



Income Tax, National Insurance Contributions and the case for alignment.

Harry Milligan

INTRODUCTION

Academics and politicians have been making the case for alignment of Income Tax (IT) and National Insurance Contributions (NIC) since the mid-twentieth century.¹ The case has been bolstered by contributions from the Office of Tax Simplification (OTS) which is mandated with rendering the UK tax system more readily understandable. A comprehensive discussion of the NIC and IT system is beyond the scope of this work. The pursuit shall be to dissect the case for alignment made in the literature, in particular the work of Glen Loutzenhiser as a long-time advocate of alignment and a respected leader in the tax field.² Assessing the four arguments given prominence in the literature indicates a strong case for alignment. The arguments are that (1) the “contributory principle” is illusory, (2) the current system could be made more

¹ A Peacock and G Peden, ‘Merging National Insurance Contributions and Income Tax: Lessons from History’ (2014) 34 *Institute of Economic Affairs* 2.

² Glen Loutzenhiser, BComm (Sask), LLB (Toronto), LLM (Cantab), MA (Oxon), DPhil (Oxon) is Associate Professor of Tax Law and Tutorial Fellow of St Hugh's College.

efficient by alignment, (3) the current system lacks transparency, and (4) the unequal treatment of the employed and self-employed undermines the current system.

Adam Smith's canons on general taxation provide a benchmark for assessment of these arguments.³ Additionally, supporting evidence found in government reports and independent studies which provide estimated costs and savings will be used. Although Smith wrote in the 18th century, his canons continue to influence the works of today's leading economists, particularly Thomas Piketty,⁴ and remain widely relevant to any discussion of the aims of tax policy. In addition to considering taxation theory, the practicalities of alignment need to be considered. This objective will be achieved by referring to the representations made by the Institute of Chartered Accountants for England and Wales (ICAEW) as part of the OTS consultation. The pragmatic approach of the ICAEW highlights many of the practical matters which should not be overlooked in the pursuit of "nice to have" reform.⁵

THE "CONTRIBUTORY PRINCIPLE" – IS IT ILLUSORY?

The Beveridge Report of 1942 and resultant National Insurance Act 1946, perhaps the most significant development in the history of the UK's system of social welfare, was premised on there being an intrinsic link between payment toward national insurance and the entitlement to State benefits.⁶ Stuart Adam and Glen Loutzenhisser, strong supporters of IT and NIC alignment, argue that this link was broken soon after 1942 and has been

³ Adam Smith, *The Wealth of Nations* (first published 1776, Heritage Illustrated Publishing 2014) 308.

⁴ Thomas Piketty, *Capital in the Twenty-First Century* (The Belknap Press of Harvard University Press 2014) 493.

⁵ Institute of Chartered Accountants for England and Wales, *Alignment of Income Tax and National Insurance* (Tax Rep 63/15, ICAEW Representation 176/15, 2015).

⁶ William Beveridge, 'Social Insurance and Allied Services' (Cmnd 6404 1942).

reduced to the point where it is unrecognisable⁷ They support this argument by pointing to employer NICs which do not give rise to any benefits, the availability of some benefits without contribution and idiosyncrasies in the system which result in no further benefit to be earned from continued contributions. Peacock and Peden, analysing NICs from a historical perspective, make the further point that the concept of paying into the National Insurance Fund (NIF) is illusory because there are no strict rules regarding the application of money in the NIF and other tax revenue is often used to pay for the welfare system.⁸ Since the 1950s, the National Insurance Fund has functioned explicitly on a pay-as-you-go basis with a balance sheet of around two months' expenditure. In 2014-15, £4.6 billion was transferred from the Consolidated Fund (into which IT is paid) to the National Insurance Fund to cover unfinanced liabilities. Whenever the Fund runs at a surplus, this money is invested in gilts to be applied in general governmental expenditure. The fact that the division between NICs and IT funds is "entirely a matter of meaningless labelling" emphasises the breakdown of the contributory principle.

Despite advocating full alignment, Adam and Loutzenhiser are in agreement with the ICAEW with regard to the contributory principle. Both acknowledge that there is a place for a genuine social insurance system and claim that this is not the case at present. The ICAEW accepts that there has been a breakdown in the contributory principle, but points out that alignment of NICs and IT is unlikely to strengthen the contributory principle.⁹ Alignment would weaken the principle further as the illusion of reciprocity would be lost. The ICAEW also points out the persistence of a public perception that the payment of NICs relates to an entitlement to non-means-tested benefit.¹⁰ It

⁷ Stuart Adam and Glen Loutzenhiser, *Integrating Income Tax and National Insurance: An Interim Report*, IFS Working Paper WP21/07 (The Institute for Fiscal Studies, 2007) 20.

⁸ Peacock and Peden, (n 1) 3.

⁹ Institute of Chartered Accountants for England and Wales (n 5) para 31.

¹⁰ *Ibid* para 30.

must be accepted that a misconception should not justify the continuation of any law and that the illusory nature of the contributory principle strongly justifies reform. However, there is no evidence to suggest that alignment would enhance the contributory principle, and so in this regard the argument for alignment is relatively weak.

EFFICIENCY

The OTS has taken the view that administrative complexity renders NICs inefficient. Wang points out that 95 percent of businesses in the UK are classified as small, comprising less than 10 workers and that these businesses are “disproportionately exposed to the complexity of the tax system.”¹¹ Adam Smith’s fourth maxim on general taxation is that every tax should take out of the pockets of the people “all little as possible, over and above what it brings into the public treasury”.¹² Practically speaking, this means that it should be simple for taxpayers to calculate liabilities and tax authorities to collect. According to a 2010 statistic sourced from the Mirrlees Review, the collection of NICs costs the government 35p per £1 collected on top of the 1.24p cost per £1 of income tax collected.¹³ A study conducted by KPMG in 2006 estimated the annual cost of NICs on employers to be in the region of £179 million on top of IT costs.¹⁴ From these statistics, NICs create significant administrative costs for both taxpayers and the Treasury, exactly in the way Smith warns against.¹⁵

¹¹ Jingyi Wang, ‘The OTS Small Business Tax Review: a positive start to simplify the UK tax system’ (2013) *Company Lawyer* 84.

¹² Smith (n 3) 308.

¹³ Mirrlees, *Tax by Design*, (Oxford University Press, 2011) chapter 5, 1.

¹⁴ KPMG, ‘Administrative Burdens: HMRC Measurement Project’ (KPMG, 2006), <<http://webarchive.nationalarchives.gov.uk/20140109143644/http://www.hmrc.gov.uk/better-regulation/kpmg1.pdf>> accessed 20 October 2016.

¹⁵ Glen Loutzenhiser comments that the KPMG study used a Standard Cost Model in its calculations which would not take account of the costs involved in familiarising employers with the NICs regime, staying up-to-date with developments and tax planning – see Glen Loutzenhiser, ‘Operational integration of income tax and national insurance contributions’ (2011) *British Tax Review* 361, 362.

On this matter the ICAEW takes a drastically different view arguing that the differences between tax and NIC rules do not cause material administrative costs.¹⁶ According to the OTS, simply calculating NICs on an annual rather than weekly or monthly basis which would align with IT is “estimated to result in net annual administrative savings of between £40.3 million and £55.6 million for employers.”¹⁷ Writing on behalf of the Centre for Policy Studies, Johnson claims that employers would welcome the complete removal of NICs altogether in favour of an Earnings Tax. He points out that “National Insurance is a staggeringly complex system, with some 60 different categories into which employees may fall.”¹⁸ Once the task of determining under which category an employee falls, calculations are made manually, rather than through the automated PAYE system. Given the statistical support contrary to the representation of the ICAEW, it appears obvious that efficiency would be enhanced by taking the minor step of aligning the calculation periods of IT and NICs. Statistical estimates suggest that there are significant savings to be made by alignment making efficiency a sound argument both legally and practically.

TRANSPARENCY

A persistent theme among critics of the current NICs and IT regime is the lack of transparency. Loutzenhiser argues that “integrating income tax and NICs into one charge would make the overall rate structure of labour taxation much more transparent”.¹⁹ According to Smith “The tax which each individual is bound to pay, ought to be certain not arbitrary.” Smith’s primary concern

¹⁶ Institute of Chartered Accountants for England and Wales, (n 5) para 13.

¹⁷ Office of Tax Simplification, Small business tax review (2011) 15.

¹⁸ Michael Johnson, ‘NICs: the end should be nigh’ (Centre of Policy Studies, 2014) para 3.1.

¹⁹ Loutzenhiser (n 15) 364.

with regard to certainty was that uncertainty would abet corruption. The “evil” of even a very small degree of uncertainty, in Smith’s view, was greater than “a very considerable degree of inequality”.²⁰ Smith’s sceptical view of political corruption is reflected by Loutzenhiser as he offers two reasons why enhanced transparency is important. Firstly, he argues that governments take advantage of the lack of public understanding by promising not to increase IT to win votes and then proceeding to increase NICs with equal consequences for taxpayers.²¹ Johnson supports this argument stating that “It would be far more obvious... that direct tax on earnings is not as progressive as would appear from today’s rates of Income Tax.”²²

A recent example of the use of NICs to increase tax without impacting upon the headline figures of income tax was the Spring Budget 2017. This Budget contained a provision for a 2% increase in NICs for the self-employed despite a Conservative Party manifesto pledge to the contrary. After provoking public outrage, the government was forced to remove the provision from its Budget. This demonstrates how governments can focus public attention on the progressivity of the IT system, quoting the 20% basic rate of tax, when in reality these basic rate taxpayers are contributing an additional 12% in NICs while those in the higher and additional bands are only contributing an additional 2%. Loutzenhiser secondly argues that NICs inhibit fruitful public debate on other tax issues, such as the capital versus income ratio, because statistical evidence is vulnerable to distortion as NICs may be included or excluded to support the relevant political agenda.²³ Public debate and freedom of information are core democratic tenets, suggesting that reform is essential.

As Thomas Piketty points out the paradox that has grown from the original intention that National Insurance would grant taxpayers clearer insight

²⁰ Smith (n 3) 308.

²¹ For example, Labour in 2002.

²² Johnson (n 18) para 3.2.

²³ Loutzenhiser (n 15) 364.

into the way their money is spent: “Rather than clarify the purpose of tax collection, a system of such complexity can actually obscure matters”.²⁴ The ICAEW accepts that the current regime is largely misunderstood but takes the view that there is little evidence that alignment of IT and NICs would lead any way toward improving understanding.²⁵ This is a fair comment because NICs have been paid for over 100 years and have been subject to political contestation for much of that period without avail. The argument for greater transparency is always strong in a legal sense. However, the arguments made by Loutzenhler could just as easily be made in support of other practical endeavours such as better taxpayer education and does not point conclusively towards alignment of IT and NICs.

DISPARITY IN THE TREATMENT OF THE EMPLOYED AND SELF-EMPLOYED

IT treats the employed and self-employed in the same way with the exception of the deductibility of business expenses.²⁶ However, the self-employed are subject to far more generous treatment under the NICs regime.²⁷ Employees and employers respectively pay NICs, starting at the point where the employee earns more than £139 and £136 per week. Employees pay 12% and employers pay 13.8%. The self-employed are taxed at a flat rate of £2.50 per week, so long as their annual profits exceed £5,315, 9 percent on profits between £7,225 and £42,475 per year, and 2 percent on profits above that. The contributions of the self-employed are far less onerous than those of the employed, particularly when the employer NIC is factored in.

²⁴ Piketty (n 4) 495.

²⁵ Institute of Chartered Accountants for England and Wales (n 5) para 11.

²⁶ The allowable deduction rules vary to the effect that self-employed persons may deduct a broader range of expenses.

²⁷ This issue was the subject of the 2017 Spring Budget (considered above) that proved so controversial.

The ICAEW advocates the alignment of employed and self-employed NICs to correspond with IT on the basis that the only difference in benefit treatment is Jobseekers Allowance “which is an almost immaterial component of the NI regime.”²⁸ As Loutzenhiser argues, the treatment of the self-employed as well as incorporated businesses is advantageous, even where these arrangements are not best suited to the service or labour carried out, purely as a tax planning strategy.²⁹ In practical terms, the same work is being carried out under different titles and being treated differently for tax purposes. The practice of contracting work through a third party developed so that workers or service providers that would normally be considered employees could work on individual contracts as though self-employed. Legislation was quickly enacted to address this issue, GAAR³⁰ and IR35,³¹ which closed the intermediary loopholes. Loutzenhiser has soundly argued that in addition to increasing the yield from NICs, such anti-avoidance legislation would be obsolete if the treatment of NICs and IT were aligned, and through ending the differential treatment of the employed and self-employed.

CONCLUSION

The case made for reform is significant. The issues discussed above with the current system merely scratch at the surface of many possible criticisms of unequal treatment and administrative inefficiency. However, it cannot be said that the case for aligning IT and NICs has been made conclusively. With regards to specific alignments, such as of calculation periods to enhance efficiency and the removal of the employed and self-employed distinctions, the argumentation is well-founded and convincing. To this end, these areas should be the first to change under any program of alignment. However, this would represent minor change to what is a

²⁸ Institute of Chartered Accountants for England and Wales (n 5) para. 16.

²⁹ Glen Loutzenhiser (n 15) 366.

³⁰ National Insurance Contributions Act 2014, pt 5.

³¹ *Ibid.*, s. 2 (4).

particularly muddled area of tax law. Arguments for more comprehensive alignment remain largely unsubstantiated throughout the literature. This lack of substantiation is perhaps a prevailing consequence of the political nature of taxation law and the lacking availability of reliable unbiased statistical evidence. While reform is certainly encouraged, the literature has not provided sufficient evidence to conclude that alignment would represent material enhancement.

BIBLIOGRAPHY

Books

- Atkinson A, *Inequality: What can be done?* (Harvard University Press 2015)
- Lee N, *Revenue Law: Principles and Practices* (Bloomsbury Professional 2015)
- Mirrlees J et al, *Tax by Design*, (Oxford University Press 2011)
<<https://www.ifs.org.uk/publications/5353>>
- Piketty T, *Capital in the Twenty-First Century* (The Belknap Press of Harvard University Press 2014)
- Smith A, *The Wealth of Nations* (first published 1776, Heritage Illustrated Publishing 2014)

Articles

- Adam S and Loutzenhiser G, Integrating Income Tax and National Insurance: An Interim Report, IFS Working Paper WP21/07 (The Institute for Fiscal Studies, 2007)
- Johnson M, 'NICs: the end should be nigh' (Centre of Policy Studies, 2014)
- Loutzenhiser G, 'Operational integration of income tax and national insurance contributions' (2011) *British Tax Review* 361
- Peacock A and Peden G, 'Merging National Insurance Contributions and Income Tax: Lessons from History' (2014) 34 *Institute of Economic Affairs* 2
- Wang J, 'The OTS Small Business Tax Review: a positive start to simplify the UK tax system' (2013) *Company Lawyer* 84
- OutLaw.com, 'Burden of income tax and NICs systems forming basis of integration reforms, Treasury says' (2011) < [10](http://www.out-</div><div data-bbox=)

law.com/en/articles/2011/november/burden-of-income-tax-and-nics-systems-forming-basis-of-integration-reforms-treasury-says/>

- Drysdale D, ‘Donald Drysdale explains why hopes of aligning income tax and NICs are thwarted where one is devolved and the other is not.’ (Institute of Chartered Accountants of Scotland 2016)
<<https://www.icas.com/technical-resources/aligning-tax-and-ni-in-a-partially-devolved-world>>

Research Papers

- Beveridge W, ‘Social Insurance and Allied Services’ (Cmnd 6404 1942)
- Institute of Chartered Accountants for England and Wales, Alignment of Income Tax and National Insurance (Tax Rep 63/15, ICAEW Representation 176/15, 2015)
- KPMG, ‘Administrative Burdens: HMRC Measurement Project’ (KPMG, 2006),
<<http://webarchive.nationalarchives.gov.uk/20140109143644/http://www.hmrc.gov.uk/better-regulation/kpmg1.pdf>>
- Office of Tax Simplification, Small Business Tax Review (2011)