



BRIEFING PAPER

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National Insurance contributions: an introduction

By Antony Seely

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THE BEVERIDGE REPORT

COMPREHENSIVE SCHEME OF SOCIAL INSURANCE

BENEFITS IN UNEMPLOYMENT, SICKNESS AND OLD AGE

NEW PROVISION FOR HOME AND FAMILY

The Beveridge Report (Cmd. 6404, 2s.) was issued yesterday and is summarized below. With "freedom from want" as its goal, it proposes a far-reaching series of changes designed to consolidate and enlarge the system of social insurance.

The plan assumes the establishment of family allowances, comprehensive health and rehabilitation services, and the avoidance of mass unemployment.

It is effected by 23 main changes designed to give a unified system, under a Ministry of Social Security, on a contributory basis including all citizens without upper income limit.

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Contributing Authors:

Rod McInnes, Social Security statistics

Summary

National insurance benefits are funded by a system of compulsory contributions on earnings, paid by employees, employers and the self-employed. Receipts from these contributions – NICs, for short – are paid into the National Insurance Fund, kept separate from all other revenue raised by national taxes. A fixed proportion of NI receipts are not paid into the Fund but go to the National Health Service.

The National Insurance Fund is used exclusively to pay for contributory benefits, and operates on a 'pay as you go' basis: broadly speaking, this year's contributions pay for this year's benefits. This note gives an introduction to National Insurance system: the base and rate structure of NICs, the operation of the NI Fund, and the connection between a person's contributions into the Fund with their entitlement to receive benefits paid out of the Fund – the 'contributory principle' as it is known.

Some commentators have argued that despite these characteristics, NICs is no different in kind to other national taxes, and that integrating it with income tax would be fairer, simpler and more efficient. Although there have been a number of reforms to bring NICs and income tax into closer alignment, there remain considerable difficulties to a merger.

1. Rates, receipts, benefits

National Insurance contributions (NICs) raised an estimated £109 billion in 2014/15. This compares with estimated Exchequer receipts from income tax of £163 billion, from VAT of £111 billion and from corporation tax of £42 billion.¹

Employees pay National Insurance contributions (NICs) on their earnings if they exceed the lower earnings limit (LEL), which is set at £112 per week for 2015/16. A zero rate of NICs is charged on earnings between the LEL and the primary threshold (PT), which is set at £155 per week. A notional primary Class 1 NIC is deemed to have been paid in respect of earnings between LEL and PT to protect benefit entitlement. Earnings above the PT are charged NICs at a rate of 12%, subject to a cap at the upper earnings limit (UEL), which is set at £815 per week. Earnings *above* the UEL are charged NICs at a rate of 2%. Employees contracted out of the state second pension (S2P) pay a reduced rate of NICs.²

Employers pay NICs on employee earnings at a rate of 13.8% on earnings above the secondary threshold (ST), set at £156 a week for 2015/16. There is no upper ceiling on secondary Class 1 NICs.

Self-employed people pay a weekly flat rate Class 2 NIC. They may apply for exemption from paying class 2 contributions if their annual profits are less than the level of the 'small profits threshold' (set at £5,965 for 2015/16).³ In addition they may be liable to pay a separate Class 4 profits related contribution. Class 4 NICs are charged at a rate of 9% on profits between a lower profits limit and an upper profits limit, and at 2% on profits above the upper limit.

Further to these categories, individuals may be entitled to make voluntary Class 3 contributions to ensure that they qualify for basic retirement pension and bereavement benefits.

From April 2011 the rates of NICs paid by employees, employers and the self-employed rose by 1%. This tax increase had been announced in two stages by the Labour Government in its Pre-Budget reports in December 2008 & 2009. It was confirmed by the Coalition Government in its first Budget on 22 June 2010, and legislation to this effect was introduced in autumn 2010. To mitigate the impact on individuals on lower incomes, and on the incentives for employers to take on new staff, both the primary and secondary threshold were increased substantially above inflation.⁴

¹ OBR, *Economic & Fiscal Outlook*, Cm 9024, March 2015 p106 ([Table 4.5](#))

² This rebate applies for individuals paying into a salary-related scheme only (see, [Contracting out of the State Second Pension](#), Commons Briefing Paper CBP4822, 23 March 2011). With the introduction of the single-tier pension, scheduled for April 2016, the additional State Pension will close and, by extension, the option to contract out of it (see, [Single-tier state pension](#), CBP6525, 24 March 2015).

³ This replaced the 'small earnings exception' from April 2015. For details see, [Commons Briefing Paper 14/45, 21 August 2014](#).

⁴ For details see two Library papers: [Research paper 10/76](#), 17 November 2010 & [Research paper 10/83](#), 14 December 2010.

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NICs are charged on earnings from employment and self-employment only. By comparison income tax is charged on one's total income which includes savings and investment income, state and occupational pensions as well as earnings-replacement benefits. UK residents in the UK and others with income in the UK are liable to pay income tax, whereas only people over 16 and under state pension age working in the UK are liable to pay NICs. An employer's liability to pay secondary Class 1 NICs in respect of earnings paid to or for the benefit of an employed earner is *unaffected* by the employed earner's attainment of pensionable age.

A majority of the receipts from NICs are paid into the National Insurance Fund, which is separate from all other revenue raised by taxation. The Fund is used exclusively to pay for contributory benefits.

One portion of the income from NICs are not paid into the Fund, but go to the National Health Service. For example, in the case of Class 1 NICs, the NHS allocation is 2.05% of earnings between the primary threshold and UEL, and 1% of earnings above the UEL. The Government Actuary's Department has estimated that NICs will raise just under £105 billion in 2014/15, of which £84 billion would go into the NI Fund and £21 billion would go to the NHS.⁵

The proportion of health spending accounted for by NICs has risen in recent years, due largely to an increase in this NHS allocation.⁶ In his 2002 Budget the then Chancellor Gordon Brown proposed that UK NHS spending should rise from £65.4 billion in 2002/03 to £105.6 billion in 2007/08. Several tax measures were introduced, by far the most important of which were increases in the rates of NICs from April 2003.

For employees the rate of NICs rose by 1 percentage point to a rate of 11% on all earnings between the primary threshold and the UEL – *and* a new 1% rate was charged on earnings above the UEL. For employers the rate of NICs rose by 1 percentage point to a rate of 12.8% on earnings above the secondary threshold. For the self-employed the rate of NICs rose by 1 percentage point to a rate of 8% on all earnings between the lower profits limit and the upper profits limit – *and* a new 1% rate was introduced on earnings above the upper profits limit. It was estimated that taken together these changes would raise around £7.9 billion in 2003/04.⁷

Employees' contributions entitle them to the range of contributory benefits, including contributions-based jobseeker's allowance, incapacity benefit, retirement pensions and bereavement benefits. The flat rate Class 2 contributions of self-employed people entitle them to all

⁵ GAD, [Report on draft of the social security benefits up-rating Order 2014](#), January 2015 pp26-7

⁶ The share of NHS spending in England accounted by NICs rose from 12.1% to 18.4% from 2000/01 to 2006/07 (DoH *Departmental Reports*: 2001 report Cm 5103 May 2001 para 3.16 & 2006 report Cm 6814 May 2006 para 3.36)

⁷ *Budget 2002*, HC 592 April 2002 p121, pp154-5. Further detail on this reform is given in, [Library Research paper 02/32](#), 8 May 2002.

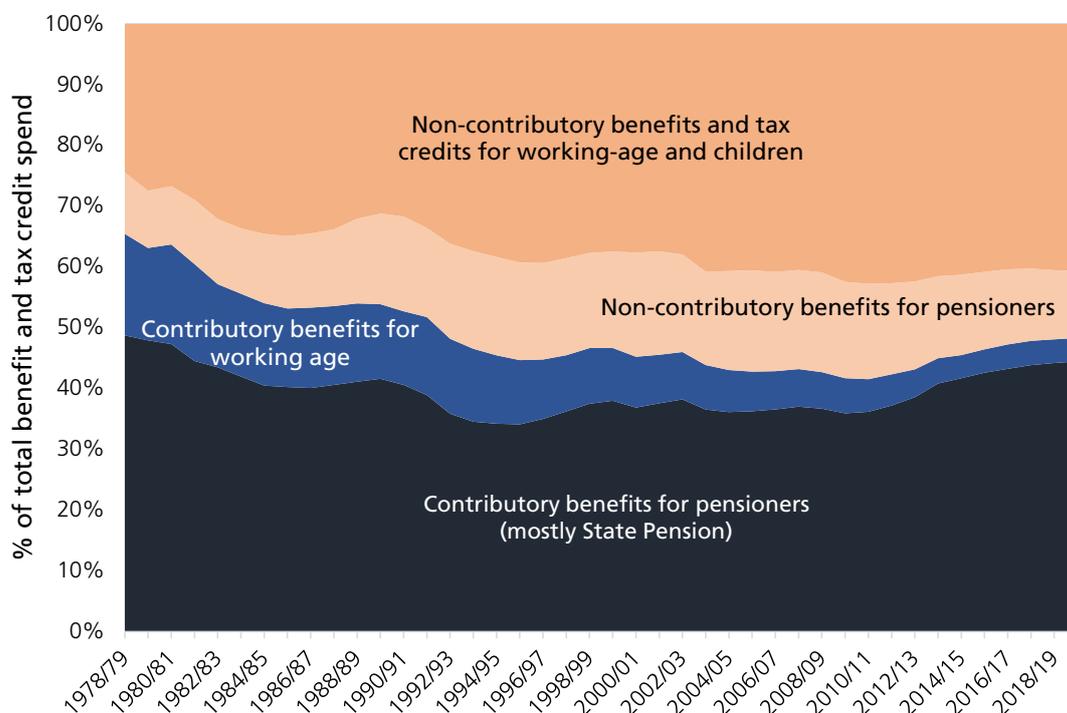
benefits apart from jobseeker's allowance – though Class 4 contributions do not count towards benefit entitlement.⁸

There are three elements to social security expenditure:

- **Contributory benefits** – entitlement for which is dependent on the claimant's NI record;
- **Income-related / means-tested benefits** (such as Housing Benefit, Pension Credit or Tax Credits), which are non-contributory and depend upon the income of the claimant and their personal characteristics such as age and family type;
- Benefits which are **neither contributory nor income-related** (such as Disability Living Allowance and Personal Independence Payment) which are available to all people who meet some qualification criteria.

Over the last thirty years, contributory benefits have declined in importance relative to other categories of government benefit spending. The share of benefit expenditure accounted for by contributory benefits fell from 65% in 1978/79 to a low of 42% in 2010/11. Since then, State Pension spending has driven an increase in the contributory share – to 46% this year (2015/16) and 48% (forecast) by the end of this Parliament.

Benefit and tax credit expenditure, Great Britain, % of total

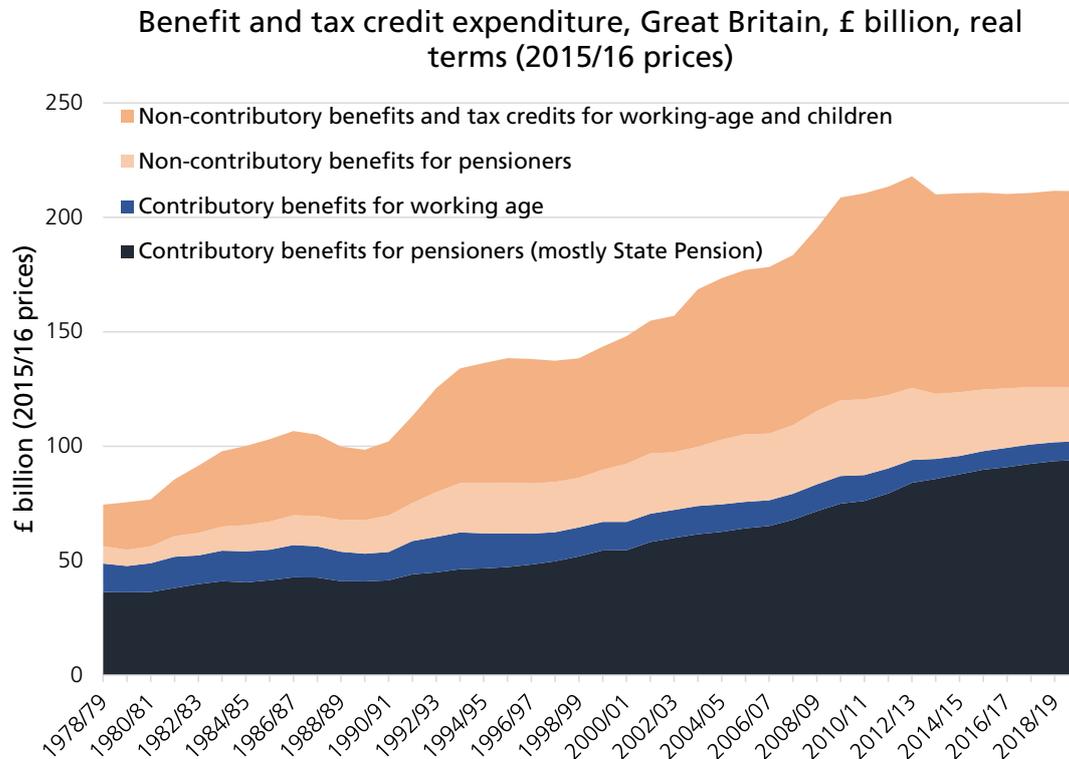


Total spending on contributory benefits in Great Britain (including overseas recipients) is around £98 billion this year (out of total benefit and tax credit spend of £211 billion). Around £90 billion of the contributory spend is accounted for by the State Pension.

⁸ For more details see, [Self-employed people and contribution-based Jobseeker's Allowance](#), CBP547, 16 July 2014

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Working-age people receive around £8 billion of contributory benefit spend this year (consisting of contributory ESA, Statutory Maternity Pay and Maternity Allowance, Bereavement benefit and contributory JSA).



Not all contributory benefit expenditure is predicated on the payment of National Insurance contributions. This is because there are circumstances when individuals are credited with NICs without having actually paid them: either from claiming credits when, say, on Jobseeker's Allowance, or from being on earnings above the LEL but below the primary threshold (as earnings in this band are charged NICs at a zero rate.)

2. The National Insurance Fund

The majority of receipts from NICs are paid into the National Insurance Fund, which is separate from all other revenue raised by taxation. The Fund is used exclusively to pay for contributory benefits, and operates on a 'pay as you go' basis: broadly speaking, this year's contributions pay for this year's benefits. Indeed, retirement pensions account for over 90% of benefit expenditure from the Fund.⁹ The Government has no powers to use NICs to fund anything else.¹⁰

In their survey of the UK tax system, the Institute for Fiscal Studies comments, "The NI Fund is notionally used to finance contributory benefits, but in years when the Fund was not sufficient to finance benefits, it was topped up from general taxation revenues, and in years when contributions substantially exceed outlays (as they have every year since the mid-1990s), the Fund builds up a surplus, largely invested in gilts: the government is simply lending itself money. These exercises in shifting money from one arm of government to another maintain a notionally separate Fund, but merely serve to illustrate that NI contributions and NI expenditure proceed on essentially independent paths. The government could equally well declare that a quarter of NICs revenue goes towards financing defence spending, and no-one would notice the difference."¹¹

The Government Actuary advises on the level of contributions necessary to meet expected benefit expenditure. The NIF annual accounts explain that a working balance is necessary to deal with short term fluctuations as the NIF has no borrowing powers:

The National Insurance Scheme is financed on a pay-as-you-go basis with contribution rates set at a level broadly necessary to meet the expected benefits expenditure in that year, after taking into account any other payments and receipts, and to maintain a working balance. Changes in contribution levels in response to the needs of the Fund take time to implement, therefore a working balance is necessary because the NIF has no borrowing powers. ...

The balance on the fund at 31 March 2014 has decreased by £5,887 million to £23,196 million (31 March 2013, £29,083 million); the balance represents 26 per cent of annual benefit expenditure (31 March 2013, 33 per cent). This decrease results from the increase in benefit payments (£5,107 million) together with the effect of historically low interest rates on the NIF working balance.¹²

The origins of the Fund were set out in a report on the NI system by the Social Security Committee in 2000:

⁹ *Report on draft of the social security benefits up-rating Order 2015*, January 2015 ([Table 4.2](#))

¹⁰ Part XII of the *Social Security Administration Act 1992* contains the statutory authority for the Fund; section 163 specifies that payments out of the Fund may only be made to finance a list of specified benefits.

¹¹ Institute for Fiscal Studies, *A survey of the UK tax system*, November 2014 p15

¹² [National Insurance Fund Account 2013/14, HC 694, November 2014](#) p5

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The National Insurance Fund was established in 1911, reformed in 1948 and assumed broadly its current form in 1975, when the separate National Insurance (Industrial Injuries) and National Insurance (Reserve) Funds were merged with it.

From 1948 its income came from three sources:

- the national insurance contributions paid by individual contributors;
- employers' national insurance contributions;
- the state (in the form of the Treasury Supplement, which accounted for just under a quarter).

Over time, the level of the Treasury Supplement was gradually reduced. It was abolished after 1988-89. Thereafter the Fund's expenditure was met wholly from workers' and employers' contributions and a small amount of investment income. This arrangement did not prove flexible enough to meet unexpected demands and from 1993-94 an Exchequer subsidy for the Fund was therefore established in the form of the Treasury Grant.

The Grant is paid out of the Consolidated Fund into the National Insurance Fund. The maximum Grant available in any tax year is set by primary legislation at 17 per cent of the National Insurance Fund's annual benefit expenditure. The maximum amount of Grant available—but not, necessarily, taken up—for each tax year is set by the annual contributions re-rating order. The amounts of Grant voted in the main Supply Estimates and paid into the Fund each year are those estimated in the Government Actuary's report on the annual social security benefits up-rating and national insurance contributions re-rating Orders. But the maximum level of Grant which can be made available to the Fund in a year is prescribed at a prudently higher level (by the contributions re-rating order).

The maximum Grant is set so that, if in that year the Fund's income from contributions is lower than expected or its expenditure is higher than forecast, additional amounts of Grant may be paid into the Fund, subject to Parliament approving the necessary Supplementary Estimate. This might arise when, for example, the level of unemployment is markedly higher than expected. The actual amount of Grant drawn by the Fund each year is usually well below the maximum that may be made available. For example, the maximum Grant for 1998-99 was set at 2 per cent of benefit expenditure in that year (£900 million); the actual Grant required by the Fund for that year was nil.¹³

Since the late 1990s, contribution income of the Fund consistently exceeded payments so that the balance of the Fund's balance grew steadily (from just under £10 billion in 1998/99 to £50.6 billion in 2008/09). However, the impact of the recession has been such that, as noted above, the surplus was £23 billion at 31 March 2014. In 1992 the Government Actuary stated that the Fund should have a balance of at least one-sixth of benefit expenditure, as "the minimum level recommended with a view to ensuring that a reasonable working

¹³ *The Contributory Principle*, 7 June 2000 HC 56-II 1999-2000 pp 175-6

balance is maintained.”¹⁴ This would now be equivalent to around £15 billion. The Government Actuary now expects that the surplus will continue to fall until 2018/19, and that without additional funding, the balance is projected to fall to 2.9% of benefit spending.¹⁵

During the period when the surplus grew so strongly, many commentators made suggestions for using it to increase government expenditure, such as raising the level of the basic state pension are often mentioned. In April 2008 Kelvin Hopkins MP put down an EDM to this effect which 56 Members signed.¹⁶ For its part the Labour Government took the position that the surplus was not a reliable source of government funding, as noted in answer to a PQ:

Paul Flynn: To ask the Secretary of State for Work and Pensions what estimate he has made of the increases in the basic state pension payable in each year from 2009-10 to 2012-13 if surpluses in the National Insurance Fund were reallocated to state pensions.

Mr. Mike O'Brien: National insurance contributions (NICs) and associated social security benefits operate within the Government's fiscal rules designed to ensure sound public finances and when there is a surplus it is invested in public services. Any surplus of NICs over social security benefits in any one year (the NIF surplus) is not therefore an extra resource available to spend.¹⁷

The Labour Government reiterated its position in a second answer in February 2009:

Mr. Swire: To ask the Chancellor of the Exchequer what assessment he has made of the merits of using future national insurance fund surpluses to fund an increase in the state pension.

Mr. Timms: I refer the hon. Member to the answer given by my right hon. Friend (Mr. O'Brien) the Minister for Pension Reform on 5 March 2008, *Official Report*, column 2605W. Any increase in the basic state pension has a cumulative impact on Government spending going forward. The Government consider the short-term use of the surplus on the national insurance fund in this way to be unsustainable in the long term.¹⁸

The Fund's surplus was discussed in a debate in Westminster Hall in October 2003, when Paul Flynn MP argued that “a significant part” of the Fund was “being salted away in Government stocks.”¹⁹ In response Ruth Kelly, then Financial Secretary, argued that the surplus should be retained to accommodate unforeseen circumstances:

The national insurance fund provides security for those contributory benefits. It is ring-fenced and cannot be used for other Government expenditure. It is reviewed every year by the Government Actuary, who reports to Parliament on the effect of

¹⁴ Dept of Social Security, *Social Security Bill 1992 - Report by the Government Actuary on the financial provisions of the Bill*, Cm 2097 26 November 1992 para 9

¹⁵ *Report on draft of the social security benefits up-rating Order 2015*, January 2015 ([Appendix 6, section 11](#)); *Ni Fund Accounts 1975-2014, CBP797*, 20 May 2014.

¹⁶ EDM 1443 of 2007-08, 28 April 2008. 47 Members signed a similar motion put down earlier in the same Session (EDM 298 of 2007-08, 19 November 2007).

¹⁷ HC Deb 5 March 2008 c2605W

¹⁸ HC Deb 10 February 2009 c1852W

¹⁹ HC Deb 21 October 2003 c217WH

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any changes to contributions or benefits and on the state of the fund ... The accounts to the fund are audited by the National Audit Office and published annually. The national insurance fund is, therefore, a clear and transparent mechanism for demonstrating the link between national insurance contributions and contributory benefits ...

The fund is clearly in a healthy state. Income from contributions is more than enough to cover expenditure on benefits ... The Government Actuary's latest report shows that the balance at the end of 2003–04 is likely to be nearly £20 billion. That number needs to be set in context. During the current year, the fund's income is expected to be £63 billion and expenditure on benefits about £60.5 billion, 80 per cent. of which will go on retirement pensions. The difference, which is added to the balance, is only about £2.5 billion. Last year, the difference was £3 billion, and that is a small proportion—about 4 per cent.—of the amounts flowing through the fund.

As my hon. Friend said, the then Government were sufficiently confident of the state of the fund in 1989 to abolish the Treasury supplement. However, by 1993—just four years later—legislation had to be introduced to provide for a Treasury grant to prevent the fund from running out of money. That clearly illustrates how wrong it is to take a short-term view of the fund ... I am arguing that, although a surplus might appear very large at any point time, it is not right to assume that it will not be needed for the purposes of the fund in future ... Events—some of them, perhaps, inspired by the Government, in which instance there were obviously aggravating factors—can mean that the surplus turns around very quickly. I am cautioning against viewing a surplus above the 16.7 per cent. margin that the Government Actuary specifies as unnecessary and available to be spent.

The Minister went on to argue that the surplus on the fund was not wasted, because it was invested in government debt:

There is a more significant point. The balance on the fund is not wasted. The hon. Member for Northavon (Mr. Webb) made that point. Any surplus in the fund is used to buy gilts, which provide security for contributory benefits and reduce the Government's need to borrow elsewhere. It is a mistake to think that there is a pot of money that could be used to fund spending on another purpose.²⁰

Since 2007 the Fund has been invested in the Government's 'Call Notice Deposit Account', administered by the Debt Management Office, rather than any part of it being held in gilts.²¹ This is an overnight account facility, which pays interest to the Fund at the prevalent Bank of England bank rate. The Fund has maximum liquidity for withdrawals (or deposits) out of (into) the Fund on a day-to-day basis. It is worth emphasizing that these funds are being held in this account on loan – much as with the purchase of gilts: there is no question of the Government being in a position to use this facility to extract money from the Fund as an extra source of revenue. In addition, the new arrangements minimise transaction costs, whilst still retaining zero credit

²⁰ *op.cit.* cc231-232WH

²¹ *National Insurance Fund Account 2006-07*, HC 466 30 April 2008 p26; [Debt Management Office website](#).

risk and the guarantee that the Fund will always earn a fair and observable market rate of interest.

In March 2010 the House debated the legislation to uprate the state pension for the year 2010/11; on this occasion, the nature of the Fund's surplus was mentioned by the then Liberal Democrats spokesman on work and pensions, Steve Webb, who was Pensions Minister in the Coalition Government:

The law only requires the balance in the fund to be one sixth of annual expenditure on benefits. The actual balance in the fund is about two thirds of annual estimated benefit payments. So pensioners' groups always ask us where the money has gone. When we find out where it has gone, it is a bit of surprise. A little bit of the money goes to the National Health Service, but the law says that most of it must go towards national insurance benefits, pensions and so on. But at the rates in the order, it cannot all be spent on national insurance benefits and pensions. They are not big enough to spend all the cash on, so the balance keeps rising year after year.

Where does the money go? My understanding is that the fund is a bit like a soft bank that lends money to the rest of public sector, so that the Government need not borrow it from elsewhere. Of course, when the Chancellor said in a recent Budget that he would increase national insurance contributions to help fill the hole in the Budget, he was doing so to spend that money not on national insurance benefits and pensions, but on others things, presumably. How can the fund be used as a label and a soft way to raise tax, when the money is not spent on national insurance benefits and pensions? ... Is that really what Beveridge had in mind? Did he think that the national insurance fund would essentially become a kind of easy credit option for the Government? We have come an awful long way since the start of the contributory principle.²²

²² [HC Deb 1 March 2010 c763](#)

3. The contributory principle

The UK's contributory system for financing social security benefits was established in 1948, following the recommendations of Sir William Beveridge's 1942 report *Social Insurance and Allied Services*. Beveridge described his plan for social security as: "first and foremost a plan of insurance - of giving in return for contributions benefits up to subsistence levels, as of right and without means test, so that individuals may build freely upon it."²³

To fund this plan, he proposed a tripartite scheme of contribution, based on the more limited scheme of national insurance introduced in 1911, and drawing on the contributory principle which, in his view, accorded with "the wishes and feelings of the British democracy." The principle might be stated in this way: "that a material part of the total cost of maintaining income under the plan shall be met from monies contributed by citizens as insured persons, on the basis of each individual paying the same contribution for the same rate of benefit."

As a consequence, Beveridge argued, general taxation should meet part – but only part – of the cost of any scheme:

Contribution means that in their capacity as possible recipients of benefit the poorer man and the richer man are treated alike. Taxation means that the richer man, because of his capacity to pay, pays more for the general purposes of the community. These general purposes may, and in practice they must, include bearing a part of the cost of social security; if security is to be based on the contributory principle, they cannot include bearing the whole cost.²⁴

The report summarised the case for funding from individual contributions as follows:

- The insured persons themselves can pay and like to pay, and would rather pay than not do so. It is felt and rightly felt that contribution irrespective of means is the strongest ground for repudiating a means test.
- It is desirable to keep the Social Insurance Fund self-contained with defined responsibilities and defined sources of income. The citizens as insured persons should realise that they cannot get more than certain benefits for certain contributions, should have a motive to support measures for economic administration, should not be taught to regard the State as the dispenser of gifts for which no one needs to pay.
- To require contribution on an insurance document for each individual has administrative convenience, particularly for a scheme which, while it covers all citizens, takes account of their different ways of livelihood, and classifies them, giving different benefits according to their needs. Contribution provides automatically the record by which the insured

²³ Cmd 6404 November 1942 para 10

²⁴ Cmd 6404 November 1942 para 273

person's claim to be qualified for any particular benefit can be tested.²⁵

Turning to the third part of the scheme's funding, Beveridge made three arguments for levying contributions on employers as well as on employees and taxpayers:

- An employer's contribution should be "regarded as a proper part of the cost of production, maintaining the labour force that is necessary both when it is actually working and when it is standing by."
- It was in the employer's interest that their employees should have security – against the risk of unemployment or sickness – and that they should "feel concerned for those who work under their control."
- It was necessary to "give to employers a definite status, based on contribution, for making representations as to the administration of social insurance and its possible improvement."²⁶

Many commentators have observed that Beveridge's plan was not fully realised, even at the outset, and that since its introduction "the national insurance scheme has been undermined, both directly as a result of successive governments' policies and indirectly as a result of economic and social change."²⁷

Nevertheless some have argued that the contributory principle remains important. In June 2000 the Social Security Committee completed an enquiry on the principle, and in evidence to the Committee Frank Field MP argued, "for those paying for welfare, a significant advantage of the contributory principle over simple funding by taxation is the inherent transparency of making a designated contribution."²⁸ The Government Actuary took a similar view, pointing to the greater scope for parliamentary accountability:

From the point of view of parliamentary control I would say that the National Insurance Fund has a very important function because it does focus through the uprating process, the annual review and the reports that we do in connection with that, on whether there is a proper approach being taken to the benefits uprating, whether they are being considered adequately in relation to the income, and that gives Parliament quite a good influence in principle over the way in which the scheme is developing in a way which would be much less so if there was not a Fund and this was all general budget expenditure.²⁹

In their report the Committee observed that the eligibility requirements for contributory benefits were both detailed and complex:

²⁵ Cmd 6404 November 1942 para 274

²⁶ Cmd 6404 November 1942 paras 275-6

²⁷ Social Security Committee, *Fifth report: The Contributory Principle*, 7 June 2000 HC 56-I 1999-2000 p xvi

²⁸ HC 56-II 1999-2000 p 126

²⁹ HC 56-II 1999-2000 Q 285 p 160

The contribution rules are complex, requiring the contributor not only to have paid contributions on a certain proportion of earnings, but also to have paid the contributions during a particular tax year, or, in the case of widows or retirement pensions, over a certain number of years of a working life.³⁰

As the Committee went on to observe “there is very little direct financial relation between what an individual puts into the Fund and what they get out”:

Most national insurance benefits are paid at a flat rate whereas contributions are earnings-related. The Government Actuary commented: “Over time the link between the benefit and the contribution of the individual has been loosened so that now it is very clearly on a pay as you go basis and contributions are set to meet the benefits in that year rather than the benefits of the individual in the future.”³¹

Writing on this issue in 1995 the then director of the Institute for Fiscal Studies, Andrew Dilnot, commented, “it would be hard to find much evidence of any persisting actuarial link between contributions paid and benefits received.”³²

In his article Mr Dilnot cites an exchange back in June 1982 between an official at the Department of Health and Social Security, and Richard Wainwright MP, as part of an enquiry into the personal tax system being undertaken by the then Commons Treasury and Civil Service Select Committee. On this occasion Mr Wainwright suggested that national insurance “seems to be an extraordinarily arbitrary system because in no way is a certain level of contribution paid for an average benefit.” He went on to ask Mr CM Regan, an under-secretary at the Department giving evidence to the Committee, “how on earth are the contribution requirements fixed and what relationship do they bear to the marvellous benefits they unlock?”

Mr Regan’s response to this question is illuminating:

They are not fixed on any particularly rational basis but on the basis that you want a reasonable test and do not want to make it too hard for people to get the benefits, because, after all, the contingencies are there and you do not want resort to means-tested benefits. But all the benefits in some sense are based on a pay as you go system, which is what the National Insurance system is. If you like, all the benefits are too easy. None of us has ever paid, or will ever pay, because even on the pension side it is not actuarially calculated, the full value of our benefits.

This is a function of the inter-generation apportionment process whereby the working generation today basically pays for the pensions of the generation which has now retired and we go forward in the hope that each successive generation will, in return for something which is much less than full value, go on doing so.

³⁰ HC 56-I 1999-2000 para 14

³¹ HC 56-I 1999-2000 para 15. For a subsequent discussion of the contributory principle see, Lewis Williams, “Fair rewards of just deserts? The present and future of the contributory principle in the UK”, *Benefits* vol.17 no.2 2009 pp159-69.

³² “Integrating income tax and social security”, in Cedric Sandford (ed.), *More Key Issues in Tax Reform*, 1995 p26

In answer to an earlier question from Mr Wainwright, Mr Regan observed, “the great majority of our fellow citizens believe that there is a direct relationship between what they pay and what eventually they get out of it at the end of the day as of right without the proof required for means-tested benefits, and that is something which people value.”³³

On this theme, quite often constituents will raise the possibility of getting their ‘surplus’ contributions rebated, posing the question: once someone has met the contributory conditions to receive a full state pension, why should they continue to pay NICs on their earnings until they reach state pension age?

There are two answers to this question – the first focusing on the range of contributory benefits that exist, the second looking more widely at the wider principles which underpin National Insurance.

First, NICs do not only give entitlement to the State Pension. Other NI benefits, such as contributory Employment and Support Allowance and contribution-based Jobseeker’s Allowance use a contribution test which shows recent attachment to the labour market – namely that you must have contributed in each of the last two tax years before the benefit year in which you claim.³⁴

Second, this type of complaint would carry more force if the National Insurance system was a classic insurance system, structured in the same way as a private pension, where the value of a person’s benefits relied wholly and exclusively on the size of their payments into the fund. In this sense one could talk of NICs which one ‘loses’, or do not ‘count’, if paid after the point of reaching the contributory conditions for a full state pension. But, as discussed, even from the time of Beveridge, the NI system has not been structured in this way. The ‘pay as you go’ principle underpinning NI was set out clearly as part of an answer to a recent PQ:

The National Insurance scheme operates on a ‘pay-as-you-go’ basis. This means that today’s contributors are paying for today’s social security entitlements and pensions, and those paying contributions previously were paying for the pensioners of that time. Contributors do not accumulate an individual pension fund of actual monies they have paid which is personal to them. Instead, payment of contributions entitles them or, in certain circumstances, their spouses or civil partners to a range of social security benefits which are available on the basis of the rules applicable at the time of the claim.³⁵

As a system of *social* insurance, National Insurance then balances the ability of those of working age to pay against the entitlement of those whose working lives are over to be afforded protection by the State – in this transfer between generations. So, in the case of someone working now, while one will go on making payments which fund pensions for pensioners now, the system offers one the guarantee that the next

³³ Treasury and Civil Service Select Committee: *Structure of personal income taxation & income support - Minutes of Evidence 23 June 1982*, 11 May 1983 HC 331-viii 1981-82 Qs 839-841 pp 398-9

³⁴ There is more detail on the contributory conditions for these benefits on the [Citizens Advice site](#).

³⁵ [HL Deb 3 December 2013 c40WA](#)

generation of earners will do as much for oneself, when one comes to retirement.

Finally, as noted above, one part of all NICs paid do not go into the Fund to pay for contributory benefits, but go direct to the National Health Service. In this respect, paying NICs up until one reaches state pension age is a reflection of the communal responsibilities we have assumed, as a country, to prevent health care being means-tested, or prey to the vagaries of private insurance.³⁶

One observation may be made here about the appeal of the contributory approach as a method for social security provision; as the authors of the standard text, *The Law of Social Security*, comment, “the popularity of [this approach] rests on its psychological appeal”:

People are prepared to subscribe more by way of contributions, which they see as offering returns in the form of personal and family security, than they would be willing to pay by taxation, which might be diverted to a wide variety of uses. They are led to believe that because of their contributions to the scheme they are participating in its administration and may thus exercise political control over its development.³⁷

In a qualitative study of perceptions of the NI system published by the Department of Social Security in 1998, the author found that although the respondents lacked detailed knowledge of the benefits system, in their responses they were strongly committed to the contributory principle, believing that “contributors had a ‘right’ to insurance benefits, because the act of contributing legitimated claims for benefit.”

Nonetheless those interviewed usually saw no distinction between NI and taxes:

Generally, the respondents saw no real distinction between paying national insurance and tax. This was partly because they only looked at their net salaries, and not at the breakdown of any deductions. Indeed, some, typically employee earner respondents, said they did not know how much they paid in national insurance. It also partly reflected many respondents’ belief that the National Insurance Fund had only a notional existence. That whilst in practice there was a separate fund they saw national insurance contributions as part of the wider tax revenues collected by government. They believed that in practice there was just one ‘coffer’ or ‘main pot’ into which national insurance contributions and tax revenues were paid to fund all government expenditure.

A few respondents in one of the groups thought that the distinction between the two was merely for presentational reasons, in that it allowed governments to levy a lower rate of income tax than if there was no national insurance. At the same time ... payment of national insurance contributions was seen as important in legitimating a person’s right to claim insurance benefits.

Generally, the respondents were unsure about which benefits were funded from national insurance. When asked ‘what do national insurance contributions pay for?’ respondents in all of the

³⁶ This issue is explored in relation to the contributory conditions for the new State Pension in, [Pensions 2015, Commons Briefing Paper 7202](#), 27 May 2015 pp29-30.

³⁷ Ogus, Barendt & Wikeley, *The Law of Social Security*, 5th edition 2002 p29

groups said hospitals or the health service. Respondents in most of the groups also identified state pensions and, what was usually called, '*sickness pay*' as being funded by national insurance. Only one group mentioned, unprompted, unemployment as a risk covered by national insurance; it was also this group which was the only one to identify '*maternity benefit*' as a contributory benefit.³⁸

Many commentators have argued that NICs are poorly understood by the general public, despite the amount of money they raise:

John Whiting ... a tax partner at PricewaterhouseCoopers ... has a question that he tries out on people at parties when they talk to him about the tax system. "I ask them what the second biggest tax is, after income tax," he says. "People flounder. They suggest value-added tax and you shake your head. They suggest corporation tax. Wrong again. Then they start the wilder guesses and suggest petrol duties. They rarely come up with the correct answer, which is national insurance contributions." NICs are, in the words of Peter Bickley, technical manager at the Tax Faculty of the Institute of Chartered Accountants in England and Wales, "the Cinderella of taxes". They are the unseen tax. They are a dream come true for Chancellors of the Exchequer. They are a tax that ordinary people, by and large, have not noticed.³⁹

A standard guide to the tax notes that "very many people know little about [the tax]", though the two increases in rates in 2003 & 2011 could have had an impact on public perceptions:

Just over a century ago, David Lloyd George stood before Parliament and introduced to the honourable members the novel concept of National Insurance. Anticipating a hostile response to the new levy, however, he described his contribution scheme as nothing more than a 'temporary expedient' and he hastened to assure the House that it was something which would 'at no distant date' become 'unnecessary'. Ironically, Lloyd George's 'temporary expedient' has now achieved a permanence even greater than that of income tax (another 'temporary' measure, but one which, unlike National Insurance, requires an annual Finance Act to revive it), and has established itself as, with some regulatory, the State's second largest source of income ahead of Value Added Tax ...

It is a curious fact ... that despite the size and permanence of this levy, very many people know little about it. Even those who have the task of advising others of their financial responsibilities to the State – accountants, solicitors, business consultants and the like – have (until more recent times) treated it with a disregard that they would not dream of according to any other of Parliament's taxation measures; and they have done so, it seems, in the belief that it cannot 'bite' in the way that other taxes can ... The increase in the working population's National Insurance contributions by 1% from 6 April 2003 made people far more aware of the existence of this form of taxation ... The further universal increase of 1% introduced from 6 April 2011 should have increased awareness.⁴⁰

³⁸ B.Stafford, *National Insurance and the Contributory Principle: DSS In House Report 39*, 1998 p40, pp18-19

³⁹ "A vital contribution", *Financial Times*, 11 April 2002

⁴⁰ *Tolley's National Insurance contributions 2014/15* paras 1.1-2.

19 National Insurance contributions: an introduction

In February 2014 Ben Gummer MP introduced a Ten Minute Rule Bill to rename NICs as 'Earnings Tax', on the grounds that "National Insurance is now a tax", although this was not how it was "universally perceived", because "the fiction of contributions consists." Mr Gummer argued that the NI Fund could be merged "into general Government funds, which would save administration costs", and that these changes would be "an important move in being clearer, simpler and more transparent about how our constituents are taxed, on what and where it is spent." However, as with Ten Minute Rule Bills [generally](#), Mr Gummer's Bill made no further Parliamentary progress.⁴¹

⁴¹ [HC Deb 25 February 2014 cc165-6](#)

4. Integrating NICs & income tax

4.1 The 1998 Taylor Report

Following the 1997 General Election, the then Chancellor Gordon Brown set up a Task Force, chaired by Martin Taylor then chief executive of Barclays Bank, in line with the Labour party's manifesto commitment to "examine the interaction of the tax and benefits systems so that they can be streamlined and modernised, so as to fulfil our objectives of promoting work incentives, reducing poverty and welfare dependency, and strengthening community and family life."⁴²

In his report, published alongside the March 1998 Budget, Mr Taylor made the general case for reforming the tax system to improve the benefits of work for those on low incomes.⁴³ With respect to NI, the report led to changes in the rates and the base of NICs for employers and employees and in the rate of contributions paid by the self employed.

Mr Taylor argued that the schedule of rates for both primary and secondary Class 1 NICs seriously distorted the labour market. To illustrate this argument the report summarised the structure of Class 1 NICs in 1998/99:

If an employee earns over the lower earnings limit (£64 a week in 1998-99), he or she pays NICs at a rate of 2 per cent on earnings up to the lower earnings limit (LEL) [known as the 'entry fee'] and 10 per cent on earnings over the LEL subject to a cap at the upper earnings limit (UEL) of £485 a week. Employees contracted out of the state earnings related pension scheme (SERPS) receive a rebate of 1.6 per cent on earnings between the LEL and UEL, ie a reduction in the rate of national insurance they pay ...

Employers pay a uniform rate of NICs on all earnings for employees earning above the LEL. The rate paid depends on the earnings of the employee as set out below:

- £64 - £110 3%
- £110 - £155 5%
- £155 - £210 7%
- £210 and over 10%
- For those contracted out of SERPS, employers receive a 3 per cent rebate on earnings between the LEL and UEL.

With employer NICs, entry into each new band triggers the application of the higher rate to all earnings (unlike in income tax where the tax rate only applies to income in excess of any threshold). The result is that for employers there are steps not just at the LEL but at the three other thresholds.⁴⁴

He argued that these steps in both primary and secondary Class 1 NICs had negative effects – especially in relation to employers' administrative costs – and that the step at the LEL imposed high marginal tax rates on

⁴² HM Treasury press notice 47/97, 19 May 1997; Labour Party, *New Labour: because Britain deserves better*, April 1997 pp12-13

⁴³ HM Treasury, [Work incentives: a report by Martin Taylor, March 1998](#)

⁴⁴ *op.cit.* pp11-12. The State Earnings Related Pension Scheme (SERPS) was the predecessor of the state second pension.

those on low incomes. Mr Taylor recommended a number of changes to the structure of the tax:

- the introduction of a single flat rate of employer NICs
- the abolition of the 'entry fee' for employer and employee NICs
- aligning the lower earnings limit for employer and employee NICs with the single person's income tax allowance (provided that the rules on contributory benefits were amended to prevent significant loss of employees' benefit entitlement).

In his March 1998 Budget speech Gordon Brown announced that he had accepted this programme for a "simpler, fairer and more employment-friendly national insurance system."⁴⁵

Over the following three years each of these proposals was implemented. The changes in employer NICs were made in April 1999, whereas the changes in employee NICs were made in two steps in April 2000 and April 2001. In his March 1999 Budget the Chancellor also announced that the UEL would be increased in two steps, in line with these increases in the LEL, to £535 per week from April 2000, and £575 per week from April 2001.⁴⁶

In his report Martin Taylor had argued that the lack of alignment between NI and income tax was a cause for concern, particularly as employers were faced with separately recording and accounting for two sorts of NICs as well as income tax. He suggested that the NICs coverage of benefits in kind should be extended, although he did not advocate the much wider change supported by some employers – full integration of NICs and income tax:

At present, benefits in kind are not subject to NICs, other than the employer-only Class 1A charge on company cars and car fuel. This gives employers an advantage in offering benefits in kind, so reducing the NICs yield and distorting competition. However, it does not look straightforward to value benefits in kind, at least on anything like the income tax rules, on the current NICs pay period basis. So a full employee and employer NICs charge may not be easy for employers to handle. The pragmatic solution may be to extend, perhaps at a higher NICs rate, the Class 1A employer-only charge ...

Some employers and representative bodies have in the past argued that NICs should be completely merged with income tax. This would save them the work of separately recording and accounting for two sorts of NICs as well as tax. This is an understandable suggestion, particularly for small employers who face relatively high unit costs for operating PAYE and NICs. However, full integration of employee NICs would require a substantially higher, basic rate of income tax. This could have very large redistributive effects, particularly if this higher rate were applied to other sources of income, such as pensions ... Full integration would also mean a complete redefinition of the contributory principle for short term benefits and for pensions. It seems more worthwhile to focus on changes which would reduce

⁴⁵ HC Deb 18 March 1998 c1104

⁴⁶ *Budget 99* HC 298 March 1999 p102. Historically the UEL for NICs has been between 6½ and 7½ times the earnings point at which NICs first become payable.

the disincentives in the NICs system without raising such major policy questions.⁴⁷

These conclusions were echoed in a major study of employers' tax compliance costs, carried out by the Centre for Fiscal Studies at the University of Bath. It found that, "some employers found it frustrating and costly that treatment of benefits is not consistent across PAYE and NI" and recommended that, "the treatment of benefits in kind should be common across PAYE and NI Class 1A contributions."⁴⁸

In his March 1999 Budget speech the Chancellor confirmed that the Government would introduce legislation to extend Class 1A NICs to all taxable benefits in kind not already subject to NICs, such as private medical insurance, beneficial loans and assets transferred to the employee.⁴⁹ The Government took the position that the revenue raised from this change facilitated the wider changes in NI mentioned above:

Not levying NICs on these benefits means NIC rates elsewhere in the system have to be higher. Since this Government's major objective as far as national insurance is concerned is to make it fairer, and to structure it so that it does not discourage work, the revenue from NICs on benefits in kind has been put to very good use, cutting NIC rates for low earners and improving work incentives.⁵⁰

Legislation was included in the *Child Support, Pensions and Social Security Act 2000*.⁵¹ Following the scrutiny of these provisions in Committee,⁵² the Government announced in Budget 2000 that an exception would be made for childcare benefits in kind: all forms of childcare provision would remain exempt from employers' NICs.⁵³

In addition, a new class of employer NICs – Class 1B contributions – was introduced in April 1999. This had been recommended by a working group set up under the Conservative Government's deregulation initiative, to find changes to the definitions of income (for tax) and earnings (for NICs) which would cut employers' costs and make it easier for them to meet their obligations in the administration of both.⁵⁴

Although the Government rejected this group's recommendation for full integration,⁵⁵ it accepted the principle of closer alignment between the rules for each charge: in particular, the introduction of 'annual voluntary settlements' for NICs. Under these agreements employers have been able to settle the income tax liability on certain benefits in kind and for expenses in a single payment, thereby avoiding having to reach a

⁴⁷ *Work incentives: a report by Martin Taylor*, March 1998 p14, p13

⁴⁸ *The Tax Compliance Costs for Employers of PAYE and National Insurance in 1995-96: Inland Revenue Economic Papers No.3*, 1998 p87

⁴⁹ HC Deb 9 March 1999 c187. Prior to this, a series of changes were made to the coverage of employer NICs in relation to benefits in kind over the period 1991-96 (HC Deb 11 February 1997 c172W).

⁵⁰ HM Treasury Budget press notice HMT9, 9 March 1999

⁵¹ specifically s74 of the *Child Support, Pensions and Social Security Act 2000*, and the *Social Security (Contributions) (Amendment No.8) Regulations Order SI 2000/2207*.

⁵² SC Deb (F) 29 February – 2 March 2000 cc658-690

⁵³ Inland Revenue Budget press notice REV9, 21 March 2000

⁵⁴ DSS, *Deregulation Review: Report of the Tax/NICs working group*, 1993

⁵⁵ *Deregulation Task Forces Proposals for Reform*, January 1994 para 350; *Business Deregulation Task Forces Proposals for Reform: Update*, November 1995 para 350

separate settlement for each individual employee. The rules for these payments were revised in 1996, and renamed PAYE Settlement Agreements (PSAs).⁵⁶ Following consultation,⁵⁷ the Labour Government introduced legislation as part of the *Social Security Act 1998* to introduce a new class of NI contribution - Class 1B - payable in circumstances where a PSA has been agreed, from April 1999.⁵⁸

Finally, in Budget 2000 the Labour Government announced that it intended simplifying some aspects of NICs "that create complexity and worry for employers and their payroll administrators."⁵⁹ Following a consultation exercise, a number of minor measures to improve the administration of NICs, as well as that of statutory sick pay and statutory maternity pay were introduced in 2004.⁶⁰

4.2 The case for and against integration

For some years it has been argued that with the erosion of the contributory principle, the NI system merely represents an administrative burden for employers and that NICs should be integrated with income tax. However, there are two significant obstacles to full integration: the redefinition of the contributory principle, and the implications for taxpayers for whom earnings form a relatively small or insignificant part of their taxable income (primarily pensioners, but also those who enjoy income from interest, rents or dividends).

In March 1986 the Conservative Government published a green paper on personal taxation. In publishing the paper, the then Chancellor Nigel Lawson sought to reinvigorate the debate about the tax treatment of marriage, and it led to the introduction of independent taxation in 1990: the system under which all individuals are assessed for tax as separate persons. The green paper also looked at how the tax system might develop in the longer term, and as part of this, the benefits and costs of integrating NICs with income tax. It concluded that there were good grounds for a merger with regard to the administration costs of both charges, but that the costs were too great, particularly in terms of the contributory principle:

In the case of people solely or mainly dependent on investment income, they would be paying for benefits, such as unemployment benefit, which would not be relevant to their circumstances. Tax-paying pensioners would in a sense be asked to pay twice: after a lifetime of paying NICs, they would then have to pay contributions towards benefits which they thought they had earned as of right on the basis of their earlier contributions record. This kind of anomaly would tend to weaken the link between contributions and entitlement and thus undermine the contributory principle ...

⁵⁶ under s 110 of the *Finance Act 1996*

⁵⁷ Inland Revenue, *Proposed Changes to Align NICs with Inland Revenue Treatment of Tax under PAYE*, 1996 (DEP 3/2743)

⁵⁸ specifically s 53 of the *Social Security Act 1998*

⁵⁹ Inland Revenue Budget press notice REV10, *Helping to get it right*, 21 March 2000

⁶⁰ under the *National Insurance Contributions and Statutory Payments Act 2004*

A combined charge replacing both income tax and employees' NICs could lead to reductions in administrative costs. The size of these would depend on the precise scope and nature of the new charge, and on the form taken by any new qualifying entitlements test. To the extent that the new charge was not extended to all income and/or differentiation was introduced into it the benefits of administrative simplification would be reduced.

A combined charge could have benefits for employers, especially small employers. It would simplify the calculations which have to be made separately at present. The increasing use of computers and hand calculators for payroll work, however, and their declining cost may well mean that the complexity of the present arrangements will increasingly impose less and less of a burden even on small employers.

Against the benefits must be weighed the major distributional effects of such a change, the need to find a satisfactory way of upholding the contributory principle and the need for a new separate charge for employers' NICs. The Government's view is that the benefits of a combined charge would be unlikely to justify the ensuing upheaval.⁶¹

Nigel Lawson identified another downside to integration: the combined impact of income tax and NI rates had on marginal tax rates as incomes rose. To illustrate this, one can use the tax schedule as it operated in 2007/08. In that year, employees were charged NICs at 11% on earnings between the primary threshold – set at £100 a week – and the upper earnings limit (UEL) – set at £670 a week. NICs was charged at 1% on earnings above the UEL. The marginal rate of deduction faced by employees – combining income tax and NICs – was:⁶²

Earnings (£ per week)	Marginal rate
£100 - £143	21%
£143 - £670	33%
£670 - £766	23%
Above £766	41%

Eliminating this 'kink' by abolishing NICs would hit some taxpayers particularly hard – particularly those with incomes close to the top of the basic rate band.⁶³ In his memoirs Lord Lawson, called this dilemma the 'elephant trap', citing it as the main reason why he left the UEL unchanged. Some years later, in 2009, the UEL was aligned with the higher rate threshold, removing this 'kink' - this is discussed below. However, the obstacles to full-scale integration remain considerable.

In his memoirs Lord Lawson also refers to the possibility – discussed at that time – of abolishing the UEL, but without allowing contributions above it to confer any additional benefit entitlement. "This somewhat bizarre arrangement," Mr Lawson argues, "would have solved one

⁶¹ HM Treasury, *The Reform of Personal Taxation*, Cmnd 9756, March 1986 pp 39-40

⁶² Taking account of the basic personal allowance – which is £5,225 for 2007/08 – employees are charged income tax at: 10% on earnings between £100 and £143 a week; 22% on earnings between £143 and £766 a week; and 40% on earnings above £766 a week. The figures ignore the impact of tax credits.

⁶³ The distributional effects from raising or abolishing the UEL were discussed in [The IFS Green Budget, January 2002](#) pp62-68.

problem only to create another. For 'contributions' above the [UEL] would become a straight-forward tax, risking undermining the contributory principle and leading to increased pressure to assimilate employees' NICs into income tax altogether."⁶⁴

Abolishing the UEL could well have political costs as well. Many have suggested that a factor in the Labour Party's defeat in the 1992 general election was their manifesto pledge to abolish the UEL.⁶⁵ In that year the Institute for Fiscal Studies reviewed the case for integration, suggesting that if implemented, "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" but that the political objections to this reform were considerable: specifically the impact on the contributory principle "and the prospect of large losses among middle-to-high earners."⁶⁶

One solution to the first of these obstacles would be "that NICs could simply be grafted on to the income tax system with no change in the relationship between contributions and benefits." To prevent pensioners being adversely hit, the authorities would apply only the income tax component of a combined rate to the income of pensioners. On the second obstacle to reform – the 'elephant trap' – the noted that the numbers of taxpayers who benefited from the kink "has fluctuated greatly in recent years, from just under one million in 1981/82 to more than two-and-a-half million in 1989/90":

This fluctuation has arisen from variations in the rate at which the UEL and the higher rate threshold have been uprated. The UEL, whose value is linked to that of the basic state pension, has been price indexed for most of the 1980s. Given that earnings typically grow faster than prices, the number with earnings in excess of the UEL would thus tend to increase. This phenomenon accounts for most of the rise in the numbers between 1981-82 and 1989-90. However, the threshold at which higher rate tax becomes payable has on some occasions been frozen or under-indexed. This has tended to increase the number of higher rate taxpayers, and thereby reduce the numbers in the 'gap' between the UEL and the higher rate threshold. This accounts for ... falls [in this number seen] in 1981-82, 1991-92 and 1992-93.

The authors presented some estimates of the distributional impact of integrating NICs and income tax, noting that the losses faced by taxpayers from raising the UEL to the higher rate threshold could be mitigated by reductions in the basic rate of tax – an approach which, in their opinion, would "avoid a torrent of opposition of the sort which faced the opposition parties who in June 1992 proposed the immediate abolition of the UEL."⁶⁷

As noted above, in April 2003 the rates of NICs for employees, employers and the self employed were all increased by 1 percentage

⁶⁴ Nigel Lawson, *The View From No 11*, 1992 p827

⁶⁵ David Butler & Dennis Kavanagh, *The British general election of 1992*, 1992 pp 267-8; Anthony King et al., *Britain at the polls 1992*, 1993 pp205-7

⁶⁶ "Income tax and national insurance: better together?" in [Tax Reform for the Fourth Term, October 1992](#) p124

⁶⁷ [Tax Reform for the Fourth Term](#), October 1992 pp 113-4, p107, p124

point, to fund a substantial increase in public health spending – a change announced in the 2002 Budget. In their 2003 Green Budget the IFS noted that in its manifesto for the general election in June 2001 the Labour party had made a commitment not to raise the rates of income tax but no such commitment in respect of NICs, prompting the question, “why did Labour feel impelled to make a pledge in respect of one but not the other?”:

From a purely economic perspective, it makes little sense to be implacably opposed to a percentage point increase in the basic and higher rates of income tax, but at the same time to have no objection to a National Insurance increase with similar effects over most of the income distribution. The trend towards increased levels of NICs coupled with lower rates of income tax began almost thirty years ago and shows no sign of abating ...

On economic grounds, it would seem sensible in many ways to aim towards a complete integration of the income tax and NI systems. This would offer the advantages of transparency and administrative efficiency with few apparent drawbacks. The original rationale for separate systems – the ‘contributory principle’ underlying the NI system – is all but obsolete ... Nor do the other remaining differences between income tax and NI provide a strong justification for maintaining separate systems. Lower rates of taxation on unearned income and on self-employment income create a distortion in favour of these income sources, which is probably undesirable.

Yet even if the government wishes to retain either or both of these anomalies, it would still be possible to do so within the income tax system (to have a lower rate of tax on pension income, for example). If the government believes that payroll taxes have different effects depending on whether they are levied on the employer or the employee, another option would be to integrate employee NI with income tax, leaving NI as a pure employer tax.

Given these arguments, the barrier to full integration of the two systems seems primarily political. Governments appear to believe that raising NICs is likely to be less costly to them in votes than raising income tax. It will be interesting to see if the high-profile increases in NICs due to take effect in April change this political calculus. If they do not, full integration of NI and income tax remains much less likely than further gradual alignment, with equalisation of the UEL and higher-rate threshold perhaps the obvious next step.⁶⁸

These observations have proved prescient. In the 2006 Budget the Government announced that it would consult a review of the case for further aligning the administration of income tax and NICs.⁶⁹ This was published alongside the 2007 Pre Budget Report (PBR): its conclusion – that the benefits of aligning the two charges did not outweigh the costs. In the 2007 Budget the then Chancellor Gordon Brown had announced several significant changes to personal taxation: a cut in the basic rate of income tax from 22% to 20%, abolishing the 10% starting rate from April 2008, and equalizing the UEL with the higher rate

⁶⁸ Institute for Fiscal Studies, [The 2003 Green Budget, January 2003 pp 62-63](#)

⁶⁹ *Budget 2006*, HC 968 March 2006 para 5.87

threshold from April 2009.⁷⁰ (The decision in May 2008 to increase the personal allowance for the 2008/09 tax year, as compensation for the withdrawal of the 10% rate, meant that NICs and income tax were no longer aligned at the point when individuals *start* to pay each tax. Subsequent changes to these thresholds have not resulted in their being realigned.) At the time the IFS welcomed these changes as “welcome simplifications” though noted that “they raise the question of whether a much greater simplification could be achieved by fully integrating income tax and National Insurance.”⁷¹

When the Treasury Committee took evidence on the 2007 Budget, John McFall, then Chairman, asked John Whiting at PricewaterhouseCoopers if the alignment of the UEL with the higher rate threshold meant that “the distinction between the National Insurance and the taxation system is now all but meaningless?” Mr Whiting replied:

In terms of the calculation of how much you should pay under each, no, it is not meaningless because the core figure on which you charge income tax and National Insurance is still different. The prime example of that is contributions to a pension fund which, of course, are deductible for income tax but not for National Insurance. What we do get is still differences in the base to which the two calculations are applied. Although employers have always argued and called for a combination of the two levies, that may be extremely difficult to achieve politically and structurally in terms of the contributory nature of National Insurance, although it should be achievable. There is still some bringing together possible of the exact base on which the two levies are charged.

When asked whether there was a case for integration, Mr Whiting said:

I would say that there is probably a lot to be said for combining the two ... One accepts that there is probably a necessity for a payroll tax on employers, which is what employers' National Insurance is, but if one swept away the contributory principle and just had done there would be scope for simplification, but I realise I am straying into quite a minefield here.

Picking up on this last point Dr Martin Weale, at the National Institute of Economic & Social Research, said: “It seems to me the main reason for keeping National Insurance separate from income tax is that the Chancellor can say to people, “There is a standard 20p rate of tax” and forget about the employers' and employees' NICs ... Politically it follows the Colbertian principle of plucking as much as you can from the goose without it squawking.”⁷²

⁷⁰ *Pre-Budget Report*, Cm 7227 October 2007 paras 5.74-7; *Budget 2007*, HC 342 March 2007 paras 5.5-6. The *National Insurance Contributions Act 2008* aligned the UEL with the basic rate threshold. Two Library papers give more details: [RP 07/88, 11 December 2007](#) & [RP 08/07, 24 January 2008](#).

⁷¹ IFS press notice, *Analysis of the Budget 2007*, 21 March 2007

⁷² *Fifth report: The 2007 Budget, 23 April 2007 HC 389-II* 2006-07 Ev10 Qs57-9. Mr Weale is referring to Jean-Baptiste Colbert, the 17th century French finance minister, who said, “The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing.”

4.3 The 2007 review on further alignment

As mentioned, in the 2006 Budget the Labour Government announced that it would review the case for further alignment between NICs and income tax. This was completed in October 2007. The review focused on the proposal that NICs should operate more like tax, by being moved onto an annual basis and being collected cumulatively. It concluded that potential savings for employers would be lower than might have been expected, there would be mixed outcomes for lower-paid individuals, and alignment would come at a high Exchequer cost.

At the outset the authors underlined that they had taken “the current policy framework as a given, namely that each system serves a different purpose, with NICs providing entitlement to contributory benefits. Therefore *[the review] has not looked at merging income tax and NICs into one charge.*”⁷³ One commentator in the *Tax Journal* commented that “the absence of any appetite for radical change is, one assumes, due to the feared political fallout if the voting population begins to equate NIC with being a real tax”:

The alignment of income tax and NIC would be a huge and complex undertaking for any Government and it would be unfair to single out this Government as not being willing to rewrite the appropriate legislation ‘from the ground up’; it is following precedent.⁷⁴ A question that I would like to raise, though, is why the prospect of alignment continues to be held out when, in fact, occasional tinkering is all that is really intended. Whilst I do not dispute the findings of the latest paper, I suggest that it does not address the key matter that needs to be aired: whether an alignment of income tax and NIC is feasible.⁷⁵

Another commentator writing in *Taxation* was more positive:

The ... possibility of aligning National Insurance and PAYE for employers ... has long been a favourite topic in Budget representations and ... HMRC have done some very detailed work on exactly what such an alignment would entail. Perhaps surprisingly, the conclusion is that there would not in fact be many administrative savings from such an alignment and that in some cases the administrative burden would actually increase. So the recommendation is that there should be no such alignment.

I have not really had a chance to evaluate the evidence yet and want to reserve my judgment on the outcome, but I applaud the openness of HMRC in publishing the research. In the past I fear we would have been fobbed off by a statement to the effect that ‘we have looked at it and it would not work’. That would have satisfied nobody and would have led to all sorts of suspicions about what the research actually said. But now the evidence is there, laid out for all to see. This must be the way forward.⁷⁶

The review estimated that, for employers, the maximum savings from making NICs annual and cumulative would be “around 4.5 per cent of

⁷³ HM Treasury, [Income tax and national insurance alignment: an evidence-based assessment](#), October 2007 p3 *Emphasis added*.

⁷⁴ [Earlier in his piece the author noted that the integration of tax and NICs had been considered, and rejected, in both the 1986 green paper on personal taxation and the Taylor review of work incentives.]

⁷⁵ “Much ado about nothing?”, *Tax Journal*, 19 November 2007

⁷⁶ “Crushing the burden”, *Taxation*, 25 October 2007

the costs of operating the payroll taxes by 2012, which is the earliest year by which changes could be introduced”:

These savings would vary between different employers, and would be significantly greater for those employers using manual payroll processes rather than payroll software or outsourcing their payroll ... The level of potential savings is also expected to fall further over coming years, as the number of those employers using manual payroll processes continues to decline: from perhaps 210,000 at present, it is estimated that this number will have fallen to between 25,000 and 100,000 by 2012.

This translates to a reduction in estimated savings from between £40 million and £56 million now, to between £4 million and £34 million in 2012, assuming current trends persist. In addition there would be one-off transitional costs of around £200 million but could range from between £150 million to £250 million.⁷⁷

This reform would also have implications for individuals:

At present, individuals' contributions and benefit entitlement are determined on the basis of their earnings in each pay period in each employment. Under an annual system, NICs would be calculated on the basis of an annual NICs-free allowance, equivalent to 52 times the current weekly Primary Threshold (PT). Similarly, the basis for calculating the earnings factor that determines benefit entitlement would be calculated differently. Earnings across employments would also be aggregated, meaning that individuals no longer received the benefit of a separate PT in each employment. The UEL would apply across annual pay, and not when pay reached the limit in individual earnings periods.⁷⁸

The review looked at the impact on three groups of employees: those working for just part of the year, those with fluctuating earnings, and those with more than one job:

Working for part of the tax year

In an annual and cumulative system, employees would no longer have a PT for each pay period. Instead, there would be an annual NICs-free 'allowance', similar to the personal allowance for tax. This would mean that individuals working for part of the year would receive the full benefit of their annual allowance; such individuals would therefore pay less NICs under an annual system than at present. An estimated five million people would benefit from this each year, with an average annual saving per person of around £120.

Fluctuating earnings

The introduction of an annual UEL, rather than a UEL in each earnings period would also mean some individuals paying additional NICs. Those whose annual earnings are between the LEL and UEL, but who receive earnings in one or some earnings periods over the UEL (for example as a result of overtime or bonus payments) would no longer pay NICs at 1 per cent on those earnings above the UEL in certain pay periods. Instead, NICs would be charged upon these earnings at 11 per cent. It is estimated that around 400,000 individuals would pay an extra £200 on average each year in NICs as a result of this change.

⁷⁷ *Income tax and national insurance alignment*, October 2007 p3, p44

⁷⁸ *op.cit.* p45

At present, employees' total pay in earnings periods in which earnings have met or exceeded the LEL contributes to their earnings factor. If NICs were made annual and cumulative, however, all earnings could count towards the earnings factor. This could allow around 250,000 individuals each year to improve their earnings factors sufficiently for them to reach the qualifying earnings factor, so accruing a year of entitlement to basic State Pension, when they would not have done so under the current system. However, the White Paper on pensions: Security in Retirement includes proposals to make it easier for people with incomplete NICs records to obtain a full State Pension. It is expected that around 90 per cent of people in the UK reaching pension age in 2025 will receive a full State Pension. This means that it is less likely that particular individuals would gain from all of their earnings counting towards the earnings factor.

More than one job

Annualising the PT would, as set out above, reduce the amount of NICs paid by those employees who work for part of the year. However, while these individuals would gain from receiving an allowance for the full year, those with more than one job would no longer be able to receive several allowances, as they can at present. This is because NICs are currently calculated in each job, with no aggregation of earnings across jobs.⁷⁹ It is estimated that around 600,000 individuals who work in more than one job would pay more NICs as a result of this change. The average increase in NICs would be £300 per year, but some individuals could pay up to £550 per year extra, with no change in their benefit entitlement position. Of the 600,000 people who work in more than one job, the majority already build up entitlement to contributory benefits because they earn above the Lower Earnings Limit in one of their jobs. If all earnings from each job counted towards benefit entitlement, around 20,000 employees would be brought into the benefit system and would start to build up benefit entitlement.⁸⁰

Taking these together, the review estimated that approximately 5 million people would save an average of £120 per year in NICs but 1 million individuals, including some low earners, would pay up to £550 more NICs per year.

Finally there would be an Exchequer cost to this reform:

A significant number of individuals would gain from the introduction of an annual NICs 'allowance', in place of the PT for each pay period. These gains would have a substantial cost to the Exchequer, estimated at around £600 million. While there would be some yield from those individuals who would pay increased levels of NICs, the net effect on the Exchequer of making NICs annual and cumulative would be a cost to the public purse of £340 million.⁸¹

Although the Labour Government ruled out formal integration, the review identified a number of areas "to reduce administrative burdens by between £14 million and £21 million through changing the way

⁷⁹ Unless jobs are with the same employer or employers who carry on business in association with each other – in which case the jobs are treated as one and earnings are aggregated.

⁸⁰ *Income tax and national insurance alignment*, October 2007 pp 45-6

⁸¹ *op.cit.* p47

benefits in kind and expenses are reported, removing the end of year reporting process and dealing with all payments of earnings, expenses or benefits in kind in a single payroll process.” In October 2007 HMRC confirmed it would:

- consult with business, in the autumn, on how best to improve guidance on tax and NICs to ensure it more closely meets business needs;
- issue a consultation document in November 2007 on how best to introduce a system to tax benefits in kind and expenses through the payroll; and
- consult, in the autumn, on ways of improving the processes for collecting Classes 2 and 4 NICs from the self-employed.⁸²

There have been some developments in each of these areas. Following consultation, HMRC completed a survey in mid-2009 of the small number of businesses who chose to collect benefits and expenses through the payroll, to inform any wider change in the rules.⁸³ In March 2008 HMRC reviewed the way the self-employed paid NICs, and from April 2011 the payment dates for Class 2 NICs were aligned with income tax self-assessment (ie, 31 January & 31 July each year).⁸⁴ In 2013 the Coalition Government consulted on using self assessment to collect Class 2 NICs alongside income tax and Class 4 NICs,⁸⁵ and this is to be introduced from April 2016.⁸⁶

4.4 The 2010 Mirrlees Review

In November 2010 the Institute for Fiscal Studies published the conclusions of a review of the UK’s tax system chaired by the Nobel laureate Sir James Mirrlees.⁸⁷ Among its many recommendations the review argued that income tax and NICs should be merged, and some of its analysis is reproduced below. It should be emphasized that one of the review’s central arguments was that the tax system should be considered as a *whole*, and that policymakers should consider how individual taxes interacted with each other and with the benefits system.

The review rehearsed many of the criticisms that have been made of the system of NI in recent years – such as the administrative burden and compliance costs created by having two separate taxes on earnings – but it went on to make a wider criticism about transparency: “National Insurance is not a true social insurance scheme; it is just another tax on earnings, and the current system invites politicians to play games with NICs without acknowledging that these are essentially part of the

⁸² *op.cit.* p52. See also, *Pre-Budget Report*, Cm 7227 October 2007 pp 62-3, p68

⁸³ [Including Benefits in Kind and Expense Payments in the Payroll - A Fresh Approach](#), 13 December 2007

⁸⁴ Under SI 2011/797 – see also, HMRC, [Impact assessment: improved collection of NICs from the self-employed](#), February 2011.

⁸⁵ *Budget 2013*, HC 1033, March 2013 para 2.42. Details of the consultation are collated [on Gov.uk](#).

⁸⁶ *Budget 2014*, HC 1104, March 2014 para 2.212. Provision for this was made by ss2-3 of the [National Insurance Contributions Act 2015](#).

⁸⁷ IFS press notice, *Mirrlees Review of tax system recommends radical changes*, 10 November 2010. A final version of the report [was published in 2011](#).

taxation of labour income.” As the authors observed, this lack of transparency could be seen in nearly all public debate over the rates of tax individuals pay on their income:

The tax schedule that people actually face on their earnings reflects the combination of income tax and National Insurance contributions (NICs). Transparency requires that it is the combined schedule that should be described and debated. When politicians debate whether the current 20% basic rate, 40% higher rate, and 50% additional rate of income tax are appropriate, people should not have to remind themselves (or be reminded) that the true rate schedule includes NICs on top of that, nor should they have to do the calculations.

It is rare in popular discourse to hear discussion of the 31%, 41%, and 51% rates that (in 2010-11) apply once employee NICs are taken into account, let alone consideration of the effect of employer NICs (or the different rate schedule that applies to the self-employed). Because attention is often restricted to headline income tax rates (which rise from 20% to 40% and then 50% at higher incomes), ignoring NIC rates (which fall from 11% to 1% for employees), the degree of progression towards the top of the distribution is easily overstated.⁸⁸

Further than this, “governments may see the lack of transparency in the current system as a positive rather than a negative”, and the authors cited the case of the General Election in 2001 which preceded the increase in NI rates announced by the Labour Government in its first Budget after being returned to office:

Just one example of the way in which the separation of the systems can lead to confusion (to put it generously) was the Labour Party’s 2001 general election manifesto. This included a pledge not to increase rates of income tax, but contained no such pledge on NICs. Labour was re-elected and, in its first Budget after the election, promptly announced an across-the-board increase in NIC rates.

It is hard to believe that the government had decided after careful deliberation that tax rates on earnings (subject to NICs as well as income tax) should increase but that the tax rate on other income (subject only to income tax) should not, and that the manifesto pledge had been intended to guarantee the latter while leaving open the former.

Such an intention was certainly not made clear to the public during the election campaign. Whether the shortcoming was duplicity, incoherence, or merely poor communication, we should strive to make such episodes unrepeatable.⁸⁹

The authors acknowledged that one serious obstacle to integration would be reforming employer NICs. The choice would be between merging employer NICs into employee NICs and income tax, or levying an equivalent tax on non-employment income. Neither reform would be politically easy:

There is ... a strong case for phasing out the employer contribution altogether ... [but] given where we start, such a transition would be painful. The immediate effect of an overnight

⁸⁸ [Tax by Design, September 2011](#) p482, pp127-8

⁸⁹ *op.cit.* pp 128-9

shift from employer to employee taxes is that take-home pay would fall and employers' profits increase. Earnings would eventually rise to return take-home pay and employer cost to their previous levels, but this could take a long time ...

Income tax and employee NICs could be merged while leaving a separate employer tax in place. But retaining an employer tax has a price beyond simply forgoing part of the benefits of integration. Since it is necessarily confined to employment income, it has consequences for the tax system as a whole.

For example, suppose we wanted to apply the same overall tax schedule to all forms of income, not just employment income—something we will argue for [elsewhere in this review] ... Employment income is currently taxed more heavily than self-employment and capital income (and capital gains), largely because NICs apply only to earnings. For all forms of income to be subject to the same overall rate schedule, NICs or something equivalent to them would have to be extended to other forms of income. It is easy to see how this could be achieved for employee NICs, the scope of which could simply be extended.

The same would apply to employer NICs if they too were brought within a merged tax. But if employer NICs were kept as a separate tax, it could apply only to employment income; so to achieve equal treatment, additional tax equivalent to employer NICs would have to be levied on capital income, self-employment income, and so on. This would add further complexity to the system, and it hardly seems politically appealing either. Whether it is a more attractive prospect than phasing out employer NICs and raising income tax instead is a moot point.⁹⁰

In its analysis of small business taxation, the report mentioned two other arguments for integration: first, the relative burden of NICs on the self-employed, compared with employees ...

Self employed individuals pay significantly lower NICs than employed individuals, particularly when both employer and employee NICs are taken into consideration. This advantage is partially offset by lower entitlements to some state benefits for self-employed individuals. Nevertheless, actuarial estimates suggest that the value of additional social security benefits for a typical employee is substantially lower than the additional cost imposed by these higher NICs.⁹¹

The absence of employer NICs results in slightly higher taxable income and hence personal income tax for the self-employed individual, but the net effect remains a significant inducement for individuals to choose self-employment over employment, in situations where they would otherwise be indifferent.

... and second, the ability of owner-managers of small companies to make considerable tax savings, by avoiding NICs:

The absence of National Insurance contributions on both company profits and company dividends provides opportunities for even greater savings for owner-managers of small companies. By paying themselves a wage below the earnings threshold for National Insurance (and also below the personal allowance for

⁹⁰ *op.cit.* pp131-2

⁹¹ [HMRC estimates the Exchequer cost of reduced NICs for the self-employed not attributable to reduced pensions eligibility to be £2.65 billion in 2014/15. [HMRC Statistics: Main tax expenditures and structural reliefs](#), December 2014.]

income tax), they can avoid any income tax or NICs on this component of their remuneration. By taking the rest of their remuneration in the form of dividend income paid out of company profits, the only tax paid is corporation tax on these profits ...

Moreover, no NICs are charged on dividend income. By taking a substantial share of his remuneration in the form of dividends paid out of company profits, rather than in the form of wages or salary, the owner-manager of a small company can thus enjoy a substantial saving in combined direct tax and National Insurance contributions, relative to both a self-employed individual with an unincorporated business and, still more, relative to an employee.⁹²

The authors acknowledged that in some respects this over-simplifies the picture – “for example, company dividends will generally be paid out less frequently than wages and salaries, which may limit the extent to which some small company proprietors can take advantage of this tax saving” – but, nevertheless “there remains a substantial tax advantage”, and one that has been recognised in the development of anti-avoidance legislation, to prevent this advantage being aggressively exploited:

Whatever one thinks about the economic case for subsidizing particular kinds of small businesses—for example, those that are highly innovative or that have considerable growth potential—it is difficult to rationalize tax advantages on this scale for all small businesses. Evidently, this view underpins the growth of anti-avoidance legislation in the UK.⁹³ However, by tackling symptoms of the problem, rather than addressing the difference in the rates at which labour income and capital income are taxed, the result has been a dramatic increase in the complexity of the legislation covering these aspects of small business taxation, rather than a coherent solution ...

Closer alignment of the taxation of income from employment and self employment could be achieved by increasing the National Insurance contributions paid by self-employed individuals towards the combined level paid by both employers and employees in respect of income from employment. Any difference should reflect only the actuarial value of differences in entitlements to state social security benefits, and these entitlement differences should be limited to benefits where it would be administratively difficult to extend full coverage to the self-employed.⁹⁴

Alternatively, NICs could be integrated with the personal income tax in one of the ways discussed [earlier in this report], and residual elements of the ‘contributory principle’ for state social security benefits be replaced by different entitlement rules, with equal treatments of employed and self employed individuals in so far as this is administratively feasible.⁹⁵

⁹² *op.cit.* pp456-8

⁹³ Crawford and Freedman [[“Small Business Taxation”](#) in, *Dimensions of Tax Design: The Mirrlees Review*, 2010] provide a detailed discussion of various special measures that have been introduced in the UK to limit the extent to which particular types of small companies can exploit these savings.

⁹⁴ For example, this may be difficult where the level of a benefit payment is related to past earnings.

⁹⁵ [Tax by Design, September 2011](#) p462, pp463-4

5. The Coalition Government's approach

5.1 Assessing the case for integration

In its first Budget in June 2010 the Coalition Government announced that it would set up an independent body to review the tax system and make recommendations for its simplification.⁹⁶ The following month the then Exchequer Secretary, David Gauke, announced the establishment of the Office of Tax Simplification. The OTS would undertake two reviews in its first year, looking at the existing structure of tax reliefs and at small business taxation and the specific question of finding a simpler alternative to IR35.⁹⁷ Michael Jack and John Whiting were appointed as the chair and tax director respectively.⁹⁸

Just prior to the 2011 Budget the OTS published reports on both of these issues. In its paper on simplifying the tax system for small business, the OTS argued that combining income tax and NICs would remove a series of anomalies in the tax system which distorted taxpayers' behaviour, and would result in significant administrative simplification. The report acknowledged that there were serious obstacles to full integration, but went on to suggest a number of steps that could be taken to bring the base of each tax into closer alignment:

Consistency in the definition of earnings: e.g. tax and NICs on benefits in kind and reimbursed expenses;

Consistency in the required calculations: this includes aligning thresholds, calculating NICs based on annual and cumulative earnings, and assessing NICs liability on a per person basis rather than per employment;

Reliefs and exemptions on either income tax or NICs: some of these discrepancies have been highlighted in the final report of the OTS review of tax reliefs⁹⁹;

Treatment of pensioners: one of the major issues identified is with the taxation of pensioners, as noted [earlier in the report]. We also believe that any review would also need to cover issues such as the married couples allowances and the age related allowance;

Treatment of self-employment: including examining current differences in NICs between employees and self-employed and recommending potential, costed, methods to align the rates. As noted in Chapter 4, a potential initial step could be to combine Class 2 and Class 4 NICs; and

⁹⁶ *Budget 2010*, HC 61 June 2010 para 1.64

⁹⁷ IR35 refers to anti-avoidance legislation introduced in 2000 to counter the exploitation of one-person companies, channelling income from clients through a company to be taxed on this remuneration as dividends rather than earnings, avoiding NICs. The rules have long been criticised; see, [Personal service companies: introduction of the IR35 rules](#), CBP914, 20 May 2011.

⁹⁸ HC Deb 20 July 2010 c8WS; HC Deb 20 July 2010 cc175-84; HM Treasury press notice 29/10 20 July 2010. Details of the OTS's work is collated [on Gov.uk](#)

⁹⁹ OTS, [Review of tax reliefs; final report](#), 3 March 2011

Treatment of savings and dividend income: these are currently exempt from NIC and the OTS view is that the difference in the treatment to earnings is central to the tax motivation for incorporation and is a major incentive to operate a personal service company. This should be examined in more detail to see whether this income should be taxed at a lower or higher rate than earnings (this should be looked at in conjunction with the treatment of the self-employed, and employer NIC).¹⁰⁰

Although the Coalition Government did not publish a formal response to Mirrlees, the Exchequer Secretary was not enthusiastic when asked about integration in December 2010:

John Stevenson: To ask the Chancellor of the Exchequer whether he has plans to merge income tax and national insurance as a means of tax simplification.

Mr Gauke: The Government aim for a tax system which is more competitive, simpler, greener and fairer, and keeps the system under continual review with a view to meeting these objectives. While national insurance shares some of the characteristics of income tax, it is a system of social insurance which determines entitlement to state pensions and other benefits. Therefore the two cannot easily be merged.¹⁰¹

In the weeks before the 2011 Budget there was some speculation that the Government had changed its position on this issue.¹⁰² In his Budget speech on 23 March the Chancellor, George Osborne, announced a consultation on merging the *operation* of income tax and NICs; the Chancellor went on to make clear that any reforms would *not* result in NICs being extended to other forms of income, or the end of the contributory principle:

For decades, we have operated income tax and national insurance as two fundamentally different taxes and forced businesses large and small to operate two completely different systems of administration, with two different periods and bases of charge. The resulting anomalies are legion, and it imposes totally unnecessary costs and complexity on employers and costs the taxpayer in the extra burden that it places on Her Majesty's Revenue and Customs. So I am announcing today that the Government will consult on merging the operation of national insurance and income tax.

I am not proposing that we extend national insurance to pensioners, or to other forms of income, or that we abolish the contributory principle. Our purpose is not to increase taxes; it is to simplify them, and this huge task will therefore require a great deal of consultation and take a number of years to complete, but it is time we took this historic step to simplify dramatically our tax system and make it fit for the modern age.¹⁰³

¹⁰⁰ [Small business tax review](#), March 2011 paras 3.12-4. The authors noted that the IFS had explored this in more detail: [Integrating Income Tax and National Insurance: an interim report](#), December 2007.

¹⁰¹ HC Deb 21 November 2010 c1144W

¹⁰² "Tax and national insurance merger is mooted", *Financial Times*, 18 March 2011; "Income tax to be merged with National Insurance", *Sunday Times*, 20 March 2011

¹⁰³ HC Deb 23 March 2011 cc954-5

The Budget report simply stated the Government would consult later in 2011 “on the options, stages and timing of reform.”¹⁰⁴

Several commentators pointed out that the Chancellor’s choice of words indicated that any reform would stop well short of a full merger.¹⁰⁵ At the IFS post-Budget briefing James Browne noted that it was not clear exactly what was meant by integrating “the operation” of the two taxes, though the decision to keep savings and dividend income outside NICs would mean the system would continue to create perverse incentives for individuals to convert labour income to capital income to avoid tax.¹⁰⁶

The Chartered Institute of Taxation congratulated the Chancellor “on finally grasping a nettle that successive administrations have shied away from” but expressed disappointment on the fact Mr Osborne had ruled out abolishing the contributory principle: “with the announcement elsewhere in his speech of moves toward a flat rate pension, the burden of running the contributory aspects of the system may outweigh the benefits.”¹⁰⁷ Writing in *Taxation*, one practitioner suggested that “the end result will probably be a mere tinkering around the edges, which could reduce administration but is unlikely to be noticed by the majority of those currently in employment.”¹⁰⁸

When the Chancellor appeared before the Treasury Committee he was asked if the retention of the contributory principle would nullify most of the potential benefits to any merger:

I think there are very substantial operational benefits. I think there are two issues with running National Insurance and income tax alongside each other. The first is for the taxpayer, which is you basically have two taxes on income that are levied in different ways and at different rates and so on, and you could, if you were being completely idealistic about it, you would say the whole thing is a fantasy, let’s get rid of it all, let’s have a single rate of income tax. I don’t think that is realistic ...

There is a separate problem with National Insurance and income tax that I am trying to address, which is companies, small businesses and others, have to run two completely separate payroll systems. Now, if we can merge the operation of that so there is a single payroll but there is still a separate National Insurance and income tax, then we should be able to save for business very substantial sums of money and save for the taxpayer very substantial sums of money because we have to run two different systems in the Inland Revenue as well.

Mr Osborne went on to argue why, in his view, the contributory principle still mattered:

I think [the contributory principle] ... is quite an important principle of our pension system, and there are other contributory benefits as well, there is a contributory job seekers allowance and

¹⁰⁴ *Budget 2011* HC 836 March 2011 para 1.77

¹⁰⁵ “Fiercely complex reform to stop short of a radical merger”, *Financial Times*, 24 March 2011

¹⁰⁶ [Personal tax and benefit changes: IFS 2011 post Budget briefing](#), 24 March 2011

¹⁰⁷ CIOT press notice, [Income tax and NICs reform a nettle that needed grasping](#), 23 March 2011

¹⁰⁸ “Cancel the wedding”, *Taxation*, 7 April 2011

employment support allowance, but particularly for our state pension I think there is a long established principle in Britain that if you work and you make contributions or indeed now if you are a mother and you look after children, you are making a contribution to your future pension and I think a Government should think long and hard before it abolished that.¹⁰⁹

For its part the Committee noted that, while it understood the Chancellor's "desire to move cautiously" given the complexities to reform, "the change appears to have been anticipated as a radical measure but turned out, at second glance, to be a modest one."¹¹⁰

In July 2011 the Treasury issued a 'call for evidence' on the greater integration of income tax and NICs, with a view to "build a strong evidence base on the burdens to employers of having to operate two different systems." Responses were invited on a series of questions, most of which are focused "on the burdens employers and payroll professionals face in paying income tax and NICs through the PAYE system. For example, how much staff time and other resource is required to manage the systems, which aspects of the process currently work well and how often problems are encountered when calculating payments."¹¹¹ The department's consultation paper suggested that "closer integration of the operation of income tax and NICs has the potential to deliver benefits in four areas":

Reducing burdens on employers. ... Employers are required to understand and comply with two different systems and two different sets of rules. Integration has the potential to make compliance simpler and cheaper.

Removing distortions in the economy and improving transparency. As the OTS noted, maintaining two systems leads to a number of anomalies that provide incentives to distort behaviour.¹¹²

Fairness. The current systems deliver different outcomes depending on the nature of a person's employment. In short, individuals with similar circumstances and income may pay different amounts and receive different benefit entitlements. Greater integration may be able to improve the fairness of outcomes by making it more likely that individuals with similar circumstances pay similar amounts and gain similar contributory benefit entitlements. More generally, many individuals may find it hard to understand how much they will pay under the two systems. A more integrated system may be more transparent, helping individuals make better decisions regarding their employment.

Cutting administrative costs for government. Each year operating PAYE costs private sector employers and pension providers £0.7 billion and HMRC spends around £1 billion on PAYE administration. Any changes to the current system will entail up-front costs. But if closer integration can reduce complexity (for employers and for government), it may be able to reduce the

¹⁰⁹ [Tenth report: Budget 2011, 9 April 2011](#), HC 897 of 2010-11, Ev82-83 Qs 521-2

¹¹⁰ *op.cit.* para 136

¹¹¹ [HM Treasury press notice 77/11, 11 July 2011](#)

¹¹² *Small Business Tax Review* (Office of Tax Simplification, March 2011)

likelihood of error and HMRC's overall costs of collection in the longer term.¹¹³

Responses were invited by 19 September 2011 – and in November the Government published a document describing the next phase of work on this project.¹¹⁴ One issue raised by many respondents had been the fact that tax and NICs are assessed in different ways. So, income tax is assessed on total annual income, and the deductions employers make through PAYE are based on pay to date (cumulative). Liability is then finalised following the end of the tax year. By contrast, NICs is assessed on earnings in each earnings period (non-cumulative); liability is finalised at the point that the earnings are paid. There is also a key difference in liability *across* employments. For tax earnings from separate employments are aggregated, whereas for NICs liability is calculated on each employment in isolation.¹¹⁵

As the paper stated, “the Government sees the main path to integration as bringing NICs closer to income tax, rather than vice versa ... reform in this direction would be a continuation of changes that have gradually made NICs more like income tax over recent decades. The alternative – moving income tax closer to NICs – would imply changing the annual assessment of income tax to a pay period basis, which could be unworkable given the need to cover non-earnings forms of income.” Given this, a “priority for further work would be to look at:

- **Annual NICs.** Whether assessment for NICs should be based on the tax year as it is for income tax.
- **Cumulative NICs.** Whether liability for NICs should be based on earnings over the year-to-date, rather than assessed independently in each pay period.
- **Aggregated NICs.** Whether earnings should be considered across employments when determining NICs liability, rather than per each employment.¹¹⁶

The paper set out some of the challenges to any reform, including the implications for individual earners in terms of the tax and NICs they pay as well as their access to contributory benefits:

Any reform of NICs to an annual, cumulative and aggregated basis to match the income tax structure could mean a significant number of individuals would end up with a different NICs liability – some could pay more and others less. On the one hand, there are around nine million individuals in the UK who currently work less than a full year. Many of these individuals would pay less NICs if only one NICs threshold was applied each year. Some of these individuals might find their contributions record is affected, though they would be able to compensate by paying voluntary NICs.

On the other hand, there are nearly three million individuals who work more than one job simultaneously. They would be likely to pay more NICs if only one NICs threshold were applied across

¹¹³ [Integrating the operation of income tax and National Insurance contributions : a call for evidence](#), July 2011 pp7-8

¹¹⁴ HC Deb 14 November 2011 c27WS

¹¹⁵ HM Treasury, [Integrating the operation of income tax and national insurance contributions: next steps](#), November 2011 p9 (Table 2.C)

¹¹⁶ *op.cit.* p23

multiple employments. Some of these individuals would find themselves eligible for contributory benefits for the first time. And there are over seven million individuals who have earnings that fluctuate across NICs thresholds within the year (e.g. through periods of overtime or irregular bonus payments). This final group could pay either less or more depending on the level and pattern of their earnings.¹¹⁷

In his foreword to the paper, the then Exchequer Secretary, David Gauke, argued that “in this area, as with many aspects of tax reform, a consultative and deliberate approach is desirable.” The paper gave a possible timetable for reform:¹¹⁸

It is the Government’s view that any significant reform of the operation of income tax and NICs will take two Parliaments to deliver. This will give sufficient time for issues of design to be resolved, legislation to be passed, and systems used by government and employers to be redesigned ...

[The timetable shown in the table below] should be considered indicative only, as there may be a number of options as to how to introduce reform in phases. The timetable will be confirmed at Budget 2012, following further work.

Date	Activity
Winter 2011/12	Working groups including key stakeholders develop detailed proposals on how reform can be achieved.
Budget 2012	High level options identified; timetable for consultation confirmed
Spring 2012	Stage 1 consultation seeks comments on the high level options for reform
Autumn 2012	Stage 2 consultation refines options and seeks comments on a narrower set of more detailed proposals
Budget 2013	Detail of reforms decided and announced
2013-15	Legislation drafted, consulted upon and then taken through Parliament
2015-17	Systems changes within government; employers prepare for new system
Around 2017	Reforms come into effect

As one commentator noted, “mindful of the number of people it would affect (and, no doubt, the ... 10% rate debacle¹¹⁹) the timetable for further consultation and eventual implementation is slow.”¹²⁰ Another practitioner writing in *Taxation* was more critical, arguing that the Government’s consultation on merging the operation of the two taxes “is like announcing the re-invention of the wheel, provided it is square, and has no axle, and consulting on what the colour should be.”¹²¹

As it transpired the Budget report simply stated that the Government would “consult on integrating the operation of income tax and NICs after Budget 2012.”¹²² In a speech on tax reform in October 2012 the then Exchequer Secretary, David Gauke, underlined the Government’s

¹¹⁷ *op.cit.* p25

¹¹⁸ *op.cit.* p27. Details of the consultation are collated [on the National Archives site](#).

¹¹⁹ [The Labour Government’s decision in 2007 to abolish the 10% starting rate of income tax from April 2008. For more details see, [Income tax: the 10p starting rate. Commons Briefing Paper 4685](#), 5 March 2013]

¹²⁰ “Digitally transparent”, *Taxation*, 17 November 2011

¹²¹ “No convergence”, *Taxation*, 17 May 2012

¹²² *Budget 2012*, HC 1853, March 2012 para 2.41

view that it would be “crucial that major reforms are well thought through rather than rushed”:

Any reforms that make NICs match income tax structure could mean a significant number of individuals would end up with a different NICs liability. Some could pay more and others less. Therefore before proceeding with any reform, it is our responsibility to ensure we have a clear understanding of the number of individuals likely to be affected and how they will be affected. I encourage businesses and representative bodies ... to continue to engage with us on this and other reforms ... [and] I hope to be in a position to provide an update on this detailed programme of work shortly.¹²³

However, in the 2012 Autumn Statement the Government stated that it would “wait for further progress on planned operational changes to the tax system before formally consulting on the operational integration of income tax and NICs.”¹²⁴ No further details were published for the remainder of the 2010-15 Parliament.

5.2 Reforms to NICs (2010-2015)

Arguably the most important change to National Insurance during this period was a policy that had been announced by the previous Labour Government. From April 2011 the rates of NICs paid by employees, employers and the self-employed rose by 1%. This tax increase had been announced in two stages by the Labour Government in its Pre-Budget reports in December 2008 & 2009. It was confirmed by the Coalition Government in its first Budget on 22 June 2010, and legislation to this effect was introduced in autumn 2010. To mitigate the impact on individuals on lower incomes, and on the incentives for employers to take on new staff, both the primary and secondary threshold were increased substantially above inflation.¹²⁵

In their assessment of the Coalition Government’s tax policy, published in March 2015, the IFS noted that this was the Government’s second biggest single tax increase, raising an estimated £11.8 billion in 2015/16. The Government’s decision in the first Budget to raise the standard rate of VAT to 20% is estimated to raise £14 billion in the same year. The increases made to NI thresholds at this time were of a considerable cost, though, as the authors note, these were a ‘one-off’. NI thresholds were not raised in line with the personal tax allowance, which was increased each year in real terms over the 2010-15 period. (The personal allowance was increased to £10,600 in 2015–16, £2,835 higher than the £7,765 it would have been if the 2010/11 allowance had simply been increased in line with RPI inflation (used by default for uprating at the time):

¹²³ HM Treasury press notice, [Speech by the Exchequer Secretary, David Gauke MP: taxation for the 21st century](#), 5 October 2012

¹²⁴ *Autumn Statement*, Cm 8480, December 2012 para 2.52. see also, [HC Deb 10 March 2014 cc2-3W](#)

¹²⁵ For a summary see, [National Insurance contributions: changes from April 2011, Commons Briefing Paper 5550](#), 13 November 2013

In April 2011 the rates of NICs paid by employees, employers and the self employed all increased by 1 percentage point, raising £11.8 billion. These increases had been announced, but not implemented, by the previous Labour government; the coalition chose to go ahead with them. At the same time, the thresholds at which NICs become payable were increased. The increase in thresholds for employees and the self-employed (costing £3.6 billion) had also been planned by Labour; the increase in the threshold for employers (costing £3.9 billion) was a new announcement. These threshold increases reduced the impact of the NICs rate rise on low earners.

However, the NICs thresholds have not increased in line with the income tax personal allowance. It is hard to think of a good economic reason for wanting to increase the income tax allowance but not the NICs thresholds. The emphasis on income tax and neglect of NICs highlights the absurdity of continuing to have two similar but separate taxes given that National Insurance is not a true social insurance scheme.¹²⁶

As an aside, the present Government is committed to increasing the personal allowance over the 2015-20 Parliament to £12,500.¹²⁷ In a recent address to the CIOT the barrister Jolyon Maugham noted that the gap that now exists between the primary threshold and the personal allowance is a major political obstacle to integrating the two taxes, whatever the merits of a merger might be in terms of transparency, efficiency or fairness.¹²⁸

In his Budget on 20 March 2013 the Chancellor, Mr Osborne, announced a new 'Employment Allowance' – to reduce employers' NIC costs:

The cost of employing people is a burden on small firms. It is a real barrier to taking an extra person on. To help create jobs and back small businesses in this country, I am today creating the employment allowance. The employment allowance will work by taking the first £2,000 off the employer national insurance bill of every company. It is a tax off jobs. It is worth up to £2,000 to every business in the country. It will mean that 450,000 small businesses—one third of all employers in the country—will pay no jobs tax at all.

For the person who has set up their own business and is thinking about taking on their first employee, a huge barrier will be removed. They can hire someone on £22,000, or four people on the minimum wage, and pay no jobs tax. Ninety-eight per cent. of the benefit of this employment allowance will go to small and medium-sized enterprises. It will become available in April next year, once the legislation has passed. We will also make it available to charities and community sports clubs. The previous Government's answer to Britain's economic problems was to

¹²⁶ [The Coalition Government's Record on Tax: IFS Briefing Note BN16Z](#), March 2015 p6, p9, pp12-13. For more details on the Government's approach to increasing the personal allowance see, [Commons Briefing Paper 6569](#), 13 May 2015.

¹²⁷ Cabinet Office, *The Queen's Speech 2015 Briefing Notes*, May 2015 p21

¹²⁸ "Raising the NICs floor so it matches the income tax floor would be another hugely expensive commitment. Will Government tackle it? It's not impossible to imagine it might – but certainly not in order to deliver the technical win of unifying the two taxes." The speech is published on Mr Maugham's blog: ["My address to the Chartered Institute of Tax"](#), *Waiting on Godot: musings on tax*, 12 June 2015.

propose a tax on jobs. We stopped that and today this Government are taking tax off jobs.¹²⁹

The cost of the allowance was projected to be £1.26 billion in 2014/15, rising to £1.73 billion by 2017/18.¹³⁰

Mr Osborne announced a second employer NI relief in the 2013 Autumn Statement, for employers taking on employees under 21. This relief took effect from April 2015.¹³¹ Provision for these reliefs was made by *National Insurance Contributions Act 2014*.¹³²

As noted above, in April 2011 the procedure for paying NICs was simplified for self-employed persons, when the dates for paying Class 2 were aligned with the dates for tax under self assessment. Payments of Class 2 NICs & Class 4 NICs continued to be made separately, though in its report on small business published in March 2011, the OTS argued that this created difficulties for many taxpayers, who were obliged to recover over-paid NI after the end of the tax year:

From 6 April 2011, payment of Class 2 NICs will be collected on 31 July and 31 January in the year of liability. From that date quarterly billing will be superseded by biannual or monthly direct debit payments, but this is not being collected through the self assessment system.

Problems can arise after the tax year end. HMRC has to calculate and refund any NICs paid by an individual which is in excess of the annual maximum NICs for the tax year. A self-employed person who has employment income will be liable to national insurance Classes 1, 2 and 4 and may pay more than the effective annual maximum. Such individuals can apply in advance to defer paying their Class 2 and Class 4 NICs until after total income for a tax year is known. The deferment process is paper based and has several stages.

Further, where business profits are below a 'small earnings' threshold, the individual may apply for a 'small earnings exception' ("SEE") from paying Class 2 NICs (Class 4 NICs would not be due) but cannot apply for deferment. This separate form and process, with different time limits, is confusing and frustrating for those whose earnings fluctuate above and below the threshold.¹³³

In July 2013 HMRC published a consultation document, which looked at the problems for businesses applying for an SEE certificate, and for deferring payment of Class 2 NICs. The paper illustrated the difficulties created by basing the SEE process on *anticipated* profit levels:

John anticipates profits above the SEE limit and pays Class 2 NICs throughout the year. At the end of the tax year John finds that he has made profits below the SEE limit and decides to apply to

¹²⁹ HC Deb 20 March 2013 c944

¹³⁰ *Budget 2013*, HC 1033, March 2013 p64 (Table 2.1 – item 25). See also, Treasury Committee, *Budget 2013, 20 April 2013, HC 1063 2012-13* paras 117-121. General guidance on the Allowance is on Gov.uk.

¹³¹ *Autumn Statement, Cm 8747, December 2013* para 1.195. The relief was projected to cost £440m in 2015/16, rising to £505m by 2017/18: *Budget 2014, HC 1104, March 2014* p58, Table 2.2 – item d

¹³² For details see [Library Research paper 13/60](#) 1 November 2013 & [Commons Briefing paper 6761](#), 26 February 2014.

¹³³ *Small business tax review*, March 2011 para 4.12-14

HMRC for a refund of the Class 2 NICs he has paid. He has to provide evidence of his profits. John applies for a refund within the time-limits, HMRC approves his application and John gets a refund of the Class 2 NICs that he has paid.

Jake on the other hand expected low profits and applied to HMRC for a SEE. HMRC approves Jake's SEE application and issues Jake with a SEE certificate. Jake doesn't pay any Class 2 NICs. At the end of the tax year Jake finds that he has made profits above the SEE limit. Because Jake had a SEE in place he is not required to pay any Class 2 NICs for the past periods. However Jake is required to inform HMRC who will cancel his SEE certificate going forward and Jake commences Class 2 NICs payments.¹³⁴

Similarly the process for deferring payment of Class 2 NICs until the end of the tax year was quite complex:

There is a maximum amount of NICs an individual is liable to pay across Class 1, Class 2 and Class 4 NICs. Individuals who think they might exceed this maximum can choose to defer payment of NICs until the end of the year. The individual can request deferring Class 2 payment from HMRC via a paper application form. However individuals who expect to have profits below the SEE limit are requested not to apply for Class 2 deferral and instead apply to HMRC for a SEE certificate ...

Deferment of NICs can only be made for one year at a time. If an individual expects to exceed the annual maximum in subsequent years, then they currently need to apply to HMRC and renew their deferral to pay Class 2 NICs each year. Where deferral has previously been granted, HMRC automatically issues a renewal application to the individual.¹³⁵

Taken together, these processes "drive significant administrative burdens on small business ... Class 2 account for less than 0.3% of the £102bn NICs collected by HMRC in 2012/13 and yet accounted for around 40% of NI related telephone calls to HMRC and associated processing work."¹³⁶

As an alternative, the paper proposed that liability to Class 2 NICs could be calculated as part of the process for completing an annual return, and to someone's liability for income tax and Class 4 NICs:

When an individual completes their SA Return, they will be asked for a start date and an end date of their self-employment (if these are not completed the system will assume that the individual has been self-employed for the full tax year). They could also be asked on the return whether they want to apply for the small earnings exception if their profits are below the SEE limit. The SA system could calculate the amount of Class 2 NICs due based on the number of weeks the individual has been self-employed.

The Class 2 NICs liability will be added to the individual's total SA liability and will be due by the SA final payment deadline. Once the SA Return is filed, payments against the final liability could be made at any time from the point of filing the SA Return to the 31st January following the end of the relevant tax year ... When the individual makes their SA payment, the Class 2 element would

¹³⁴ [Simplifying the National Insurance Processes for the Self-Employed](#), July 2013 p12. Details of the consultation are collated [on Gov.uk](#)

¹³⁵ *op.cit.* p14

¹³⁶ *op.cit.* p15

still be accounted for separately to enable HMRC to update the individual's contribution record to show that Class 2 NICs has been paid for the relevant tax year.

If an individual reports profits below the SEE limit, they could opt-out of paying Class 2 NICs. This could be prompted through the SA calculation process ... As occurs today the individual would need to be alerted to the potential impact on benefit entitlement if they opt out ... Additionally because the Class 2 NICs liability will be calculated after the end of the tax year when the self-employed person files their SA Return, the timing means that the total amount of any Class 1 contributions made during that year will be known. This could offer the opportunity to explore how the annual maximum calculation could form part of the SA calculation allowing the Class 2 deferment process to be removed.¹³⁷

The consultation also asked whether the SEE process should be scrapped, removing the liability to pay Class 2 NICs for those on profits below the SEE limit.¹³⁸ As responses were generally positive, in the 2014 Budget the Government confirmed it would bring forward legislation to effect this reform.¹³⁹ While the Bill to give effect to this reform was being scrutinised by the House, the Chancellor, in his Autumn Statement in December 2014, proposed that the NI relief for employers taking on young people would be extended: from April 2016, employers would not be liable to pay NICs, up to the UEL, on earnings for apprentices under 25.¹⁴⁰ Subsequently the Government amended this legislation to make provision for the new relief.¹⁴¹

5.3 The OTS Employment Status report

In March 2015 the OTS published its last report of the 2010-15 Parliament on 'employment status' – the ways employment and self-employment are categorised, for the purposes of taxation and employment law. As the authors observed in their foreword, it is "a complex and wide-ranging subject that many have said has no real solution – and that if we did manage to 'solve it', we should immediately move on to world peace as we'd clearly be on a roll." While the report did not offer "the tax equivalent of the philosopher's stone", it made the case that this was a real problem, one that, due to changing work patterns, "was getting worse":

The tax system is still in many ways stuck in an out-of-date mindset: of categorising workers as either employees, firmly on the payroll, or self-employed, with the traditional jobbing plumber in mind. This made sense in the 1950s and 1960s but the huge

¹³⁷ *op.cit.* pp18-19

¹³⁸ Individuals operating property or investment businesses can find their earnings fall under the statutory scope of Class 2 but not Class 4 NICs (for more detail see Annex B to the consultation document).

¹³⁹ [Budget 2014, HC 1104, March 2014](#) para 2.212. For more details [see Library Research paper RP14/45](#), 21 August 2014.

¹⁴⁰ [Autumn Statement, Cm 8961, December 2014](#) para 2.53. This was projected to cost £105m to £120m from 2016/17 to 2019/20: [Budget 2015, HC1093, March 2015](#) p66, Table 2.2 – item d.

¹⁴¹ For more details see [Commons Briefing Paper 6975](#), 11 February 2015.

growth in freelancing as a way of life (and work) doesn't fit readily into this traditional model. That growth stems from the IT industry, but has spread far beyond it, facilitated by the internet and (nowadays) 'apps'. Some people may be forced into this form of working but more choose it and value the flexibility it brings. All of this leads some to suggest that the tax system needs to recognise a 'third way' of working.¹⁴²

The authors noted that, in developing their ideas, they "kept coming back to three key points":

- 1 The tax (mainly NICs) differential between employees and self-employed is significant; as long as it exists there will be pressures on the employment status boundary from those who wish to gain an advantage or manage the risk of getting it wrong.
- 2 Often of greater significance to business is the issue of employee rights.
- 3 Because the dividing line for employment status is blurred rather than clear, it brings a lack of certainty and invites attempts to 'game' the rules.¹⁴³

Given its length, it would be infeasible to summarise the report. It makes 28 recommendations spanning questions of administration, legal definition and tax incidence. Among these recommendations the authors suggested that the Government should consider two options to simplify the determination of employment status:

- Setting a 'de minimis' level of payment or period of time for any contract, where the person providing their services would definitely not be classified as their client's employee.
- Establishing a statutory employment test.¹⁴⁴

The OTS also argued that the Government should initiative a joint review between HMRC, HMT, DWP and BIS, to look "at the possibility of developing an agreed code of principles on employment status":

Ideally there would be an agreed, coherent set of principles developed from case law to guide and govern decisions on employment status. In an ideal world that set of principles would apply to all relevant areas: tax, National Minimum Wage, benefits and employment law.

However desirable, that goal seems unlikely to be achieved, not least because of constantly changing circumstances and the tendency of cases to be taken that seek to distinguish previous decisions. It would, though, be the basis of a statutory test if it is decided to introduce one.

One advantage of an agreed set of principles would be that where decisions are taken to introduce statutory rules, there would be clear bases for the changes. Whether or not the set of principles can be developed, any statutory changes that are made need to assess the impact on the general principles that do exist as part of the process of consultation.¹⁴⁵

¹⁴² [Employment Status report](#), March 2015 pp1-2

¹⁴³ *op.cit.* p6

¹⁴⁴ For details see [paras 6.15](#) and [9.53](#) respectively.

¹⁴⁵ [op.cit. p45](#)

In the report's discussion of longer-term options to simplify employment status, one point is worth highlighting; as the authors put it, "if progress is to be made in 'solving' employment status as an issue, it is difficult to see how this can really be made without tackling NICs" – particularly in respect of the contributions paid by *employers*.

Longer term ideas to explore

The main onus [for proving an individual's employment status] is currently on the business (hence the tendency to 'solve' the situation by hiring only through an intermediary) ... We think there is a need to put more of the onus/responsibility on the individual ... Something that would help many businesses would be a set 'de minimis' level in the employment status (ES) area. The principle would be that someone who is paid under a set amount or works for less than a defined period would never be regarded as an employee

We think that a statutory employment test needs to be explored further ... There are two approaches possible:

- a detailed, complex exposition that would aim to reflect all relevant case law
- a simple or pragmatic set of rules that would have rough edges

There was a lot of support for exploring the idea, though much of that support was predicated on the statutory employment test applying 'across the board' – so to employment rights in particular and areas such as benefits and auto-enrolment. This is a key point that needs to be explored: whether or not we end up with a statutory rule, there is an almost universal call for rules to apply to both tax and employment rights ...

If progress is to be made in 'solving' employment status as an issue, it is difficult to see how this can really be made without tackling NICs: the differences between NICs and income tax and, of course, the differing NICs rates. The OTS has recommended the integration of income tax and NICs in the past in a number of our reports and we do so again in [this report] ... There is a strong case for evening up NICs (and consequent benefits entitlement) between employment and self-employment (ignoring employers' NICs at this stage).

But employers' NICs is the real 'elephant in the room'. It is not an easy thing to tackle, given the money it raises, but it is key to 'solving' the employment status issue. If it could be tackled, many of the problems go away – though differences around employment rights would remain. We have some ideas for making progress here but the starting point is more honesty and transparency about the levy: if more people realise how much it costs/raises, would there be more support for looking afresh at how to raise the money involved?¹⁴⁶

In his March 2015 Budget the Chancellor, George Osborne, announced two important proposals for the next Parliament to simplify personal taxation for the next Parliament:

Businesses, like people, want their taxes to be low. They also want them to be simple to pay. We set up the Office of Tax Simplification at the start of this Parliament, and I want to thank

¹⁴⁶ *op.cit.* pp9-10

Michael Jack and John Whiting for their fantastic work in this regard. To support 5 million people who are self-employed and to make their tax affairs simpler, we will, in the next Parliament, abolish entirely class 2 national insurance contributions for the self-employed.

Today, we can bring simpler taxes to many more people. Some 12 million people and small businesses are forced to complete a self-assessment tax return every year. It is complex, costly and time-consuming. So, today I am announcing that we will abolish the annual tax return all together. Millions of individuals will have the information the Revenue needs automatically uploaded into new digital tax accounts. A minority with the most complex tax affairs will be able to manage their account online. Businesses will feel like they are paying a simple, single business tax, and again, for most, the information needed will be automatically received.

This revolutionary simplification of tax collection will start next year, because we believe that people should be working for themselves, and not for the tax man. Tax really does not have to be taxing, and this measure spells the death of the annual tax return.¹⁴⁷

The Budget report gave details of how the Government would proceed with replacing the annual return:

As a first step, the government will:

- publish a roadmap later this year setting out the policy and administrative changes needed to implement this reform
- introduce digital tax accounts for all 5 million small businesses and the first 10 million individuals by early 2016
- abolish Class 2 NICs in the next Parliament and consult on reforming Class 4 NICs to include a contributory benefit test.¹⁴⁸

The Financial Secretary, David Gauke, referred to both of these proposals in his initial response to the OTS' report on employment status, and a report on partnership taxation published earlier in the year:

Before I address your recent reports, I want to highlight a major announcement in the Budget on our plans to modernise tax administration. This sets out our intention to transform how individuals and small businesses engage with the tax system over the next parliament, with every taxpayer able to manage their tax affairs through their digital account.

It will mean the end of the tax return for millions of individuals (including many pensioners, as you have championed). Small businesses will only have to provide information once, be able to link their accounting software to their digital account, and if they wish they will be able to pay as they go so that it will feel like paying one tax. It also means that those who use the cash basis introduced following your small business review will not have to do an end-of year tax return at all (around a million small businesses used the cash basis in its first year of operation in 2013-14).

¹⁴⁷ HC Deb 18 March 2015 c777

¹⁴⁸ *Budget 2015*, HC 1093, March 2015 para 1.109. For more details on the first of these reforms see, HMRC, [Making tax easier: The end of the tax return](#), March 2015 & [Making Tax Digital](#), December 2015.

Building on another of your recommendations, the Chancellor also announced that we will abolish Class 2 NICs in the next Parliament and consult on reforming Class 4 NICs to include a contributory benefit test. This will simplify NICs for five million self-employed people.

Mr Gauke went on to say the Government would consider the OTS' recommendations regarding employment status in the next Parliament:

I welcome your report and think you have effectively highlighted the challenges of ensuring the tax system reflects the reality of the modern day labour market, and of providing certainty for individuals and employers. As you note, there are no 'quick wins' here, but I believe there is considerable merit in some of your more ambitious and longer term recommendations.

There are trade-offs between which of these to pursue and we will need to work through the broader implications of any change, including the impact on employment law. The government will therefore consider the recommendations carefully in shaping its programme of tax reform and administration for the next parliament.¹⁴⁹

At this time the OTS published a summary of the responses it had had to its report on employment status, in which it noted the "wide range of press comments on the report when it was published: these were, pleasingly, almost universally supportive of the report and its ideas."¹⁵⁰

In November 2015 the Government announced that it would take forward the majority of the OTS's recommendations.¹⁵¹ In a letter to the OTS the Minister, David Gauke, confirmed that the Government would set up a cross-government working group for employment status, and that it would consider looking at a statutory employment test, although he rejected the idea of a 'de minimis' test, on the grounds that this would increase the risk of tax avoidance. An extract from Mr Gauke's letter is reproduced below:

As your review found, the dividing line between employment and self-employment can differ depending on whether status is being decided for the purposes of employment law or tax. This is a complicated situation which can cause confusion for both workers and employers. To help to address this, I have asked officials to establish a Cross Government Working Group for Employment Status. The intention is for this group to include representatives from HM Revenue and Customs (HMRC), HM Treasury, the Department for Work and Pensions (DWP) and the Department for Business, Innovation and Skills (BIS). The Working Group will consider the benefits of and barriers to an agreed set of employment status principles and a statutory employment status test.

Since the publication of your report, BIS have asked Julie Deane OBE to carry out a review of self-employment in the UK. DWP have also launched a review of business start-ups and entrepreneurship in disadvantaged communities, which will be led by Baroness Mone. I believe it would be premature to establish a separate review of employment status while these two reviews are taking place, though I expect that the Working Group will

¹⁴⁹ [Letter from the Financial Secretary to the OTS on Budget 2015](#), 19 March 2015

¹⁵⁰ OTS, [Employment Status Report – follow up summary of responses](#), July 2015 p1

¹⁵¹ [Spending Review & Autumn Statement](#), Cm 9162, November 2015 [para 3.97](#).

consider any relevant findings. I have written to DWP and BIS ministers and intend for the group's first meeting to take place in early 2016.¹⁵²

An appendix to the Minister's letter shows that the Government has accepted 17 of the report's recommendations, and will further consider another 6.

The OTS had floated the idea of increasing the transparency around employers' NIC, on the grounds that this might provoke a better-informed debate on how best to reform the tax. This proved to be one of its recommendations that the Government rejected, arguing that "including employer's NICs on payslips will decrease simplicity for individuals." The report had also raised the much wider question of merging NICs with income tax, which, as noted above, the OTS had recommended in its 2011 report on small business taxation published in 2011. In this case, the Minister's letter simply states that the Government would 'consider' this suggestion, with no further comment.

¹⁵² [Letter from the Financial Secretary to the Treasury to OTS on Autumn Statement 2015](#), 26 November 2015.

6. Recent developments

In its 2015 General Election manifesto the Conservative Party stated that, in government, it would “not increase the rates of VAT, Income Tax or National Insurance in the next Parliament.”¹⁵³ In a speech the Conservative leader David Cameron confirmed that this ‘tax lock’ also meant that there would not be any extension to the scope of VAT, or an increase in the ceiling to NICs.¹⁵⁴ In its manifesto the Labour Party stated in government it would “not increase the basic or higher rates of Income Tax or National Insurance. Nor will we raise VAT”, though it would reverse the Coalition Government’s decision to cut the additional rate of income tax from 50p to 45p.¹⁵⁵

In its analysis of the parties’ tax and spending proposals the IFS noted that these commitments did not discount increases in these taxes through other measures:

The Conservatives ... have pledged not to increase the rates of income tax, National Insurance contributions (NICs) or value added tax (VAT) during the next parliament ... Like the Conservative Party, Labour has pledged *not* to implement certain kinds of tax rises ... their manifesto rules out increases to the basic and higher rates of income tax or rates of National Insurance; and it rules out increasing rates of VAT, as well as extending the VAT base to include food, children’s clothes, books, newspapers or public transport fares.

This does not rule out raising more revenue from these taxes in other ways: they could, for example, change income tax or National Insurance thresholds, or implement further restrictions to income tax relief on pension contributions. These could affect many of the same people, via the same tax, as the hypothetical tax rises that they have ruled out.¹⁵⁶

Writing in the *Financial Times*, the paper’s economics editor, Chris Giles, argued that such pledges were “positively dangerous”:

Britain’s income tax already bears the hallmarks of commitments not to increase the main rates. Labour and Tory-led governments since 2000 have complicated the levy, introducing higher rates over large slices of income, necessary to remove the financial benefits of child benefit and the personal allowance from richer people.

Income taxation is further complicated by national insurance, an income tax in all but name, from which pensioners are exempt and which uses a different definition of income: all of which encourages the tax avoidance industry that politicians say they abhor. When individuals arrange their affairs quite legitimately to avoid taxation, it is no surprise productivity suffers as they waste

¹⁵³ Conservative Party, *2015 General Election Manifesto*, April 2015 p27

¹⁵⁴ “Cameron pledges to ban tax rises until 2020”, *Financial Times*, 29 April 2015. Mr Cameron also publicised this commitment [on Twitter](#).

¹⁵⁵ Labour Party, *2015 General Election Manifesto*, April 2015 p18, p27

¹⁵⁶ *Taxes and Benefits: The Parties’ Plans - IFS Briefing Note BN172*, April 2015 p12, p29. See also, “Triple tax lock puts other revenue sources in spotlight”, *Financial Times*, 28 May 2015.

time minimising tax bills rather than doing something more productive.¹⁵⁷

In the Queen's Speech the Government confirmed that legislation would be brought forward to ensure "there are no rises in income tax rates, value-added tax or National Insurance for the next five years." The [Cabinet Office's Briefing Notes](#), published alongside the Speech, provide this commentary (p21):

The purpose of the legislation is to:

- Ensure there are no rises in income tax rates, VAT rates or National Insurance contributions (NICs) rates for individuals, employees and employers.
- Ensure that the NICs upper earnings limit (the point at which the Employee NICs rate reduces to 2%) is no higher than the income tax higher rate threshold (the point at which income tax increases to 40%).
- Ensure there will be no extension of the scope of VAT.

Following the Queen's Speech the Government announced that the Chancellor would present his first Budget on 8 July 2015.¹⁵⁸ Several commentators have argued that, as this represented the first Budget of the Parliament, it presented a good opportunity for tax reform – as debates over 'winners and losers' from any controversial changes were likely to have faded from view by the time of the next General Election.

Paul Johnson, director of the Institute for Fiscal Studies, has argued that the Government should set out a long-term plan, so that the Chancellor could set out "how he means to address the growing challenges created by increased dependence on a few very well off taxpayers, by international mobility of people and of profits, and by the growth of e-commerce." Mr Johnson goes on to mention a number of changes to be made, including [setting] us on a course toward the real integration of income tax and NICs":

The latter serves purely as an additional tax on earnings and exists only to attempt to fool the electorate into believing that they pay less tax than they do and into believing there is a meaningful link between what each individual pays in and what they get out. There is not.¹⁵⁹

Writing in the *Financial Times*, Chris Giles suggested the Chancellor should follow this advice, and, in particular, supported the case for a merger:

Almost 30 years after the last serious attempt to simplify tax on incomes, the complications and contradictions of the system are again crying out for reform. Bringing the rates and thresholds of income tax and national insurance into line could be the first step to a merger of the base and the rate structures, ensuring over time that, unlike today, everyone faces the same income tax bills if

¹⁵⁷ "The battle for Britain's most reckless tax pledge", *Financial Times*, 8 April 2015; see also, "Cameron's pledges unwise or costly or both, says Lawson", *Financial Times*, 29 April 2015

¹⁵⁸ HMT press notice, [Chancellor announces summer Budget date](#), 16 May 2015

¹⁵⁹ ["Time for tax reform"](#), *IFS Observations*, 2 July 2015

they have the same income, regardless of age or source of income. Whether such a radical move would help families on middle incomes, the poor or the rich is entirely a political choice.¹⁶⁰

However, as recent history has illustrated, consensus among academics, journalists and tax practitioners is no guarantee of change. In his recent address to the CIOT, quoted earlier, the barrister Jolyon Maugham suggested that the goals of transparency and simplification did not, by themselves, remove the major political obstacles to integration. Certainly, a merger would “demonstrate that we pay really quite high rates of income tax”, but what of the costs of that demonstration?

People might be shocked to hear that employment income above £10,600 bears an effective tax rate of over 40%. One can see that shock as being enormously politically helpful to a party that believes in a smaller state. So there is an argument in favour of merging the two taxes. It would absolutely be a helpful stepping stone on that path. But, gosh, this Government has some rather uncomfortable shoes to don before it takes that first step.¹⁶¹

In his Budget speech on 8 July the Chancellor confirmed that “in the coming weeks” the Government would legislate to “prohibit any increase in the main rates of income tax, national insurance and VAT for the next five years.”¹⁶² The Budget report explained that provision to this effect would be included in a Summer Finance Bill, to be presented to the House at the conclusion of the Budget debates:

The government will legislate to set a ceiling for the main rates of income tax, the standard and reduced rates of VAT, and employer and employee (Class 1) NICs rates, ensuring that they cannot rise above their current (2015-16) levels. The tax lock will also ensure that the NICs Upper Earnings Limit cannot rise above the income tax higher rate threshold; and will prevent the relevant statutory provisions being used to remove any items from the zero rate of VAT and reduced rate of VAT for the duration of this Parliament. (Summer Finance Bill 2015)¹⁶³

It is worth adding that the Budget including a series of measures to *increase* taxes as well as measures to reduce public expenditure. As Paul Johnson, director of the IFS, noted in his post-Budget presentation, “The figures are quite clear though – this was a tax raising budget ... we told you before the election that post-election budgets tend to raise at least £5bn in tax – and this one expects to bring in a little more than that.”¹⁶⁴ (This analysis was published in the IFS’ *Green Budget* in February 2015.¹⁶⁵) The Budget report estimates that, taken together, tax

¹⁶⁰ “George Osborne’s brief chance to seal his reputation as a reformer”, *Financial Times*, 1 July 2015

¹⁶¹ [“My address to the Chartered Institute of Tax”](#), *Waiting on Godot: musings on tax*, 12 June 2015.

¹⁶² HC Deb 8 July 2015 c336

¹⁶³ *Budget 2015*, HC 264, March 2015 [para 2.53](#). see also, HMRC, [Tax lock: Income Tax, NICs and VAT: tax information & impact note](#), 8 July 2015

¹⁶⁴ [“Paul Johnson’s opening remarks”](#), *IFS Summer post-Budget briefing*, 9 July 2015

¹⁶⁵ [“Chapter 10: Options for increasing tax”](#), *IFS Green Budget*, February 2015 pp228-9 ([Figure 10.1. Taxes and the electoral cycle](#)). See also, [“Taxes and elections: are they by any chance related?”](#), *IFS Observations*, 15 March 2010.

policy measures announced in the Budget are set to raise £5.1bn by 2017/18, rising to £6.5bn by 2020/21.¹⁶⁶

On 14 July the Government published *Finance Bill 2015-16*. Clauses 1 & 2 provide for this ‘tax lock’ for income tax and VAT.¹⁶⁷ At the same time the Government published the [National Insurance Contributions \(Rate Ceilings\) Bill](#) which would prevent any increase in the current rates of Class 1 NICs, and any increase in the UEL above the higher rate threshold.¹⁶⁸ The lock would apply to a tax year which came after the date of the Bill’s Royal Assent, and before the first parliamentary general election after that date. In the case of the UEL, the lock is set by reference to the ‘proposed’ higher rate threshold set in the Government’s “pre-budget proposals”. This is intended to be the Chancellor’s Autumn Statement before the tax year in question.¹⁶⁹

The reason for this separate Bill is that statutory provisions regarding NI cannot be included in the annual Finance Bill. This is because the Bill’s remit – as set out in its long title – specifically excludes any tax that does not raise money for financing central government *as a whole*. Usually the long title of the Finance Bill is of the form, “a Bill to grant certain duties, to alter other duties, and to amend the law relating to the National Debt and the Public Finance, and to make further provision in connection with finance.”

As a consequence the Bill cannot include provisions relating to NICs – since, as noted, they are collated in the National Insurance Fund, to meet the costs of contributory benefits exclusively. Similarly the Finance Bill cannot impose a charge to finance other bodies in the public sector (such as local authorities), or to authorise borrowing.¹⁷⁰

As noted, in the March 2015 Budget the Government had proposed reforming NICs for the self-employed by abolishing Class 2, and introducing a new contributory benefit test tied to the payment of Class 4. The new Government confirmed it would take this measure forward,¹⁷¹ and a consultation to this effect was launched in December 2015.¹⁷²

Finally, in the July Budget the Conservative Government also confirmed that it would establish the Office of Tax Simplification as “a permanent office of HM Treasury.”¹⁷³ The Financial Secretary, David Gauke, gave more details in a letter to the OTS, announcing that the OTS would be commissioned to carry out two new reviews in the coming year: the

¹⁶⁶ *Budget 2015*, HC 264, March 2015 p74 ([Table 2.1: Total Policy Decisions](#))

¹⁶⁷ The Bill, explanatory notes and details of its scrutiny are on [its Parliament page](#).

¹⁶⁸ This legislation makes no other provisions. It received Royal Assent on 17 December 2015. Full details are [on its Parliament page](#).

¹⁶⁹ [Bill 54-EN, July 2015](#) para 15. See also, [Commons Briefing Paper CBP7260](#), 2 November 2015.

¹⁷⁰ For more details on these procedures see, [The Budget and the annual Finance Bill](#), CBP813, 10 July 2015.

¹⁷¹ *Budget 2015*, HC 264, July 2015 para 2.163

¹⁷² [The abolition of Class 2 National Insurance: Introducing a benefit test into Class 4 National Insurance for the self-employed](#), December 2015

¹⁷³ *Budget 2015*, HC 264, March 2015 para 2.157. see also, HMRC, [OTS: permanent establishment – tax information & impact note](#), December 2015

taxation of small companies, and, notably, the closer alignment of tax and NICs; a short extract is given below:

The closer alignment of income tax and NICs ... is an area often cited as a major source of complexity for taxpayers. I would like the OTS to look at what the impacts, costs and benefits of closer alignment would be and to set out what the necessary steps would be to achieve closer alignment. This is a new type of review for the OTS, focusing on the issues and impacts rather than on making specific recommendations.¹⁷⁴

Both of these reviews are ongoing.

¹⁷⁴ HM Treasury, [*Summer Budget 2015: Office of Tax Simplification – correspondence*](#), 8 July 2015

Appendix: main features of NICs

	Rate in 2014/15	Rate from April 2015
Class 1		
Lower earnings limit (LEL)	£111 a week	£112 a week
Upper earnings limit (UEL)	£805 a week	£815 a week
Upper accrual point (UAP) ¹	£770 a week	£770 a week
Primary threshold	£153 a week	£155 a week
Secondary threshold	£153 a week	£156 a week
Upper Secondary threshold ²	N/A	£815 a week
<i>Contribution rates (NI Fund and NHS combined)</i>		
Primary (employee)		
On earnings between the primary threshold and UEL ³	12.0%	12.0%
On earnings above the UEL	2.0%	2.0%
Reduced rate for married women and widow optants, on earnings between the primary threshold and UEL	5.85%	5.85%
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 ⁴	13.8%	13.8%
NHS allocation included in above (percentage of all earnings for employees earning above the secondary threshold) ⁵	1.9%	1.9%
Class 1A and Class 1B		
Contribution rate (employer only)	13.8%	13.8%
NHS allocation included in above	1.9%	1.9%
Class 2		
Flat rate contribution	£2.75 a week	£2.80 a week
Small earnings exception	£5,885 a year	N/A
Small profits threshold	N/A	£5,965 a year
NHS allocation included in above (percentage of contribution)	15.5%	15.5%
Class 3		
Flat rate contribution	£13.90 a week	£14.10 a week
NHS allocation included in above (percentage of contribution)	15.5%	15.5%
Class 3A⁶		
Contribution	N/A	Varies
NHS allocation included in above (percentage of contribution)	15.5%	15.5%

	Rate in 2014-15	Rate from April 2015
Class 4		
Lower profits limit (LPL)	£7,956 a year	£8,060 a year
Upper profits limit (UPL)	£41,865 a year	£42,385 a year
Contribution rate		
On profits between the LPL and UPL	9.0%	9.0%
On profits above the UPL	2.0%	2.0%
NHS allocation included in above		
On profits between the LPL and UPL	2.15%	2.15%
On profits above the UPL	1.0%	1.0%

Notes :

(1) The UAP was introduced from April 2009 by the *National Insurance Contributions Act 2008*, and remains fixed in cash terms at the level of the UEL in 2008-09 (£770 a week or £40,040 a year).

(2) The *National Insurance Contributions Act 2014* introduced a zero band for Class 1 secondary NICs for employees under the age of 21 on earnings up to the UST, with effect from 6 April 2015.

(3) The contracted-out rebate for primary contributions in 2014-15 and 2015-16 is 1.4% of earnings between the LEL and UAP for COSRS. The contracted out rebate for secondary contributions in 2014-15 and 2015-16 is 3.4% of earnings between the LEL and UAP for COSRS.

(4) The amount of the secondary Class 1 NICs apportioned to the NHS is calculated as the relevant percentage (currently 1.9%) of the total earnings of those employees who earn above the primary threshold. This is in line with the interpretation of subsections (5) and (5A) of section 162 of the *Social Security Administration Act 1992* provided to GAD by HMRC.

(5) The replacement of the SEE by the SPT was provided for by the *National Insurance Act 2015*.

(6) Class 3A voluntary contributions are distinct from the Class 3 voluntary contributions. They are introduced from 2015-16, under the *Social Security Class 3A Contributions (Units of Additional Pension) Regulations 2014*. Class 3A contributions will differ by age, sex and amount of State Pension top up to be purchased (up to a maximum).

Adapted from, Government Actuary's Department, *Report on draft of the social security benefits up-rating Order 2014*, January 2015 ([Appendix 2: pp23-4](#))

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