



A Critical Assessment of the Case for Reform of National Insurance Contributions for the UK's Self-Employed.

*Iain Mathieson**

Introduction

The case for reform of National Insurance Contributions (NICs) for the UK's self-employed has recently been the subject of much political debate. As a result, the Office of Tax Simplification (OTS) published its recommendations for a less complex and more equitable system of NICs,¹ in particular where self-employed individuals are concerned.

In his 2016 Autumn Statement, the Chancellor of the Exchequer set out the Government's intention to reform NICs.² This essay will critically assess the Government's case for reform, specifically in relation to the abolition of Class 2 contributions, in favour of a reformed system of Classes 3 and 4 for the self-employed.

This assessment will be made in two parts: part one will contextualise and set out the substantive reforms; while part two will specifically address the contentious provisions for those self-employed individuals who will have insufficient earnings for Class 4 contributions under the new regime.

This work will seek to show that while this area of law is in need of significant reform, the Government proposals do not, in their current state, effectively achieve its desired goals of simplicity and equity.

* Student at the University of Dundee (4th Year LLB Scots Law with French).

¹ OTS, "*The closer alignment of income tax and national insurance*" (PU1909, 2016).

² HM Treasury, Autumn Statement (Cm9362, 2016).

Part 1 – The case for reform

NICs were initially introduced in 1911³ as a weekly flat-rate contribution to entitle certain social security benefits. In 1961, NICs became a compulsory system of earnings-related contributions which build entitlement to a State Pension and other state benefits. This change is seen as a significant erosion of the contributory principle and has faced criticism for having caused NICs to operate more like a second Income Tax (IT).⁴

This section will briefly contextualise the current proposals before setting out the Government's case for reform, namely through the abolition of Class 2 NICs in favour of a reformed Class 4.

1.1 The Current System for Self-Employed Individuals

Self-employed individuals currently pay NICs through Classes 2 and 4. Class 2 is a flat-rated weekly contribution of £2.85⁵ which provides access to the State Pension and other contributory benefits.⁶ These contributions are compulsory for those with profits of, or exceeding, the Small Profits Threshold (SPT) of £6,025 and can be made voluntarily by those whose profits do not meet that threshold.⁷ Class 4 contributions are a second levy on profits and do not currently confer access to any contributory benefits.⁸

This system has received significant criticism. Principally, in relation to its complexity and inequitable administration, both of which will now be discussed below.

1.1.1. Inequity

The principle of equity has, since its conception, been a fundamental pillar of the UK fiscal system.⁹ The principle prescribes that individuals in equal circumstances should pay equal tax. Consistently, self-employed individuals have received different NI treatment than employed individuals.¹⁰ Lower rates for the self-employed have typically been justified as a means of promoting entrepreneurship and offsetting the risk involved with self-employed status.¹¹ This

³ The National Insurance Act 1911.

⁴ The Institute for Fiscal Studies, "Integrating Income Tax and National Insurance" (WP21/07, 2007).

⁵ All limits and rates in this text refer to the current year of assessment: 2017/18.

⁶ Social Security Contributions and Benefits Act 1992, Section 11(2).

⁷ *ibid.*

⁸ *ibid.*, Section 15.

⁹ Adam Smith, *The Wealth of Nations* (Revised edn, Simon & Brown 2011).

¹⁰ For a summary of these differences see OTS (n.1), Table 5A.

¹¹ See *ibid.*, 40.

policy, however, is increasingly being viewed as inequitable.¹² It has long been argued that the greater the tax on employed individuals, the more workers will seek to bring themselves within the more attractive self-employed regime.¹³ Furthermore, self-employed persons range greatly from low to high earners and a general tax relief cannot fairly be applied to such diversity. It is argued that if the Government wishes to encourage entrepreneurship through the tax-system, this can be better achieved through a more specific, targeted system.¹⁴

1.1.2 Complexity

An additional criticism of the current regime is its complexity. In 2010, the UK Government established the Office of Tax Simplification (OTS), institutionalising its commitment to reduce tax compliance burdens on the taxpayer.¹⁵ The complex nature of the NICs regime is most evident in relation to its position alongside IT. These two systems simultaneously share areas of overlap and separation.¹⁶ More specifically, in relation to self-employment NICs, we have seen that contributions are made through two distinct classes. This is significantly more complex than the single impost for employed individuals. Moreover, there exists several complex rules in the current Class 2 relating to specific groups of individuals.¹⁷ This system is generally regarded as being excessively complex and not well understood by the individuals it applies to.¹⁸

The above criticisms have arguably been exacerbated by the UK's changing workforce.¹⁹ The Taylor review of modern working practices was published earlier this year highlighting the current trend towards self-employment and the development of the *gig-economy* in the UK.²⁰ This review considered that the inequity inherent in the current NI regime is not justified, sustainable, nor is it conducive to the goal of a good labour economy.²¹

¹² Sean Lavery, "Are the self-employed paying their way?" (Chartered Accountants Ireland, 1 April 2017) <<https://www.charteredaccountants.ie/News/are-the-self-employed-paying-their-way>>accessed 17 October 2017.

¹³ Natalie Lee, *Revenue Law: Principles and Practice* (34th edition, Bloomsbury Professional 2016).

¹⁴ Professor Judith Freedman, "Three myths about tax and the self-employed", *Financial Times* (10 March 2017).

¹⁵ HM Treasury, "The Office of Tax Simplification" (Press Release 29/10, 20 July 2010).

¹⁶ For a detailed discussion see: -----, "Income Tax and NIC – four options: a hard choice" (ICAEW Briefing Paper, 2015).

¹⁷ See Social Security Contributions and Benefits Act (n.6) above, Section 11.

¹⁸ David Heaton, *Taking the NIC* [2017] 179 *Taxation Magazine* 10.

¹⁹ Helen Miller, *Tax in a changing world of work* [2017] *Tax Journal* 1350.

²⁰ Department for Business, Energy & Industrial Strategy, "Good work: The Taylor review of modern working practices" (Independent report, 2017).

²¹ *ibid* 68.

It is in response to the above criticisms that the Government has proposed to reform the system of NICs in the UK. The following section will discuss the Government's substantive proposals.

1.2 The Government's Proposal

The Government's commitment to reform is built upon the recommendation of the OTS,²² which noted that the abolition of Class 2 NICs would be a worthwhile simplification of self-employment contributions.²³ From the 6th of April 2018:

- Class 2 will be abolished and the contribution conditions attached to contributory benefits will be changed to enable Class 4 contributions to count towards entitlement;
- A new zero-rate band will be introduced into Class 4 NICs on profits between the Small Profits Limit (SPL) and the Lower Profits Limit (LPL)²⁴; and
- The SPL in Class 4 will be aligned with the annual equivalent of the Lower Earnings Limit (LEL) in Class 1 employee NICs.

This will mean that the self-employed will be liable to pay only one Class through which they will gain access to state benefits whether paid, or treated as paid, through the zero-rate band. The complex rules that apply in Class 2 will be removed with its abolition, creating a simpler, more transparent and understandable system of NICs for those with profits equal to or above the SPL.

By aligning the profits limits with that of earnings in Class 1, the Government's intention to improve equity between the Classes is clear. The director of the Institute of Fiscal Studies has commented that this is a "*modest but welcome change [...] taking a small step to correcting the big problem in the current system.*"²⁵ It is argued, however, that without further alignment of the rates applied between the Classes,²⁶ and equal benefit entitlement for both employed and self-employed individuals, the inequity in the system will continue.

²² HM Government, "Abolishing Class 2 and reforming Class 4 National Insurance contributions: response to the consultation" (PU2010, 2016), 7.

²³ See OTS (n.1) above.

²⁴ Class 4 contributions will be treated as having been paid on these profits.

²⁵ Jon Stone, "IFS says Government is right to raise National Insurance for Self-Employed Workers" *Independent* (9 March 2017).

²⁶ It is notable that this is unlikely to be forthcoming following recent political activity - Earlier this year the Chancellor for the Exchequer proposed an increase to the main rate of Class 4 to 10% in 2018/19, and then 11% in 2019/20. This caused political uproar and the government subsequently announced that it would not proceed with the increase.

A more concerning consequence of the reform involves moving the self-employed benefit test to an annual basis while retaining the weekly basis of the actual contributory benefit system. Questions are raised as to how short-term benefits will be granted as an individual's taxable profits cannot be calculated until the end of the year of assessment. Additionally, how will those with taxable profits below the Small Profits Limit gain entitlement to benefits? These issues will be explored in the following sections of this essay.

Part 2 – The Class 4 Cliff-Edge

As noted above in part 1, self-employed individuals will gain access to contributory benefits through Class 4 NICs when their profits reach the SPL. This creates what is being described by some as the Class 4 Cliff-Edge²⁷ - those individuals whose taxable profits do not reach the SPL may be liable to make contributions through Class 3. It will be argued here that if the Government fails to implement appropriate safeguards for those with lower taxable profits, or where benefit entitlement cannot be conferred through Class 4, they risk negating their efforts by replacing one complex and confusing system with another.

2.1 Class 3 Contributions

Class 3 contributions are voluntary and intended for those who have insufficient contributions to qualify for full earnings-related state benefits through another Class. Currently, these contributions are paid at a rate of £14.25 per week. This, notably, is significantly higher than the current Class 2 voluntary system for self-employed individuals at £2.85. It is for this reason that the Government's proposal that self-employed individuals be liable to pay Class 3 contributions where their earnings do not reach the SPL has been heavily criticised as being inequitable.²⁸

²⁷ Equity, "Equity briefing on Class 2 Abolition" (12 February 2016)

<<https://www.equity.org.uk/documents/equity-briefing-on-class-2-abolition/>>accessed 12 October 2017.

²⁸ Citizens Advice, "Citizens Advice to OTS review of IT and NICs alignment" (2016)

<[https://www.citizensadvice.org.uk/Global/Public/Campaigns/CitizensAdviceresponsetoOTSreviewofITandNICalignment%20\(1\)%20\(1\).pdf](https://www.citizensadvice.org.uk/Global/Public/Campaigns/CitizensAdviceresponsetoOTSreviewofITandNICalignment%20(1)%20(1).pdf)>accessed 12 October 2017.

In response to the government proposals, the Institute of Chartered Accountants of Scotland proposed a two-tier system of Class 3 contributions: one for non-earners, and one for earners.²⁹ While this would be more equitable, it would introduce an element of complexity which contradicts one fundamental objective of the reform.

The Association of Accounting Technicians suggested that the new zero-rate band should be extended to include all profits between £0 and the LPL, arguing that this would protect all self-employed individuals while providing an incentive for persons with small profits to register their activity with HMRC.³⁰ This would arguably be no more complex than the current reforms, but it is inherently inequitable when you consider that the same protection is not afforded to employed individuals.

The Government has responded to these concerns by stating that the number of affected individuals will be negligible.³¹ They argue that the majority of these individuals will retain access to contributory benefits through Class 1 contributions or NI credits. Additionally, those who would not retain access in this way will have the option to pay Class 3 contributions at a time when they are more able during the six years following the year of assessment. Alternatively, they may choose not to make any contribution at all. Access to the full State Pension requires 35 qualifying years of contribution, the Government maintain that a small number of gaps in an individual's NI record would be unlikely to affect their future State Pension.³²

The Government's response may be workable in practical terms. It is right that in practice, small gaps in an individual's NI record will not be likely to affect their future State Pension under the new regime. This, however, is contingent on a process of education and publicity. Class 3 contributions have previously been unused by self-employed individuals and are administered differently from contributions made through Classes 2 and 4. The Government must be careful to ensure that self-employed individuals understand the changes, and any actions they may be required to take as a result of the reform.

²⁹ ICAS, "Response from ICAS to the HMRC consultation document" (26 February 2016) <https://www.icas.com/__data/assets/pdf_file/0004/236263/Abolition-of-Class-2-National-Insurance.pdf> accessed 12 October 2017.

³⁰ ATT, "Response to HM Treasury, DWP and HMRC Consultation on The Abolition of Class 2 National Insurance" (1 March 2016) <<https://www.att.org.uk/technical/submissions/abolishing-class-2-national-insurance-introducing-contributory-benefit-test>> accessed 12 October 2017.

³¹ See HM Government (n.22) above, p.18.

³² Ibid.

Having addressed the proposed regime for those with taxable profits below the SPL directly above, the following section will address continuing areas of complexity linked with short-term benefits.

2.2 The Continuing Complexity in Short-Term Benefits

A significant concern in relation to the applicability of Class 4 NICs relates short-term benefits. To take one example, the Government has highlighted that Maternity Allowance cannot reasonably be dealt with through Class 4 and the entitlement will be under Class 3 of the new regime.³³ This has been criticised for replicating the existing complex characteristics of Class 2.³⁴

The Government argues that while this provision cannot be said to reduce complexity, this option is so similar to the current operation that it will enable continuity and understanding of the process.³⁵ It will be argued here however, that this response is not satisfactory. While the Government is correct in its assertion that this option is similar to its predecessor, it is argued that this similarity does not immediately confer continued understanding – due not only to the fact that it has been established that the current system was not well understood to begin with.³⁶ As with the section above, this benefit is being moved into a Class previously unused by self-employed individuals and will require significant education to ensure successful application.

Conclusion

It is clear from the substantive proposals, set out in part 1, that the Government's intention is to install a simplified and more equitable system of NICs in line with the OTS proposals. This is evidenced by the alignment of profit limits in the proposed Class 4 with those of earnings in

³³ See HM Government (n.22), above, 7.

³⁴ Low Income Tax Reform Group, "The abolition of Class 2 National Insurance: Introducing a benefit test into Class 4 National Insurance for the self-employed Response from the LITRG" (2016) <<http://www.litr.org.uk/sites/default/files/files/160222-LITRG-response-Class-4-NI-benefits-FINAL.pdf>> accessed 16 October 2017.

³⁵ See HM Government (n.22) above, 15.

³⁶ See: "Part 1: The Current System" above.

Class 1; and through the abolishment of Class 2 allowing self-employed individuals to gain access to contributory benefits through a single impost.

It has further been shown that the proposals achieve their intended goals in relation to self-employed individuals who have taxable profits of, or exceeding, the SPL. Those individuals will pay £148.20 less for the same level of access to contributory benefits through a simplified system.³⁷ There are, however, areas of the proposal that do not benefit from the intentions of this reform and consequently are causing significant concern; namely, for persons who do not have sufficient taxable profits to gain access to contributory benefits through Class 4, and concerning short-term benefit entitlement. In both cases, benefit entitlement will be gained through Class 3 under the reformed system.

It is in relation to Class 3 that a majority of commentators have criticised the Government proposals for having the potential to pose significant problems. The implementation of a special regime for short-term benefits in this Class arguably replicates the complexity in the current Class 2. The Government response to such criticism is that these particular proposals will instead benefit from continued understanding. It is the conclusion of this work, however, that the Government position on this matter is incorrect. The Government ought to be mindful of the fact that self-employed individuals are unfamiliar with Class 3 and significant education will be required to prevent negating their efforts by replacing one complex and inequitable system with another.

³⁷ £148.20 being the annual sum of contributions made through Class 2.