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National Insurance Contributions Bill

Bill 7 of 2007-08

In his Budget speech on 21 March 2007 the then Chancellor Gordon Brown announced a series of changes to personal taxation, including the alignment of the upper earnings limit (UEL) for National Insurance contributions (NICs) with the higher rate threshold – the point at which taxpayers start to pay the higher rate of income tax. The *National Insurance Contributions Bill* is to introduce new regulation-making powers to enable Ministers to effect this reform.

In addition the Bill introduces an upper accrual point (UAP) for the state second pension (S2P) from April 2009. At present S2P is earnings-related: the amount any individual accrues in a year is based on their earnings between the lower earnings limit for NICs and the UEL. Under provisions in the *Pensions Act 2007* S2P is to be transformed into a flat-rate top-up to the basic state pension by around 2030 or shortly afterwards. This is to be done in part by the introduction of the UAP, which is to be frozen in cash terms. Initially it was expected that the UAP would be introduced in 2012. In the *Pre-Budget Report* in October 2007 the Government announced that the UAP would be set in 2009. This prevents increases in the UEL from 2009 onwards from boosting the S2P that higher earners accrue.

Antony Seely & Djuna Thurley

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Summary

National insurance benefits are funded by a system of compulsory contributions, paid by employees, employers and self-employed people. Receipts from National Insurance contributions (NICs) are paid into the National Insurance Fund, which is separate from all other revenue raised by taxation. The Fund is used exclusively to pay for contributory benefits, and operates on a 'pay as you go' basis: broadly speaking, this year's contributions pay for this year's benefits (retirement pensions account for just over 85% of benefit expenditure from the Fund).

In his Budget speech on 21 March 2007 the then Chancellor Gordon Brown announced a number of reforms to the personal tax system, to create "a tax system for income that has just two rates and two thresholds" as well as "to reward work, to ensure working families are better off and to make the tax system fairer."[1] First, the basic rate of income tax will be cut by 2 percentage points – from 22% to 20% – and the 10% starting rate of income tax on earnings will be abolished from 2008-09. As a result income tax on earnings will be charged at two rates: the basic rate of 20% and the higher rate of 40%. Second, the upper earnings limit for NICs will be aligned with the higher rate threshold.

For 2007-08 individuals are charged NICs at 11% on earnings between the primary threshold – set at £100 a week – and the upper earnings limit (UEL) – set at £670 a week.[2] NICs are charged at 1% on earnings above the UEL. Ignoring tax credits, the marginal rate of deduction faced by employees – combining income tax and NICs – is:[3]

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

Aligning the UEL with the higher rate threshold will remove this 'dip' in the marginal rate. This is to be done in two steps:

- In 2008-09 the UEL is to be increased above indexation by an additional £75 a week.
- In 2009-10 the higher rate threshold is to be increased by £800 above indexation. The UEL will be further increased to align it with this threshold.

It is estimated that the phased alignment of these higher thresholds will raise £1.49 billion in 2009-10.[4]

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1 HC Deb 21 March 2007 cc 827-8

2 NICs are charged at a zero rate on earnings above the lower earnings limit (LEL) and the primary threshold. The LEL is set at £87 a week in 2007-08.

3 Taking account of the basic personal allowance, for 2007-08 employees are charged income tax at: 10% on earnings between £100 and £143 a week; 22% on earnings between £143 and £766 a week; and 40% on earnings above £766 a week.

4 *Budget 2007* HC 342 March 2007 p 208. Raising both thresholds in 2009-10 is estimated to cost the Exchequer £250 million in that year.

Under the current legislation establishing the thresholds for NICs, the UEL may be amended by secondary legislation – although it must be set at between 6½ and 7½ times the primary threshold.[5] It is anticipated that the second stage of the proposed alignment would infringe this rule. The *National Insurance Contributions Bill 2007-08* seeks to remove this restriction for the tax year 2009-10 and beyond.

The second purpose of the Bill is to introduce an 'upper accruals point' for the state second pension (S2P) from April 2009. In broad terms, for any given tax year S2P accrues on the portion of an employee's annual earnings between the lower earnings limit (LEL) and the UEL. Earnings above the UEL do not accrue any S2P. The Government first proposed that S2P should become a simpler, flat rate scheme in its green paper on pensions published in 1998.[6] In its report on the pensions system in 2005, the Pensions Commission suggested this process should be accelerated, as part of its wider recommendation that "constrained" tax and national insurance resources should be focused "on ensuring as generous and non-means-tested, flat-rate state pension provision as possible."[7] The Government accepted this proposal in its white paper on pensions published in 2006,[8] and a number of provisions were included in the *Pensions Act 2007* to effect this change. One of these changes is to establish a set figure as the upper limit of earnings on which S2P accrues, rather than the UEL.

As this upper accruals point (UAP) is to be frozen in cash terms, its introduction will lead to a gradual erosion of earnings-related accruals for S2P. The UAP is to be set below the level of the UEL from 2009-10. This prevents higher earners accruing additional S2P from the increase in the UEL which fully aligns it with the higher rate threshold. The *National Insurance Contributions Bill* provides that the UAP will be introduced in April 2009, and will be set at £770.

Although the Bill is relatively short in length, it is quite technical. Before reading further, those who are unfamiliar with the basics of the National Insurance system, or the state second pension, may wish to look first at two Library standard notes. The first of these deals with the structure of NICs where the debate has been about integrating NICs with income tax;[9] the second sets out the current rules for the state second pension and the Government's policy to its reform.[10] As with other Library standard notes these are published on the Commons intranet. In addition this material is collated with links to the Bill, its progress in the House, and other related material on the Library's Bill Gateway for this Bill – which is also on the Commons intranet.

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[5] Under section 5(3) of the *Social Security Contributions and Benefits Act 1992*

[6] *A new contract for welfare: partnership in pensions*, Cm 4179 December 1998

[7] *A New Pension Settlement for the Twenty-First Century: The Second Report of the Pensions Commission*, 30 November 2005 p10. The Commission was set up by the Government in 2002 to review the UK private pension system and long term savings.

[8] *Security in retirement: towards a new pensions system*, Cm 6841 pp116-9 May 2006

[9] "National Insurance contributions: an introduction", Library standard note SN/BT/4517, 29 November 2007

[10] "State Second Pension", Library standard note SN/BT/255, 13 November 2007

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I Introduction

In his Budget speech on 21 March 2007 the then Chancellor Gordon Brown announced a series of changes to the personal tax system. One of these measures was to "align the income tax system with the national insurance system" from April 2009 "thereby creating a tax system for income that has just two rates and two thresholds."[11] The Budget report summarised these changes as follows:

> The Government will:
>
> - remove the starting rate and cut the basic rate of income tax from 22 pence to 20 pence, creating a simpler structure of two rates:[12] a 20 pence basic rate and a 40 pence higher rate from April 2008;
> - increase the upper earnings limit for national insurance by £75 a week above indexation in April 2008, and then from April 2009 fully align it with the higher rate threshold – the point at which taxpayers start to pay the higher rate of income tax, further simplifying the system;
> - raise the aligned higher rate threshold and upper earnings limit by £800 a year above indexation from April 2009;
> - increase the higher personal allowances for those aged 65 or over by £1,180 above indexation from April 2008;
> - raise the child element of the Child Tax Credit by £150 a year above earnings indexation in April 2008, making further progress in helping families and tackling child poverty, and raising the child element to £2,080 a year;
> - increase the threshold for Working Tax Credit by £1,200 to £6,420 a year in April 2008, further increasing the incentives to work for families with children and low-income working households; and
> - raise the withdrawal rate on tax credits by 2 per cent to 39 per cent in April 2008, helping to retain their current focus.[13]

When Mr Brown appeared before the Treasury Committee following the Budget, he was asked about the benefits of this new tax rate structure; in reply, he said:

> On the personal tax system, it seems to me to have two rates and two thresholds is something that has eluded every government for the last 40 years, even when they have tried to do this ... We have now not only got 20p as the basic rate of income tax, and I think the public will understand the importance of that as a signal about the importance of work and the rewards that are available for work, but we have also managed to get two thresholds because the resources that we have got have made it possible for us to harmonise the threshold for top rate income tax and the ceiling for National Insurance. That is a major change that any Chancellor would like to have done were the resources available to do so ... Because we can provide money through the child benefit and child tax credits, through pensioner tax allowances and through the pension credit, and through the working tax credit, because these three instruments are now available to us, it

[11] HC Deb 21 March 2007 c827

[12] For all income other than savings and dividend income.

[13] *Budget 2007* HC 342 March 2007 p109

> is possible to move from 22 pence to 20 pence without having a 10 pence rate which in a sense was a transitional rate while we got the new system into being.[14]

At an earlier evidence session the Chairman of the Committee, John McFall, asked Robert Chote, director of the Institute for Fiscal Studies, whether the removal of the 10% starting rate was a surprise, given that Mr Brown had introduced it in his 1999 Budget:

> **Mr Chote:** It is a testament to the fact that if anybody is Chancellor for long enough you end up abolishing some of the measures you put in in the first place. I think the issue in the first place was it was never very clear that the 10p rate was a particularly effective tool in terms of the distributional implications that were claimed for it at the time, so removing that and the rather curious drop in the combined marginal rate of income tax and NI above the top of the upper earnings limit look like sensible changes. The Treasury's argument is that now they have tax credits which do the job that the 10p rate was designed to do to begin with. I do not think it was very clear that the 10p rate was very well designed to do that job to begin with so it would be churlish not to welcome its departure.[15]

Mr Chote also speculated about the Government's reasons for retaining the 10% rate on savings income:

> There is probably a presentational issue in that in terms of labour income the Chancellor could say that people were compensated from raising the 10p rate to 20 by the cut in the basic rate from 22 to 20 but for savings the basic rate was already 20 so there was no equivalent cut there. There may have been a presentational concern that you could not tell the same story of taking with one hand and giving back with the other.[16]

Many commentators noted what Anatole Kaletsky in the *Times* called "the element of conjuring" in this reform.[17] Martin Wolf in the *Financial Times* noted that "if one looks carefully, one finds that [the Chancellor] is not so much robbing Peter to pay Paul, as robbing Peter to pay Peter."[18] The abolition of the starting rate on earnings income, taken with the alignment of the UEL, is estimated to raise £10.12 billion in 2009-10. The cut in the basic rate, combined with the increases in age-related allowances, is estimated to cost £10.59 billion in the same year.[19] In fact the Chancellor had noted in an early part of his Budget speech that, "the changes that I make today will be broadly neutral for the public finances."[20]

The redistributive effects of these changes will depend on someone's income *and* their household circumstances, though the Institute for Fiscal Studies (IFS) have estimated that "those who are affected [by the Budget] neither gain nor lose much. The maximum

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[14] *Fifth report: The 2007 Budget*, 23 April 2007 HC 389-II 2006-07 Ev 44 Q296
[15] HC 389-II 2006-07 Ev 10 Q54
[16] HC 389-II 2006-07 Ev 10 Q56
[17] "A fitting climax, but …", *Times*, 22 March 2007
[18] "A display of virtues and vices", *Financial Times*, 22 March 2007
[19] HC 342 March 2007 p208
[20] HC Deb 21 March 2007 c819. Taken together all the changes announced in the Budget are estimated to cost £525 million in 2007-08, and raise £280 million in 2008-09 (HC 342 March 2007 p209).

gain is £325 and the maximum loss is £223 a year."[21] The *Financial Times* noted that "many taxpayers will feel marginal impact from the changes."[22] For its part the Treasury Committee argued that "an important part of any change to the personal taxation regime must be that both winners and losers can identify, with ease, how they are affected by the changes stated within a Budget package. We recommend that, in future, this information be provided within the Red Book."[23]

In his piece quoted above, Anatole Kaletsky went on to say that although the Chancellor would be accused of "taking away with one hand what he gives with the other … there is nothing wrong with this":

> It is what tax simplification is all about. Anyone who calls for a simpler tax code or a lowering of marginal tax rates without any overall reduction in government revenues and spending is calling for exactly what Mr Brown did yesterday.[24]

In an editorial on the Budget the *Financial Times* noted that "these changes should nevertheless improve the complex interface between the tax and national insurance systems … Income tax rates are not necessarily the most difficult aspects of fiscal administration, but a move from five rates to three is still simpler. Common thresholds should help too."[25] The paper quoted John Cullinane, president of the Chartered Institute of Taxation, as saying aligning NI with income tax rates was a step in the right direction: "it is still a hugely complicated system, but this is the first time that a serious regard has been paid to simplification as an objective."[26] In a presentation following the Budget, Mike Brewer at the IFS noted that this was a welcome simplification given that the justification for the 10p band had never been clear, although it would have been "much simpler" if the 10p rate had been withdrawn on savings income as well.[27]

In its report on the Budget the Treasury Committee noted that alignment of the UEL with the higher rate threshold raised the issue of fully integrating NICs with income tax:

> [Other than the changes to income tax rates and age-related allowances] the other main area of simplification in this year's Budget lay in the changes to the National Insurance system. Despite the modifications to be adopted after the Budget, [John Whiting, at PricewaterhouseCoopers] was still convinced that there was a meaningful distinction between the National Insurance and taxation systems, although when asked whether he still thought there was a case for National Insurance, he replied "I would say that there is probably a lot to be said for combining the two".
>
> [Dr Martin Weale, at the National Institute of Economic & Social Research] concurred with this notion on the grounds of transparency, stating that "It seems

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[21] "Fiscally neutral swings and roundabouts", *Financial Times*, 23 March 2007

[22] "'Harmonisation' with NI rate less than tuneful", *Financial Times*, 22 March 2007

[23] HC 389-I 2006-07 para 41. More details on the projected distributional impact of these changes were given in a series of written answers: HC Deb 18 October 2007 cc 1266-70W.

[24] "A fitting climax, but …", *Times*, 22 March 2007

[25] "Editorial: Brown tidies up before he takes his leave", *Financial Times*, 22 March 2007

[26] "'Harmonisation' with NI rate less than tuneful", *Financial Times*, 22 March 2007

[27] Mike Brewer, *Winners and losers from personal and indirect tax changes : presentation*, IFS March 2007. This is available at: http://www.ifs.org.uk/publications.php?publication_id=3928 [ret'd 11/12/2007].

> to me the main reason for keeping National Insurance separate from income tax is that the Chancellor can say to people, 'There is a standard 20p rate of tax' and forget about the employers' and employees' National Insurance contributions which are in effect also deductions from wages."[28]

Although an individual's record of paying NICs during their working life triggers their entitlement to contributory benefits, there is little direct financial connection between the contributions someone pays into the NI fund, and the value of benefits they may receive. As noted, the NI fund operates on a 'pay as you go' basis: broadly speaking, this year's contributions pay for this year's benefits. Many commentators have argued that this is reason enough to merge NICs into income tax, thereby simplifying the tax system, and reducing the administrative burden on employers and the tax authorities. However, there are strong arguments against this reform: the major distributional effects of such a change, the need to find a satisfactory way of upholding the contributory principle and the need for a new separate charge for employers' NICs. Although the prospects for integration have been discussed for many years, governments of both parties have concluded that the costs would be too great.[29]

On 11 July 2007 the Government published its draft legislative programme for the forthcoming Session. This noted that the Government intended to introduce a *National Insurance Contributions Bill* to allow the UEL to be aligned with the higher rate threshold.[30] At this time the *Pensions Act 2007* received Royal Assent. The Act contained several provisions to reform the state second pension, so that instead of being earnings-related it would, over time, become a flat-rate benefit.[31] It is anticipated that this process will be completed around 2030 or shortly afterwards.[32]

One of these changes is the introduction of an upper accrual point (UAP). In broad terms, for any given tax year S2P accrues on the portion of an employee's annual earnings between the lower earnings limit (LEL) and the UEL. In general both the LEL and the UEL are increased in line with prices. Unlike both of these limits, the UAP is to be frozen in cash terms, so that once it is introduced, earnings-related accruals to S2P will be gradually eroded.[33]

On 8 October the Government published the Pre-Budget Report, and in this it explained that the forthcoming *National Insurance Contributions Bill* would include provision to introduce the UAP from April 2009:

> Following the Pensions White Paper, the Pensions Act 2007 puts in place proposals to reform the State Second Pension so that it becomes a simple, flat-

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[28] *Fifth report: The 2007 Budget*, 23 April 2007 HC 389 2006-07 para 39

[29] This issue is discussed at length in, "National Insurance contributions: an introduction", Library standard note SN/BT/4517, 29 November 2007 (pp14-21).

[30] Cm 7175 July 2007 p52; HC Deb 11 July 2007 cc1449-52

[31] specifically ss 10-12 of the *Pensions Act 2007*

[32] The case for this reform was briefly discussed at the Committee stage of the *Pensions Bill 2006-07*; for details see, "Pensions Bill 2006-07 – debates in Parliament", Library standard note SN/BT/4295, 23 August 2007 (pp29-30).

[33] The background to the changes set out in the Act is discussed in, *The Pensions Bill*, Library Research paper 07/05, 11 January 2007.

> rate weekly top-up to the basic State Pension by around 2030, providing a clearer foundation for private saving. To ensure this timetable is met, while delivering the personal tax reforms announced at Budget 2007, the Government will introduce the Upper Accruals Point for the State Second Pension in 2009.[34] Legislation will be introduced in the NICs Bill to ensure there is no delay in State Second Pension simplification.[35]

There does not appear to have been much comment on the Bill at this time, although one commentator writing in the technical journal *Taxation* noted that "the end result [of fixing the UAP in April 2009] is … that we pay more NIC (ie, up to a higher UEL), but receive none of the benefits in due course that this should entail. I don't know about you, but that looks like a straightforward tax increase to me!"[36]

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[34] This was originally intended for 2012, to coincide with wider pension reforms.

[35] Cm 7227 October 2007 para 5.60

[36] "Exactly what are we saving for?", *Taxation*, 8 November 2007

II The Bill

The *National Insurance Contributions Bill 2007-08* was introduced in the House of Commons on 12 November 2007.[37] Explanatory notes to accompany the Bill were published at this time, and the Treasury issued an impact assessment the following day.[38] HM Revenue & Customs has a series of pages on its site which collate material on the Bill, including a series of frequently asked questions.[39] The Bill is relatively short, composed of seven clauses and two schedules, and is eight pages long. Both the Bill and the explanatory notes are published on Parliament's internet site.[40] An appendix to this paper reproduces a glossary of terms provided in the explanatory notes to the Bill.

As with all other Bill pages, the website page keeps track of its progress through the House. The Bill is expected to be debated on second reading on 17 December 2007.

Legislation dealing with NICs is not included in the annual Finance Bill, and generally changes to NI that require primary legislation are made by including such provisions within a much larger Act covering a range of social security issues. It is a Parliamentary convention that Finance Bills are concerned with moneys that go into the Consolidated Fund. As receipts from NICs go into the NI Fund, not the Consolidated Fund, legislative provisions relating to NI are not contained in the Finance Bill.

A. Setting the Upper Earnings Limit

As discussed, the alignment of the UEL with the higher rate threshold is one of a series of linked reforms to the personal tax system announced in the 2007 Budget. A press notice issued at the time gave details of how each of these measures would be implemented (*emphasis added*):

> The basic rate of income tax up to and including 2007-08 is 22% … The basic rate will be changed to 20% in Finance Bill 2008. The starting rate of income tax is 10% up to and including 2007-08. It is the first rate of income tax charged on all income types after personal allowances have been deducted. The starting rate limit for 2007-08 is £2,230. Finance Bill 2008 will remove the starting rate of tax from earned income and pensions. It will continue to be available for savings income and capital gains. There are no changes to the rates applicable to dividends.
>
> Personal allowances are increased in line with prices inflation each year, unless the increase is overridden in the Finance Act. There are three levels of personal allowance: the basic level for those under 65 and two higher levels, for those aged 65 to 74 and 75 or more. Finance Bill 2008 will increase the amount of the two higher levels by £1180 over the indexation figure. Finance Bill 2011 will

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[37] Bill 7 of 2007-08. HC Deb 12 November 2007 c398

[38] HC Deb 13 November 2007 c35WS. HM Treasury/HM Revenue & Customs, *Impact Assessment of the National Insurance Contributions Bill 2007*, Deposited paper DEP2007-0083, 13 November 2007. This is available at: http://www.hmrc.gov.uk/ria/nics-bill-ia.pdf

[39] At: http://www.hmrc.gov.uk/legislation/nics-bill.htm

[40] At: http://services.parliament.uk/bills/2007-08/nationalinsurancecontributions.html

increase the personal allowance for those aged 75 and over to £10,000. Indexed rises will be maintained in the intervening two Finance Bills.

Current Social Security legislation requires the maximum UEL to be less than seven and a half times the Primary Threshold. The Primary Threshold is the point at which Class 1 NICs become due. Changes to the UEL below this amount are made by Regulations annually. Any change to the UEL above this maximum requires primary legislation in a NICs Programme Bill ...

The first step in the alignment of the UEL … with the amount at which higher rate tax is payable will be made in 2008 by Regulations and the Re-rating Order respectively. The second step for the UEL alignment will be made in a NICs Programme Bill in time for a start date of April 2009 ...

The amount of the aligned figure for income tax purposes will be achieved for 2009-10 by increasing the amount of the basic rate limit by £800 above indexation in Finance Bill 2009.[41]

One tax practitioner writing in the *Tax Journal* at the time of the Budget discussed the fact that the UEL "has its roots firmly in the state pension system, not the tax system":

> When the state earnings-related pensions system was redesigned in the 1970s, the weekly lower earnings limit (LEL) was set by law to be equal to or up to 99p less than the full weekly basic state pension.[42] The basic principle was that, once you earned at the LEL, you and your employer paid a contribution that bought eventual entitlement to a weekly state pension of the same amount. The earnings-related component added to the basic pension was based on contributions on earnings between the LEL and the UEL, which was always to be set at between 6½ and 7½ times the basic pension. Contributions were capped by the UEL for both employer and employee, which in effect capped the SERPS pension too. When Nigel Lawson removed the cap on employer contributions in 1985, the cap on SERPS entitlement remained in place.
>
> As part of the early attempts at harmonisation and 'simplification' of PAYE and NIC, the starting point for contributions was increased to equal the single personal allowance, now known as the [primary threshold – PT]. The LEL, as one of the basic building blocks of the contributory social security regime, intimately bound up with the basic state pension, could not be touched and remained in place, with a new set of rules deeming contributions to have been paid where earnings fell between the LEL and the [PT] … With the starting point for NIC increased to the [PT], the formula for the UEL was also amended, so that it became, and remains, between 6½ and 7½ times the [PT] for the year.[43]

The introduction of the PT and its alignment with the personal allowance meant that employees became liable for NICs and income tax at the same weekly wage. This was achieved in two steps in April 2000 and April 2001. In effect the point at which NICs became payable rose from £66 a week in April 1999, up to £87 in April 2001. In Budget

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41 HM Revenue & Customs *Budget Note BN01*, 21 March 2007

42 [The State Earnings Related Pension Scheme (SERPS) as it was known was replaced by the state second pension (S2P) in 2002.]

43 "Budget 2007 – NIC", *Tax Journal*, 9 April 2007

2000 the Government noted that with this limit "being raised by over 25 per cent in two years, it is right to raise the UEL as well: to £535 per week from April 2000 and to £575 per week from April 2001."[44] This measure required the statutory limit set on the UEL be amended: instead of the UEL being set at 6½-7½ times the LEL, it is now set at 6½-7½ times the PT. This was made by the *Welfare Reform and Pensions Act 1999*: para 1 to schedule 9 of the Act, which amended section 5 of the *Social Security Contributions and Benefits Act (SSCBA) 1992* accordingly.[45]

The origin of the LEL and UEL – and the 6½-7½ multiple limit on the size of the UEL – lie in the transition of NICs to an earnings-related contribution system in the mid-1970s. When NICs were first introduced in 1911 contributions were flat-rate, and continued to be so after WW2, although they were varied by age and sex. Partially earnings-linked (graduated) contributions were added to this structure in 1961, but it was not until 1975 that NICs became fully related to earnings. As part of this reform, lower and upper earnings limits for contributions liability were introduced. A lower limit was required both for practical administrative reasons and to concentrate contributions and benefits on people who depended substantially on income from work. As noted above, the lower limit was linked to the level of the basic retirement pension. An upper limit was required to prevent excessive burdens, and the acquisition of very high benefit entitlements.[46]

Incidentally, it is another aspect of the Government's reforms of the state pension system that the statutory link between the LEL and the basic state pension – mentioned in the quote above – is to be broken.[47] It is the Government's intention that in future, increases in the basic state pension should be linked to earnings rather than prices. "Subject to affordability and the fiscal position" this is to be done in 2012, or by 2015 at the very latest.[48] Preserving the link would mean the LEL would automatically rise in line with earnings, and the Government has resisted this, given this would mean people on lower incomes falling out of the NI system.[49] Under section 7(5) of the *Pensions Act 2007*, the statutory requirement which links the LEL and the weekly rate of the basic state pension is to be removed from the first year that the earnings link is restored. From this point the LEL is to be set by Order, and these regulations will be subject to the affirmative procedure.

Clause 1 of the Bill removes the current statutory limit on the UEL not exceeding 7½ times the Primary Threshold for NICs. In addition it provides for the UEL to be set for 2009-10 and beyond by means of secondary legislation, which is to be subject to the affirmative procedure. This is similar to the procedure established by the *Pensions Act*

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44 HC 298 March 1999 para 4.57

45 The provisions were added to the Bill at its Committee stage: SC Deb (D) 27 April 1999 c981

46 Social Security Committee, *The Contributory Principle*, 7 June 2000 HC 56-II 1999-2000 p169

47 As with the current statutory limit set on the UEL, this rule is contained in section 5 of *SSCBA 1992*.

48 *Security in retirement: towards a new pensions system*, Cm 6841 May 2006 para 3.24. This is provided for by s 5 of the *Pensions Act 2007.*

49 At the Committee stage of the Pensions Bill, the then Pensions Reform Minister James Purnell noted the LEL was "the earnings point at which employees start to build up entitlement to contributory working-age and pension benefits" and could be seen as "the benefit entry point" (Pensions Bill Deb 30 January 2007 c179).

2007 for setting the LEL, when its link with the basic state pension is removed. **Clause 2** effects the same change for the equivalent legislation covering Northern Ireland.[50]

There has been some recent comment in the press that aligning the UEL with the higher rate threshold will result in higher earners paying more tax.[51] The *Times* quoted Mike Warburton, of the accountants Grant Thornton, saying, "it has always been illogical for people to reach the upper earnings limit for national insurance before they start paying higher rate tax. But everyone has to remember this is a finance-raising measure."[52]

There was relatively little comment on the Bill by Members of either House in the debates on the Queen's Speech. In the Commons, speaking for the Liberal Democrats, Julia Goldsworthy was critical of the way in which the Government had presented this reform:

> What is often paraded as simplification hits people's pockets. Subjects that we will consider in this Session's finance Bill—a cut in the basic rate, funded by abolition of the starting rate; changes to capital allowances for small businesses dressed up as simplification—appeared in the last Budget. However, they are incomplete. We have seen only part of the proposals, with a promise of more later … All the proposals raise billions of pounds but nothing indicates a clear simplification programme. The cuts hardly increase fairness, and there is no clear statement of simplification or that it will be made on a tax neutral basis. That does not inspire confidence.
>
> The national insurance contributions Bill is another example of what I have described. Again, we support the principle because it makes sense for national insurance contributions and income tax thresholds to align, but there are cost implications for the amount of tax that people pay. Why could not the Treasury be up front about that? Why could not the Treasury be explicit and demonstrate that the policy is designed to make the tax system fairer and simpler, rather than being an underhand way in which to raise revenue.[53]

In the Lords, speaking for the Government, Lord Jones of Birmingham mentioned the Bill briefly:

> The National Insurance Contributions Bill will ensure that the Government begin to implement their commitment to provide a solid and simpler state pension foundation as an incentive to private saving while delivering the Budget's personal tax reforms. It will also include changes to the state second pension following the announcement by the Chancellor in the Pre-Budget Report that the Government would bring forward the introduction of the upper accruals point in 2009. Both those reforms will offer more support for working families and pensioners.[54]

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[50] 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.

[51] for example, "£500 blow to middle class workers", *Daily Telegraph*, 20 October 2007

[52] "National insurance comes into line with income tax", *Times*, 7 November 2007

[53] HC Deb 14 November 2007 cc714-5

[54] HL Deb 14 November 2007 c501

Speaking for the Conservatives, Baroness Noakes supported this simplification in the NICs structure, but suggested that the way in which it was being achieved was motivated by the wish to raise money:

> Not mentioned in the gracious Speech, though mentioned by the noble Lord, Lord Jones, was a National Insurance Contributions Bill, which we will greet with little enthusiasm. By aligning the income tax and national insurance thresholds, the Bill will achieve a welcome simplification of the structure of personal tax. However, it is being introduced not in a cost-neutral way but in the tax-grabbing style of this Government, and will cost middle-income families around £1.5 billion a year. The Bill will also legitimise the Chancellor's latest pension raid via the state second pension. Put simply, the Bill is just one big money-raising exercise to shore up shaky government finances.[55]

B. Introducing the Upper Accrual Point

Following the 2007 Budget, the Pensions Policy Institute commented that one effect of increasing the UEL – to align it with the higher rate threshold – would be to increase the value of S2P built up by higher earners, running counter to the intention that S2P should become flat-rate:

> The alignment of the UEL for National Insurance (NI) Contributions with the higher rate tax band will increase the revenue collected in the NI fund. S2P is currently paid on all earnings between the lower and upper earnings limit. So unless the link between S2P and NI contributions is broken before 2012, it will increase the annual build up of S2P for people earning above the UEL of £38,840. Those earning above the new UEL of £40,625 will build up a pension of £2.83 a week in 2009 compared to £2.38 without the Budget changes.
>
> The increase in the value of S2P built up by higher earners runs counter to the direction of reform of state pensions, which aims gradually reduce the difference between the S2P received by low and high earners. The new increase for high earners will mean that low and higher earners will not receive the same S2P each year until 2035, compared to 2031 in the current system.[56]

In the *Pre-Budget Report 2007*, the Government announced that the introduction of the upper accrual point would be brought forward to April 2009, to ensure that the changes announced in the May 2006 White Paper would take place as originally intended. Details were given in a press notice issued at the time:

> Following the announcement at Budget 2007 of the harmonisation of the National Insurance Contributions (NICs) Upper Earnings Limit (UEL) with the threshold at which higher rate income tax becomes payable from 6 April 2009, legislation will be introduced to bring forward the introduction of the Upper Accrual Point (UAP) prescribed in the Pensions Act 2007 to 6 April 2009. This will ensure that the reforms to the State Second Pension (S2P) announced in the May 2006 White

[55] HL Deb 14 November 2007 c505

[56] PPI, *Briefing Note Number 37: Was Budget 2007 good for pensioners?* April 2007 p2

> Paper ("Security in retirement: towards a new pension system") take place as originally intended. In the absence of this action there would have been a small increase in the S2P payable to those earning above the UEL for the tax year 2007-08 (assuming indexation for prices from 6 April 2008) and in the rebates received by those same earners and their employers who are contracted out.[57]

One result of this change is a small gain in S2P accruals or contracted out rebates for affected employees and employers up to April 2012:

> At the time of the May 2006 White Paper the intended date for these changes was 2012, or the date at which the basic State Pension is first linked to earnings. This measure will bring forward one of these changes. On 6 April 2009 the UAP will be introduced and set at a level that is consistent with the level the UAP would have been under White Paper pension reforms from 2012 onwards. This level will be cash fixed from the point it is introduced, and will be below the level of the UEL from 6 April 2009 to 6 April 2012, but above the level the UEL would have been prior to the announcements on personal tax made at Budget 2007. Therefore there is still a small gain in S2P accruals or the contracted out rebates for affected employees and employers until 6 April 2012, compared to the pre Budget 07 position.[58]

It is estimated that this change will raise £290 million in 2009-10, rising to £440 million in 2010-11.[59] Recently the Government was asked if this money would be 'ring-fenced':

> **Chris Grayling:** To ask the Chancellor of the Exchequer whether the Government plan to ring-fence the additional revenue his Department will receive as a consequence of bringing forward the introduction of an Upper Accruals Point for the State Second Pension for future pensions spending; and if he will make a statement.
>
> **Kitty Ussher:** The announcement made in the 2007 pre-Budget report to bring forward the introduction of Upper Accruals Point for the State Second Pension (S2P) will lead to a reduction in the rebates paid in respect of employees earning above the 2007-08 value of the Upper Earnings Limit (UEL) who are contracted out of S2P. Those employees would have otherwise seen anomalous gains in their contracted out rebates and S2P benefits following the announcement at Budget 2007 to align the UEL for national insurance contributions with the higher rate threshold for income tax from 2009-10.
>
> The reductions in the rebates result in an increase in national insurance contributions paid into the National Insurance Fund. The National Insurance Fund (NIF) is maintained under the control and management of Her Majesty's Revenue and Customs. It is run on a "pay-as-you-go" basis; current income, mainly from national insurance contributions, pays for current expenditure mostly on contributory benefits. The uses to which the NIF can be put are clearly specified in legislation, with the majority spent on state pensions.[60]

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[57] HM Revenue & Customs Pre Budget Note PBRN01, 8 October 2007

[58] HM Revenue & Customs Pre Budget Note PBRN01, 8 October 2007

[59] Cm 7227 October 2007 Table B4, p164

[60] HC Deb 3 December 2007 c1040W

At present the UEL is set at the cap for additional pension contributions for S2P purposes under ss 22, 44 & 122 of the *Social Security Contributions and Benefits Act (SSCBA) 1992*. Section 12 of the *Pensions Act 2007* amended these provisions, to allow for the UEL to be replaced by the UAP from "the flat rate introduction year."[61] In turn **Clause 3** of the Bill determines that the UAP will be introduced from 2009-10. In addition the value of the UAP from that date is set at £770, equal to the UEL for 2008-09.[62]

The department's impact assessment on the Bill focuses on the decision to introduce the UAP early, and mentions the benefits of setting the UAP at £770 from April 2009:

> On the basis of the current RPI projections the value of the UEL would have been £775 per week in 2012/13 in the absence of the Budget 2007 announced increases to the UEL. This is sufficiently close to the 2008/09 value of the UEL to make a strong case for fixing the UAP at the 2008/09 level of the UEL to provide certainty for employers and software providers going forward. Delaying the introduction of the UAP beyond 2009/10 would require a reduction in the UAP compared to the previous years UEL to meet the White Paper timescales for a simplified flat rate S2P by 2031/32. Therefore introduction of the UAP in 2009/10 reduces potential disruption for individuals and employers that could arise from the value of the contracted out rebates needing to be reduced year on year.[63]

The assessment compares this option with simply doing nothing. This would mean the achievement of a flat rate S2P would be delayed by three years (ie, only by 2034-35). It also looks at the possibility of bringing in a UAP in 2010 or 2012, but keeping to the original timetable for establishing a flat rate S2P. To achieve this, the UAP would have to be set *below* the level of the UEL for the previous year. Overall, the department concluded that the option chosen in the Bill was "the most suitable .. to meet timescales for state pension simplification whilst minimising disruption for individuals and employers."[64]

One of the questions posed in HMRC's list of FAQs on the Bill is, "will people lose out because of this?" The department's answer is:

> No-one loses out because of the withdrawal of the earnings related element of S2P or because of the new cap in S2P or NICs rebate. Although earnings relation will be withdrawn, the gap even for the highest earners will be more than made up by the earnings uprating of basic State Pension. Even in the short term people do not lose out because of the erosion of earnings relation. A high earner retiring in 2015 would get a total State Pension of £190 a week under the current system. Under reform they will get £197.[65]

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[61] The 'flat rate introduction year' refers to another of the changes made in the *Pensions Act 2007* to accelerate the transition of S2P to a flat-rate benefit: the introduction of a weekly flat-rate accrual amount of £1.50. The Act allows for the year to be set by Order (*Explanatory Notes to the Pensions Act 2007* para 62). For details see, Library standard note SN/BT/255, 13 November 2007 p26.

[62] As noted, the first stage of aligning the UEL is to increase it by £75 above indexation from April 2008 – so that it would rise from £670 a week in 2007-08 to £770 a week in 2008-09 (Bill 7-EN para 19).

[63] *Impact Assessment of the National Insurance Contributions Bill 2007*, November 2007 para 13

[64] *Impact Assessment of the National Insurance Contributions Bill 2007*, November 2007 para 15

[65] HM Revenue & Customs, *National Insurance Contributions Bill - FAQs*, November 2007

The *Daily Telegraph* described the change as a "£2 billion raid" on middle-class retirement funds", comparing the Exchequer cost of introducing the UAP in 2009 rather than 2014.[66] In their response to the announcement the National Association of Pension Funds noted that the change was part of already decided policy, and that its impact was uncertain:

> Commenting on changes to the S2P highlighted in yesterday's PBR, Nigel Peaple, NAPF Director of Policy said: "It is true that the move to a flat rate State Second Pension beginning in 2009 could increase the cost to employers offering a contracted out Defined Benefit salary-related pension. However, the precise impact will depend on how employers react. If employers alter their schemes (by contracting them back in or changing the benefit design) they may be able to limit the financial impact. However, this is not a straightforward exercise as they would have to consult all the members, entail extra costs, and some scheme rules might prohibit it. We hope the Government will remember these pressures when they make their final decision on the Pension Deregulation Review over the next few weeks.[67]

In their response to the PBR, the Pensions Policy Institute suggested that the change would simply "restore the flat-rating of S2P back towards the path originally intended in the *Pensions Act 2007*":

> In the PBR speech the Chancellor announced that '*We will bring forward the start date for flat rating the State Second Pension to 2009*.' While this may sound like a significant policy change, widely reported to save the Exchequer £2 billion, it in fact refers to a technical change introduced to restore the flat-rating of S2P back towards the path originally envisaged in the Pensions Act 2007.
>
> Budget 2007 announced the alignment of the Upper Earnings Limit (UEL) for National Insurance Contributions (NICs) with the threshold for paying higher rate tax from 2009. Previous PPI analysis highlighted that this would mean that higher paid individuals would become entitled to higher amounts of S2P, and that S2P would potentially still not be flat rate by 2030 (Chart 1).
>
> The announcement in the PBR reverses this change, and brings the 'flat rate path' back in to line with the Pensions Act intention. The 'Upper Accruals point' (the new name for the top of the earnings band for S2P contributions) will now be different to the top of the band for paying NICs from 2009. In 2009 it will be set at the level it would have reached in 2012 before the changes in Budget 2007. So from 2012, S2P will be payable on the same earnings as originally envisaged in the Pensions Act 2007, becoming flat rate around 2030 (Chart 1).

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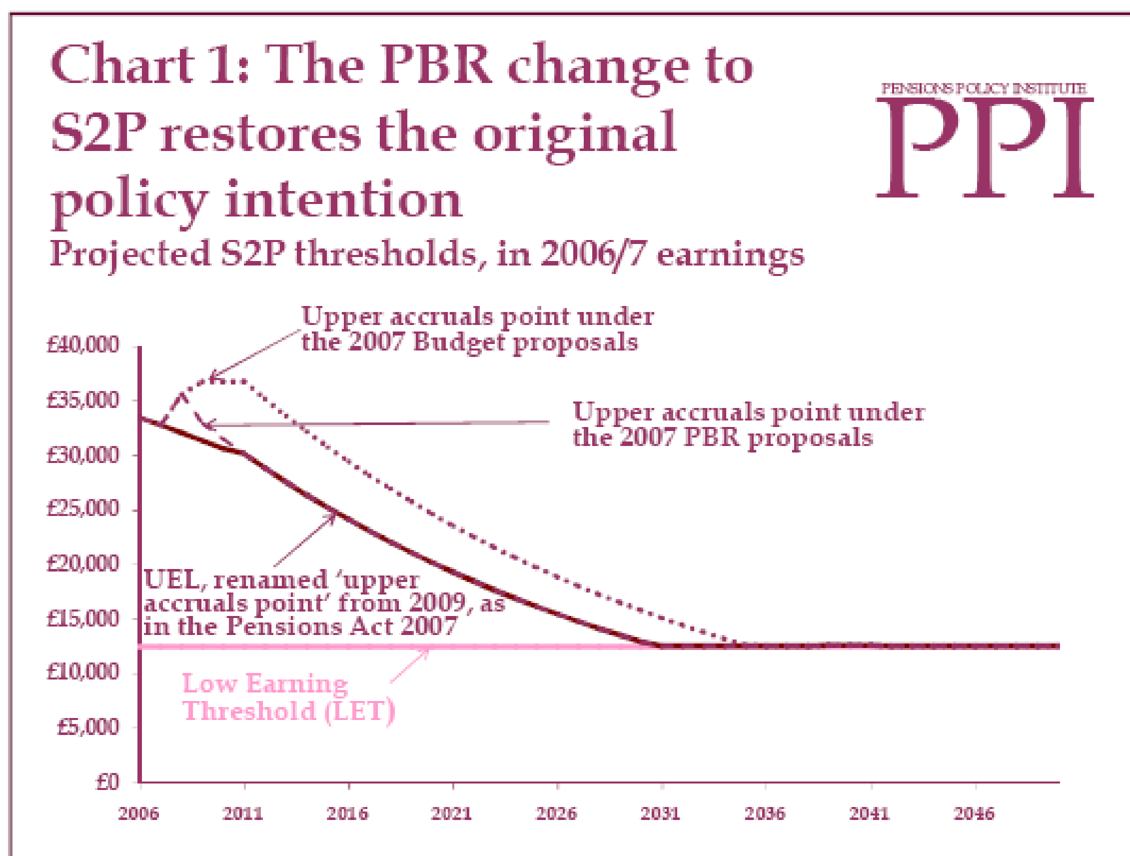
[66] "Top-up pensions hit by £2bn 'stealth tax'", *Daily Telegraph*, 11 October 2007

[67] NAPF press notice PR/40/07, *NAPF Responds to State Second Pension Changes*, 10 0ctober 2007



> Compared to the position before Budget 2007, people earning above around £33,000 will receive higher S2P accruals between 2009 and 2012. Compared to the situation after Budget 2007, people earning above the new Upper Accruals point will receive less S2P. Estimates in the PBR suggest that this measure will save £440 million in 2010, and adding the annual figures between 2009 and 2014 gives a cost of around the £2bn figure quoted in the press. This is not less paid out in S2P, but less paid out in rebates to the pension schemes of those who have contracted-out of S2P.
>
> More than two thirds of this would have been paid to Defined Benefit (DB) occupational pension schemes. This would not have increased the pension income payable by the scheme, but would have meant that employers and employees could have made lower contributions to the DB pension scheme.[68]

As noted, there has been relatively little comment on the Bill in the House. During the debates on the Queen's Speech in the Lords, Lord Northbrook argued that the decision to introduce the UAP in 2009 was designed simply to raise funds for the Exchequer:

> The Prime Minister promised an era of more open government, yet, in a couple of tax moves announced by the Chancellor in his Pre-Budget Report, he is back to his master's old tricks of stealth tax increases. Can the Minister confirm that, in a very technical move which many of the public will fail to understand, realigning national insurance and income tax ceilings will increase the tax burden on middle-

[68] PPI, *Briefing Note Number 40: The Pensions Implications of the Pre-Budget Report*, October p1

> income families by £1.5 billion a year? Will he admit that, even more stealthily, bringing forward the flat-rating of the second state pension will bring the Government an extra £400 million a year? In the words of Chris Grayling, our shadow Secretary of State for Work and Pensions in the other place: "This is a nothing less than a new stealth tax on retirement".[69]

Winding up the debate for the Government, Lord McKenzie responded to this point:

> As to the £2 billion tax raid that was mentioned by the noble Baroness [Baroness Noakes, who opened the debate for the Conservatives] and the noble Lord, Lord Northbrook, in May 2006 we announced our intention to convert the earnings-related state second pension into a flat rate top-up to the basic state pension, and the changes in the Budget earlier this year, because they increased the upper earnings limit, would have changed the originally conceived timeframe by which that would have been delivered. All these proposals do is take us back to where we were and where we expected to be.
>
> Baroness Noakes: My Lords, will the noble Lord concede that the original proposals were framed so that the S2P levelling out would coincide with the introduction of earnings indexation in relation to the basic state pension? That was very clearly stated, I believe, in the May 2006 document.
>
> Lord McKenzie of Luton: My Lords, the proposal was that the earnings related would be phased out by 2030. To achieve that, if the upper earnings limit, with a normal uprating for inflation, had been where it was expected to be, it would have started in 2012. But because that upper earnings limit is increased, it needs to start in 2009. There is no change to where we expect to be and where we will end up.[70]

It is worth noting that the *Pensions Bill 2007-08* – which was presented to the House on 5 December 2007 – contains further provision to simplify S2P.[71] In addition to their basic state pension, pensioners can have accrued rights under S2P accrued from 2002, but also from its two predecessors.[72] Clause 80 of the Bill changes the method of calculating these earnings-related components of state pensions for people who reach state pension age after 5 April 2020. The impact assessment of the Bill provides the following explanation of this measure:

> Having put in place measures to simplify State Second Pension in the future this Bill takes steps to simplify the three additional State Pension schemes that today's workers may have contributed to in the past and in which they will have a stake in for many years to come. At the moment these pension accruals are only notional and cannot be given a firm cash value until a contributor retires.
>
> We propose that the three schemes are brought to account after the end of the 2011/12 tax year and given a cash valuation. This cash amount will be revalued by earnings until the contributor retires. People of working age will then know the

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69 HL Deb 14 November 2007 c554

70 HL Deb 14 November 2007 c566

71 Bill 25 of 2007-08. HC Deb 5 December 2007 c853

72 ie, the State Earnings Related Pension Scheme (SERPS) from 1978 to 2002, and the Graduated Retirement Benefit scheme (GRB) from 1961 to 1975.

> amount of pension their past contributions have paid for and will be able to estimate in a straightforward way the value of the pension they will be able to build up in the future. Simplifying additional State Pension in this way, combined with an earnings uprated basic State Pension, will provide contributors with a much better understanding of their retirement income from the State and its value to them as a foundation for private saving.[73]

C. Other provisions in the Bill

The remaining clauses of the Bill are relatively minor.

Clause 4 introduces **schedules 1 & 2** which set out a series of consequential amendments and repeals respectively.

Clause 5 provides for the Bill's extent. Both National Insurance contributions (NICs) and pensions are reserved matters for Scotland and Wales. 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. As noted, clause 2 of the Bill amends the relevant legislation for Northern Ireland to align the UEL with the higher rate threshold. However, the Bill does not make similar provision for Northern Ireland regarding the UAP. This is because pensions – including the basic state pension and S2P – are transferred matters under the *Northern Ireland Act 1998*. Following the restoration of the Northern Ireland Assembly in May 2007, the Government confirmed that the Assembly would enact equivalent legislation to the *Pensions Act 2007*.[74]

Clause 6 deals with the commencement of the Bill's provisions.

Clause 7 gives the short title of this legislation.

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[73] Dept for Work & Pensions, *Pensions Bill - Impact Assessment*, December 2007 paras 7.4-5

[74] HL Deb 11 June 2007 c1581. Legislation to this effect has recently been presented to the Assembly: Department for Social Development in Northern Ireland press notice, *Significant increase in women receiving full pension proposed by Ritchie*, 26 November 2007.

Appendix: Glossary of terms

Term	Explanation
Additional Pension	This is the earnings related element of state pension – accrued from 1978 to 2002 under SERPS ("State Earnings Related Pension Scheme") and since 2002 under the S2P ("State Second Pension") scheme (see sections 44, 44A, 45 and Schedule 4A of the SSCBA 1992).[75]
Basic State Pension	This is the flat rate element of state pension (see section 44 of the SSCBA 1992).
Class 1 contributions	These are contributions paid by employees and employers on earnings that exceed the primary and secondary thresholds (which are set at the same level).
Contracted-out rate	Contracted-out rate contributions are contributions payable in respect of earnings paid to earners who are in contracted-out salary related or contracted-out money purchase employments.
Lower Earnings Limit	Historically the lower earnings limit (see section 5 of the SSCBA 1992) was both the point at which a liability to pay National Insurance Contributions arose and the point at which entitlement to contributory benefit began. It is also the point at which contracted-out rebates become payable. In 2001 the point at which contribution liability arises was changed to a new earnings threshold, aligned with the income tax personal allowance. Despite this change, the lower earnings limit retains both its contributory benefit and contracting-out rebate purposes.
Primary Threshold	The primary threshold (see section 5 of the SSCBA 1992) is the point at which employees begin to pay National Insurance contributions.
Secondary Threshold	The secondary threshold (see section 5 of the SSCBA 1992) is the point at which employers begin to pay National Insurance contributions.
State Second Pension	This is the name for the earnings related element of state pension from 2002.
State Pension	This is the generic name for retirement pension payable under the SSCBA 1992.
Upper Accrual Point	The upper accrual point (see section 122 of the SSCBA 1992) is a new threshold which replaces the upper earnings limit as a feature in state second pension and contracted-out rebate calculations. The Bill provides for the upper accrual point to be a

[75] The *Social Security Contributions and Benefits Act (SSCBA) 1992*

	weekly figure for both state second pension and contracted-out rebate purposes. Once introduced the amount of the upper accrual point will be frozen.
Upper Earnings Limit	Historically the upper earnings limit (see section 5 of the SSCBA 1992) was both the point at which a liability to pay primary Class 1 contributions ended and the point at which entitlement to contributory benefit was capped. It was also the point at which contracted-out rebates were capped. In 2003 an additional Class 1 contribution liability on earnings in excess of the upper earnings limit was introduced and it became the point at which liability for Class 1 contributions at the main primary percentage ceased. Despite this change, the upper earnings limit retained both its contributory benefit and contracting-out rebate purposes. Following the introduction of the upper accrual point the upper earnings limit will no longer be of relevance in the calculation of state second pension or contracting out rebates.

Source: Annex A to *National Insurance Contributions Bill 2007-08 Explanatory Notes* [Bill 7-EN], November 2007 pp 10-11