.

- The anomalies include measures which reward the profligate while penalising the thrifty.

- The complexity of the system is such that few individuals can understand it; and cannot plan for their retirement or adverse circumstances efficiently. This acts as a disincentive to saving.

- NICs are often unfair. The value of contributory benefits can be less than the corresponding non-contributory benefits.

- The National Insurance Fund is an accounting device largely ignored by the Treasury which treats payments in and out in the same way as other government receipts and expenditure.

- NICs impose high marginal rates of tax on low earners and also create a large burden on employers taking on staff.

- The system has also been used to disguise ordinary tax increases and to divert money for other purposes – such as the NHS and green taxes – from the National Insurance Fund.

Recommendations

- The introduction of a universal state pension will provide the ideal opportunity to merge NICs and income tax. A simple payroll tax will also be needed to cover the cost of abolishing employers' NICs.

- This should be done once the fiscal situation has improved as it will require a small overall tax cut so that the most entrepreneurial classes are not penalised.

- While the actual amount paid by individuals in tax will reduce, greater transparency and simplicity will mean that the "headline rate" of income tax will inevitably increase. Such a reform will therefore require great political skill.

FOREWORD

As the Coalition's welfare reform programme takes shape, a number of principles are emerging. Foremost is the Government's commitment to provide a welfare system that makes work pay. Integral to this objective is a massive simplification of the system, replacing a wide range of benefits with a single universal credit (following the recommendations in *Benefit Simplification*, David Martin's 2009 CPS report).

The Coalition's latest proposal for a universal flat-rate pension is consistent with this approach, removing the need for complex means-tested pension credits or top-ups. Such a universal pension would also remove the penalty that currently falls on those individuals who save for a modest personal pension only to find that in so doing they are merely depriving themselves of state top-ups to which they would otherwise be entitled.

These moves to simplification, and the removal of deterrents to working and saving, are welcome. However, it is clear that these reforms further weaken the contributory principle, since it appears that neither universal credits nor universal pensions will be determined by the level of the recipient's National Insurance contributions. The contributory principle is, as David Martin explains in this new report, already "threadbare." The connection between contributions made and benefits later received is at best tenuous and, in the case of many entitlements, non-existent.

This report shows clearly how National Insurance (NI) has become income tax by another name. Yet, as the author shows, it is riddled with inconsistencies, is extremely complex and difficult to compute or to predict. In fact, if NI were a tax, it would be likely to fail all four of Adam Smith's principles of taxation: fairness, simplicity, certainty and efficiency. The solution recommended in this report is to simplify NI whilst merging it with income tax.

The abandonment of the contributory principle, as originally conceived, is a cause for regret: individuals should be encouraged to be independent and to make provision for their own health and retirement needs. But it is clear that contributions through the agency of the state are not the answer, since these contributions are largely subsumed into government revenues. A better way forward would be to ease the overall burden of taxation and provide incentives for taxpayers to take greater responsibility for funding their own health and social care, whilst supporting those unable to do so.

The Centre for Policy Studies has long argued for lower and simpler taxation. A merger of tax and NI would lead to a much higher headline rate of tax. Such a step would provide a simpler, more transparent and more honest approach to taxation. Politicians wishing to raise taxes would no longer be able to hide behind the device of raising NI rates. David Martin recommends that the proposed merger should be accompanied by an overall tax cut. Indeed, such a merger would surely intensify pressure to cut tax rates and to keep taxes low, thereby incentivising work and generating prosperity for all.

Jill Kirby **November 2010**

1. INTRODUCTION

On 25 October 2010, plans for a universal state pension of £140 a week were announced in the media. While no official announcement has yet been made, it appears likely that this welcome reform will be introduced shortly.

What has not been commented on, however, is how a universal state pension will remove one of the last remaining justifications for National Insurance Contributions (NICs).

In 2009/10, the total of NICs collected by government was £97 billion. This was higher than the total VAT collected (£84 billion), and was 67% of the aggregate amount of both income tax and capital gains tax for that year (£144 billion). NICs constituted over 20% of government receipts of £476 billion for that year.

So NICs are clearly an important source of revenue. Yet what NICs actually are, who pays, where the money goes, and how the system works is not well understood.

This paper attempts to throw light on these issues. The conclusion is that the NIC system badly needs attention. It is complex, cumbersome, misleading and ramshackle. The system is riddled with anomalies and inconsistencies.

In particular, with the exception of the state pension, the value of contributory benefits is not very large. Furthermore, over recent years, politicians have referred to the contributory principle when increasing rates of NICs to disguise what were in truth ordinary tax increases.

But, as this paper demonstrates, the contributory principle has become threadbare, and those paying NICs might well be surprised to learn how little they get back in return. The only logical solution to these problems – particularly if the state pension is to be replaced by a universal pension, available to all – is to end the pretence that there is a real contributory basis to benefit entitlements; and to merge the income tax and NIC systems.

The result would be a more honest system whereby the claim that benefits are substantively linked to contributions is abandoned; a fairer system in which many of the excessively high marginal rates would be eliminated; and a simpler system which could be understood by all.

2. NICS FROM BEVERIDGE TO TODAY

For William Beveridge, social security was only a part of the fight against “the five giant problems” of want, disease, ignorance, squalor and idleness. The social security system should tackle the problem of *want*, without undermining the effort to tackle the other giant problems. The state “should not stifle incentive, opportunity, responsibility; in establishing a national minimum, it should leave room and encouragement for voluntary action by each individual to provide more than that minimum for himself and his family”.

The Beveridge Report of 1942 proposed that in return for a flat rate contribution – of four shillings and threepence (22½p) per week by an adult man in employment, and three shillings and threepence (17½p) per week from his employer – workers should be able to claim specified benefits which would also be paid at a fixed rate. There were to be eight available benefits: sickness, medical, unemployment, widows, orphan, old age, maternity and funeral benefits. The system proposed was based on a real insurance contract, which involved the pooling of the insured risks through premium payments which reflected the value of potential benefits.

Beveridge was opposed to means-tested benefits. Means-testing was intended to play a tiny part in the new system, because in particular it created high marginal tax rates for the poor, ie. the poverty trap.

The rationale for Beveridge

There are strong arguments for social insurance. Claimants retain a sense of dignity and self-respect, as they have paid the insurance premiums for their benefits. Further, because contribution-based benefits are not means-tested, there are few disincentives on people to take extra steps, such as saving, to provide for more than the minimum that is provided from the state under its social security scheme. It was also intended that social security would enhance a sense of social solidarity, because of the pooling together of risks.

What actually happened

It is commonly stated that the Attlee Government implemented Beveridge's recommendations in 1948. But it is important to understand, however, that many of Beveridge's recommendations were never actually implemented, primarily because of the need to provide benefits to those who did not have a full contribution record.

For example, Beveridge had said that a state pension should not be paid to those with less than a 20 year contribution record – but this stipulation was not practicable given the needs of, for example, older returning ex-servicemen. Beveridge had also said that means-tested benefits should be set at a very low level. But not only were contributory benefits set at levels higher than Beveridge advised but non-contributory benefits were set with even higher scales than contributory ones. The means-tested "National Assistance" thus undermined from the outset one of Beveridge's foundations for his National Insurance

Scheme. Contrary to what Beveridge and others had predicted, there was dramatic growth in the numbers of those claiming National Assistance. Further, NICs received were insufficient to pay contributory benefits, and Treasury grants were needed to top up the National Insurance Fund

Thus the insurance principles expounded by Beveridge had already been largely superseded by 1948. The desire to pay higher benefits than were funded by contributions, and the need to make some provision for those who had not paid their requisite contributions, undermined these principles. But on top of that, from its inception, there was no real actuarial link between payments in for the different insured risks, and payments out of the National Insurance Fund.

Since then, as will be seen below, the extent to which the contributory principle has been applied has continued to diminish, even though many (wrongly) assume that this principle still applies in some substantial way. We should recognise that universal welfare is now largely provided by means-tested benefits rather than through the National Insurance Scheme.

The decline of the contributory principle

Flat rate NICs were abandoned in the 1960s and replaced by earnings-linked contributions. Unlike in some overseas jurisdictions, however, (such as Germany and France), benefits in the UK continued to be paid at a flat rate. Those who paid in more because of higher earnings were not given higher benefits or pensions as a result.

A few changes did enhance the contributory principle (such as the 1978 earnings related pension provisions (SERPS)). However, the great majority of changes tended to undermine it further. For example, the value of contributory benefits has continually declined because they have not been index-linked, either in line with earnings or sometimes not in line with inflation either. Resources have been channelled into costly means-tested benefits, such as Housing Benefit, Pension Credit and Tax Credits. Restrictions have also grown on contributory benefits such as Incapacity Benefit and contribution-based Jobseeker's Allowance. The latest example of such a restriction is the new time limit for receiving contribution-based Employment and Support Allowance which was announced in the spending review of 20 October 2010.

Current Contribution Rates

NICs payments are now collected in a number of distinct classes. Class 1 NICs are paid by employees and their employers, Class 1A NICs are paid by employers only, on the value of benefits in kind such as company cars. Class 1B NICs are payable by employers when entering into a PAYE settlement agreement with HMRC. Class 2 contributions are small fixed amounts payable by the self-employed. Class 3 NICs are voluntary contributions paid by people who want to fill a gap in their contribution record, and Class 4 contributions are further charges on the self-employed people who earn more than a minimum level of profits.

Class 1 contributions are paid by employees at the rate of 11% for earnings above the primary threshold of £110 a week and below the upper earnings limit of £844 a week. They are paid at the rate of 1% for earnings above the upper earnings limit. Contracted-out rebates of 1.6% are available for employees in salary-related or money purchase pension schemes.

Employees who have earnings exceeding the lower income limit of £97 a week but below the primary threshold of £110 a week are granted NIC credits to protect their benefit entitlement without being liable for actual payment.

There is a continuing reduced rate of 4.85% for Class 1 NICs available for some women employees who married before 1977 and elected to receive reduced benefits. NICs are not due from employees after they reach the state pension retirement age, although their employers are still required to contribute.

Class 1 contributions payable by employers are due at 12.8% for earnings above the secondary threshold of £110 a week, save that rebates (of 3.7% and 1.4% respectively) are available where salary related or money purchase pension schemes are also in effect.

The Class 2 rate for self employed workers is £2.40 a week, although there is no liability where earnings fall below £5,075 a year. There are special Class 2 rates for certain workers, such as fishermen and volunteer development workers.

Class 3 voluntary contributions are due at £12.05 a week.

Class 4 contributions are due at 8% for earnings over £5,715 a year and below £43,875 a year, and are due at the rate of 1% on earnings over £43,875 a year.

In the year 2008/09, the National Insurance Fund received the following payments from the various Classes of NICs.

Class 1, 1A and 1B NICs	£72 billion
Class 2 NICs	£230 million
Class 3 NICs	£126 million
Class 4 NICs	£1.7 billion

As explained below further NIC payments were paid directly to the National Health Service rather than into the National Insurance Fund.

People who are unable to work or do not work for specified reasons may be able to claim NIC credits, as if they had actually paid Class I NICs. This is an area of real complexity.[1]

Currently, for the full state pension to be payable sufficient payments must either have actually been paid or have been credited as being paid in each of 30 years before the retirement date (this will apparently no longer apply if the non-contributory pension of £140 a week is introduced).

Steve Webb MP, Minister of State for Pensions, has recently launched a consultation on changes to National Insurance credits,

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1 For example a person can claim credits if he is in receipt of Jobseeker's Allowance (JSA), or would be in receipt of JSA were he not sanctioned for benefit offence, or he can show that he can satisfy certain specified conditions for JSA (such as being available for work and actively seeking work), even though he is not actually receiving JSA. Credits can also be available for persons who are 16 to 18 years old, or who are older but in full-time education, or who are claiming maternity benefit, on jury service, aged 60 or over, who are claiming tax credits, or have been wrongly awarded credits as a result of official error, or who get child benefit for a child under 12, or who have certain caring responsibilities, or who receive income support for certain specified reasons, or who have wrongly served imprisonment etc. The rules are complicated further where a person is married or is cohabiting.

Such credits count towards one of the two contribution conditions that need to be satisfied. The first condition is that specified contributions must actually have been paid in the relevant number of tax years before the claim – the exact rules vary depending on the benefit being claimed. The second condition is that specified contributions must either actually have been paid or have been credited as paid in the two tax years preceding the claim.

which will be particularly aimed at grandparents, and anyone who is providing care for a young relative under the age of 12.

The National Insurance Fund

Most NICs are paid into the National Insurance Fund. The Fund also receives income from making investments, and, although this has not happened for some years, the Treasury may also make grants to the Fund.

The Fund is used to pay contributory benefits, including the state pension which is easily the largest expense met by the Fund. The Fund operates on a pay as you go basis, with NICs received being used to pay benefits in the same year. It is therefore very different to a private pension or insurance fund which accumulates reserves to pay future benefits or meet future claims.

A surplus of over £50 billion has nevertheless accumulated in the Fund in recent years. This is largely because the state pension has only been increased in line with inflation in recent years whereas NICs have increased in line with earnings, which have generally risen more quickly than inflation. The surplus is invested in Government gilt-edged stock. This surplus is greater than recommended by the Government Actuary, who suggests that the Fund should keep a balance equal to two months' expenditure on benefits. There are, however, no announced plans to reduce the surplus.

It appears that from the Treasury's point of view NICs are a convenient form of taxation, where in practice it seems that rates can be increased with less protest than would be true for income tax. From this point of view National Insurance benefits, including the state pension, are simply a part of total public expenditure, and it does not matter whether the money to pay them comes from NICs or from any other source of taxation. A good example of this appeared in the government spending review. No one mentioned that the time restriction on contribution-based ESA would save the National Insurance Fund money. It was only stated that the saving would help government finances.

Fudge One: payments to hospitals

The lack of any hard boundary between the National Insurance Fund and general government finances can also be illustrated by the way in which money has been diverted from the Fund by successive government manoeuvres relating to the NHS and to environmental taxes.

Since 1948 it has been possible for money in the Fund to be used for payments to the National Health Service. But under current legislation, a proportion of NICs can be paid to the NHS without passing through the Fund at all. Just over £20 billion a year in NIC payments is currently diverted in this way.

The mechanism has undermined the integrity of the National Insurance Fund. For example, it was stated in 2002 that the increase in contribution rates of 1% on earnings (including earnings above the upper earnings limit) would be paid directly to the NHS. However, as the Government Actuary pointed out, these changes had a negative rather than merely a neutral effect on the Fund, because the NHS contribution was increased by 1% of all earnings, not just earnings above the threshold on which contributions were payable.

There is however a fundamental problem which goes deeper than this. No true hypothecation to the NHS is possible for these payments. The Government can plan to increase expenditure on anything it wishes. If it then increases NICs to pay more to hospitals, the residue of expenditure that it needs to fund hospitals from general taxation is reduced, so that the Government thereby obtains the funds that it needs to release for the other planned expenditure.

Fudge Two: payments to green causes

In a similar way, the Fund has also been deliberately and substantially reduced by the small print in a number of green taxes – including the landfill tax, the climate change levy and the aggregates levy. These taxes were levied in order to further green objectives and to burnish the Government's green credentials. But a concurrent repayment was made to employers by means of a reduction in their Class 1 contributions. This was for example 0.3% in the case of the climate levy. The Government could therefore say that the green taxes were revenue neutral on employers, but they did of course reduce the NICs paid into the Fund.

Answers given to parliamentary questions from Paul Flynn MP demonstrate that employers have actually been over-compensated in this way, with reductions in employer's contributions exceeding the amounts of the green taxes paid.[2] For example, in the case of the first two years of operating the landfill tax in 1997/98 and 1998/99, the Fund lost £550 million and £610 million respectively, whereas landfill tax receipts were only £352 million and £323 million respectively. It has been estimated that in the period up to 2005/06 the Fund has lost about £13 billion through this process.[3]

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2 Commons written answers to Parliamentary Questions of 13 June 2005 and 21 June 2005.

3 Calculations based on the answers to the Parliamentary Questions.

What do people really get for paying NICs?

Today, the only remaining contribution-based benefits are Bereavement Allowance, contribution-based JSA and contribution-based ESA, Incapacity Benefit (which is being superseded by ESA), Statutory Maternity Pay and the state pension. (Maternity Allowance is also based on the employment record, although not strictly on NICs paid). The state pension is by far the most important of these in terms of total cost to the National Insurance Fund.

These contrast with a much wider range of non-contributory benefits including Attendance Allowance, Carer's Allowance, Child Benefit, Council Tax Benefit, Disability Living Allowance, Income Support, Income-based JSA, Income-based ESA, Incapacity Benefit for young people, Guardian's Allowance, Housing Benefit, Industrial Injuries Benefit, Pension Credit, Statutory Adoption Pay, Statutory Maternity Pay, Statutory Paternity Pay, Statutory Sick Pay, and War Pensions/Armed Forces Compensation Scheme. Many further subsidiary benefits, such as free school meals, free prescriptions, dental treatment, spectacles and so on may also be available. Many of these benefits are means tested but some, notably Disabled Living Allowance and Child Benefit (pending the changes in three years' time which have recently been announced) are not.

How claimants who have paid NICs may be no better off

Not only are non-contributory benefits more widespread and comprehensive than contributory benefits, a particular means-tested benefit may be more generous than the corresponding contributory benefit. An example of this is Jobseeker's Allowance (JSA).

Income-based JSA and contribution-based JSA are both paid at the same basic rate of £65.45 a week for a single adult over 25.

Entitlement to income-based JSA is restricted where the claimant has capital in excess of £6,000 or income in excess of a small disregard. However income-based JSA is more generous for the claimant compared to contribution-based JSA. This is because income-based JSA is an automatic passport to health benefits, such as free prescriptions, and education benefits, such as free school meals. It may also help a claim for social fund payments. If in receipt of income-based JSA a person is automatically entitled to maximum housing benefit and council tax benefit. Contribution-based JSA carries no such automatic entitlement to any of these benefits. Further it is taken into account in calculating income for the purposes of housing and council tax benefits so that these benefits may be reduced below the amounts paid to someone on income-based JSA, who receives the maximum. Also contribution-based JSA is limited to a 183 day period, although complicated rules may permit an extension for a further 183 days – no such time limit applies to income-based JSA.

Similar rules apply for the Employment and Support Allowance (ESA) – both are paid at the rate of £65.45 a week for a single adult in the assessment phase, although extra components are payable in the "main phase". There are similar advantages to having income-based ESA rather than contribution-based ESA as apply for JSA, a strict time limit for which contribution-based ESA can be paid having been announced recently in the comprehensive spending review.

The system also contains hidden and unexplained cross-subsidies and anomalies. Some immediate anomalies spring from the system of classifying NICs. For example, only Class 1, 2 and 3 NICs are credited to an individual's NIC account. Class 1A, 1B and 4 NICs do not count towards benefit entitlements, although of course they must still be paid.

Class 1 NICs are paid as a higher proportion to benefits received by the employed than Class 2 and 4 NICs paid as a proportion of benefits received by the self-employed. – it is estimated that this gives rise to a hidden subsidy of £1.95 billion a year to the self-employed.[4] In fact Class 2 NICs are of such a small amount that, as confirmed by notes to the National Insurance Fund Account, no action is in practice taken to enforce payment if they are not paid. It is stated that the cost to the authorities of doing this would not be justified.

In practice, it is often uncertain whether workers are employed or self-employed. The issue has given rise to numerous disputes, some of which have only been resolved through further legislation. This may, for example, deem specified classes of workers to be employed for NIC purposes even if this is not actually the case.

It can be hard to say what value is truly received for voluntary Class 3 contributions. These will generally be paid to enhance the state pension. But the calculation of whether this is worth doing will often be so difficult, having regard to the availability of pension credit and other uncertainties and complexities that one can hardly expect most people to manage to evaluate this issue.

Another anomaly is that the proportion of NICs paid to the NHS represents a transfer of value from those whom pay NICs to

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4 HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, Table 7, November 2008.

those who do not pay NICs, because all get National Health, whether or not they pay NICs.

As mentioned above, it is clear that there is no formal actuarial relationship between the amounts of NICs paid and any benefits receivable as a result. Although the Government Actuary is asked to confirm that the aggregate amounts paid into the National Insurance Fund will suffice on an annual basis to meet payments due to be made from the Fund, there is no attribution or hypothecation of payments to specific risks or rewards, or calculations of how NICs are matched to specific benefits. In other words, the type of actuarial calculations which real insurance companies need to carry out are simply not done.

It could be argued that, viewed as an insurance contract, the better-off get a bad deal for NICs paid, because NICs are earnings-related and they therefore pay more for their benefits, in particular the state pension. One could also say that the poorer section of society also get a bad deal, because they are better off on means-tested benefits and so contributory benefits have little real value for them.

The low value of contributory benefits

With the exception of the state pension, contributory benefits are of minor importance in overall welfare provision.

The income of the National Insurance Fund for the year ended 31 March 2009 was £78 billion, of which £74 billion was NICs received with the balance coming from investment income and other receipts. Benefits paid from the National Insurance Fund totalled £70 billion. Of this, £61 billion – or 87% – was for the state pension and £7 billion (10%) for Incapacity Benefit. Other benefits were for smaller amounts – for example, contribution-based JSA was just £700 million.

The contributory principle behind the state pension is apparently being scrapped. But the second largest contributory benefit – Incapacity Benefit – is also currently being replaced by ESA. To the extent that Incapacity Benefit is in practice substituted by income-based ESA, and to the extent that contribution-based ESA is reduced by having become time limited, the amounts of non-pension payments from the Fund will become even smaller.

It seems quite clear that if the state pension is to be funded through general taxation, or in some other fashion outside the NIC system, there would be no justification for retaining the NIC system, with all its cost, complexity and difficulties.

Only 42.5% of benefit expenditure is now for contributory benefits. The fraction has been declining steadily over the years – it was 63% in the late 1970s. Further, these percentages overstate the extent to which benefits are paid in return for actual contributions received, because of the system for crediting NICs for many people. If the state pension is excluded, less than 10% of benefits paid are contributory benefits, and this percentage can be expected to fall further to around 6% in the near future as the cost of providing contribution-based ESA falls in comparison to that previously spent on Incapacity Benefit.

The moves towards a new universal working age benefit, and the proposed universal state pension, are both much to be welcomed – they should promote great simplification. The universal benefit should enable great progress to be made on creating proper work incentives and the universal pension should similarly encourage people to save for their future. But it should also be recognised, that – however attractive the idea of contributory benefits in principle – these reforms should also herald the effective end of NICs.

3. PENSIONS

It has recently been stated that Britain now has one of the most complex systems for pension provision in the world.[5] The NIC and state pension system have substantially contributed to this complexity. Over the years reforms have tended to add layers of complication and short-term political considerations have collided with the need for long term and comprehensive planning.

The state pension is £97.65 a week for a single person and £156.15 a week for a couple (based on full contributions paid). However the pension credit minimum guarantee is £132.60 a week for a single person and £202.40 for a couple, irrespective of contributions paid. A complicated system for allowing NIC credits clouds the picture further, while the combination of the state pension rules and the pension credit rules produce a number of apparent anomalies.

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5 Pensions Commission, *Pensions challenges and choices: the first report of the Pensions Commission*, 2004.

Punishing the thrifty, rewarding the prodigal

Suppose for example that a single person (Mr A) has worked on a self-employed basis for 45 years and paid his NICs accordingly, which have aggregated to many thousands of pounds. He has also managed to save, say, £30,000 in the bank. He is just retired, aged 65, and is entitled to the state pension of £97.65 a week. His actual interest income earned on his bank savings is about 2%, or £12 a week.

However he has deemed income on his bank balance for the purpose of calculating any pension credits is £1 a week for every £500 that his savings exceed £10,000, which works out at £40 a week. His pension plus his deemed income totals £137.65 a week and he is not therefore entitled to any guaranteed pension credit because this exceeds the minimum income guarantee of £132.60.

Mr A then has to calculate whether he has any pension savings credit. He first deducts the pension savings threshold of £98.40 from his total income for PC purposes of £137.65 to get £39.25. He then calculates 60% of this, which is £23.55. Because this exceeds the maximum of £20.52 he is restricted to this maximum for savings credit. The calculation is not finished however. He calculates 40% of the amount by which his total income exceeds the minimum income guarantee, which is £40% of (£137.65 minus £132.60), or £2.02. This is deducted from the amount of £20.52 previously calculated to yield an entitlement to savings credit of £18.50 a week.

Fortunately Mr A's circumstances and finances are simple – otherwise the calculation of his pension credit would be even more complicated than this.

So his actual income will be his pension of £97.65 plus his actual interest income of £12, plus savings credit of £18.50 a week, a total of £128.15 a week.

Now compare his position with that of Mr B. Mr B inherited some money in his youth which he invested to receive investment income. He has never needed to work and he has never been liable to pay NICs. However by the age of 65 his inheritance is exhausted and he is therefore able to claim pension credit. Fortunately his calculation is very straightforward. Even more fortunately (for him), the calculation yields an entitlement to receive the minimum guarantee of £132.60 a week. He is therefore receiving £4.45 a week more than Mr A.

Pension rights based on residence

There has been a special provision for many years which allows increased pensions (under “category D”) to persons over 80 based on their period of residence in the UK if they would not be entitled to a full pension under the normal contribution rules. The Turner report proposed extending this mechanism to pensioners over 75. There would be substantial advantages to extending this residence rule further so that it apples to all pensioners. As the Turner report confirms, (in line with many other commentators), the current system unfairly disadvantages sections of society, in particular women, who have interrupted working lives and caring responsibilities. Currently only about 30% of women are estimated to have rights to a full pension on their own account, compared with 85% of men, although the reduction to 30 qualifying years for a full pension will clearly alleviate the position.

It would be better to have all pension rights based on UK residence, and to have it funded from general taxation. Obviously income tax would then have to increase accordingly.

Mr B in the example given above would of course be entitled to a full state pension because of his residence in the UK. It is worth noting however, that if there were a merger of the NIC and income tax systems the same rates of tax would apply to all income. This would lower the tax burden on earned income and increase it on investment income, and create a more streamlined and effective system. So Mr B would pay more tax on his investment income, and Mr A would correspondingly pay less tax than the tax and NICs which are due under the current system on his earned income.

This proposed reform, based on Turner's analysis, would substantially simplify matters and help people to understand their own position. Importantly, it would also encourage many people to save who at present have little incentive to do so. People would be entitled to the state pension, which would be due to many people now receiving pension credit, whatever their other income or assets. This is in line with the objectives set by Turner, that we should have a less means-tested and more universal state pension. At present, for those anticipating receiving pension credit in retirement, it may not be worthwhile to save, notwithstanding the savings credit. In particular investment in a private pension could offer real value to all savers under such a new system, which is not true for many at the moment.

The second state pension would cease under this proposal, and the right to reduced payments by people who were contracted out would no longer apply.

Current entitlements based on NICs paid would be converted into a credit for a number of years UK residence on a formula basis to avoid a very lengthy transitional process. The formula, which should be kept as simple as possible, should also contain an adjustment so that those who have benefitted from reduced NICs by contracting out of the second state pension, should have their universal state pension reduced somewhat. They would be compensated for this through their other pension arrangements, and fairness across all NIC contributors would be achieved in this way.

It would also seem desirable that as far as possible, and subject to fulfilling obligations to EU citizens, permanent immigrants to the UK over a certain age should be required to secure their financial position on retirement as a condition of entry. This would mean that their future needs could be met even though they would not be able to satisfy the residence condition for a full UK pension.

To summarise however, in a year that a person is resident in the UK he has corresponding obligations as a resident to pay UK tax. Paying due tax would give rise to the pension entitlement under the above proposal.

4. NICS AND INCOME TAX

A further range of anomalies and complications occur through the inter-relationship of NICs with income tax.

The level of earnings at which NICs become payable has been set in the past to match the personal allowance at which income tax becomes payable. However the two amounts are separating again with the increase in the personal allowance for tax purposes, which will rise to £7,475 in 2011/12. The last Labour Government increased the upper earnings limit for NICs to match the point at which income tax became payable at 40%. This addressed a curious discrepancy where marginal aggregated rates of tax and NICs fell from 31% to 21% between salary levels between the earlier upper earnings NIC limit of £33,000 a year and the higher rate threshold for income tax of £40,000, and then increased back up to 41%. However, as the two systems for NICs and income tax are separate, it is inevitable that anomalous marginal tax and NIC rates will occur, whether in specific individual circumstances, or for taxpayers generally.

There are other peculiar features, generally caused by history rather than any present justification, arising in a comparison of the income tax and NIC rules. For example, an employee is liable to income tax but is not liable to NICs on many benefits in kind. NICs are calculated on a weekly or a monthly basis, whereas tax is calculated on an annual basis. NICs are calculated per employment, whereas tax is calculated on the aggregate for all employments.

The differences can lead to more anomalies and complexities. For example if an employer pays salary to an employee he has to deduct income tax and NICs under the PAYE system. If the employee then uses some of the money to make a pension contribution he can obtain a tax refund but not a NIC refund. If, however, the employer pays into the pension fund direct for the employee's benefit the employee will have neither a tax nor an NIC liability. Other discrepancies arise, for example, on the treatment of share awards to employees. These anomalies are of sufficient importance that often taxpayers are almost obliged to seek out expensive tax advice before they can decide what to do for the best.

For most of the twentieth century, investment income was taxed more heavily than earned income. The most recent mechanism for achieving this was the investment income surcharge, which stood at 15% at the time it was abolished in 1985. Now, however, because of NICs, we have what is in effect an earned income surcharge. It is not surprising that this encourages taxpayers to try and arrange their affairs to avoid the charge. The best known example of this is where individuals set up personal service companies to supply their services to third parties. The service company charges a fee, and then pays a dividend to the individual concerned. In this way it is intended to avoid payment of the NICs which would be due if the individual were employed directly and paid a salary by the third party.

This has provided a good illustration of an arms race between HMRC and taxpayers. It commenced with HMRC introducing the notorious tax rules known as IR35 (after the Press Release in which this law was first proposed). The rules involve an eight stage calculation, broadly taking the income received by the personal service company, deducting an arbitrary 5% allowance, deducting other actual expenses and allowances, deducting pension and salary actually paid to the individual, and then calculating tax and NICs on the balance as if it had been paid out in salary by the company. This combined amount is then payable by the company. Further calculations are then required to give credit for tax already paid if the personal service company subsequently pays dividends to the individual.

The question of identifying which companies are caught by this law is a very grey area, but it matters to many thousands of small businesses because the risk of a charge is a cause of concern for them.

In an effort to avoid the charge a large number of managed service companies came into being. They were intended to get around the IR35 rules since these companies were not controlled by any of the individuals whose services were being supplied. To tackle this problem HMRC introduced a further tranche of complicated legislation, which itself needed further amendments in order that it should apply as intended.

All this might perhaps be justified if IR35 was an effective tax-raising measure. When IR35 was introduced it was estimated that it would raise £900 million a year; this figure was confirmed by the Paymaster General, Dawn Primarolo MP, speaking in Parliament on 3 May 2000. However, in May 2009, following a Freedom of Information request, it was revealed that IR35 had raised only £9.2 million in the five years from 2002/03 – that is, less than £2 million a year.

It is likely that the rules have had some deterrent effect, so that a percentage of people pay more than the individual personal allowance tax as salary in the hope of avoiding an IR35 enquiry. However, the majority of those potentially affected pay little by way of salary, and instead seek to escape IR35 by restructuring their working arrangements.

So IR35, for the reasons discussed above, is a cumbersome and largely ineffective piece of anti-avoidance legislation. It has failed to prevent the growth of packaged service companies, which was a key objective of the legislation when introduced in 1999. Between 2002 and 2006 the number of people using packaged companies more than tripled – from 65,000 to 240,000.

It is not surprising that one of the first tasks given to the new Office for Tax Simplification is to advise how to simplify the IR35 rules. This would help not only the small businesses who are charged, but also the many thousands of other small businesses who recognise that they could be affected and try to arrange their affairs to minimise the risks that they may be caught. But the root cause of all the problems, it will be noted, is the NIC system itself.

5. OTHER ADVERSE CONSEQUENCES OF NICS

Politics

In the past, NICs have been increased as a less high profile way to increase government revenue compared with raising the rate of income tax. For example it was widely reported ahead of the election in June 2001 that, while the Chancellor had promised not to increase income tax rates, he was planning to raise NIC rates. Indeed, in the April 2002 budget it was confirmed that NICs would go up by 1p in the pound from April 2003. This increase would also apply to earnings above the upper earnings limit (which had previously been an absolute cap). The extra money was stated to be for the NHS, but as explained above, the rise in NICs had a similar economic effect for the Government as a rise in income tax.

A tax on employment

Employer's NICs are due at the rate of 12.8%, as mentioned above. This high levy inevitably reduces the amount that employers can afford to pay for its payroll, meaning that wages are reduced and/or the number of employees are reduced. The nature of this tax has therefore been widely criticised, by the IFS and others, who say that other forms of taxation would have a less damaging effect on the economy.

The Conservatives accepted this point by promising in their 2010 election manifesto to give new small businesses an exemption from employer NICs.

Costs of running NICs

The costs charged to the National Insurance Fund by HMRC for collecting NICs totalled £300 million for the year 2008/09. The costs charged by DWP for distributing benefits totalled £1 billion. Clearly the former cost could be substantially reduced or eliminated if the tax and NIC systems were merged.

It is not easy to evaluate what are the extra compliance costs for taxpayers of a separate NIC system. It is however clear that payroll compliance is a heavy burden on business, and that this burden falls disproportionately hard on small business. The HMRC Measurement Project (KPMG 2006) estimated that the administrative burden of tax regulation in the UK was £5.1 billion a year of which 70% is borne by companies with fewer than 10 employees. Anything which can be done to reduce their compliance costs is clearly to be welcomed.

A Treasury paper of October 2007 on income tax and NIC alignment indicated that the cost savings of aligning specific rules for NICs and income tax may be disappointing. However this paper made it clear at the outset that it took “the current policy framework as a given, namely that each system has a different purpose, with NICs providing entitlements to contributory benefits. Therefore it has not looked at merging income tax and NICs into one charge.”

It would seem a merger of NICs and income tax should in fact confer significant administrative benefits on business, which would no longer have to concern itself with the separate rules that apply for NIC purposes. In a 2006 survey of business conducted for the

Tax Reform Commission, (which was set up by George Osborne MP when he was Shadow Chancellor), 65% of respondents agreed or strongly agreed that a system that combined income tax and NICs, leaving the total tax burden unchanged, would be beneficial to them. Only 8% disagreed or strongly disagreed.

A regressive system

For over 40 years NICs have been paid as a percentage of income rather than at flat rates. This means that the current system is less regressive than it might be. However, the rates of NICs are now so high that the system retains some strongly regressive features. Take the example of a check-out lady at a supermarket who earns £16,000 a year. She has to pay NICs of 11% on the excess of her salary over the primary threshold of £5,750, which is a direct charge on her of £1,120. On top of this the employer has to pay NICs of 12.8% on the same excess amount, which is £1,310. Economists have said that the economic consequence of employer's NICs is to reduce wage rates by a corresponding amount. As a result of NICs the lady's wages are therefore arguably reduced by an aggregate of up to £2,440 (simplifying the calculation by ignoring the issue of the grossing up effect of employer NICs).

This is in addition to basic rate income tax which is paid at the rate of 20% on the excess over the personal allowance. This amounts to a lower figure of £1,905, but this will be reduced to £1,705 when the personal allowance is increased next year.

In this case, the NIC burden therefore exceeds the income tax burden, and she is suffering aggregate marginal rates of tax and NICs of up to 43.8%, taking employer NICs into account. These high marginal rates for low earners constitute a regressive feature of the current system.

6. A WAY FORWARD

The most straightforward way of resolving the above problems would be to merge the income tax and NIC systems. Indeed this proposal has already been made on several occasions.[6] A simple payroll tax (based on a set percentage of salary and the value of any employee benefits) could then be charged to employers. This would be calculated at a level required to pay those benefits that are only enjoyed by employees, such as maternity pay, sick pay and contribution-based JSA etc, and this level would be lower than that currently charged as employer NICs.

The National Insurance Fund should be wound up.

Pensions would be based on years of residence in the UK. Pensioners could be compensated for increased tax rates (because they are not at present liable for NICs) through a further increase to their personal allowances.

This would not mean that the contributory principle had been sacrificed entirely. People would become entitled to their

6 See Appendix A for a list of recent proposals.

benefits by paying their due taxes. To see this more clearly simply imagine that NICs were called income tax, and the current charges left unchanged. This would not affect the substance of current arrangements. If tax rates were then adjusted to work more equitably the principle would not have been further undermined. But most of the problems described above would have been eliminated.

Indeed, reform along these lines could *enhance* the contributory principle. Once people understand how the contributory principle has been debased, then the incentive to take out private insurance will increase.[7] Legal & General is, for example, investigating possibilities for private insurance in situations where cover provided by the state is considered inadequate.

The current policy imperative is to ensure that there remains an incentive for people to work; and to save to improve their situation. Given the proposal for a pension for all satisfying the residence condition it would be much easier than at present to work out the level of any means-tested benefits for pensioners that would not undermine such incentives.

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7 As a technical point, the UK is party to arrangements which apply throughout the European Economic Area. The UK also has a network of reciprocal agreements with other countries, relating to pensions and to social security contributions. These rules generally exempt citizens of one state from such contributions in another state if they are only there for a limited time. If NICs were abolished as a separate levy these arrangements would need to be revised or reinterpreted.

Different countries have different systems for social security, for example whether or not hospital treatment is covered. Some countries such as Australia have no separate system at all – all benefits there are paid out of general taxation. It would be a task for specialists in this area to evaluate the impact of a merged tax for these cross-border purposes. It may be that a specified part of the merged income tax should be expressly stated to be for social benefits, and that amount could be used for the purposes of our international arrangements.

7. THE COST TO THE EXCHEQUER

Merging income tax and NICs will inevitably lead to a higher rate of income tax. This could appear to be very bad news, even if net pay packets were unaffected. Some reduction in the aggregate rate would be made possible by charging the combined tax on a broader tax base of income. It may still appear, however, that a further reduction in the rate would be appropriate. This would make a change much easier to sell politically, as employees could be advised that their net pay packets would actually increase. Although there would be administration cost savings in a merger, these would not be large in relation to the overall amounts paid.

The effect of the above proposals is therefore likely to be a reduction in Government net revenues. It is relevant to mention in passing that other sensible reforms needed for the tax system are likely to have a similar effect.

However this potential loss of tax should be evaluated in the light of a number of further factors:

- Because of the dynamic effect of lower and simpler taxes, increased levels of economic activity would result in higher taxes actually being received in the future. The point has often been made that a dynamic model for tax costs should be used by the Treasury to reflect the knock-on consequences of lower taxes.

- Once growth in the economy is resumed, it would be possible to reduce the tax burden as a percentage of GDP without actually reducing the amount of tax collected, without needing to take dynamic effects into account.

- If there is to be any real success in creating more subsidiarity and localism in politics, it will be necessary for local authorities to raise more in local taxation than at present. There are powerful arguments for moving in this direction, whilst taking into account the need to continue to help local authorities in poorer areas.

The details of how the Government proposes to fund its new universal pension will remain unclear until the publication of their Green Paper on the subject later this year. Estimates of its cost vary widely, partly because different authors may make different assumptions in order to make the comparison. The facts that pension credit would be abolished and that contracted out rebates would cease to apply clearly reduce the cost. Also, more people would qualify for a full pension under the existing rules because of the 30 year rule. Further, all pension costs will be reduced (whether under the current system or any replacement system) by increasing the pension age.

These factors reduce the incremental cost of a universal pension. On the other hand, under the current system many people do not claim pension credit, even though they are entitled to it.

Timing of implementation

The merging of NICs and income tax will require an overall cut in the amount of tax received by the Treasury (not least so that the current advantages enjoyed by the self-employed are shared by other employees).[8]

As a result, these reforms would best be implemented as the economy moves out of recession, when such a tax cut would be economically feasible.

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8 At present, the self-employed pay 8% of earnings in NICs. The full rate for employees is 11%, but the contracted-out rebate is 1.6%, bringing it down to 9.4% (this is the correct comparison because the self-employed do not qualify for the second state pension, and so theirs is a "contracted-out" rate).

8. CONCLUSION

The problems discussed in this paper are important because of their direct financial impact.

But they are also important to anyone who believes that an individual has a democratic right to a broad understanding of how fundamental matters such as tax and benefits work without having to take a specialist course of study in the subject. It is only fair that every citizen should be able to have a reasonable grasp of his financial obligations and rights to and from government. The current system makes this very difficult for too many people.

It would be wrong to say that this is because the problems are insoluble. But solving them will require a more radical approach than has to date been adopted.

The most significant financial effect of any reforms is perhaps the likely impact on state pensions. If it were to be accepted, however, that citizens should be entitled to a pension simply based on years of UK residence funded by general taxation, or if it were decided to pay for the state pension in some other way, it would be appropriate to administer the last rites to the existing NIC system.

The radical changes proposed in this paper will take time to introduce. There would be formidable technical and political challenges. Merging NICs and income tax would inevitably lead to a higher headline rate of income tax (although the amount taken by government would remain about the same). Opposition parties may be tempted to claim that this is equivalent to a tax increase. It may also make our tax system appear at first sight to be uncompetitive in comparison to that in other countries – but it would be attractively simple and actual rates would not of course be any higher than they are today. But these points should be considered primarily as presentational.

Yes, the changes will require a combination of political will and extremely effective communication skills. For a reforming Government that believes in tax simplification and honesty, the potential gains from such reforms are great.

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APPENDIX:

RECENT REVIEWS OF NICS

In 1986 a Green Paper was published by the Treasury under Nigel Lawson. Apart from addressing issues such as independent taxation, it also looked at the possibility of merging NICs and income tax. It concluded that there would be cost savings from doing this, but the penalty of losing the contributory principle would be too great. The paper pointed out that if the two systems were merged people who were not in employment would find themselves funding benefits to employees – as mentioned above this problem would be solved by funding such benefits through a simple payroll tax. The Green Paper also pointed to the problem of distributional effects of a merger – in particular the "kink" which then existed for incomes above the upper earnings limit and below the higher rate income tax threshold would be affected (which Mr Lawson referred to as the "elephant trap"). As mentioned above, however, the "kink" has already been removed, and this problem no longer exists.

However a working group set up by the last Conservative Government's deregulation initiative recommended full integration (see DSS Deregulation review, *Report of the Tax/NICs working group,* 1993).

Further, most authors on the subject have come to the conclusion that a merger is the right answer.

The 2007 IFS interim report on integrating income tax and NICs stated that "The literature specifically addressing income tax-NI integration… is almost universally supportive… As long ago as 1978, the British Tax Review published an article entitled "National Insurance Contributions – A Second Income Tax", which concluded:

> "In places the disparities between income tax and national insurance contributions are distinctions without differences, and.. .in other places the disparities may be unnecessary and unfair… In practice even more than in theory the contribution system is merely an adapted form of the income tax system, and its separate status is to some extent a mere illusion."

The IFS report continues by confirming that this set the tone for much of the literature that followed. Dilnot et al (1984) proposed the integration of income tax and NICs as part of a broader integration of the tax and social security system. Webb (1992) in a thorough analysis of integration, concluded:

> "A comprehensive integration of the systems of income tax and National Insurance contributions would produce a major improvement to the structure of the personal direct tax system in the UK. The tax system would be more coherent, the scope for removing structural anomalies would be greater, and the scope for tax avoidance would be

> reduced… now is the time to begin moving towards that objective.”

Dilnot (1995) argued that integration would be desirable and that “the main continuing barrier to income and social security tax integration is politics and public perceptions.”

Reports by business groups (British Chambers of Commerce, 2004) and professional groups (Chartered Institute of Taxation, 1998) suggested that full integration is likely to be the ideal long-term goal, but then both elected to focus on incremental technical steps towards alignment in the shorter term.

The Taylor report published in 1998 also looked at NICs. But it largely confined its attention to issues such as distortions created by the rates of NICs, which have to some extent already been corrected, rather than the wider issues addressed in this paper.

Coalition proposals for a universal flat-rate pension effectively remove the last justification for our National Insurance system. Whether we like it or not, the contributory principle underlying National Insurance Contributrions (NICs) will shortly be superfluous.

In any case, NICs are riddled with anomalies, complexity and a lack of cohesion. They can reward the proflgate while penalising the thrifty. They can discourage saving. They can be unfair. They can impose high marginal rates on low earners. They have been used to disguise tax increases.

They should be merged into the income tax system once an overall tax cut is affordable.

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