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The *National Insurance Contributions Bill*

Bill 130 of 2001-02

In his Budget speech on 17 April 2002 the Chancellor Gordon Brown announced a substantial increase in health spending over the next five years, following the conclusions of the *Wanless Report* – a report on long-term health trends commissioned from Derek Wanless, former Group Chief Executive of NatWest Bank. It is proposed that UK NHS spending should rise from £65.4 billion in 2002-03 to £105.6 billion in 2007-08 (HC 592 April 2002 p 121). To this end a series of tax measures is to be introduced which will, for the most part, take effect from April 2003. These measures include increases in the rates of national insurance contributions for employees, employers and the self-employed.

The necessary legislative changes to national insurance are to be made by the *National Insurance Contributions Bill 2001-02,* which is due to have its second reading debate on 13 May 2002.

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Summary of main points

In his Budget speech on 17 April 2002 the Chancellor Gordon Brown announced a substantial increase in health spending over the next five years, following the publication of the final report on long-term health trends commissioned from Derek Wanless, former Group Chief Executive of NatWest Bank.[1] It is proposed that UK NHS spending should rise from £65.4 billion in 2002-03 to £105.6 billion in 2007-08.[2] This represents an annual average increase of 7.4% after inflation over these five years.

To this end a series of tax measures is to be introduced which will, for the most part, take effect from April 2003; as a consequence it is anticipated that net Exchequer tax revenues will increase by £6.12 billion in 2003-04. By far the largest proportion of this increase in Exchequer receipts will be accounted for by increases in the rates of national insurance contributions (NICs) for employees, employers and the self-employed.

For employees the rate of NICs will be increased by 1 percentage point to a rate of 11% on all earnings between the primary threshold and the upper earnings limit – *and* NICs will be charged at a rate of 1% on earnings *above* the upper earnings limit. For employers the rate of NICs will be increased by 1 percentage point to a rate of 12.8% on earnings above the secondary threshold. It is estimated that these two measures will raise £3.55 billion and £3.9 billion in 2003-04 respectively. For the self-employed the rate of NICs will be increased by 1 percentage point to a rate of 8% on all earnings between the lower profits limit and the upper profits limit – *and* NICs will be charged at a rate of 1% on earnings above the upper profits limit. It is estimated this will raise £450 million in 2003-04. In addition the primary and secondary thresholds and the lower profits limit will be frozen at 2002-03 rates for 2003-04. The income tax personal allowance is also to be frozen at its 2002-03 level[3] – and taken together these measures are estimated to raise £700 million in 2003-04.[4]

This additional 1 per cent national insurance contribution by employers, employees and the self-employed is implemented in the *National Insurance Contributions Bill 2001-02*. The Bill also makes provision for the extra receipts raised by these changes – around £7.9 billion in 2003-04 – to be added to the proportion of NIC receipts that already goes towards the cost of the NHS: in effect, it will roughly double the amount going to the NHS from NICs. The Bill was printed on 1 May, along with explanatory notes prepared by the Inland Revenue (Bill 130-EN); it is due to have its second reading on 13 May 2002.

Legislation dealing with NICs is not included in the annual Finance Bill, and generally changes to national insurance that require primary legislation are made by including such provisions within a much larger Act covering a range of social security issues.[5] It is a Parliamentary convention that Finance Bills are concerned with moneys that go into the

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1 Derek Wanless, *Securing our future health: taking a long term view – final report*, April 2002

2 HC 592 April 2002 p 121

3 The main changes to direct tax rates and allowances for the current tax year are set out in *Direct taxes: rates and allowances 2002-03*, Library Research paper 02/27, 23 April 2002.

4 *Budget 2002*, HC 592 April 2002 pp 154-5

5 For example, provisions related to NICs and benefits in kind that came into effect in April 2000 comprised part IV of the *Child Support, Pensions and Social Security Act 2000*.

Consolidated Fund. As receipts from NICs go into the NI Fund and not the Consolidated Fund, legislative provisions relating to NI are not contained in the Finance Bill.

At Business Questions on 25 April 2002 the Leader of the House, Robin Cook, confirmed that the Government would have to introduce a Ways and Means resolution, before introducing primary legislation to effect these changes to NICs.[6] It did so on 1 May 2000, and the motion's approval was followed by the publication of the *National Insurance Contributions Bill 2001-02*.[7]

Part I of this paper provides an introduction to the system of national insurance and the major changes seen over the last fifty years, with particular reference to the implications of the Taylor Report published at the time of the March 1998 Budget. Part II sets out the changes to both NICs and income tax announced by the Chancellor in his 2002 Budget speech, before looking at the debate there has been on hypothecating tax revenues to fund the NHS. It concludes with a discussion of the responses there have been to the Budget changes in NI. Part III gives a short summary of the Bill. Part IV illustrates the changes to be made to the structure of NI from April 2003, and the financial effects of these changes on employees. Sources for this paper and suggestions for further reading are set out in Part V.

Further to the announcement of increased funding for the health service, the Chancellor confirmed in his Budget speech that the Government would introduce a series of reforms in the operation of the NHS, "including a new audit system that will link the money paid to benefits received."[8] The Secretary of State for Health, Alan Milburn, gave a statement to the House the following day,[9] on the publication of a Command Paper setting out these changes.[10] Clearly these issues lie beyond the scope of the Bill itself, but they are examined in a second recent Library Research paper.[11]

National taxation (including NICs) remains a reserved matter:[12] the changes to NIC rates set out above have no direct consequences for either of the devolved assemblies. That said, the Bill makes a number of consequential amendments to ensure there is no impact on entitlement to contributory benefits or on the rate of such benefits, nor any change in the way in which reductions in contributions are applied in respect of employees who are contracted-out of the state second pension. Of these amendments, those the Bill makes to Northern Ireland benefits and pensions legislation are subject to the approval of the Northern Ireland Executive Committee and Assembly.[13]

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6 HC Deb 25 April 2002 cc 465-7

7 HC Deb 1 May 2002 cc 956-1012

8 HC Deb 17 April 2002 c 591

9 HC Deb 18 April 2002 cc 714-8

10 Department of Health, *Delivering the NHS Plan: next steps on investment, next steps on reform*, Cm 5503 April 2002

11 *NHS funding and reform: the 'Wanless Report'*, Library Research paper 02/30, 3 May 2002

12 With the obvious exception that the Scottish Parliament is empowered under ss 73 & 74 of the *Scotland Act 1998* to introduce a tax varying resolution, to increase or decrease the basic rate of income tax for Scottish taxpayers from the rate determined by the UK Parliament by up to 3p in the £.

13 Bill 130-EN, 1 May 2002 para 23-4. Northern Ireland has a separate national insurance scheme to Great Britain, though the two schemes are closely co-ordinated and maintain parity of contribution rates.

CONTENTS

I National insurance contributions (NICs): an introduction

A. Rates, receipts, the NI Fund and contributory benefits

> It is a curious fact … that despite the size and permanence of this levy, few people know very much about it. Even those who have the task of advising others of their financial responsibilities to the State … 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.[14]

> John Whiting is a tax partner at PricewaterhouseCoopers and President of the Chartered Institute of Taxation. He 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.[15]

National insurance benefits are funded by a system of compulsory contributions, paid by employees, employers and self-employed people.

Employees pay primary Class 1 contributions on their earnings if their earnings exceed the lower earnings limit (LEL), which is set at £75 a week for 2002-03. A zero rate of NICs is charged on earnings between the LEL and the primary threshold (PT), which is set at £89 a week. No NICs are actually payable but a notional primary Class 1 NIC is deemed to have been paid in respect of earnings between the LEL and the PT to protect benefit entitlement. Earnings above the PT are charged NICs at 10%, subject to a cap at the upper earnings limit (UEL), which is set at £585 per week. Employees contracted out of the state second pension (S2P) pay a reduced rate of NICs. Employers pay secondary Class 1 NICs on employee earnings at a rate of 11.8%, on earnings above the secondary threshold (ST), also set at £89 a week for 2002-03.[16] There is no upper ceiling on secondary Class 1 NICs.[17]

Self-employed people pay a weekly flat rate Class 2 NIC (£2 for 2002-03). In addition they may be liable to pay a separate Class 4 profits related contribution, which is charged

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[14] *Tolley's National Insurance contributions 2001-02*, para 1.2

[15] "A vital contribution", *Financial Times*, 11 April 2002

[16] Both the PT and ST are aligned with the personal tax allowance.

[17] The then Chancellor Nigel Lawson announced the abolition of the upper earnings limit for employers' NICs from October 1985 in his March 1985 Budget (HC Deb 19 March 1985 cc 802-3).

at a rate of 7% on profits between a lower profits limit (£4,615 a year for 2002-03) and an upper profits limit (£30,420 a year for 2002-03). Voluntary contributions are also possible to assist people to qualify for basic retirement pension and bereavement benefits (Class 3 contributions, charged at a flat rate of £6.85 a week for 2002-03).[18]

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. Moreover anyone resident 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.[19]

It is estimated that national insurance contributions will raise £65 billion in 2002-03. This compares with the Exchequer receipts from income tax (gross of tax credits) of just under £118 billion, from VAT of £64 billion and from corporation tax of £33 billion.[20] In evidence to the Social Security Committee in 1999, the Department for Social Security made some observations on the coverage of the contributions system:

> Over 20 million employees each year pay some national insurance contributions—though not necessarily sufficient to qualify for benefits—and employers contributions are paid by over 1 million employers. Around 2.3 million people pay national insurance contributions in respect of self-employment (some 300,000 paid both in respect of self-employment and employment). About a quarter of a million people will pay Class 3 (voluntary) contributions for the current tax year. About 10.5 million people are credited with National insurance contributions for various spells, by reason of incapacity, unemployment etc and about 12.9 million claimants are at any one time expected to receive benefits financed from the National Insurance Fund. About 4 million rebates will be paid to contributors who are in personal pension schemes.[21]

The Department's memorandum goes on to explain how receipts from contributions are paid into the National Insurance Fund:

> The National Insurance Fund (NIF) is separate from all other revenue raised via taxation which is payable to the Consolidated Fund. Revenue from contributions is paid into the Fund after an allocation to the National Health Service. The NIF operates on a pay-as-you-go basis, in which current contribution income finances current outgoings on contributory benefits. It does not have borrowing powers

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[18] The rates of NICs for both 2002-03 and 2003-04 are set out in *Budget 2002* (HC 592 April 2002 pp 159-161). Rates for earlier years back to the introduction of the NI system in 1948 are given in the Treasury's *Tax Benefit Reference Manual 2001-02* pp 96-100.

[19] 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.

[20] *Budget 2002*, HC 592 April 2002 p 217

[21] *The Contributory Principle*, 7 June 2000 HC 56-II 1999-2000 p 168

and thus keeps a safe working balance of about a sixth of annual benefit expenditure as a protection against unexpected demands. The National Investments and Loans Office manage the investment of balances … 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.

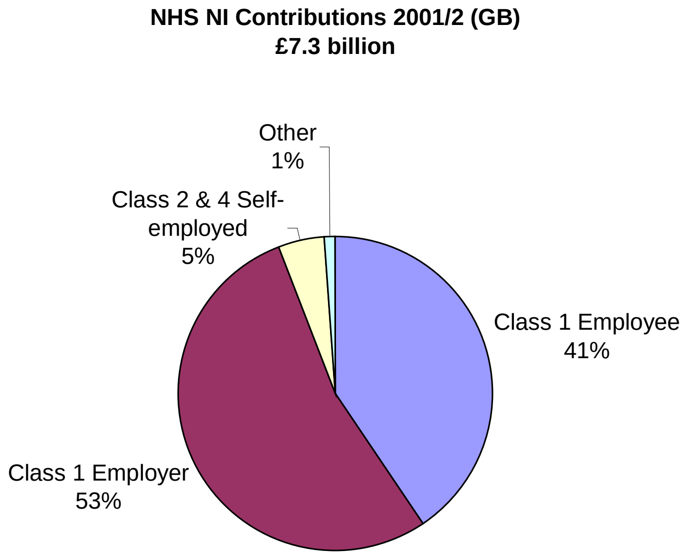
The Grant is paid out of the Consolidated Fund into the National Insurance Fund. The maximum Grant available in any tax year is set by primary legislation at 17 per cent of the National Insurance Fund's annual benefit expenditure. The maximum amount of Grant available—but not, necessarily, taken up—for 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 …

A small proportion of income from contributions is not paid into the Fund, but to the National Health Service, meeting between 6 per cent and 17 per cent of NHS costs at various times.[22]

[22] HC 56-II 1999-2000 pp 175-6

Total receipts from contributions were just under £65.2 billion in 2001-02, of which £57.9 billion went into the NI Fund. The remaining £7.3 billion (11%) represents the allocation made from contributions that year to the health service.[23] This represents around 12% of NHS revenues.[24] The proportion of health spending accounted for by NICs has been relatively stable over the last five years: that is, between 12% and 13.5%.[25] The vast bulk of these contributions is made in respect of employees: 41% come from employees themselves and 53% are paid by employers. A breakdown of the health service allocation for 2001-02 by contribution Class is given below:



The current formula for calculating the NHS allocation is specified in section 162 of the *Social Security Administration Act 1992*. In the case of Class 1 contributions made by employees, this is 1.05 percent of earnings between the primary threshold and upper earnings limit. For Class 1 contributions made by employers, 0.9 percent of total earnings in respect of which contributions are made is allocated to the NHS.

For convenience the main features of the contributions system are set out over the following two pages.

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23 Government Actuary's Department, *Report by the Government Actuary on the drafts of the Social security benefits up-rating Order 2002…*, Cm 5383, February 2002 p 22

24 NHS revenues are comprised 80% taxation, 12% NIC contributions, 4% charges and miscellaneous 3% from Trust interest receipts and 1% from capital receipts (European Observatory on Health Care Systems, *Health care systems in eight countries: trends and challenges*, April 2002 p 108).

25 "Figure 3.12: NHS Sources of Finance 1995-96 to 2000-01" Department of Health, *The Government's Expenditure Plans 2001-2002 to 2003-2004 and Main Estimates 2001-2002*, Cm 5103 May 2001 p 31

Main features of the contribution system (1)

	Rate in 2001-02	Rate in 2002-03
Class 1		
Lower earnings limit (LEL)	£72 a week	£75 a week
Upper earnings limit (UEL)	£575 a week	£585 a week
Primary threshold	£87 a week or £378 a month	£89 a week or £385 a month
Secondary threshold	£87 a week or £378 a month	£89 a week or £385 a month
Contribution rates (NI Fund and NHS combined)		
Primary (employee)		
On earnings between the primary threshold and UEL (2)	10.0%	10.0%
Reduced rate for married women and widow optants, on earnings between the primary threshold and UEL (3)	3.85%	3.85%
NHS allocation included in above (percentage of earnings between the primary threshold and UEL)	1.05%	1.05%
Secondary (employer)		
On all earnings above the secondary threshold (4)	11.9%	11.8%
NHS allocation included in above (percentage of all earnings for employees earning above the secondary threshold)	0.9%	0.9%
Class 1A and Class 1B (5)		
Contribution rate	11.9%	11.8%
NHS allocation included in above	0.9%	0.9%
Class 2		
Flat rate contribution	£2.00 a week	£2.00 a week
Small earnings exception	£3,955 a year	£4,025 a year
NHS allocation included in above (percentage of contribution)	15.5%	15.5%
Class 3		
Flat rate contribution	£6.75 a week	£6.85 a week
NHS allocation included in above (percentage of contribution)	15.5%	15.5%
Class 4		
Lower profits limit	£4,535 a year	£4,615 a year
Upper profits limit	£29,990 a year	£30,420 a year
Contribution rate	7.0%	7.0%
NHS allocation included in above (percentage of profits between lower and upper profits limit)	1.15%	1.15%

Notes :

(1) Adapted from appendix 2 to Government Actuary's Department, *Report by the Government Actuary on the drafts of the Social security benefits up-rating Order 2002 and the Social security (contributions) (re-rating and national insurance funds payments) Order 2000*, Cm 5383 February 2002 pp 13-14

(2) The contracted-out rebate for primary contributions in 2001-02 and 2002-03 is 1.6% of earnings between the LEL and UEL for all forms of contracting out – contracted-out salary-related schemes (COSRS), contracted-out money purchase schemes (COMPS), appropriate personal pensions (APPs) and stakeholder pensions.

(3) Married women opting to pay contributions at the reduced rate earn no entitlement to contributory national insurance benefits as a result of these contributions. No women have been allowed to exercise this option since 1977.

(4) The contracted-out rebate for secondary contributions is 3.0% of earnings between the LEL and UEL for contracted-out salary-related schemes in 2001-02 and 3.5% in 2002-03. For contracted-out money purchase schemes, the employers' contracted-out rebate varies according to the age of the employee: however, only a rebate of 0.6% in 2001-02 and 1.0% in 2002-03 will be deducted from contributions at the time they are paid, the remainder should be paid by the National Insurance Contributions Office in the following financial year after the submission by employers of end-of-year returns. For appropriate personal pensions, the total rebate (primary and secondary combined) applicable to earnings is, like the rebate for COMPS, related to the age of the employee. The rebate will be paid by the National Insurance Contributions Office to the personal pension provider after the submission by employers of end-of-year returns, with the employee and employer paying the not contracted-out rate of contributions during the year. Stakeholder pensions will be treated in the same way as personal pensions.

(5) Class 1A contributions are paid by employers on benefits in kind and Class 1B contributions are paid where an employer enters into a PAYE settlement agreement.

(6) The increases in the contracted out rebate rates, which take effect in 2002-03 were introduced by the *Social Security (Reduced Rates of Class 1 Contributions) (Salary Related Contracted-out Schemes) Order 2001*, the *Social Security (Reduced Rates of Class 1 Contributions and Rebates) (Money Purchase Contracted-out Schemes) Order 2001* and the *Social Security (Minimum Contributions to Appropriate Personal Pension Schemes) Order 2001*.

As noted above, the Government Actuary's Department (GAD) is responsible for producing a report whenever national insurance benefit rates or contribution structures are altered, to examine the finances of the NI scheme over the very short term and the cost of increasing benefits or altering contributions.[26] In addition the Department must report to Parliament every five years on the finances of the NI scheme over the next 50 years or so. These reports consider the effects of changes in the demographic structure of the population, based on the population projections produced by GAD.[27] The contribution rate necessary to pay a certain level of benefits is calculated for each future year, and the effects of different assumptions are also considered.[28]

[26] The most recent report – Cm 5383 – was published in February 2002.
[27] These are available on the Department's site at: http://www.gad.gov.uk/population/population.html
[28] The most recent report – Cm 4406 – was issued in July 1999.

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 benefits apart from jobseeker's allowance – though notably Class 4 contributions do not count towards benefit entitlement. By far the largest contributory benefit in terms of both coverage and costs is retirement pension: in 2001-02 it is estimated that total payments from the NI fund for benefits were £50.5 billion of which retirement pensions accounted for £41.9 billion.[29] Statistical data on the Fund's receipts and payments over the last ten years are given in an appendix to this paper.

As the Social Security Committee has noted, entitlement to any particular benefit depends on satisfying the contribution conditions (as well as other conditions of entitlement) for that benefit:

> 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 goes 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]

Similar observations have been made by the Institute for Fiscal Studies: "in practice, payments from and receipts into the [NI] fund bear little relation to each other for any individual contributor. In the national insurance system, current contributions finance current benefits, with the fund merely being a device to prevent cash-flow problems."[32]

Finally it is worth recalling that contributory benefits represent one part of social security expenditure, which also includes means-tested benefits such as income support (where receipt of the benefit will depend upon the income of the claimant and their personal characteristics such as age and family type), and other benefits such as child benefit (which are universally available to all people who meet some qualification criteria). A

29 Cm 5383, February 2002 p 20
30 HC 56-I 1999-2000 para 14
31 HC 56-I 1999-2000 para 15
32 IFS, *A survey of the UK tax system*, November 2001 p 7

recent survey of the UK benefit system by the Institute for Fiscal Studies observes the declining role played by contributory benefits over the last twenty years:

> The decline in relative importance of contributory benefits has been largely due to the growth of non-contributory benefits since the late 1970s. In real terms (2000-01 prices), expenditure on income-related benefits has increased from £10 billion in 1978–79 to £34.4 billion in 2000-01, an increase of 245 per cent. Expenditure on non-contributory non-income-related benefits has, over the same period, grown by some 167 per cent. In contrast, expenditure on contributory benefits increased from £35.1 billion in 1978–79 to £46.8 billion in 2000-01, an increase of just 33 per cent. …
>
> Recent developments such as increases in government expenditure on the working families' tax credit continue this trend by expanding welfare payments to those on low incomes rather than focusing on those who have 'paid in' to the system.[33]

B. 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."[34]

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 thus: "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 must 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.[35]

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[33] IFS, *A survey of the UK benefits system*, January 2002 p 41
[34] Cmd 6404 November 1942 para 10
[35] Cmd 6404 November 1942 para 273

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 person's claim to be qualified for any particular benefit can be tested.[36]

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."[37]

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."[38] A detailed history of the NI system is beyond the scope of this paper.[39] Nevertheless one observation may be made here about the appeal of the contributory approach as a method for social security provision; as the

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36 Cmd 6404 November 1942 para 274
37 Cmd 6404 November 1942 paras 275-6
38 HC 56-I 1999-2000 p xvi
39 A short history is given in the Social Security Committee's report cited above (HC 56-II 1999-2000 pp 169-170).

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.[40]

In evidence to the Social Security Committee Frank Field MP observed, "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."[41] In evidence to the Committee 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.[42]

In a qualitative study of perceptions of the NI system published by the DSS 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.

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[40] Ogus, Barendt & Wikeley, *The Law of Social Security*, 4th edition 1995 p 29
[41] HC 56-II 1999-2000 p 126
[42] HC 56-II 1999-2000 Q 285 p 160

> 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 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.[43]

C. The Taylor Report and changes in NICs since 1997

Following the 1997 General Election, the 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."[44] In his report, published at the time of 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.[45] With respect to national insurance, the report's recommendations 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. The following paragraphs look at each of these measures in turn.

1. The rate structure of Class 1 NICs

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

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[43] Bruce Stafford, *National Insurance and the Contributory Principle: DSS In House Report 39*, 1998 p 40, pp 18-19

[44] HM Treasury press notice 47/97, 19 May 1997; Labour Party, *New Labour: because Britain deserves better*, April 1997 pp 12-13

[45] HM Treasury, *Work incentives: a report by Martin Taylor*, March 1998. At present the report is available from the Treasury's site at: http://www.hm-treasury.gov.uk/mediastore/otherfiles/taylor.pdf.

> (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.[46]

Mr Taylor 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 those on low incomes. He recommended a number of changes, in particular:

- 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 the Chancellor announced that he had accepted this programme for a "simpler, fairer and more employment-friendly national insurance system."[47] 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

46 *op.cit.* pp 11-12

47 HC Deb 18 March 1998 c 1104. One further part of this reform was the transfer of the Contributions Agency to the Inland Revenue, implemented by the *Social Security Contributions (Transfer of Functions etc.) Act 1999*. The background is set out in the Library Research paper published when this legislation was brought before the House (Library Research paper 99/12, 5 February 1999).

these increases in the LEL, to £535 per week from April 2000, and £575 per week from April 2001.[48]

The rate of secondary Class 1 NICs has been cut twice since the Taylor report. In his March 1999 Budget the Chancellor announced that a levy on the business use of energy, with offsetting cuts in employers' NICs and additional support for energy efficiency schemes and renewable sources of energy, would be introduced from April 2001. Initially it was estimated that this 'climate change levy' would raise around £1.75 billion in its first full year, and to ensure that this did not represent an increase in the burden of taxation on business, the rate of secondary Class 1 NICs would be cut to 11.7%:

> The Government have received Lord Marshall's report, for which I thank him, on the role of economic instruments and the business use of energy. We will now implement Lord Marshall's recommendations and we will introduce a levy on business use of energy from April 2001. And it will be brought in, after further consultation with the industry, on a revenue-neutral basis, with no overall increase in the burden of taxation on business. Because we intend at the same time to cut the main rate of employers' national insurance contributions from 12.2 per cent. to 11.7 per cent.[49]

In his Pre-Budget Statement on 9 November 1999, the Chancellor announced that following consultation, changes in the scope and charge of the levy would cut its estimated yield to £1 billion – so that employer NICs would only be cut to 11.9%.[50]

Further refinements in the design of the climate change levy were announced in the March 2000 Budget.[51] In addition the Government proposed cutting the rate by a further 0.1 percentage point in April 2002 to 11.8%, to recycle the receipts from the aggregates levy to be introduced at this time.[52]

2. The base of NICs

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

[48] *Budget 99* HC 298 March 1999 p 102. Historically the UEL for NICs has been between 6½ and 7½ times the earnings point at which NICs first become payable.

[49] HC Deb 9 March 1999 c 181. It was estimated that this cut in the rate of employer NICs would cost £1,700 million in 2001-02 (*Budget 1999* HC 298 March 1999 p 112).

[50] HC Deb 9 November 1999 c 889

[51] Inland Revenue Budget press notice REV/C&E4, 21 March 2000

[52] The Financial Statement & Budget Report estimated that this second cut in the rate of the employer contribution rate would cost £350 million in 2002-03 – and that the aggregates levy would raise £385 million in the same tax year (*Budget 2000* HC 346 March 2000 pp 150-1).

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 redistributional 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 the disincentives in the NICs system without raising such major policy questions.[53]

Clearly NI may no longer be described as a genuinely insurance-based system. Some commentators have argued that the erosion of the insurance principle over the last fifty years means that the contributions system simply represents an extra administrative burden for employers to deal with and that NICs should be integrated with income tax. As Martin Taylor observed, there are fundamental problems with full integration: namely, 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 addition the interaction of NICs and income tax results in an uneven pattern of marginal combined deduction rates across the income distribution, of considerable benefit to those on certain incomes.[54]

Briefly, if one considers the structure of primary Class 1 NICs for the tax year 2002-03, the primary rate of Class 1 NICs is 10% on earnings between £87 and £585 per week. Prior to

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53 *Work incentives: a report by Martin Taylor*, March 1998 p 14, p 13

54 The issue is examined in *The Reform of Personal Taxation*, Cmnd 9756, March 1986 pp 37-39, and, Social Security Select Committee, *Tax and Benefits: an interim report*, 19 November 1997 HC 283 1997-98 paras 25-39. The IFS has also done work in this area: for example, “Income tax and national insurance: better together?” in *Tax Reform for the Fourth Term*, October 1992 pp 103-124; and, Andrew Dilnot, “Integrating income tax and social security”, in Cedric Sandford (ed.), *More Key Issues in Tax Reform*, 1995 pp 19-33.

the Taylor reforms sketched out above, individuals started paying NICs before they paid income tax as the LEL was below the personal tax allowance. Now that these thresholds are the same, individuals' marginal rate of combined tax and NICs is 20% when their earnings exceed the primary threshold, rising to 32% when their earnings exceed the 10p starting rate threshold.[55] However, once earnings rise above the upper earnings limit (UEL), the marginal rate falls back to the basic rate of income tax of 22%. An individual's earnings would have to be in excess of £664 per week at least for them to be paying income tax at the higher rate.[56] Of course, once this occurs, their marginal rate of tax rises to 40%.

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.[57] In his memoirs Nigel Lawson, called this dilemma the 'elephant trap' and referred to it as the key reason why he left the UEL unchanged when Chancellor in 1988. Mr 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 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."[58] It could prove electorally disastrous too: many have suggested that one major factor in the Labour Party's defeat in the 1992 general election was their manifesto pledge to abolish the UEL.[59]

Turning back to the Taylor Report's recommendations on benefits in kind, 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."[60]

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

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55 For 2002-03 income tax is charged at the starting rate of 10% on the first £1,920 of someone's taxable income. The basic rate of 22% is charged on taxable income above this threshold, up to £29,900.

56 As noted, for 2002-03 the basic rate threshold is £29,900; in addition, the personal tax allowance is £4,615. As a consequence someone would have to earn over £34,515 a year (£664 a week) to start paying income tax at the higher rate.

57 The distributional effects from raising or abolishing the upper earnings limit are discussed in *The IFS Green Budget*, January 2002 pp 62-68.

58 Nigel Lawson, *The View From No 11*, 1992 p 827

59 David Butler & Dennis Kavanagh, *The British general election of 1992*, 1992 pp 267-8; Anthony King et al., *Britain at the polls 1992*, 1993 pp 205-7

60 *The Tax Compliance Costs for Employers of PAYE and National Insurance in 1995-96: Inland Revenue Economic Papers No.3*, 1998 p 87

to the employee.[61] In a press notice issued at this time, it was suggested that the revenue raised by this change had allowed for 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.[62]

To this end legislation was included in the *Child Support, Pensions and Social Security Act 2000.*[63] Following the scrutiny of these provisions in Standing Committee,[64] the Government announced in the March 2000 Budget that an exception would be made for childcare benefits in kind: all forms of childcare provision would remain exempt from employers' NICs.[65] In addition the Inland Revenue has continued to consult on simplifying NICs for employers.[66]

It is worth adding that a new class of employer NICs – Class 1B contributions – was introduced in April 1999. The origin of this measure was 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.[67] Although the Government rejected this group's recommendation for full integration,[68] 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 separate settlement for each individual employee. The rules for these payments were revised in 1996, and renamed PAYE Settlement Agreements (PSAs).[69] Following a consultation exercise,[70] the

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[61] HC Deb 9 March 1999 c 187. Prior to the introduction of Class 1A NICs, a series of changes were made to the coverage of employer NICs in relation to benefits in kind over the period 1991-96; these are summarised in a written answer (HC Deb 11 February 1997 c 172W).

[62] HM Treasury Budget press notice HMT9, 9 March 1999

[63] specifically s 74 of the *Child Support, Pensions and Social Security Act 2000*, and the *Social Security (Contributions) (Amendment No.8) Regulations Order* SI 2000/2207.

[64] SC Deb (F) 29 February – 2 March 2000 cc 658-690

[65] Inland Revenue Budget press notice REV9, 21 March 2000. This exemption includes employers contracting for places in commercial nurseries or for the services of a childminder, as well as providing workplace nurseries or childcare vouchers.

[66] To this end the Revenue has published *Simplifying NICs for employers: a technical discussion paper*, June 2000 & *Simplifying NICs for employers: summary of comments and IR response*, July 2001. Both are available on the Revenue's site at: www.inlandrevenue.gov.uk/menus/consult.htm.

[67] DSS, *Deregulation Review: Report of the Tax/NICs working group*, 1993

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

[69] under s 110 of the *Finance Act 1996*

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

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.[71]

3. NICs and the self employed

The Taylor report also made a number of recommendations regarding Class 2 and Class 4 NICs paid by the self-employed:

> The self-employed will pay a flat rate Class 2 charge of £6.35 a week in 1998-99. That will be paid by everyone with earnings over about £69 a week. They also pay a 6 per cent Class 4 charge, based on their taxable profits, between the lower profits limit (LPL) at around £140 a week and the upper profits limit (UPL) at £485 a week. Only the Class 2 charges gives entitlement to contributory benefits. The Class 2 charge is analogous to an entry fee. Indeed, it is markedly larger than the entry fee at the LEL for employees. At 6 per cent, the Class 4 rate is below either the employee or the employer headline rate, let alone both together.
>
> Taking these factors together, it would be consistent with my proposals for employees:
>
> - to abolish the Class 2 charge (which means inventing a new benefit entitlement test, such as a minimum profits test or a minimum Class 4 payment, for contributory benefits);
> - to align the LPL with the revised LEL;
> - to increase the Class 4 rate nearer to the employee rate, so as at least to restore the Class 2 yield. (There are timing issues for the year of introduction, since Class 2 is paid in-year and Class 4 essentially end-year.)
>
> Although the self-employed have less entitlement than employees to contributory benefits, they substantially under-contribute to the National Insurance Fund, even allowing for their reduced entitlements. So there would be an argument for making the self-employed component of such a package revenue-raising, rather than revenue-neutral.[72]

Initially the Government deferred a decision on these recommendations, as the Chancellor explained in his March 1998 Budget;[73] however, the following year Mr Brown announced changes to both Class 2 and Class 4 NICs to "align national insurance arrangements for the self-employed closer to those of employees."[74] Details were given in a press notice:

> From April 2000 the position of self-employed workers with lower profits will be improved significantly. The flat-rate Class 2 national insurance charge, currently payable once profits reach £69.00 a week, will be reduced from £6.35 per week to

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

72 *Work incentives: a report by Martin Taylor,* March 1998 pp 16-17

73 HC Deb 17 March 1998 c 1104

74 HC Deb 9 March 1999 c 187

£2 per week. This will reduce the burden of national insurance on the lowest earning self- employed and encourage start up of self-employed businesses.

The point at which Class 4 contributions on profits become payable will be aligned with the personal tax allowance (£85 per week for 2000/2001, assuming statutory indexation). The rate of class 4 will change from six to seven per cent. The upper profits limit - the point at which liability for class 4 ends - will rise to £535 from April 2000 and then to £575 in April 2001, in line with the changes to the upper earnings limit for employees set out above.

These changes:

- reduce the self-employed's 'entry fee' into the NICs system by over £4.35 per week;
- enhance work incentives by taking a large part of the burden of NICs off the shoulders of low earners - all self-employed people earning under around £9,460 per year will be better off as a result of these changes;
- recoup national insurance revenue lost through changes to class 2 and address the undercontribution to the National Insurance Fund of the sector as a whole;
- make national insurance for the self-employed fairer; and
- simplify the system by bringing closer alignment with the tax system and with NICs for employees.

Benefit entitlement for the self-employed is based on Class 2 NICs which is why they will be retained, but at £2 per week.[75]

[75] HM Treasury Budget press notice HMT9, 9 March 1999

II The 2002 Budget: increases in NICs and income tax

A. Introduction

In his Budget speech on 17 April 2002 the Chancellor Gordon Brown announced a substantial increase in health spending over the next five years – following the conclusions of the *Wanless Review* on long-term health trends – and to meet this increase, a series of tax measures which, for the most part, would take effect from April 2003. By far the largest proportion of this increase in Exchequer receipts would be accounted for by increases in the rates of NICs for employees, employers and the self-employed.

For employees the rate of NICs will be increased by 1 percentage point to a rate of 11% on all earnings between the primary threshold and the upper earnings limit – *and* NICs will be charged at a rate of 1% on earnings *above* the upper earnings limit. For employers the rate of NICs will be increased by 1 percentage point to a rate of 12.8% on earnings above the secondary threshold. For the self-employed the rate of NICs will be increased by 1 percentage point to a rate of 8% on all earnings between the lower profits limit and the upper profits limit – *and* NICs will be charged at a rate of 1% on earnings above the upper profits limit. In addition the primary and secondary thresholds and the lower profits limit will be frozen at 2002-03 rates for 2003-04. The income tax personal allowance is also to be frozen at its 2002-03 level.[76]

In total these measures will raise £8.6 billion in 2003-04: the total increase in employee's NICs will be £3.55 billion, the total increase in employer's NICs will be £3.9 billion and the total increase in self-employed NICs will be £0.45 billion. The additional £0.7 billion comes from freezing the NICs threshold for 2003-04 (£0.25 billion) and freezing the income tax personal allowance for the under 65s (£0.45 billion).[77]

An extract from the Chancellor's Budget speech, summarising these tax measures, is reproduced below:

> It is the Government's view not just that the NHS system of funding is the most equitable, but that a reformed NHS, by offering the most comprehensive insurance policy to meet the rising costs of medical advances, can give British people the greater security they want. Although meeting the challenges and costs of future health care does cost money, it is my hope that we can renew a shared national consensus around an NHS freely accessible at the point of need, paid for from taxation, not for its own sake but for the purpose of delivering for British people a better public service. It is therefore my duty to set out what we, as a

76 The age-related personal allowance for those over 65 is *not* to be frozen for 2003-04: the allowance for people aged 65-74 years will be increased to £6,610; the allowance for those 75 years and over will be increased by £240 above statutory indexation.

77 *National Insurance Contributions Bill : regulatory impact assessment*, May 2002 para 8-9

> nation, need to pay in tax to fund, for the long term, the health service that we want …
>
> Having agreed NHS reforms,[78] including a new audit system that will link the money paid to benefits received, and having also resolved after deliberation to exempt the elderly and vulnerable, I have decided that, for the year 2003–04, there will be a freeze of the non-pensioner income tax personal allowance and national insurance thresholds at £4,615. From April next year, there will be an additional 1 per cent. national insurance contribution from employers, employees and the self-employed on all earnings above £4,615. All other national insurance and income tax allowances will be indexed in line with inflation. Save for this 1 per cent. contribution, the ceiling of £30,420 remains in place and will be indexed in line with inflation to £30,940. But I believe it is right that when everyone—employees and employers—benefits from the insurance provided by the national health service, everyone who can should make a fair contribution ...
>
> To budget effectively for our long-term spending plans, including our major commitments to the NHS, I have also to make major decisions about other taxes. I have to make this year's decision on duties on beer, spirits and wine: I have decided to freeze them. My decision on cigarettes is, for public health reasons, to go ahead with the annual inflation increase at a cost of 6p per packet of 20. Today all estates below £242,000 are not subject to inheritance tax. From today I am exempting all estates below £250,000, and 96 per cent. of estates will pay no tax. I have also to make a decision for this year for fuel duties. I said in the 2000 pre-Budget report that I would respond to rises in oil prices and, given the high and volatile oil price, I have decided to freeze fuel duties this year. I have also to make a decision on licences for cars, vans and lorries, and I will freeze them too.
>
> The overall effect of the tax and other decisions I have made today is to raise net revenues by £6.1 billion in 2003–04, £7.6 billion in 2004–05 and £8.3 billion in 2005–06.[79]

B. Using general taxation to fund health spending

The Government first announced that it was commissioning "a long-term assessment of the technological, demographic and medical trends over the next two decades that will affect the health service" in the March 2000 Budget, with the intention that the report be delivered to the Chancellor "in time for the start of the next spending review in 2002."[80] The following year it confirmed that the review would be led by Derek Wanless, former Group Executive of NatWest Bank.[81] An interim report was published at the time of the

78 Further details of these changes were given to the House by the Secretary of State for Health, Alan Milburn, the day after Budget day (HC Deb 18 April 2002 cc 714-8).

79 HC Deb 17 April 2002 cc 590-592

80 *Budget 2000* HC 346 March 2000 para 5.69

81 *Budget 2001* HC 279 March 2001 para 5.76

Pre-Budget Statement on 27 November 2001; as the Chancellor noted in his statement, in this first report Mr Wanless had concluded that "the principle of an NHS publicly funded through taxation, available on the basis of clinical need and not on ability to pay, remains both the fairest and most efficient system for this country."[82]

Although the review was not charged with examining the way in which the health service should be financed, Derek Wanless observed "the Terms of Reference specify that the Review should examine the resources required for a publicly funded, comprehensive and high quality health care service and so the Review needs to identify the key factors determining the resources required." Examining the alternative options for financing health care, Mr Wanless argued that the current UK system was preferable:

> - financing through general taxation is generally regarded as being more efficient than other means of financing, ensuring strong cost control and prioritisation and minimising economic distortions and disincentives;
> - a reliance on financing through general taxation and some forms of social insurance such as in the UK involves the maximum separation between an individual's financial contributions and their utilisation of health services. This meets the key objective of providing universal access to medical care irrespective of ability to pay. Of 13 major countries studied, the UK has been found to have the most progressive financing system overall;
> - there is evidence that a greater share of public financing of health care is associated with better health outcomes; and
> - the general absence of out-of-pocket payments for clinically necessary services and treatments and widespread exemptions in the limited cases where such charges are levied ensures that the financing system is equitable and does not discourage people from seeking treatment.[83]

These conclusions were reiterated by the Chancellor in his Budget 2002 speech.[84] The Chancellor also noted that the decision to finance the health service through general taxation posed a second question: whether receipts from general taxation should be 'hypothecated' or not.

Hypothecation is the term used to describe the process of assigning tax revenues to a specific end, or - in certain cases - ensuring that they are not spent on one particular end. Earmarking taxes may be in relation to a given proportion of a wider pool of revenue (such as spending the receipts from an extra 1p on the basic rate of income tax on education), or a single tax base (such as spending all receipts from motoring taxes on road

82 HC Deb 27 November 2001 c 838

83 Derek Wanless, *Securing our future health: taking a long term view – an interim report*, November 2001 pp 57-58

84 HC Deb 17 April 2002 c 590

building). In each case hypothecation contrasts with the funding of all government expenditure from a consolidated fund.

Some commentators have argued that hypothecation allows voters to make a stronger connection between the taxes they pay, and the services those taxes are spent on. By increasing 'transparency', the hope is that taxpayers will be better informed about the funding of the public sector. The case has been made by those who think funding should be increased - often in particular areas, such as health or education - and those who think it should be cut - including those who would wish their own taxes not to be spent on certain things, such as military weaponry.

Hypothecation has been discussed in some detail in relation to health expenditure, with a number of organisations in the health field publishing papers in the early 1990s. The policy unit of the Institute of Health Services Management examined the issue as part of a larger study of funding options for the NHS, which concluded that general taxation remained the best way of funding healthcare, but that some form of social insurance could provide an alternative source if political constraints prevented general taxation from delivering optimal levels of resources.[85] The Independent Healthcare Association[86] and the British Medical Association's Health Policy and Economic Research Unit[87] each produced reports on the possibility of 'full-blown' hypothecated taxation, while the National Economic Research Associates carried out a comparison of a number of developed countries' systems and proposed a new prototype based on social insurance.[88]

The BMA returned to the issue in its report on healthcare funding published in February 2001[89] – following speculation that the Government were considering the introduction of a "special earmarked health tax."[90] The Association found that "people would be prepared to pay more tax if they were confident that the money would be well spent and would result in genuine improvements. But there is a general loss of confidence in governments and in their ability to spend money effectively." Hypothecation was one of the possible funding solutions considered, though the BMA concluded, "the very characteristics which make hypothecation popular with the public also make it unpopular with governments, and funding the health service from a specific tax source would be unlikely to provide any advantages over the current system."[91]

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85 IHSM Policy Unit, *Future health care options: final report*, 1993

86 IHA, *Hypothecated taxation and the future of UK healthcare: an initial discussion paper*, 1994

87 BMA Health Policy and Economic Research Unit, *Hypothecated tax funding for the NHS: a briefing/ discussion paper*, February 1994

88 published in 2 vols by Hoffmeyer & McCarthy, eds, *Financing health care*, 1994. In addition in November 1995, the Office of Health Economics published an evaluation of these proposals (A Jones & A Duncan, *Hypothecated health taxes: an evaluation of recent proposals*, London OHE 1995).

89 BMA press notice, *New report urges open and honest approach to rationing*, 6 February 2001

90 "Health tax may help fund NHS", *Financial Times*, 18 January 2000

91 "Executive summary" in BMA, *Healthcare Funding Review*, 2001 pp 5-6

In November 2000 the Commission on Taxation and Citizenship, set up by the Fabian Society, published a report on public spending, which recommended the use of an earmarked tax for the NHS, as one of a series of proposals to 'reconnect' the public with their taxes:

> Drawing on original research into public attitudes towards taxation and public spending, the Commission found the public to be 'disconnected' from their taxes: unsure how much tax they pay, unable to say where the money goes, and cynical about the competence and honesty of all governments and politicians. Arguing that this 'disconnection' undermines public support for the whole system of taxation and public services, the report makes a series of recommendations designed to 'reconnect' people to their taxes and to the public services which these pay for …
>
> The Commission proposes that around half of income tax, along with tobacco and alcohol duties, should be earmarked for the National Health Service. This would make it absolutely clear to the public that taxes pay for the services they value. If health spending rose by more than the natural rise in income tax revenues, the NHS tax would have to be increased (though other taxes, including the remaining General Income Tax, could be reduced if the government so chose.) The Commission notes the practical and constitutional issues raised by this proposal, and some members of the Commission opposed it, but the majority felt that it would be an important symbol 'connecting' citizens to their taxes. [92]

An editorial in the *Financial Times* was strongly critical of the report – "the Fabians have identified a real problem. But their solution is a triumph of hope over analysis"[93] – although Samuel Brittan – a strong critic of hypothecation in the past[94] – was more favourably disposed to the Commission's analysis, when commenting on the report some days later.[95]

A detailed analysis of the arguments for and against hypothecation is beyond the scope of this paper,[96] though it may be of use here to sketch out some of its disadvantages. The first is that the Treasury would soon become deluged with petitions, as taxpayers decided they might prefer not to pay for a given service in the light of a particular aspect of current government policy. Moreover the Government of the day would have to aggregate individual demands for greater spending, where one's own desire for 1% on VAT for health would have to be qualified if others were making similar demands for education or policing.

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92 *Paying for progress: a new politics of tax for public spending*, November 2000; Fabian Society press notice, 27 November 2000. The case for an earmarked tax for the NHS was also made in a concluding article to a series in the *Independent* on other countries' health systems in June 2000 ("The care we get is unacceptable in a civilised society", *Independent*, 23 June 2000).

93 "Editorial: Fabian taxes", 28 November 2000. The authors responded some days later in a letter to the paper ("Letter: not all experience of hypothecated taxes is bad", *Financial Times*, 4 December 2000).

94 "Time to know what you pay for", *Financial Times*, 15 December 1994

95 "In defence of earmarked taxes", *Financial Times*, 7 December 2000

96 The issue is examined at length in Margaret Wilkinson, "Paying for public spending: is there a role for earmarked taxes?", *Fiscal Studies* vol 15 no 4 1994 pp 119-135.

There would be a fundamental problem in balancing preferences without arbitrary outcomes. In principle hypothecation represents a fundamental shift in the democratic nature of society, given that at present the elected government is responsible for allocating resources, and has to account for its decisions to the electorate. The job of politicians might become just a matter of lobbying voters on the future uses of tax revenues before a referendum.

Second, many proposals for earmarked taxation might be termed tokenism, making little contribution to informed decision making. To put it bluntly, the request that taxpayers pay an extra 1p on the basic rate of income tax to boost health spending, in itself, may do little to improve their understanding of how their money is spent in practice. Further, there will be practical difficulties of ensuring tax revenues only go to specified causes, especially in deciding if any given project qualified or not. Tying expenditure on individual services to the yields of individual taxes makes spending vulnerable to the vagaries of the business cycle, as tax yields rise and fall in line with incomes, profits and sales.[97] Indeed the Chancellor argued in his 2002 Budget speech that for this reason alone hypothecation should be ruled out as a solution to financing the NHS:

> In considering reforms I have also considered the hypothecation of revenues to the NHS. But I have concluded that it would make the public services subject to the ups and downs of the economic cycle and unpredictable changes in revenues. And it might achieve the opposite of what its supporters and the NHS needs: a sound long-term and sustainable stream of funding.[98]

Clearly marginal topping up - say during a recession when incomes are depressed – could tackle this problem, although it is feasible to imagine that the level of spending on any one service might come to be determined by how emotive it proved to be with the electorate. Hospitals and schools might easily argue for greater spending less glamorous but no less necessary services might suffer in the short run – support for local authorities, say, or the costs of running the Inland Revenue. If taxpayers reacted to cash crises in the Ministry of Defence or the Home Office by having a change of heart, the end result might simply be a ballooning in public expenditure, something taxpayers had not bargained for when they made their first hypothecated decisions.

Finally, hypothecation might require the public to put *more* trust in politicians' promises - not less - given they would have to believe the Government would not change the terms under which revenues are spent, once they had been collected.[99]

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97 Naturally changes in the structure of taxes - altering the rate of tax charged, say - mitigate this effect.

98 HC Deb 17 April 2002 c 589

99 This last point has been argued persuasively by the Institute for Fiscal Studies (*Options for 1994: The Green Budget* , October 1993 pp 64-65).

C. Responses to the Budget

Initial reactions to the Chancellor's proposals might be characterised as a general welcome for the increase in health spending matched with a variety of views as to whether increases in national insurance contributions were the best way to fund this increase.

The CBI argued that the Chancellor "is now imposing a business tax burden that impacts directly on the cost of employing people at a time when UK competitiveness is being put to the test."[100] The Institute of Directors raised concerns that "the promise of very large additional sums for the NHS will make little difference without major reforms."[101] The Federation of Small Businesses was more critical:

> The rise in employers' national insurance is a direct increase in business costs and when combined with the increase in the employees' NI contributions, this is the equivalent of an increase of 2p on income tax … it is a tragedy that the Chancellor has decided that the self employed will also pay higher NICs … in March 1999 the Chancellor stated that the £2 per week Class 2 NIC made by the self employed was adequate to fund their benefit entitlement. The Class 4 entitlement is therefore a separate additional tax on entrepreneurs.[102]

Indeed during the Budget Resolution debate on 23 April the Secretary of State for Trade and Industry, Patricia Hewitt, acknowledged that "the decision of my right hon. friend the Chancellor on employers' national insurance contributions came as an unwelcome surprise" – though the Minister went on to make the following point:

> However, almost everyone—including almost every business person I have spoken to in the last week—agrees that, as a country, we need to put more investment into health care and to reform it. The British Chambers of Commerce, for instance, has estimated that more than 200 million working days are lost through illness every year in Britain. That is about 400 times more than the number of days lost to strikes last year. The Institute of Directors says that an efficient health care sector is as vital a part of the infrastructure for business to survive as education and transport. The CBI … has estimated that absence from work due to sickness costs British businesses nearly £11 billion a year.[103]

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[100] CBI press notice, *CBI gives mixed reaction to the Budget*, 17 April 2002. Business concerns about the impact of these changes were reiterated by the CBI director-general, Digby Jones, in a recent interview with the *Financial Times* ("CBI warns Brown of fading business support", 29 April 2002).

[101] IoD press notice, *The Budget: laudable aims, but a gamble on public services and growth, says IoD*, 17 April 2002

[102] FSB press notice, *Double blow for self employed in 'tax and spend' Budget*, 17 April 2002.

[103] HC Deb 22 April 2002 c 29

Similar criticisms were made at the conference of the British Chambers of Commerce which Ms Hewitt had attended the previous day,[104] though many large companies were reportedly less concerned about the change than others: “some of the [country’s] biggest employers are also some of the biggest users of part-time or low-paid labour, making them less vulnerable to the tax increase than might appear.”[105] Recently there have been reports that some companies are considering axeing final salary pension schemes to recoup the cost of the increased rate in employers’ NICs.[106]

In their response to the Budget, the Chartered Institute of Taxation argued that the extra NIC burden on employers should have been compensated “by a real commitment to simplify the administrative burden on employers.”[107] The Institute of Chartered Accountants were also critical of the increase in secondary Class 1 NICs, though they welcomed the announcement of new audit procedures for the NHS; in addition the Institute were concerned that the Budget represented a significant increase in the complexity of the tax system:

> Ian Hayes, chairman of the Tax Faculty, said: “While on the surface many of the changes announced by the Chancellor appeared straightforward, it is clear that the details of the changes are far from simple. From next year, the top rate of tax to the working man will be 41%, as there is a new 1% national insurance charge on all earnings over the NIC threshold … This does not apply to investment income so penalising those who go out to work … While we welcome the move to the new integrated child tax credit the mechanics appear hidden in complexity. When the interaction with tax credits is taken into account, middle income earning families will now need to know and understand the benefits and tax credits system. Tax and benefits have moved out from beyond the needy to become mainstream benefits.”[108]

Despite these anxieties it is worth noting that the Inland Revenue’s *Regulatory Impact Assessment* on these changes – published at the same time as the *National Insurance Contributions Bill 2001-02* – concluded that the only significant extra burden would be on those employers who did not use payroll software:

> For employers using payroll software the administration impact will be minimal as it will simply involve a change in the figures the software uses to calculate both the employer and employee contributions. Where the employer uses a commercial payroll package this will simply involve installing the upgrade from the provider. Otherwise this would involve changing the rates himself. Either way the employer would need to make similar changes after each rates change anyway

[104] “Business feels sense of betrayal over impact of Brown’s Budget measures”, *Financial Times*, 23 April 2002
[105] “Part-timers help employers dismiss rise”, *Financial Times*, 19 April 2002
[106] “Budget backlash threatens final salary pensions”, *Financial Times*, 24 April 2002
[107] CIOT press notice, *The CIOT and business tax measures*, 19 April 2002
[108] ICAEW press notice, *Beware the devil in the detail warns Institute*, 17 April 2002

and the ability to change these figures readily is an essential feature of these software packages in order that they can cope with any periodic changes in contribution rates hence for these employers the change is not considered a significant burden.

For employers who perform their payroll manually there will be no extra cost resulting from the change to the employer NICs contribution. There may, however, be an extra level of calculation to be added to interpreting the tax tables when working out employee NICs. This will involve calculating 1% of any earnings above the upper earnings limit. However, no extra forms/ boxes need to be filled in and obviously this only applies to employers whose employee earns above the upper earnings limit.

We estimate the amount of additional time it takes to perform this calculation at around 2 minutes initially although over time this will drop significantly. Therefore the initial start-up impact on the employer would be around 2 minutes per payday per employee earning over the UEL and calculated manually. Assuming an average hourly rate of £20 for an owner/proprietor using manual methods this equates to 66p per employee earning above the UEL per payday.

There are around 1.2 million employees whose NICs contributions are worked out manually. Of the working population 15% earn above the UEL therefore we can calculate the number of employees above the UEL who have their NICs calculated manually by taking 15% of 1.2 million to get 180,000 employees. This number is highly conservative as an individual that earns above the UEL is far more likely to work for a company that calculates its payroll automatically than an individual that earns below the UEL. However using the figure of 180,000 employees and 66 pence per payday per employee … we can calculate that it costs around £118,800 per payday and thus assuming 12 paydays in the year the cost of performing manual payroll for the relevant employee's earning above the UEL is around £1.5 million in 2003/04.

This cost will obviously decrease over time as the recommendations in the Carter Report[109] are implemented and more companies become IT literate and able to calculate their payroll using computers. In addition to the increase in time there may be a small initial increase in the error rate as individuals get to grips with the new calculation. This initial error increase would, of course, only apply to employers performing the calculation of employee NICs manually for employees earning over the upper earning limit and would also only apply for the first few calculations. For employers who have implemented adequate payroll software there will be no related increase in the error rate.[110]

[109] For details on these recommendations see Inland Revenue/HM Customs & Excise Budget press notice REV/C&E 2, 17 April 2002; and, Inland Revenue, *Partial regulatory impact assessment for payroll services*, April 2002.

[110] *National Insurance Contributions Bill : regulatory impact assessment*, May 2002 para 14-19

For its part the TUC argued that the increase in NICs was “a fair way to pay for investment in public services”:

> No one likes paying higher taxes, but it is worth remembering that, between 1979 and 1997, national insurance contributions were raised for most workers from 6.5% to 10%, with no equivalent improvement in the social wage in return. Indeed, when the increase from 9% to 10% was announced in 1995, it coincided with a major *reduction* in benefit, the cut in national insurance support for unemployed people from twelve months to six. This increase, on the other hand, is being used to pay for improvements to the NHS, and is announced alongside £2.7 bn more for low-paid workers through the new tax credit system. Even when the contribution increase and the frozen personal allowance are taken into account, a two children family with one adult in full-time employment at average pay will be nearly £4 a week better off. The 1% increase that continues above the upper earnings limit is clearly the fairest way to introduce a Contributions increase. Without this measure, any increase in contributions is regressive, because the better off would not pay their fair share.[111]

On the question of fairness, there has been some criticism of the fact that the 1% increase in the rate of primary Class 1 NICs represents a proportionately bigger increase for those married women who took up the option – prior to its withdrawal in 1977 – to pay NICs at a reduced rate, earning no entitlement to contributory national insurance benefits as a result of these contributions. This reduced rate is 3.85% at present, and will rise to 4.85% in April 2003. The *Financial Times* quoted Chas Roy-Chowdhury, head of taxation at the Association of Chartered Certified Accountants, as saying, “This extreme and disproportionate increase for those currently paying the lower rate is grossly unfair and is a case of the government wishing to wring as much money as possible from everybody, even widows and older women. Many of these women are near retirement and the last thing they need is this tax hike to upset their finances.”[112]

Some commentators suggested that the increase in NICs had been forced on the Chancellor by the Labour Party’s general election manifesto pledge not to raise the basic or top rates of income tax in the next Parliament,[113] and that this represented a second best solution. The following is taken from an editorial in the *Financial Times*:

> The means by which Mr Brown has chosen to raise the extra money for the NHS raises important questions about the most appropriate form of taxation to pay for this public service. By raising national insurance, Mr Brown has decided that people who work should bear the burden - even though much of the spending is on people whose working lives have ended. If health is to be paid for out of general taxation, it should be just that - taxes paid by everybody.

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[111] TUC, *The Budget: TUC overnight analysis*, 18 April 2002
[112] “Women hit by national insurance increase”, *Financial Times*, 3 May 2002
[113] Labour Party, *Ambitions for Britain: Labour’s manifesto 2001*, 2001 p 10

> Labour is boxed in on raising income tax by election pledges not to raise the basic rate or the higher rate. It is also reluctant to extend value added tax to items currently exempt, despite the absurdities of many of those exemptions. Yet it could have decently widened the tax base for the health service by the long overdue reform of combining income tax and national insurance. By not doing so, it has widened the gap between the cost of employing people and their net reward for work - a measure that must have some negative employment consequences.[114]

Others argued that the introduction of a 1% rate on earnings above the upper earnings limit was simply an increase in the higher rate of income tax; as John Whiting of Pricewaterhouse Coopers was quoted as saying, "we now have a top tax rate of 41 per cent, and another hole in the fiction that national insurance contributions are anything other than a tax."[115] Many appear to have taken the view that for higher earners the increase in tax was much less than had been feared and thus not unwelcome.[116] In evidence to the Treasury Committee on 22 April, Andrew Dilnot – director of the Institute for Fiscal Studies – argued that the differences between income tax and NICs should not be glossed over:

> Mr Dilnot told us that the increase of 1 per cent in NICs for employees and the self-employed and the removal of the upper limits for these rises "delivers a tax increase which is very, very close to being identical to an increase of 1 per cent in the 10 per cent, 22 per cent and 40 per cent rates of income tax. There are only two ways in which it differs. It differs in that the richest third of retired people who do pay income tax will not pay this, and it differs in that those able to live off unearned income will not pay this, but will pay income tax. I think it is a reasonable presumption that for most forms of public spending one might want to give better-off pensioners and those living on unearned income the opportunity to serve through paying tax."[117]

In its report on the Budget, the Committee recorded the views of the Treasury and the Chancellor on the fairness of increasing NICs rather than income tax, before expressing some scepticism as to whether the 1% NICs rate on all earnings did not compromise the upper earnings limit:

> The Treasury told us that the distinction between NICs and income tax is that pensioners are not subject to NICs and, as a result, the vast majority of pensioners

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114 "Editorial: Dr Jekyll and Mr Brown", *Financial Times*, 18 April 2002

115 "Extra 1p will hit higher earners and raise about £3.6bn", *Financial Times*, 18 April 2002. The *Economist* went so far as to say the Government had effectively broken with their election manifesto pledge: "To help pay for this unprecedented increase in [NHS] funding … [the Chancellor] is raising the tax rate on the earnings of people who work, thus breaking the spirit of repeated government promises not to increase income tax. Although he is calling this an increase in employees' national insurance contributions, it's a distinction that will elude most of those paying it" ("The Budget: Gordon's gamble", *Economist*, 20 April 2002).

116 "Extra £900 will come off £100,000 salary", *Financial Times*, 20 April 2002

117 Treasury Committee, *2002 Budget*, 1 May 2002 HC 780-I para 52

> were not being expected to contribute to the increase in spending on health. The Chancellor said that he had chosen NICs "because it did not seem to me right that pensioners should pay more when they were older towards the National Health Service if we could avoid it, and therefore the national insurance route seemed the right route to take ..."
>
> We asked the Treasury whether, given the uncapped nature of the 1 per cent rise in NICs, it was still possible to regard the upper earnings and profits limits as a ceiling for NICs. Treasury officials told us that the Chancellor had described exactly the situation. Employees and the self-employed will not be paying the full rate they pay on earnings or profits up to the upper limit, but merely the 1 per cent rate above. They said that the definition of the upper earnings limit on NICs is "the point at which 11 per cent stops and 1 per cent starts with respect to employees." This view seems to be at variance with the previous, widely accepted, definition of the upper earnings limit, which was that it was the maximum amount of weekly earnings in respect of which employee contributions are payable.
>
> **The proposed increases in NICs for employees and the self-employed will deliver a tax increase to those groups that is very similar to a 1 per cent increase in the rates of income tax. However, unlike increases in income tax, increases in NICs will not affect pensioners and those living off unearned income, who benefit from the insurance provided by the National Health Service, and may be in a position to make a contribution. We think that the Treasury has, as yet, failed to make the case for choosing a method of revenue raising (higher employer and employee national insurance contributions) which excludes well-off pensioners and people living comfortably off unearned income from making a contribution to higher NHS spending.**
>
> **While the upper earnings and profits limits for employees and the self-employed were uprated in the Budget, they will not apply to the 1 per cent increase in NICs. To insist, therefore, that the Upper Earnings ceiling remains intact seems to us mere sophistry. We note this departure from previous practice which could be viewed as a move of the national insurance contribution system towards that of general taxation.**
>
> **The House will shortly be asked to consider legislation to implement the new NIC arrangements. We recommend that it should be framed in such a way that further primary legislation will be required before the rate of charge above the upper earnings limit can be increased.**[118]

The last point the Committee made was also raised during the debate on 1 May, on the Ways and Means resolution required for the introduction of the *National Insurance Bill 2002-03*. On this occasion the Paymaster General, Dawn Primarolo noted the following:

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[118] *2002 Budget*, 1 May 2002 HC 780-I para 52-56

"there was a further question about the need for primary legislation with regard to the 1 per cent. level varying on national insurance above the upper earnings limit. I can confirm that primary legislation would be required if there was to be any variation above that upper limit."[119]

[119] HC Deb 1 May 2002 c 1008

III The *National Insurance Bill 2001-02*

A. The debate on the Ways and Means resolution

At Business Questions on 25 April 2002 the Leader of the House, Robin Cook, confirmed that the Government would have to introduce a Ways and Means resolution, before introducing primary legislation to effect the changes to NICs announced in the 2002 Budget.[120] This it did on 1 May 2002, and the motion's approval was followed by the publication of the *National Insurance Contributions Bill 2001-02*.[121] In the opening speech to the debate, the Chief Secretary to the Treasury, Andrew Smith, put the case for using an increase in NICs to fund the health service:

> The Government believe that national insurance contributions are the fairest way of raising additional resources for the NHS. Using national insurance will ensure that people contribute according to their ability to pay. It will also ensure that vulnerable groups on fixed incomes, such as pensioners, will be protected, and that incentives to save will be unaffected … To increase the resources, employees and the self-employed will pay an extra 1 per cent. of all their earnings above £89 a week, so someone on the median income of £410 a week will pay £3.70, and those on higher incomes will pay more, while those on lower incomes will pay less. Indeed, half of families with children will pay less overall because of the introduction of the child tax credit and the working tax credit. As employers have a strong interest in having a healthy work force, they will make an equivalent additional contribution.[122]

When challenged by Steve Webb MP that it "would have been fairer to use income tax" given that "some of the richest people in the land live not on earned income but on dividends and investment income", Mr Smith replied, "no, we do not accept that. The hon. Gentleman must accept that if we raised the money primarily through income tax, many pensioners on fixed incomes would have to pay more, and it would deter saving."[123]

Speaking for the Conservatives David Lidington MP argued that although an increase in the resources devoted to the NHS might be welcomed – "of course our constituents want more to be spent on health care, and so does my party" – without further reform in the NHS itself, specifically "greater decentralisation and devolution of power", there would be no guarantee these resources would be properly spent:

> The Government would have us believe that the answer is simply to enable large amounts of public money, raised through additional taxation, to be spent on the health service, without the thorough reform that is necessary. To spot the problems with that we need only look at Scotland and Wales, where spending is

[120] HC Deb 25 April 2002 cc 465-7
[121] HC Deb 1 May 2002 cc 956-1012
[122] HC Deb 1 May 2002 cc 956-7
[123] HC Deb 1 May 2002 c 958

> much higher than in England but the service is worse in some important respects, and becoming worse still.[124]

Mr Lidington went on to suggest that increases in NICs ran counter to the Government's efforts to encourage people into work, would have a detrimental impact on employers as well as the self employed, and repeated the Treasury Committee's concern that the introduction of a 1% rate of primary Class 1 NICs on earnings over the upper earnings threshold effectively abolished that threshold. Mr Lidington also argued that the Government had failed to appreciate the impact on "the very public services that Ministers say they will help":

> What is shocking about the Government's approach is that they appear to have made no assessment of the effect of the increase in contributions upon jobs … I was disappointed that the compliance cost assessment made no attempt to analyse the impact of a higher rate of employers' contributions on jobs … We are being asked to vote through a motion without any assessment having been made of its impact on employment. This comes from the same Chancellor and Treasury team who two years ago claimed that the lower national insurance contributions that accompanied the climate change levy "will act to promote employment opportunities."
>
> We have a Government who think that lower national insurance contributions help to create jobs, but who refuse to acknowledge the damaging effect on jobs of higher national insurance contributions. Nor have they analysed the additional problems that these tax increases will cause to the very public services that Ministers say they want to help ... The national health service faces an increase in its payroll tax of about £250 million … What about individual public service workers? Nurses, police officers, teachers and firefighters will all get hit, too. The place worst hit will be London where, because the cost of living is higher and average wages, too, are higher … I cannot see how that will do anything other than worsen the already desperate problems in recruitment and retention of key public service workers in London and elsewhere in the south-east of England.[125]

For all these reasons, Mr Lidington suggested, the motion should be opposed.

Speaking for the Liberal Democrats, Matthew Taylor MP argued in favour of the motion:

> It our intention to support the resolution for two fundamental reasons … The first … is that we do not want to stand in the way of the investment that will improve the health service … The second … is that it is not about the national insurance increases but, in effect, about the hypothecation to the NHS of the money derived from those increases. It will specifically allow the increase in the national insurance take to be devoted to the NHS … The Conservative party is worried about tax rises and how they will be used, but this is one occasion on which the

124 HC Deb 1 May 2002 cc 961-2
125 HC Deb 1 May 2002 cc 967-8

> House can have a direct say about how money is spent and make sure that it is devoted to the NHS. The House hardly ever takes that opportunity, because we hardly ever debate in detail the way in which money raised is devoted to specific expenditure. Parliament devotes some days of the year to such discussions, but the debates are hardly ever put to a vote … The Opposition should welcome this opportunity to nail the Government's feet to the floor and ensure that the money goes where they say it will go.[126]

On the specific question of hypothecation Mr Taylor suggested that the Government had not gone far enough, and should "consider hypothecating a whole income stream to the NHS so that it can have greater certainty and transparency." In response to the criticism that any dip in the economy would, if revenues were properly hypothecated, feed through into a cut to health spending, Mr Taylor said the following:

> The answer to that is that we would treat this income flow in exactly the same way as the Treasury now wisely treats its overall income flows. It plans on the basis of long-term growth in the economy rather than short-term swings up and down. If it undershoots on its growth figure this year, as it is, it will not cut expenditure because it knows that, provided it remains in line with the 2.5 per cent. growth forecast, it will get the revenue back in future years.[127]

Nevertheless Mr Taylor was critical of the Government's decision to increase NICs, and specifically secondary Class 1 NICs, rather than income tax:

> The Government chose to raise employers' national insurance rather than to take the route for which we argued and adopt a new top rate of tax … However, his manifesto—after all, that is what it was—ruled that out, so he cannot take that approach. The result is a taxation policy that increases tax on employers and hits manufacturing in particular, as well as other businesses with low margins and high employment. At the same time, it does relatively little to put any cap on the consumer boom that is forcing up house prices in London and the south-east—increases that are driven not least by the many people on very high incomes in that area.[128]

Speaking for Plaid Cymru Adam Price MP argued that there were several disadvantages in increasing NICs rather than income tax to fund an increase in health spending: it undermined the contributory principle; it was less socially equitable; and – reiterating a point made by David Lidington MP earlier in the debate – it had a substantive impact on the public service, possibly encouraging wage inflation:[129]

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[126] HC Deb 1 May 2002 c 971
[127] HC Deb 1 May 2002 cc 978-9
[128] HC Deb 1 May 2002 c 976
[129] The last of these points was raised in a short debate in the Lords recently (HL Deb 24 April 2002 cc 244-7).

> As I understand it, the original Act [establishing national insurance] provided for mandatory contributions from employees and employers that were principally aimed at supporting benefits, although a small proportion went into the health service. It was anticipated that the Government would take up the shortfall. We are now in the opposite situation … We are now using the national insurance fund to support general Government expenditure … it cuts across the contributory principle that lay at the heart of the national insurance system, which was an earmarked social insurance system … Even when we are talking about national insurance increases, however, we are not talking about any form of hypothecation. The Treasury Committee is absolutely right to argue that it is wrong to exclude unearned income. If we accept the argument that there is a case for greater contributions through personal taxation, direct taxation is the most socially equitable means of raising those funds …
>
> If we accept that the central tenet of the Budget is to renew the national health service, it seems curious to use the payroll tax for that purpose. As we know, the national health service is the biggest employer in Europe—apart from the Russian armed forces, I believe—with 1.5 million employees. The payroll tax is therefore probably the last policy tool that should be used to effect an increase in new resources available to the national health service in the short term … There is also a danger that the employers' contribution will add further to worries about wage inflation in the public sector. The value of the extra money going into the NHS could be lost to inflation …
>
> The Secretary of State for Health has said that pay is not a something for nothing arrangement. The same applies to recruitment. The only way to recruit that number of people in what is admittedly a tight labour market is to offer serious additional incentives in terms of public sector pay. That, on top of the changes in employees' and employers' national insurance contributions, will make a very difficult environment for the public sector in the next few years. The fear is that the extra spending will be swallowed up by salaries and additional inflation that is unique to the public sector. Therefore, although the increase in investment is necessary, it is insufficient to deal with 30 years of underinvestment in the health service.[130]

As mentioned above, in the event the motion was approved by the House, and was followed immediately by the presentation of the *National Insurance Contributions Bill 2001-02*. At Business Questions the day after this debate, the Leader of the House, Robin Cook, announced that the second reading of the Bill was set provisionally for 13 May 2002.[131]

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[130] HC Deb 1 May 2002 cc 995-7
[131] HC Deb 2 May 2002 c 1049

B. The Bill

The *National Insurance Contributions Bill 2001-02* was printed on 1 May, along with explanatory notes prepared by the Inland Revenue (Bill 130-EN). In brief it has two purposes:

- It provides for an additional 1 per cent national insurance contribution by employers, employees and the self-employed, by increasing the main rates of primary and secondary Class 1 and Class 4 NICs by 1 percentage point, and by introducing an additional 1 percent charge on primary Class 1 NICs and Class 4 NICs above the upper earnings/profits limit.

- It provides for the extra receipts raised by these changes to be added to the proportion of NIC receipts that already go towards the cost of the NHS.

In addition the Bill makes a number of consequential amendments to ensure there is no impact on entitlement to contributory benefits or on the rate of such benefits from these changes in NI rates, nor any change in the way in which the reductions in contributions are applied in respect of employees who are contracted-out of the state second pension.

At present employees are charged primary Class 1 contributions at a rate of 10% on earnings between the primary threshold and upper earnings limit under section 8 of the *Social Security Contributions and Benefits Act (SSCBA) 1992*. The rate of NICs may be amended by Order under ss 143 and 145 of the *Social Security Administration Act (SSAA) 1992*.

Clause 1(1) of the Bill replaces section 8 of *SSCBA 1992*, introducing a 'main primary percentage' – on earnings between the primary threshold and the upper earnings limit – charged at 11%, and an 'additional primary percentage' – on earnings which exceed the upper earnings limit – charged at 1% (section 8(1) of the amended Act). The clause specifies that only the main primary percentage may be subject to alteration, as at present, by regulations under the *SSAA 1992* – not the additional primary percentage. The clause specifies the cases in which section 8(1) of the amended *SSCBA 1992* may be modified. (These relate to particular categories of contributor, and include the rebates which apply when an employee is a member of a contracted-out pension scheme.) **Clause 1(2)** makes the same changes for Northern Ireland, by inserting a new section 8 in the *Social Security Contributions and Benefits (Northern Ireland) Act 1992* (*SSCB(NI)A 1992*).

At present employers are charged secondary Class 1 contributions at a rate of 11.8% on earnings above the secondary threshold under section 9 of the *SSCBA 1992*.[132] As with

[132] as amended by the *Social Security (Contributions) (Re-rating and National Insurance Funds Payments) Order* SI 2002/830

the rate of primary Class 1 contributions, the rate may be amended by Order under ss 143 and 145 of the *SSAA 1992*.

Clause 2(1) of the Bill replaces subsections (2) and (3) of section 9 of the *SSCBA 1992*, increasing the rate of Class 1 NICs paid by employers (the 'secondary percentage') by 1% to 12.8%. The clause specifies that the secondary percentage will continue to be subject to alteration under ss 143 and 145 of the *SSAA 1992* – and that, as with the main primary percentage, it is subject to modification for certain categories of contributor. **Clause 2(2)** makes the same changes for Northern Ireland, by substituting new subsections (2) and (3) in section 9 of the *SSCB(NI)A* 1992.

Schedule 1 of the Bill makes consequential amendments to ss 10 and 10A of the *SSCBA 1992* and the *SSCB(NI)A 1992* to apply the secondary percentage to Class 1A contributions (paid by employers on benefits in kind) and Class 1B contributions (paid where an employer enters into a PAYE settlement agreement).

At present self-employed persons are charged Class 4 contributions between the lower and upper profits limit at a rate of 7% under section 15 of the *SSCBA 1992*.[133] Both the profit limits, and the rate of Class 4 NICs, may be amended by Order, under ss 141 and 143 of the *SSAA 1992* respectively.

Clause 3(1) of the Bill replaces subsection 3 of section 15 of the *SSCBA 1992*, introducing a 'main Class 4 percentage' of 8% on earnings between the lower and upper profits limit, and an 'additional Class 4 percentage' of 1% on earnings above the upper profits limit. The clause specifies that only the main Class 4 percentage may be subject to alteration, as now, by regulations under section 143 of the *SSCBA 1992*. The additional percentage cannot be changed by regulations. **Clause 3(2)** makes changes to section 15 of the *SSCB(NI)A 1992* to mirror the changes above.

Clause 3(3) amends section 18 of the *SSCBA 1992*, which deals with the treatment of certain workers (eg, examiners) who are, by regulations, treated as being self-employed for the purposes of NICs. The section ensures that such workers pay special Class 4 contributions on their earnings between the lower and upper profits limits. The clause ensures that the additional 1 per cent is included in any calculation. Equivalent provision is made for Northern Ireland under **clause 3(4)**.

The current formula for calculating the NHS allocation is specified in section 162 of the *Social Security Administration Act 1992*. In the case of Class 1 contributions made by employees, this is 1.05 percent of earnings between the primary threshold and upper earnings limit. **Clause 4** of the Bill will change this to 2.05 percent. For Class 1

[133] as amended by the *Social Security (Contributions) (Re-rating and National Insurance Funds Payments) Order* SI 2000/755

contributions made by employers, 0.9 percent of total earnings in respect of which contributions are made is allocated to the NHS. The Bill will change this to 1.9 percent. For Class 4 contributions made by the self-employed the allocation is 1.15 percent of profits between the lower and upper profits limits: the Bill increases this to 2.15 percent. In addition **clause 4** of the Bill attributes 100 per cent of the contributions above the upper earnings/profits limits to the NHS allocation. Corresponding provision for the health service allocation in Northern Ireland is made by **Clause 5**.

Clauses 6 and **7** of the Bill introduce **schedules 1** and **2** of the Bill, which deal with consequential amendments, and repeals and revocations respectively. In addition to the amendments relating to Class 1A and 1B contributions mentioned above, **schedule 1** deals with the consequential amendments arising from the increase in national insurance contributions rates. The main thrust of the amendments is to ensure that there is no impact on entitlement to contributory benefits or on the rate of such benefits. The amendments also ensure that there is no change in the way in which the reductions in contributions are applied in respect of employees who are contracted-out of the state second pension. Paragraphs 25 to 30, 33, 44 and 46 to Schedule 1 make changes to Northern Ireland benefits and pensions legislation. These amendments are subject to the approval of the Northern Ireland Executive Committee and Assembly.

Clause 8 sets out the short title of the Bill, its commencement and extent. Under **clause 8(2)** the Bill is to have effect from 6 April 2003.

The effect of the changes to national insurance contributions made by the Bill will raise an additional £7.9 billion in 2003/4.[134] This will roughly double the amount going to the NHS from NICs. £3.55 billion of this will come from employees; £3.9 billion from employers and £450 million from the self employed.

[134] *Budget 2002* HC 592 April 2002 p 154

IV Changes in NICs from April 2003: statistical analysis

National insurance contributions are paid by employees and employers (primary and secondary Class 1) and by the self-employed (flat rate Class 2 and profit-related Class 4). The new rate structure for Class 1 NICs to be introduced in April 2003 is shown below.

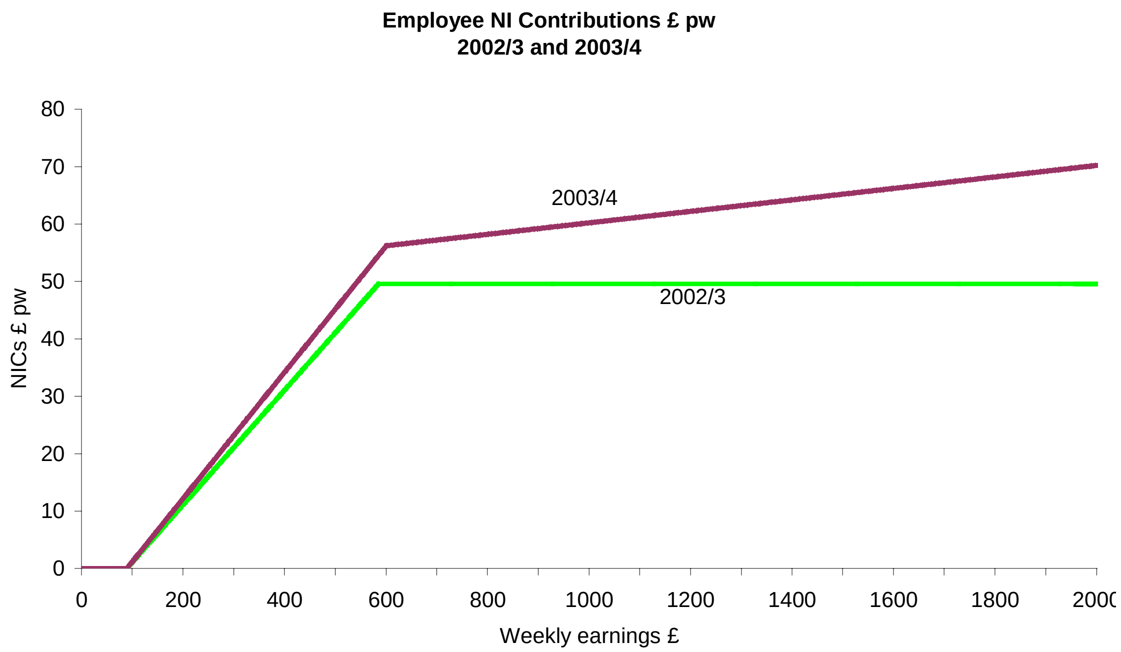
National Insurance contribution rates 2002/2 and 2003/4

Class 1	Employee %		Employer %	
Weekly earnings £pw	2002/3	2003/4	2002/3	2003/4
Up to 89	0	0	0	0
89 to 585	10	11	11.8	12.8
Above UEL	0	1	11.8	12.8

Self-employed contributions in 2002/3 are Class 2 for which £2 per week is paid when profits are above the annual lower profits limit of £4,025 and Class 4 which are earnings-related. The structure of Class 4 NICs from April 2003 is shown below.

Class 4	2002/3 %	2003/4 %
Below £4,615	0	0
£4,615 to £30,420	7	8
Above UPL	0	1

The new NI structure means that the amount of NI contributions will continue to rise as earnings or profits increase. The 1% rate for earnings above the upper earnings limit does, however, mean that the rate of contributions faced by individual employees as a proportion of total earnings tails-off as earnings exceed the upper earnings limit.



The following table illustrates the effect on an individual employee of the new rates of NI.

National insurance contributions for employees by earnings level 2002/3 and 2003/4

Earnings	Contributions £pw		
£pw	2002/3	2003/4	Difference
50	0.0	0.0	0.0
100	1.1	1.2	0.1
150	6.1	6.7	0.6
200	11.1	12.2	1.1
250	16.1	17.7	1.6
300	21.1	23.2	2.1
350	26.1	28.7	2.6
400	31.1	34.2	3.1
450	36.1	39.7	3.6
500	41.1	45.2	4.1
550	46.1	50.7	4.6
600	49.6	56.2	6.6
650	49.6	56.7	7.1
700	49.6	57.2	7.6
750	49.6	57.7	8.1

V Sources and further reading

A. Government material on the 2002 Budget & the *Wanless Report*

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2. Miscellaneous

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Stuart Adam & Chris Frayne, *A survey of the UK tax system: Institute for Fiscal Studies Briefing Note no.9*, November 2001
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http://www.publications.parliament.uk/pa/cm200102/cmselect/cmtreasy/780/78002.htm

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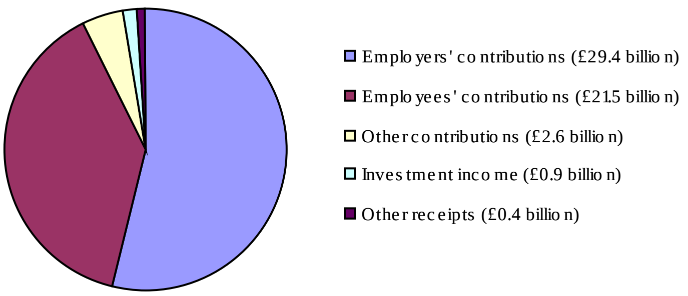
Appendix: The National Insurance Fund

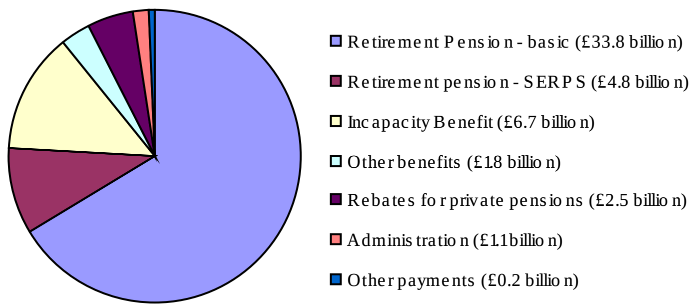
Around 90% of National Insurance Contributions are paid to the National Insurance Fund to finance contributory social security benefits, such as the Retirement Pension and Incapacity Benefit. The Fund receives contributions after deduction of the part of contributions going to the NHS.

The National Insurance Fund receives over 90% of its income from contributions paid by insured employees and their employers. 66% of its expenditure is on basic rate Retirement Pensions.

NI Fund: sources of income in 2000-01



NI Fund: payments in 2000-01



The Government Actuary recommends that the Fund maintains a working balance equivalent to 16.7% of benefit expenditure. In recent years the balance has grown well in excess of this as contribution income has grown more quickly than benefit expenditure.

In the longer-term, the Government Actuary projects that the balance will begin to fall again and – on current policies – will fall below the recommended minimum by the end of this decade. This largely reflects the effects of successive above-inflation increases in the rate of Retirement Pension in 2001 and 2002.

Receipts into and payments out of the Fund since 1990-91 are shown in the table overleaf.

NI Fund Receipts and Payments

£ billions

	Receipts	Payments	Surplus / Deficit	Fund balance at end year £ billion	Fund balance at end year % of benefit expenditure
1990-91	34.5	33.0	1.5	11.8	39.7%
1991-92	34.7	38.1	-3.5	8.3	24.3%
1992-93	35.7	40.6	-4.9	3.4	9.4%
1993-94	44.3	43.2	1.1	4.5	11.7%
1994-95	45.1	42.9	2.3	6.8	17.3%
1995-96	44.6	43.6	1.0	7.8	19.4%
1996-97	44.9	45.0	-0.1	7.7	18.5%
1997-98	47.8	46.0	1.9	9.6	22.5%
1998-99	50.3	47.6	2.7	12.3	27.5%
1999-00	52.2	50.0	2.2	14.4	31.1%
2000-01(a)	54.8	50.8	4.0	19.4	41.2%
2001-02(a)	59.3	54.6	4.8	24.2	47.7%
2002-03(a)	61.1	57.7	3.4	27.6	52.0%

Sources: *National Insurance Fund Annual Accounts, Report by the GAD on the Soc Security Uprating Order 2002*

Note: a) Estimated