Abolish National Insurance

A simpler and more transparent tax system

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Contents, about the author and acknowledgements

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Executive Summary

National Insurance is almost indistinguishable from Income Tax in its function of raising revenue for the Government and in the way it affects incentives for employees. Despite performing essentially the same task, it operates in a different manner in eight key ways (such as the collection period and definition of earnings) which add unnecessary and expensive complexity.

More importantly, National Insurance obscures public understanding of tax on earnings. Most debate on earnings tax focuses on Income Tax, ignoring both National Insurance charges. But the literature increasingly favours substantial reform. The Institute for Fiscal Studies and the Centre for Policy Studies have both recently called for employee National Insurance to be abolished and employer contributions to be simplified.

Reforming National Insurance to align it with Income Tax would cut costs, reduce complexity and improve transparency. But it would also highlight the absurdity of maintaining both systems.

The key findings of this paper are:

- The Government should abolish National Insurance – both for employers and employees. It makes the tax system opaque, complicated and costly yet serves no purpose that could not be fulfilled by the Income Tax system. Abolition would make it simpler, cheaper and more transparent.
- Pensioners, the self-employed and others who pay reduced rates of National Insurance should not pay more tax when it is merged into the Income Tax system.
- New Income Tax rates for these groups can be introduced to ensure they do not lose out. Any subsequent alignment should only happen by reducing the higher rates, not by increasing any lower rate.
- A first stage of a merger should operationally align the charges, publish employers' National Insurance on wage slips and rename National Insurance to something which more honestly and accurately describes its function.
- A second stage should simultaneously abolish National Insurance completely, mandate a reassessment of earnings to incorporate employers' National Insurance contributions and adjust Income Tax rates to collect the same revenues from the same individuals as before abolition.

Introduction

Following weeks of media speculation on merging the National Insurance system with Income Tax, the Chancellor of the Exchequer announced in his Budget 2011 speech that the Government would launch a consultation into the operation of the two systems. Following the Budget, in April, the Department for Work and Pensions released a consultation paper, 'A State pension for the 21st Century', which requested views on proposals to remove the pensions link to National Insurance contributions and the possible withdrawal of 'contracting out' of National Insurance for the self-employed.

This paper is the joint response to both consultations by the TaxPayers' Alliance. The consultation paper on the state pensions closed in June and our official response to the specific questions is included at the end of this document in Annex A. At the time of writing, the Government had not yet launched its policy consultation on the operation of Income Tax and National Insurance but it launched a call for evidence in July which indicated a policy consultation is to be launched in Autumn 2011.[1]

The TaxPayers' Alliance believes the issues involved overlap to such a degree that it is very difficult to address one without also addressing the other. This paper looks at the background to reform; proposals by others; and the differences between the National Insurance system and Income Tax first. It then details the various aspects of the two systems as they exist now before examining the problems they present. Finally, we look at the options for reform of National Insurance and then the state pension system.

Background to reform

Attempts to reform National Insurance and Income Tax have a long history. Criticism of the system has been principally concerned with the costs of duplication in terms of complexity and administration with little attention having been given to issues surrounding transparency and openness of public policy. Since at least the 1970s, it has been acknowledged in the literature that the National Insurance system is simply a second income tax.

While most reports on the matter have concentrated on how to align the two charges so that they create less of an administrative burden, recently proposals have become bolder. In 1998, the Chartered Institute for Taxation described full integration as a likely long-term goal. Six years later in 2004, the British Chambers of Commerce declared that a full merger was the most efficient long term solution. More recently, the Institute for Fiscal Studies, the Centre for Policy Studies and the Institute of Directors

[1] See section 3.3, HM Treasury, *Integrating the operation of income tax and National Insurance contributions: a call for evidence*, 2011. http://www.hm-treasury.gov.uk/d/condoc_income_tax_national_insurance_contributions.pdf

have all called for or suggested it be considered that National Insurance should be abolished.

The Government itself looked at the issue in the 1980s at the request of the then Chancellor of the Exchequer, Nigel Lawson. Abolition was dismissed due to the 'elephant trap' of distributional effects. Those over the state pension age, other pensioners and the self-employed were identified as losers from the proposal. In addition, a number of earners who earned enough to be above the National Insurance Upper Earnings Limit but below the higher rate of Income Tax would also have suffered.

However, this last obstacle, the kink between the thresholds, has been removed as the higher rate threshold has crept down the income scale since then. The self-employed and pensioners, meanwhile, need not be charged more in any merger of the taxes.

Furthermore, National Insurance formed a much smaller proportion of income taxes (24 per cent, compared to 40 per cent now) and the contributory principle was stronger as benefits were more closely related to contributions. The death of the contributory principle which worried the Treasury in 1986 has already happened.

Other proposals and reviews

1978, A *British Tax Review* article "National Insurance Contributions – A Second Income Tax" concluded "the contribution system is merely an adapted form of the income tax system, and its separate status is to some extent a mere illusion."

1984, Dilnot, Kay and Morris proposed the integration of the charges in *The Reform of Social Security* as part of a broad tax and benefits reform proposal.

1986, HM Treasury, "*The reform of personal taxation*". Under Nigel Lawson, the Treasury produced this green paper with a chapter on integration of National Insurance Contributions and Income Tax which rejected a merger because the distributional effects, which (now Lord) Lawson referred to in his memoirs, *The View from No 11*, as an 'elephant trap', outweighed the administrative savings and benefits to business, which it predicted would diminish with the spread of information technology. The benefits of transparency did not feature in the green paper's concluding analysis.

1995, Dilnot argued for integration noting "the main continuing barrier… is politics and public perception", in Sandford (ed.), *More key issues in tax reform.*

1998, Chartered Institute of Taxation, *Report on Tax/NICs Harmonisation*, full integration likely long-term goal but focused on steps towards alignment.

1998, Work Incentives, a report by Martin Taylor in *The Modernisation of Britain's Tax and Benefit System No 2*, HM Treasury, noted the radicalism of integration but opted not to investigate the ideas which raised "such major policy questions".

2004, British Chambers of Commerce argued in *A New Tax Horizon* that the most efficient long term solution would be a "full merger of Pay-As-You-Earn with National Insurance. However, because this radical step presents a number of challenges, it would require strong political will".

2006, *Administrative Burdens – HMRC Measurement Project* report by KPMG was concerned only with measuring the administrative impact of taxes on business, but noted "a significant number of businesses considered that NICs and income tax should be rolled into one, so that there were not two different taxes covering the same payments".

2007, HM Treasury, *Income tax and national insurance alignment: an evidence-based assessment* decided the benefits of annualising National Insurance contributions did not warrant the disruption. It did not assess full integration.

2007, *Integrating Income Tax & National Insurance: An Interim Report*, by Adam & Loutzenhiser for the Institute for Fiscal Studies extensively covered issues on transparency and policy option details such as the treatment of pensions. It did not arrive at a conclusion but noted that "integration could facilitate bold policy options that would be welcome in their own right as well as allowing for a simpler merged tax" and postponed recommendations to a final report.

2010, *The Mirrlees Review* (findings) for the Institute for Fiscal Studies, by Sir James Mirrlees et al, was unambiguous. "National Insurance is not a true social insurance scheme; it is just another tax on earnings, and the current system invites politicians to play games with NICs without acknowledging that these are essentially part of the taxation of labour income. The two systems need to be merged. Given our proposal to apply the same rate schedule to income from all sources, integration would be a good opportunity to, in effect, broaden the NICs base to cover self-employment and capital income in full".

2010, *Abolish NICs* by David Martin for the Centre for Policy Studies argued for abolishing National Insurance and making up for lost revenue by raising Income Tax and implementing a new payroll tax. This proposal is administratively simple but introducing a payroll tax would negate much of the transparency benefit from abolition of National Insurance.

2011, *National Insurance contributions: an introduction* by Antony Seely for the House of Commons Library reviewed (disinterested in the merits of proposals) the operation of the system and opinion on reform with particular reference to parliamentary questions and answers on the subject.

2011, Institute of Directors, Richard Baron's article in the Institute's *Big Picture* magazine argued that "Income tax and national insurance: a marriage made in heaven or hell?" argued that abolition of National Insurance by way of merging Income Tax with only employees' National Insurance and replacing employers' National Insurance with a flat-rate payroll tax should be seriously considered.

2011, *The Mirrlees Review* confirmed the assessment provided when the findings were published in 2010. "The UK has two taxes on income – income tax and National Insurance contributions... integration would underline the illogicality of most of the current differences... it is patently absurd, for example, to have one tax assessed on earnings in each individual pay period and another assessed on income over the whole year... transparency and administrative simplicity would be well served by merging them... there is a strong case for phasing out the employer contribution altogether, merging it with income tax and employee NICs to form a single tax", the review observed before concluding: "Income tax and employee NICs – perhaps employer NICs as well – should be integrated into a single tax."

Differences between National Insurance and Income Tax

There are seven key differences between the two systems: the assessment period, assessment unit, earnings definition, age applicability, employment status, pensions, and miscellaneous reliefs and international issues.

Key Area	Difference between National Insurance and Income Tax
Assessment period	National Insurance is assessed per employment period (as in per pay-slip, typically weekly or monthly, though company directors are assessed annually) while Income Tax is assessed annually (though typically an estimate is paid per employment period through the PAYE system with discrepancies resolved after the end of the tax year).
Assessment unit	National Insurance contributions are normally paid on a per-job basis, whereas Income Tax is assessed per person. This means that someone with two jobs benefits from bands of earnings under the 'Primary Threshold' (and not liable to National Insurance) for each job.
Earnings definition	Income Tax applies to most income, although with slightly different rate schedules for each of savings and dividends income. National Insurance, however, is payable only on income 'derived from an employment'. On technicalities such as expenses, gratuities (for waiters, etc.) and benefits-in-kind, the National Insurance rules are usually more favourable than those used to assess liability for Income Tax.

Key Area	Difference between National Insurance and Income Tax
Person applicability	While Income Tax applies to everyone (with the exception of more generous age-related tax-free thresholds), National Insurance applies only to those aged between 16 and the State Pension Age. Pensioners and children do not pay National Insurance. There is a special reduced rate of National Insurance contributions for women who have been married since 1977 and in continuous employment. Other than that, National Insurance largely ignores marital status whereas Income Tax contains various assumptions (such as equal shares of income arising from jointly-owned property) which are dependent on marital status.
Employment status	Those classified as self-employed for National Insurance purposes enjoy considerably more favourable rules than the employed in terms of admissibility of expenses and exemption from employers' National Insurance. Self-employed status affords much less favourable treatment under Income Tax rules. Also, for occupations including entertainers, construction workers, ministers of religion, part-time or visiting lecturers/instructors and office cleaners the categorisation as employed or self-employed may not be the same under National Insurance rules as under rules for Income Tax, as the latter are categorised only by common law tests while, for the purposes only of National Insurance, HMRC is authorised to determine employment status under Regulations irrespective of the status for Income Tax purposes.
Pensions	Neither system taxes investment returns within a fund but pension income is subject to Income Tax and yet exempt from National Insurance contributions. Contributions to pension funds are exempt from Income Tax. However, while an employer's contribution to a pension fund is exempt from both employers' and employees' National Insurance contributions, they are payable on the employee's contribution to the pension fund.
Expenses	For an expense to be deductible for Income Tax purposes it must be "wholly, exclusively and necessarily" incurred for the employment whereas for National Insurance the test is "any specific and distinct payment of, or contribution towards, expenses which an employed earner actually incurs in carrying out his employment". However, deductibility for National Insurance only applies when the employee is reimbursed by the employer. So for items such as professional fees, which are deductible for Income Tax purposes, National Insurance must be paid if the fee is not reimbursed by the employer.
Miscellaneous and international	Reliefs such as blind person's allowance (a larger personal allowance for blind people) are applicable to Income Tax but not National Insurance. Liability for National Insurance and Income Tax varies for seconded employees to/from the UK. Some pay one but not the other charge, depending on UK and EU law and bilateral treaties.

The current system

Despite its name, National Insurance is a parallel system of taxation on earned income which operates independently of Income Tax. The two systems each have their own set of rates and schedules. There are various differences between the systems in addition to rates and National Insurance contributions provide the basis for a number of 'contributory' benefits. Receipts from National Insurance contributions are paid into the National Insurance Fund, which in theory is one of the features which distinguishes National Insurance from general taxation. In reality, however, the fund is effectively meaningless.

Rates and schedules of Income Tax

Income Tax is levied on all 'taxable income' but there are separate sets of rates for income from interest on savings and dividends from profits. Taxable income is someone's entire income (including interest and dividend income) after deducting allowable expenses and the relevant Personal Allowances. Income Tax is applied to taxable income as a whole, but it is applied to the schedules sequentially. Income from interest and dividends is disregarded initially when assessing the liability under the main schedule. Interest income from savings is then added to assess what rate is applied to savings income. Finally, dividend income is added to the total to assess the applicable rate for dividend income. With the sole exception of the "starting rate for savings income", rates on bands of income are applied only to the portion of someone's total taxable income that falls into a band.

Personal allowances

Personal Allowance	Description
Under 65	£7,475 for those whose income is under £100,000. Thereafter it is reduced by £1 for every £2 earned. The allowance falls to zero at £114,950 so those earning this amount or greater have no Personal Allowance.
65-74	£9,940 for those whose income is under £24,000. Thereafter it is reduced by £1 for every £2 earned. The allowance falls to £7,475 (the under 65 amount) when income reaches £28,930 and stays at this level until income reaches £100,000 where it reduces again by £1 for every £2 earned until income reaches £114,950 where its value falls to zero.
Over 75	£10,090 for those whose income is under £24,000. Thereafter it is reduced by £1 for every £2 earned. The allowance falls to £7,475 (the under 65 amount) when income reaches £29,230 and stays at this level until income reaches £100,000 where it reduces again by £1 for every £2 earned until income reaches £114,950 where its value falls to zero.

Other allowances

- **Blind Person's Allowance:** This allowance of £1,980 reduces taxable income and is granted to blind people in addition to other allowances to which they are entitled.

- **Married Couples Allowance:** Civil partners and couples who married after 5 December 2005 where one was born before 6 April 1935 are entitled to apply the Married Couples Allowance of £7,295 to the highest income in the couple. The allowance does not reduce the taxable income, but instead provides a relief of 10 per cent of the allowance against the tax bill of the highest earner in the couple. When that income rises above £24,000 the allowance is reduced by £1 for each £2 earned over £24,000 until the allowance falls down to its minimum amount of £2,800. For couples who married before 5 December 2005 (civil partnerships did not exist then) the allowance always applies to the husband's income.

Main schedule (excluding savings and UK dividends income)

Taxable income from sources other than savings income and UK dividends is taxed at the rates in the table below:

Rate Name	Total Taxable Income (£)	Tax Due at
Basic	Up to 35,000	20%
Higher	35,001-150,000	40%
Additional	Over 150,000	50%

Savings income

Income from interest on savings is added to the non-savings income to ascertain the applicable rate and taxed at the rates in the table below:

Rate Name	Total Taxable Income (£)	Tax Due on Savings Income
Starting rate for savings*	Up to 2,560	10%
Basic	Up to 35,000	20%
Higher	35,001-150,000	40%
Additional	Over 150,000	50%

*Unlike all the other rates, the "Starting rate for savings" income band only applies if the total taxable income falls within the band. The 20 per cent Basic Rate applies to the income within the Starting Rate if taxable income exceeds the Starting Rate's threshold. For example, if Person A's entire taxable income of £2,560 comes from interest on savings, it will be falls just inside the threshold for the Starting Rate and it will be taxed at 10 per cent, leaving his tax bill at £256. Suppose Person B's circumstances are identical but he earns just one pound more than Person A. His taxable income is £2,561, just above the threshold and therefore it will all be taxed at the Basic Rate of 20 per cent. Despite earning just one pound more, his tax bill would be £512.20.

UK dividend income

UK companies pay dividend income tax at a flat rate of 10 per cent directly to HMRC before distributing dividends to shareholders. A voucher for a credit equal to the proportion of this tax paid applicable to an individual shareholder's dividends is issued with the dividends to the shareholder reduces the tax liability. This credit is not refundable to taxpayers whose income is not high enough to be taxable. Income from UK dividends is added to other income to ascertain the applicable rate and taxed at the rates in the table below:

Rate Name	Total taxable income (£)	Liability	Tax liability on total dividend income (including tax already paid at source) after deducting 10% tax credit	Amount due on dividend cash received after deducting 10% tax credit
Basic	Up to 35,000	10%	0%	0%
Higher	35,001-150,000	32.5%	22.5%	25%
Additional	Over 150,000	42.5%	32.5%	36.1%

Rates and classes of National Insurance

National Insurance 'contributions' are compulsory and payable on earnings "derived from an employment". They are not payable on rental, savings, dividends or pension income or on employment earnings of people aged under 16 or over the state pension age. Most contributions are payable by employment period (monthly for most people) but converted into weekly rates for assessment. Those who register as self-employed must pay the flat rate weekly Class 2 in addition to the annually assessed Class 4 rate. People can volunteer to pay a weekly flat rate amount (Class 3) to maintain their contribution record and thus entitlement to benefits in cases where they are not otherwise liable or treated as having made contributions.

People who earn between £102 and £139 per week do not pay National Insurance contributions but are treated as though they did when assessing eligibility for benefits through National Insurance 'credits'. In addition, people who claim Carer's Allowance, Jobseeker's Allowance, Incapacity Benefit or Employment and Support allowance, parents of a child aged under 12, approved foster carers and those who care for a severely disabled person for at least 20 hours per week are all also treated as if they had made National Insurance contributions.

Class	Description	Rate	Revenue
Employees' National Insurance			
Class 1	Standard rate between weekly earnings of £139 and £817 payable by the employee (usually through the PAYE system) from the employee's official wage or salary. 2% above £817. Married women in continuous employment since 1977 or before and widows pay a reduced rate of 5.85%. A rebate of 1.6% is due for those who 'contract out' of the Additional State Pension.	12%	£40.3bn
Class 2	Self-employed flat rate	£2.50/week	£0.3bn
Class 3	Voluntary contribution flat rate	£12.60/week	£0.1bn
Class 4	Self-employed rate for profits between £7,225 and £42,475. 2% for profits above £42,475.	9%	£2.0bn
Employers' National Insurance			
Class 1	Employers' rate payable by employers on weekly earnings in excess of £136 in addition to the stated wage or salary. Rebates apply for those who are members of contracted-out pension schemes which are paid into the schemes by HMRC, at 1.4% for money-purchase schemes or 3.7% for salary-related ones.	13.8%	£53.4bn
Class 1a	Employer-provided benefits	13.8%	£1.0bn
Class 1b	Contribution relating to certain expenses under 'PAYE Settlement Agreements' between HMRC and an employer.	13.8%	£0.2bn

Interaction with benefits

The National Insurance system interacts with nine benefits which currently rely on National Insurance contributions: the State Pension, the Additional State Pension, contributions based variants of Jobseekers Allowance, Employment and Support Allowance and Incapacity Benefit, Maternity Allowance, Bereavement Allowance, Bereavement Payment and Widowed Parent's Allowance.

Benefit	Operation and interaction with National Insurance
State Pensions	The Government is consulting on replacing the State Pension and the "Additional State Pension" with a new flat rate state pension not related to National Insurance contributions, thereby abolishing the already weak link. The value of current state pensions are based in part on National Insurance contributions, although the system is very complicated and can even have the effect of making a pension worth less if National Insurance contributions are paid in certain circumstances[2]. People qualify for the State Pension if they have accrued enough "qualifying years" (years where they earned enough to pay National Insurance contributions) while the Additional State Pension's value depends on the level of National Insurance contributions paid.

[2] 2010, *Abolish NICs* by David Martin for the Centre for Policy Studies, pp18-19.

Benefit	Operation and interaction with National Insurance
Jobseeker's Allowance	A non means tested payment of £67.50 per week (for those over 25) is paid for up to six months for people with complete National Insurance contributions records in the previous two tax years. This is in place of a means-tested equivalent payment for those who do not qualify for the (National Insurance) contributions-based JSA.
Employment and Support Allowance	ESA is paid to those with a disability which restricts the claimant's ability to work. The 'contribution-based' element is available to those who meet the National Insurance contributions criteria (firstly having paid National Insurance contributions on earnings of 25 times the weekly "Lower Earnings Limit" (currently £102) in each of the previous 3 years and secondly having paid or being treated as paid at least 50 times the LEL in each of the two previous years). This replaces Incapacity Benefit but those who do not meet the criteria may be eligible for the means-tested 'income based' ESA instead. Neither are available to people who are eligible for Statutory Sick Pay or Jobseekers Allowance. It is paid at £67.50 per week in a 14 week assessment period and subsequently £94.25 or £99.85 depending on the assessment.
Incapacity Benefit	Incapacity Benefit closed to new applicants on 31 January 2011. Existing applicants are being moved to Employment and Support Allowance (see above). Consequently, Incapacity Benefit will soon cease to affect potential National Insurance and Income Tax reforms.
Maternity Allowance	Maternity Allowance is a benefit of £128.73 (or 90% of average weekly earnings, whichever is lower) payable for up to 39 weeks to pregnant women who are or have recently been self-employed or who are employed but not eligible for Statutory Maternity Pay. National Insurance records are used to determine this, although contributions have almost no effect (people earning under £139 per week pay no National Insurance contributions but receive MA of £125.10, this rises to £128.73 for those earning £143.03 or above. Self-employed people are treated as earning £143.03 if they have paid Class 2 National Insurance contributions in 13 of the 66 weeks before the pregnancy due date).
Bereavement benefits	The surviving spouse (when the deceased partner had a good record of National Insurance contributions or whose death was caused by their job) in a marriage or civil partnership but who is neither over the state pension age, nor divorced, nor living with another person as a spouse nor in prison, is eligible for: ▪ Bereavement Payment, a £2,000 tax free payment made if applied for within 12 months of the death. ▪ Widowed Parent's Allowance, a weekly benefit of up to £100.70 when the surviving spouse receives Child Benefit or is expecting the deceased's baby. ▪ Bereavement Allowance, a weekly benefit of a maximum of £100.70 for those aged 55 to the state pension age decreasing to £30.21 for those aged 45. Payments are reduced when the deceased's National Insurance contributions record is incomplete. The benefit is not payable to those aged under 45.

Tax, not insurance

The overwhelming majority of National Insurance revenue does not pay for benefits which are dependent upon an individual's National Insurance contributions. Those who 'contract out' of the Additional State Pension must join an approved pension scheme and their 'rebate' is paid into the scheme. National Insurance contributions are based not on a risk profile but rather are a function of earnings, again like a tax and unlike insurance. The (compulsory) 'insurance' function that does exist is minimal, relating only to a few marginal benefits and a tangential relationship with the State Pension system which the Government seems likely to abolish. It is in effect, overwhelmingly, simply an additional tax on earned income.

Employers don't pay employers' NI, employees do

Academic opinion varies as to the precise degree to which employees pay the economic cost of the charge[3] but the range of opinion extends between mostly and completely on employees in the form of lower wages and salaries, higher prices (effectively lower incomes for consumers, including workers) and higher unemployment. The reason is that employers will attempt to pass on any cost, such as employers' National Insurance, to others because they seek to maximise their profits (or maximise the good they do for their cause in the case of not-for-profit organisations).

Because consumers are likely to reduce their overall spending and transfer more of it to goods and services produced where employers' National Insurance isn't chargeable, organisations are limited in the extent to which they can raise prices. Labour, however, is less mobile and for most employees reducing wages by an amount equivalent to the charge will simply reduce the net economic benefit they capture from their employment. This is why most, if not all, of the charge works its way through to workers through lower wages rather than to consumers through higher prices or capital through lower profits.

A small number of employees, however, will not simply accept a lower net income as a result of National Insurance because, for this group, the financial and other benefits of being in employment is only just outweighed by the costs in terms of the time and effort involved. For them,employers' National Insurance means the difference between work being financially worth the time and effort required and it not being so in the same way that Income Tax can. Some of these people give up work altogether while others simply reduce their employment to part-time.

[3] See John A Brittain in *The American Economic Review*, 1972, The Incidence of Social Security Payroll Taxes http://www.profluming.com/Article/UploadFiles/201008/2010081807331083.pdf and Jonathan Gruber in the *Journal of Labour Economics*, 1997 (vol 15) http://econ-www.mit.edu/files/86

In other words, they are unemployed or underemployed and it is in this manner that they carry the burden of employers' National Insurance. While its execution differs from Income Tax and employees' National Insurance, the effect of employers' National Insurance is if not wholly then almost identical: overwhelmingly paid for by workers in the form of lower net incomes for the majority who stay in work and underemployment and unemployment for the minority who do not.

The National Insurance Fund

The National Insurance Fund was established in 1911 but took on its current form in 1975 when it merged with the National Insurance (Industrial Injuries) Fund and the National Insurance (Reserve) Fund. It is the account which receives most National Insurance contributions but also sometimes receives grants from HM Treasury. It is responsible for paying contributory benefits (89 per cent of expenditure is pensions) but operates on a pay-as-you-go basis in that a given year's contributions pay for that year's expenditure. The Government has no powers to use the Fund's receipts to finance any other activities. The Fund has no borrowing powers but it deposits all of its working balance with the Government for which it accrues interest at the Bank of England bank rate and this is administered by the Debt Management Office.

Despite these technicalities the Fund's finances are not, in effect, treated very differently from general taxation. The Government decides how much contributions will be, what proportion of them will be paid into the Fund and the level of the benefits paid from it. It also provides it with grants, when necessary, to maintain its working balance. The Fund is effectively an accounting device to manage and label part of the Government's current finances. It is not a fund in any meaningful sense of the term.

Problems with National Insurance

Running two taxation systems concurrently involves the problems of a heavier administrative burden, a barrier to transparency, complexity, a public understanding disconnect between the interaction between government and personal finances and poorer management-employee relations.

Administration

In 2006 KPMG produced a report for HMRC[4] measuring the administrative impact on business of tax regulations. The report ignored the costs relating to non-compliance, the cost and uncertainty of change, the cost of economic activity discouraged by the perception of complexity and operational grit in the system and only measured direct, marginal compliance costs. Despite its narrow focus, KPMG found that just three of the 'information obligations' the separate National Insurance system imposed on businesses incurred a compliance cost to business of £146 million. It did not detail the cost of other, less onerous obligations.

HMRC spends substantially more in order to maintain separate National Insurance and Income Tax systems than it would if one of the charges did not exist and the remaining charge was commensurately higher. It charges £300m to the National Insurance Fund for collecting contributions.

The two systems require companies and their tax accountants to know more detail and this places demands on employers' and employees' time. That duplication means lower incomes, as the money is used to pay for tax advisors and HR administration, and higher taxes on those lower incomes to pay for the additional HMRC inspectors and their other costs.

Opacity

By splitting up employees' Income Tax bills and labelling part of them 'National Insurance' the tax system is made more opaque. To determine exactly how much tax is payable on income taxpayers must add together National Insurance contributions and Income Tax payments. While this is not a complicated mathematical exercise, it is nonetheless a disadvantage to all those who favour an open, honest and transparent taxation system.

[4] KPMG, 2006, Administrative Burdens – HMRC Measurement Project http://www.hmrc.gov.uk/better-regulation/kpmg.htm

But what makes the National Insurance system particularly opaque is the employers' part of National Insurance. It is an additional amount which needs to be added to Income Tax and employees' National Insurance for taxpayers to compute their true total income tax bill. But it is classified as being paid by the employer and, as a consequence, is not stated on employees' remuneration advice slips. This hides from employees the full extent of their tax bill by effectively disguising part of their income under an economic fiction that it is paid by the employer instead.

Complexity

By definition having two sets of rules is more complicated than one. People who want to understand the system have to learn the different rates and thresholds; but as the 'Differences between National Insurance and Income Tax' table illustrates, the additional complexity spreads significantly further than that. The two charges apply over different times. Indeed, the National Insurance timeframe is variable (whatever the 'employment period' is) whereas Income Tax is fixed at annual assessments. They apply to different units; National Insurance is applied per job and Income Tax per person. And then there are myriad differences in the minutiae of classification of such things as whether or not someone, particularly in the case of an entertainer, is 'self-employed', as explained in a report published by the Institute for Fiscal Studies:[5]

> *"This position changed in July 1998, when the DSS admitted that its general position towards entertainers was unsustainable in law. The Categorisation Regulations subsequently introduced between July 1988 and April 2003 ensured that most entertainers would be treated as if they were employees for National Insurance purposes (again irrespective of their status for Income Tax purposes as determined under the usual case law). Under the present National Insurance regime, the Categorisation Regulations apply, and Class 1 NICs are payable, unless the entertainer's remuneration does not involve any amount of 'salary'. At first, the Categorisation Regulations applied only where the remuneration was 'wholly or mainly' salary, but the test was extended to any amount of salary in 2003 once HMRC discovered that most entertainers entered into contracts providing for residuals and royalty payments which often exceeded the basic salary element. 'Salary' is defined in the regulations as payments made for services rendered under a contract for services where there is more than one payment, payable at a specific period or interval, and computed by reference to the amount of time for which work has been performed. If the Categorisation Regulations apply, all payments*

[5] Adam & Loutzenhiser, 2007, *Integrating Income Tax & National Insurance: An Interim Report*, Institute for Fiscal Studies, London. http://www.ifs.org.uk/publications/4101

under an engagement (including residuals and royalties) are subject to NIC, not merely the salary element."

All these differences amount to more complexity than would otherwise be the case. That complexity means more tax officials are required to administer and collect the tax but it also means employers and employees alike (together with their tax advisors) must familiarise themselves with a greater number of rules and peculiarities. The likelihood of errors and unintentional non-compliance also increases with greater complexity, which is unfair.

Public-personal finances

The complexity and opacity described above also has the effect of making it more difficult for taxpayers to link and compare the cost of the government services they receive with the tax they pay. Consumer law requires companies to advertise all compulsory charges to ensure customers know exactly how much they are paying when they make a purchase.

Of course, without the law customers would find out anyway when they actually pay the bill.But the law makes it clear that enforcing honest and transparent labelling of pricing structures is in the public interest. This principle should apply to taxation and government services, too. The overwhelming majority of National Insurance revenue does not pay for benefits which are dependent upon an individual's National Insurance contributions. The 'insurance' function that does exist is minimal, relating only to a few marginal benefits and a tangential relationship with the State Pension system. It is, overwhelmingly, simply an additional tax on earned income.

Labour relations

Because employers' National Insurance is a tax paid for by workers on lower incomes, and results in higher unemployment (see above), but is not clearly marked as such - on payslips, by politicians or in media coverage of the budget – it acts as a stealth tax with damaging effects in the labour market which go beyond that of an equivalent amount raised by Income Tax.

Many employees simply do not realise the true level of their compensation as a direct result of employers' National Insurance. Many believe the financial reward employers provide in exchange for labour is limited to the official salary plus other visible benefits and simply do not realise that their employer pays employers' National Insurance in addition to this. This has the effect of diminishing both employees' perception of the financial remuneration provided by employers and the perception of the burden of taxation they personally bear. While this 'smokes and mirrors' approach to raising revenue for public spending holds an obvious appeal for politicians keen to be seen to be offering 'something for nothing', such dishonesty cannot be a healthy part of any prospectus for government. But this has ramifications beyond honesty in politics, government and public spending.

The gap between the value to employers of the labour an employee provides and the value of the compensation received in return for that labour is a direct consequence of employers' National Insurance. This gap creates the perception that employers reap much higher profits than is the case and leads many to conclude that the basis of profitability lies not in efficient and successful organisation but simply underpaying workers. In turn, this must be responsible for a significant proportion of friction between employees and employers with all the strikes, workplace disharmony and loss of productivity and prosperity that entails.

Options

The dual system of National Insurance and Income Tax is a needlessly heavy burden on taxpayers that ought to receive serious, immediate attention. There are, essentially, two options for the Government to consider: the first is further alignment of the two systems to reduce the extent of the differences between them and therefore the complexity and administrative burden that arises from those differences. The second option is to abolish National Insurance altogether, merging it into the Income Tax system and abandoning the last remaining tokens of the contributory principle in the benefits system.

Alignment

Further alignment of the National Insurance and Income Tax systems would provide a moderate but real improvement on the status quo. Measures the Government could take to reduce the extent of the problems with having both systems include:

- Abolish the Social Security (Categorisation of Earners) Regulations 1978 and apply the same categorisation of employment status to National Insurance as to IT. This will reduce complexity and mean that employees, employers and their advisors need only familiarise themselves with one set of rules.
- Alter National Insurance from periodic, per-job to annual, per-person applicability with the same thresholds as Income Tax, with periodic execution under the Income Tax PAYE system combined. This will standardise the system and mean people need only consider one set of thresholds and applicability, with only the rates differing between the two charges.
- Exempt employees' contributions to pension funds from National Insurance Contributions to match the treatment for employers' pension fund contributions and the Income Tax treatment of both. The current system of taxing pension incomes rather than pension contributions is logical and should be consistent. There is no reason, beyond HMRC attempts to raise revenue, why one charge should be applied but not the other.
- Merge the two sets of rules for deductible expenses into a single set of rules equally applicable to both National Insurance and Income Tax.
- Rename both National Insurance charges and Income Tax so they accurately reflect their actual functions:

Current Name	New Name
Employers' National Insurance	Income Tax (Payroll Levy)
Employees' National Insurance	Income Tax (National Insurance Contribution)
Income Tax	Income Tax (Standard Earnings Charge)

- Amend remuneration advice notices to add new lines in both the 'Payments' and the 'Deductions' schedules. This will add clarity to the three economic facts currently absent: the fact that employees pay employers' National Insurance, the total amount of direct tax employees pay and the total compensation employers provide to employees. Two new lines should be added in the Payments schedule under 'Gross salary'. The first to list employers' National Insurance contributions (as "Income Tax (Payroll Levy)") with the second new line being the sum of Income Tax (Payroll Levy) and 'Gross salary', reported as 'True Total Earnings', so employees see the full extent of the financial compensation they receive from employers. In the Deductions schedule a line should be added for Income Tax (Payroll Levy) followed by another line for "Income Tax Total", representing the sum of all three charges. Year to date figures should be amended similarly.
- Abolish the National Insurance Fund. It has no useful purpose and its assets and liabilities should be assumed by HM Treasury.

Implementing the alignment reforms above would provide a worthwhile improvement in terms of reducing complexity, administrative and compliance costs and improving transparency, labour relations and the public understanding of the interaction between public and personal finances. Nonetheless they would, even if implemented in full, leave substantial duplication, opacity and complexity in place which would serve to make the existence of two separate systems even more pointless than at present. Alignment is therefore an unsatisfactory approach when compared to the potential benefits of an outright abolition of National Insurance by fully merging it into the Income Tax system.

Abolition

A much more radical and satisfactory solution lies in abolishing the contributory principle and National Insurance along with it, together with adjustments to the Income Tax system so that the two charges are entirely merged into one. This option presents many presentational obstacles and would require careful implementation and a comprehensive public information campaign to avoid the obvious danger of it being perceived as a tax rise.

Abolition would be a major change in the operation of the part of the tax system that applies to half the population at any time and most of the population at some point in their lives. There is a risk of public confusion from those who might worry that they will be suffer financially as a result of the change either because the amount of tax the Government will admit people are paying will indeed increase or simply because they may have heard that the system is changing and naturally worry about what their worst case scenario might be.

It is because of this risk that we propose that abolition ought to be carried out in two phases with a two year gap separating them. The first phase consists of the alignment reforms that would harmonise the operations of the two systems without the fundamental change involved with abolition. This operational alignment, together with renaming elements of the two charges would both more accurately reflect their true functions and enhance public understanding which would in turn make the reforms in the second phase clearer.

Two years later, as a result of a public information campaign and the embedding of the first phase reforms, the second phase of abolishing National Insurance and with it the contributory principle would be well understood as making the accounting operation of the system match the economic reality and in the process create a simpler, cheaper and more transparent tax system.

First phase (effective 6 April 20xx, as soon as practically possible)

All the recommendations for alignment should be implemented immediately, viz.:

- Abolish the Social Security (Categorisation of Earners) Regulations 1978 and apply the same categorisation of employment status to National Insurance as to IT. This will reduce complexity and mean that employees, employers and their advisors need only familiarise themselves with one set of rules.
- Alter National Insurance from periodic, per-job to annual, per-person applicability (company directors are already assessed annually) with the same thresholds as Income Tax with periodic execution under the Income Tax PAYE system combined. This will standardise the system and mean people need only consider one set of thresholds and applicability with only the rates differing between the two charges.
- Exempt employees' contributions to pension funds from National Insurance Contributions to match the treatment for employers' pension fund contributions and the Income Tax treatment of both. The current system of taxing pension incomes rather than pension contributions is logical and should be consistent. There is no reason beyond HMRC revenue raising to apply one charge but not the other.
- Merge the two sets of rules for deductible expenses into a single set of rules equally applicable to both National Insurance and Income Tax.

- Rename both National Insurance charges and Income Tax so they accurately reflect their actual functions:

Current Name	New Name
Employers' National Insurance	Income Tax (Payroll Levy)
Employees' National Insurance	Income Tax (National Insurance Contribution)
Income Tax	Income Tax (Standard Earnings Charge)

- Amend remuneration advice notices to add new lines in both the 'Payments' and the 'Deductions' schedules. This will add clarity to the three economic facts currently absent: the fact that employees pay employers' National Insurance, the total amount of direct tax employees pay and the total compensation employers provide to employees. Two new lines should be added in the Payments schedule under 'Gross salary'. The first to list employers' National Insurance contributions (as "Income Tax (Payroll Levy)") with the second new line being the sum of Income Tax (Payroll Levy) and 'Gross salary', reported as 'True Total Earnings', so employees see the full extent of the financial compensation they receive from employers. In the Deductions schedule a line should be added for Income Tax (Payroll Levy) followed by another line for "Income Tax Total", representing the sum of all three charges. Year to date figures should be amended similarly.
- Abolish the National Insurance Fund. It has no useful purpose and its assets and liabilities should be assumed by HM Treasury.

Second Phase (effective two years later, 6 April 20xx+2)

- Abolish both forms of National Insurance (renamed Income Tax (Payroll Levy) and Income Tax (National Insurance Contribution) in phase one).

- Require gross salaries and wages during the 20xx+1-xx+2 financial year to be treated as if they included the Income Tax (Payroll Levy) when determining wages and salaries effective after 1 April 2014. For example, an employer who paid an employee a salary of £25,000 would have attracted an Income Tax (Payroll Levy) (currently employers' National Insurance) of approximately £2,500. Therefore, the 20xx+1-xx+2 salary from 6 April 20xx+2 would be approximately £27,500 before applying any agreed annual increases or decreases to convert the 20xx+1-xx+2 into a 20xx+2-xx+3 salary as per normal negotiations and contractual obligations.

- Create separate Income Tax rates for three categories of earners:

  1. *The Self-employed and those who are eligible for the special married women's and share fishermen's reduced rates of NI.* This rate should absorb the abolished

Income Tax (National Insurance Contribution) to reflect the fact that the self-employed do pay this rate but do not pay employers' National Insurance.

	IT	Employees'	New Rate
Basic Rate	20	9	29
Higher Rate	40	2	42
Additional Rate	50	2	52

2. Those under 16 and over the State Pension Age. People in this category currently only pay Income Tax, so the rates applicable to this group would remain unchanged. In addition, income from sources other than earnings, dividends and savings (rental income from property) would be taxed under this schedule for all people. This proposal does not alter the treatment of savings or dividend income. The treatment of these income types would continue to be taxed at the current rates.

	Rate
Basic Rate	20
Higher Rate	40
Additional Rate	50

3. *Everyone else.* The majority of earners do not fall into the above categories and their employment is currently liable to Income Tax and both employers' and employees' National Insurance. The new Income Tax rates for this group are derived from adding the three rates together and then dividing the total by 1.138 to account for the fact that employers' National Insurance is added to gross salaries rather than subtracted.

	Income Tax	Employees'	Employers'	Total	Divided by 1.138
Basic Rate	20	12	13.8	45.8	40.2
Higher Rate	40	2	13.8	55.8	49.0
Additional Rate	50	2	13.8	65.8	57.8

Public information campaign (effective as soon as possible and ongoing until after the second phase)

A public information campaign would need to be launched to operate during both phases to explain the key facts of the reform:

- Transparency and simplicity. Salaries and taxes will not rise, but will both appear higher because tax and salary information will be more honest and accurate.

- Salaries will go up but employers will pay the same total costs because the employers' National Insurance stealth tax will be paid direct to employees as salary instead of being siphoned off to HMRC.
- Reported taxes and salaries will both rise by the same amount meaning employees will be in the same position as before, but will be able to see clearly how much they really are paid and how much tax they really do pay.
- One set of thresholds, rates, rules and regulations for each of the three groups of earners will mean a simpler, easier-to-understand and cheaper tax system.
- The self-employed, pensioners and under 16s will continue to pay the same, lower rates.
- Married women and share fishermen who qualify for the special reduced rates will qualify for the self-employed lower rate of Income Tax. This very small group of people will be better off than under the status quo.

Remaining items

- **The contributory principle.** Department for Work and Pensions has forecast spending on contributory benefits excluding pensions at approximately £10 billion for 2011-12. This is predicted to fall to under £7 billion by 2015-16. In March this year, Bennett and Sutherland estimated the take up of replacement income-based benefits for a similar range of benefits (notably including Carer's Allowance but excluding bereavement benefits) and found that between 45 and 62 per cent of the claims expenditure would transfer to means-tested benefits. Applying the same ratios to contributory benefits would produce a reduction in spending of between £3.9 billion and £5.6 billion if the £10.1 billion of contributory benefits were to be abolished. This saving for the Exchequer could be spent on new contributory benefits to replace the abolished ones, perhaps based on Income Tax payment history or perhaps on residence, as the Government is proposing with state pensions. Alternatively, the saving could be used for tax cuts or to reduce the deficit. Irrespective of the view taken with regard to contributory benefits for those who are too well-off to be eligible for income-based benefits, the National Insurance system is not a sensible system for their administration.
- **State pensions.** The Government is consulting on major reform of the state pension system and proposes to abolish the link with National Insurance. We support the proposal in option 2 of the Government's consultation paper 'A state pension in the 21st century' – a flat rate pension with eligibility based on 30 qualifying years paying tax under the earned income schedules here. This is explained in more detail in the following section, Reforming the State Pension.
- **Pension income.** While pension incomes are subject to Income Tax they are exempt from National Insurance contributions. This differential treatment of those

over 65 (who benefit from both a larger Personal Allowance and a lower combined Income Tax and National Insurance rates) complicates the tax system and there are legitimate arguments in favour of equalising rates, the Personal Allowance or both. Again, this is not considered here and this proposal simply transfers the status quo into a single Income Tax.

- **Pension contributions.** Employer contributions to pension funds are exempt from all three charges. Employee contributions, however, are subject to National Insurance but exempt from Income Tax. This anomaly is a result of the difficulty of feasibly applying employers' National Insurance to defined contribution scheme employee contributions as the employee may have several employers, leaving the question of how to assign the rebate. Likewise it would not be feasible to apply employers' National Insurance to withdrawals from defined benefit schemes as the employer may not exist at the time of the withdrawal. Because National Insurance has already been paid on earnings which have been put into pension funds, it would not be fair on the beneficiaries to tax withdrawals at the full rate of the combined charges. This means the only fair, practical way of treating employee contributions would be to exempt them from the new charge to match the treatment of employer contributions, thereby removing the distortion.
- **Irregularities in the Income Tax system.** For example, the 10 per cent Basic Rate for Savings, the treatment of dividend income and the withdrawal of the Personal Allowance for those earning over £100,000, which effectively represents a marginal Income Tax rate of 60 per cent from £100,000 to £114,950, would persist and this paper has not considered their reform. The tax advantages of self-employment status and incorporation would also remain, meaning that the need for complexity arising from legislation such as IR35 which attempts to limit the extent to which people can take advantage of differences would also remain.
- **Part-time workforces and fluctuating incomes.** Because National Insurance thresholds and rates are applied for each job rather than for an individual's total income, it distorts the labour market for those on low and average incomes (under £817 per week) against full-time employment and in favour of part-time employment. An employee who holds two part time jobs rather than one full time job will benefit from two National Insurance thresholds of income. Similarly, an employer who hires two part time employees benefits similarly from two thresholds for employers' National Insurance. Abolishing National Insurance will remove this distortion but increase the tax liability for those with total earnings under £817 per week from more than one job or which fluctuates so that it is, in some weeks, particularly high. employers with part-time low-paid workforces will similarly suffer from the conversion of National Insurance from a per-job to per-person basis.

Benefits of abolition

Abolishing National Insurance will provide three considerable benefits to the UK tax system: Simplicity, efficiency and transparency.

- **Simpler.** Instead of three separate income taxes with different rules on assessment periods, assessment units, rates, thresholds, applicability and deductibility, this reform would leave one income tax albeit with different rates for groups that do not pay National Insurance now. There is a legitimate debate over whether those groups (the self-employed, pensioners and under 16s) should continue to pay different rates of tax and whether earned income should be taxed differently from rental, savings and dividend income but this proposal shows that, irrespective of those questions, the system of taxation on earned incomes can be radically simplified.
- **Cheaper.** The current system's complexity is a source of significant expense. Cutting out the complexity will also cut out much of that cost. Companies will only need to calculate and process one payment instead of two. Employers will only need to familiarise themselves with one set of rules and regulations. With the compliance cost of National Insurance to employers in 2006 at £146 million according to KPMG, the cost of collecting National Insurance Contributions at £300 million and smaller costs (not in the top three obligations) on top of these, the saving will be at least in the order of hundreds of millions of pounds. It is more difficult to calculate just how great the cost is of enterprise not undertaken due to the perception that the British tax system is highly complicated but that too is a cost that abolition will significantly reduce.
- **Transparent.** Replacing the 'smokes and mirrors' accounting devices of National Insurance with a single clear Income Tax would represent a major improvement in the transparency of UK taxation. Merging employees' National Insurance into Income Tax would combine two figures into one and remove the misleading name and would therefore make this element of the system less confusing and more transparent. But a far greater advance for transparency lies in abolishing employers' National Insurance which raises almost £55 billion a year. Many employees are simply not aware of this tax on their earnings because the legal liability rests with the employer and it is not listed on payslips, invisible to those who actually pay: employees. Changing the misleading name of this tax on income and listing it on payslips can improve the quality of public debate; restoring honesty to the numbers can help restore trust in politics and government and will help repair strained labour relations in the workplace, too. Abolishing it and merging it into Income Tax will make the system even more transparent.

Criticisms of abolition

Will rates need to be higher?
No. The one, single, combined rate will be higher than the constituent rates but it would not be higher than the sum of the existing rates. This is a proposal to stop calling something "6 plus half a dozen" and to start calling it 12.

Won't companies have to fund salary increases?
No. Official salaries will rise by the same amount that they used to pay in employers' National Insurance contributions. Employers will pay the same as before except that it will all be paid to employees.

Won't abolition National Insurance destroy the contributory principle?
Not on its own. Abolishing the contributory principle will certainly be easier with no National Insurance system, but there is no reason why a contributory principle would need the National Insurance system. If you favour a system of benefits based on contributions this could easily be assessed by Income Tax payments instead.

Some favour residence-based tests so that eligibility for some benefits is based on length of residence in the country. Others favour a system of benefits only for those without means and believe mutual societies and insurers offer a more effective alternative, as in the UK model for car insurance or certain other countries' social and health insurance systems (such as those for healthcare in France, Switzerland or Australia).

If a genuine social insurance model were to be introduced it would almost certainly involve creating a new framework rather than using the existing National Insurance system. As set out above, National Insurance currently operates as an additional income tax. It would be simpler and more effective to create a new social insurance fund that genuinely operated in line with the principles of a social insurance model, particularly if you wanted it to be modernised in order to enable competition and private sector involvement. Ultimately, whichever option you favour, the National Insurance system does not offer anything that cannot be achieved through other means.

Won't investors lose out? Investment income isn't currently subject to National Insurance at all.
No. This proposal does not affect investment income. Pension income, dividends and savings and other investment income would continue to be taxed at the current rates. This proposal only affects earned income.

Won't people in between the thresholds lose out?

No. This group no longer exists, thanks to the expansion of the 40 per cent higher rate of Income Tax and a deliberate policy in recent years to harmonise the thresholds.

Will people with fluctuating incomes lose out?

Some will lose, some will gain. Those whose lower incomes fluctuate around the Lower Earnings Limit will gain while those with greater incomes fluctuating around the Upper Earnings Limit will lose. The numbers affected are small and any sensible reform of taxation must accept that it is impossible to change a system without any losers whatsoever.

Will workers with more than one job lose out?

Some will lose, some will gain. Those with two equally-paid jobs but no other income will lose if their total income is between £139 and £984 by a maximum of £16.68 per week. Those with a total earned income higher than this range will benefit and those below the range will not be affected. These figures only relate to people with equal pay from the each of the two jobs.

The figures become complicated when the incomes from the separate jobs are not equal and will vary. They will also vary with the number of jobs an individual has. The numbers affected are small and any sensible reform of taxation must accept that it is impossible to change a system without any losers whatsoever.

Isn't it more realistic to separate employers' National Insurance and replace that with a payroll tax instead?

Perhaps, but that would fail to achieve the transformational effects of full transparency which only outright abolition and merger into the Income Tax system can offer. Perhaps it would be more attractive to timid politicians to keep the 'employers' side of National Insurance hidden in a payroll tax, but that would be little better than the status quo and it's hard to imagine the political will materialising for the sustained, gradual cuts to eventual abolition that most payroll tax proponents hope will follow. Better to bring the tax system's 'dirty secret' out into the open in one go for a genuinely transparent system.

Reforming the state pension

The state pensions system would be affected by abolishing National Insurance because it is currently calculated in part using National Insurance contributions. The Government has recently consulted the public on abolishing the link with the amount of National Insurance paid in the Department for Work and Pensions green paper, "A state pension for the 21st century – public consultation". The TaxPayers' Alliance response to the questions in the consultation paper are reproduced below in Annex A.

We support the Government's proposal to abolish the contributory element of the state pensions system in favour of a flat-rate pension for everybody with 30 qualifying years of National Insurance payments. The Government's proposed system could easily be tweaked to alter the definition of 'qualifying years', substituting National Insurance for an amount of Income Tax on earned income for those above 16 and under the State Pension Age.

However, a better option still would be to follow the Australian model and phase out state pensions entirely, to be replaced with compulsory superannuation. This would mean that employers would be compelled to allocate a given percentage of an employee's salary or wage to an approved pension fund of the employee's choice. Over time, these funds would, as in Australia, begin to replace state pensions and would truly make the contributory principle the basis for the pension system.

Annex A – Response to the Government's State Pension consultation paper

Chapter 1 – The current pension system

1. Would the current state pension, if left unchanged, meet the Government's principles for reform and provide an effective foundation for saving?

No. It fails all four principles. It discourages saving and so fails personal responsibility, it does not treat groups fairly because it allows for those who contribute nothing to receive more than those who have made contributions and so it fails fairness, it is one of the most complicated systems in the world and very few understand it so it fails simplicity and the cost is predicted to rise sharply despite the fact economic growth is already being stifled by onerous taxes and an over-large state sector and so fails affordability and sustainability.

Chapter 2 – Options for state pension reform

2. To what extent would faster flat rating meet the principles for reform and improve savings incentives?

Faster flat rating would provide an improvement on the status quo but would nonetheless be unsatisfactory. Retaining contracting out would retain a key component which favours personal responsibility.

3. What further reforms might be required to the State Second Pension, such as crediting arrangements and uprating of pensions in payment, to better meet the Government's principles, recognising that there is a trade-off between coverage and the potential level of any combined, two-tier flat-rate pension?

There are legitimate arguments in favour of National Insurance Credits for the wrongly imprisoned, spouses accompanying members of HM forces on foreign assignments and those carrying out jury service. But it is not fair on ordinary taxpayers that the unemployed and those on approved training courses are awarded credits and gain the same entitlement as those who are working.

4. To what extent would a single-tier pension meet the Government's principles for reform and improve savings incentives?

Switching to a single tier pension would go some way to removing the perverse incentives inherent in the current state pensions system. The Pension Credit and Minimum Income Guarantee would still act as a disincentive to save for some groups of people and once someone had qualified for a 'qualifying year' within the year they would still face a reduced incentive to work and therefore save through the state pensions system until the next financial year started. However, these disincentives to working and saving are notably weaker than exist now (the disincentives to save privately would be removed for those who would not be affected by Pension Credit and Minimum Income Guarantees) and therefore this option represents a significant improvement in meeting the personal responsibility principle. It would also improve the fairness and simplicity criteria indicated in the Government's consultation document. The improved incentives to save would help improve long term financial sustainability and affordability but only to a small degree and only over the longer term.

5. Which of these two options would act as the best complement for automatic enrolment?

The TaxPayers' Alliance believes the single tier option is the better of the two presented.

6. Government would be interested in hearing views on other reform options that would meet the Government's principles for reform.

There are legitimate arguments in favour of National Insurance Credits for the wrongly imprisoned, spouses accompanying members of HM forces on foreign assignments and those carrying out jury service. But it is not fair on ordinary taxpayers that the unemployed and those on approved training courses are awarded credits and gain the same entitlement as those who are working. The Minimum Income Guarantee or a similar scheme should be maintained to prevent those who have not saved from poverty.

The state pension age must be raised more quickly to take account of the improved health of people under 70, the more sedentary and less physical nature of modern employment and the demographic trends which are already making the system unaffordable and are almost certain to continue to do so.

We favour the abolition of National Insurance system and its full merger into the Income Tax system on earned income. We believe the government should phase out the state pension and impose a compulsory superannuation scheme broadly following the Australian model introduced by the Labor government under Paul Keating in 1992. A system of state pensions paid from current taxation receipts can never be financially sustainable.

7. What would be the impact of ending contracting out, as implied by any single-tier model?

Ending contracting out will improve the simplicity of the system but worsen the impact on affordability, personal responsibility and fairness. Better to make the entire system contracted out, following the successful Australian superannuation model instead.

8. If the decision is taken to end contracting out, how could the process be best managed so as to minimise any adverse impacts on employers and individuals?

Care should be taken when devising eligibility criteria to ensure those who have contracted out are not disadvantaged as a result of the independent pension benefits they have built up.

Chapter 3 – Means-tested safety net for pensioners

9. In conjunction with the reforms outlined in Chapter 2 are there ways we can change the means-testing system for future pensioners to make it more simple, reduce disincentives and encourage personal responsibility while continuing to help pensioners avoid poverty?

It should be acknowledged that there is a fundamental trade-off between helping pensioners avoid poverty and encouraging personal responsibility. While there are reforms that can improve either one aim without much affecting the other they can only go so far before they pull at the trade-off. However, the pension savings credit thresholds should be adjusted to remove kinks which mean those who have some savings can be worse off than those who have saved nothing.

Chapter 4 – State Pension age

10. What mechanism should be used to determine future increases in State Pension age?

The current schedule for raising the state pension age to 67 by 2036 and then to 68 by 2046 is much too slow. The age should be set by a formula based on average life expectancy less a fixed number of years to be assessed every four years starting in 2012. The formula should result in a one-year adjustment in the state pension age or, when it stabilises, no change. For example, if the formula is set at average life expectancy less 8 years then if the average life expectancy was 79 then the result would be 71 which is more than one whole year above the current age of 66 and therefore it would affect an increase of one year to 67 at the next adjustment. If the average age remained over 68 at the time of the following assessment four years later, it would again affect a rise of one year. These one year adjustments would continue every four years until the formula balanced.

11. How should the Government respond to the frequent revisions in life expectancy projections while giving individuals sufficient time to prepare?

The Government should use the latest reliable data available but only assess it at predetermined, predictable intervals and there should be also be a delay in implementation sufficient enough for individuals to adjust their plans to take account of the findings. We suggest the intervals should both be four years so that a 2012 assessment would be implemented in 2016 which would also be the year of the following assessment, the result of which would be implemented in 2020.

Annex B – Typical existing, transition and post abolition pay slips

Existing typical pay slip

EMPLOYER:	Typical Company		JOE BLOGGS
Payments	**£**	**Deductions**	**£**
Salary	2,004.65	Income Tax	276.35
		National Insurance	168.32
Employee no:	000000001	Year to date totals	
Pay period:	3/12	Pay YTD:	6,013.95
Date:	28 June 2011	Tax YTD:	829.05
NI no:	AA 12 12 12 B	NI YTD:	504.96
NET PAY:	**£1,559.98**		

Typical transition phase pay slip

EMPLOYER:	Typical Company		JOE BLOGGS
Payments	**£**	**Deductions**	**£**
Official Salary	2,004.65	Income Tax (Standard	
Payroll Levy	195.35	Earnings Charge)	276.35
		Income Tax (NIC)	168.32
		Income Tax (Payroll Levy)	195.35
Total Salary	2,200.00	Total Income Tax	640.02
Employee no:	000000001	Year to date totals	
Pay period:	3/12	Pay YTD:	6,600.00
Date:	28 June 2011	Tax (SEC) YTD:	829.05
NI no:	AA 12 12 12 B	Tax (NIC) YTD:	504.96
NET PAY:	**£1,559.98**	Tax (PL) YTD:	586.05
		Tax Total YTD:	1920.06

Typical post abolition pay slip

EMPLOYER:	Typical Company		JOE BLOGGS
	£	**Deductions**	**£**
Salary	2,200.00	Income Tax	640.02
Employee no:	000000001	Year to date totals	
Pay period:	3/12	Pay YTD:	6,600.00
Date:	28 June 2011	Tax YTD:	1,920.06
NET PAY:	**£1,559.98**		