INTEGRATING INCOME TAX AND NATIONAL INSURANCE: AN INTERIM REPORT

Stuart Adam

Glen Loutzenhiser

THE INSTITUTE FOR FISCAL STUDIES
WP21/07

Integrating Income Tax and National Insurance: An Interim Report

Stuart Adam (Institute for Fiscal Studies)

and

Glen Loutzenhiser (Faculty of Law, University of Oxford)*

December 2007

Abstract

Income Tax and National Insurance are now sufficiently similar that merging them appears to be a plausible option, yet still sufficiently different that integration raises significant difficulties. This paper surveys the potential benefits of integration – increased transparency and reduced administrative and compliance costs – and the potential obstacles, assessing the extent to which each of the differences between Income Tax and NICs – in particular the contributory principle, the levying of an employer charge and the differences in tax base – constitute serious barriers to integration. The paper concludes that few of the difficulties look individually prohibitive, but that trying too hard to avoid significant reform of the current policy framework could produce a merged tax so complicated as to nullify much or all of the benefits of integration.

Keywords: Taxation, social insurance, administration.

JEL Classification: H24, H25, H83, K34.

* Addresses for correspondence: Adam: Institute for Fiscal Studies, 7 Ridgmount Street, London, WC1E 7AE, stuart.adam@ifs.org.uk; Loutzenhiser: Christ Church, Oxford, OX1 1DP, glen.loutzenhiser@chch.ox.ac.uk. Financial support from the Chartered Institute of Taxation and the ESRC Centre for the Microeconomic Analysis of Public Policy (CPP) at IFS (Grant no. RES-544-28-5001) is gratefully acknowledged. The authors thank Jonathan Shaw and members of the IFS Tax Law Review Committee for helpful discussions and comments. All remaining errors and omissions are the responsibility of the authors.

Contents

I. INTRODUCTION

Income Tax and National Insurance (NI) emerged and evolved separately as very different systems with very different functions. Over time, however, they have gradually converged. Insofar as Income Tax and NI are now very similar to each other, there are at least two large potential gains to be had from amalgamating them: transparency and administrative efficiency. There is a widespread consensus outside government that such a merger would be desirable in principle. However, successive governments have viewed the idea as too problematic to pursue, arguing that the remaining differences between Income Tax and NI are substantial and desirable, and that retaining these differences in a merged framework would be so complicated as to nullify the benefits of integration.

Given the potential benefits of integration, whether the remaining differences between Income Tax and NI do indeed constitute a prohibitive barrier to integration is an important question for public policy. The aim of this project is to address that question and provide a comprehensive analysis of full integration, setting out the major hurdles and considering how they might be overcome. We aim to examine the relationship between Income Tax and NI, taking a broader perspective than reducing employer compliance costs within the current system, and draw together analysis of the big issues – the contributory principle, the taxation of savings and pensions, the levying of employer contributions, the taxation of the self-employed – which are frequently discussed disparately and out of context, and combine them with analysis of detailed differences in, for example, the definition of earnings between the two systems. We ignore tax credits and corporation tax: such links as they have with Income Tax are largely irrelevant to the issues associated with Income Tax-NI integration.

We begin by outlining the current systems of Income Tax and National Insurance, describing how they converge, how they remain different and what others have said about integration. In Section III we outline what is at stake: the potential gains from integration. Section IV then examines each of the differences between Income Tax and NI in turn – the ‘contributory principle’, the levying of an employer charge, various differences in the tax base, and procedural differences. Section V concludes.

This paper is an interim report, published for discussion: its conclusions are not final and comments are welcome. In the final report we hope to:

- Consider the role of the contributory system in more depth
- Bring more empirical evidence to bear on the theoretical arguments presented here
- Address the difficulties that arise in an international context more closely
- Give more attention to the difficulties associated with transition
- Make recommendations for reform.

II. BACKGROUND AND THE CURRENT SYSTEM

A. DESCRIPTION OF THE SYSTEM IN 2007–08

1. Income Tax and Capital Gains Tax

Approximately 31.6 million individuals pay Income Tax in the UK, but not all income is subject to tax. The primary forms of taxable income are earnings from employment, income from self-employment and non-incorporated businesses, jobseeker's allowance, retirement pensions, income from property, bank and building society interest and dividends on shares. Income tax is not paid on employer or employee pension contributions (up to a limit), certain means-tested benefits (eg, Child Benefit), or on income from certain savings products, such as National Savings Certificates and Individual Savings Accounts (ISAs). Income tax is the largest source of government revenue, forecast to raise £154.1 billion in 2007–08.[1]

(a) Rate Structure and Allowances

Income Tax is levied in increasing marginal rates on an individual's total annual income in excess of a personal allowance. The basic personal allowance is £5,225. People aged 65 and over have higher allowances: the personal allowance for taxpayers aged 65 to 74 is £7,550; for those aged 75 and over the allowance is £7,690.

In the past, married couples were also entitled to a married couple's allowance (MCA). This was abolished in April 2000, except for those already aged 65 or over at that date (i.e. born before April 1935). For these remaining claimants, the MCA no longer acts to increase the personal allowance; instead, it simply reduces final tax liability by £628.50 (£636.50 for those aged 75 or over). Couples may choose which of them claims the MCA, or they can claim half each.

If income for those aged 65 or over exceeds £20,900 then first the higher personal allowance and then (where appropriate) the MCA are gradually reduced. The personal allowance is reduced by 50 pence for every pound of income above the £20,900 threshold, gradually reducing it to a minimum level equal to the allowance for the under-65s for those with incomes above £25,550 (£25,830 for those aged 75 or over). Above this latter threshold, those entitled to MCA have it reduced by five pence for every additional pound of income until it reaches a minimum level of £244.00 for those with incomes above £33,240 (£33,680 for those aged 75 or over).

Income above the personal allowance is taxed at the starting rate (10%) on the first £2,230, at the basic rate (22%) on the next £32,370, and at the higher rate of 40% on the remaining excess over £34,600. Savings income (other than dividends) is as above, except that income falling within the basic rate band is taxed at 20% (the lower rate). Dividend income is taxed at 10% up to the basic-rate limit and 32.5% above that. However, this is offset by a dividend tax credit, which reduces the effective rates to 0% and 25% respectively. This means that, for basic-rate taxpayers, company profits paid out as dividends are taxed once (via corporation tax on the company profits) rather than twice (via both corporation tax and Income Tax). When

[1] Source: Table C8 of HM Treasury (2007a).

calculating which tax band different income sources fall into, dividend income is treated as the top slice of income, followed by savings income, followed by other income.

It was not until 1965 that a tax on gains from the disposal of capital assets was introduced in the UK. Capital gains (actual or deemed proceeds of disposal less acquisition cost) above an annual exemption of £9,200 are in effect treated as the top slice of income and taxed as if they were savings income. However, gains may be reduced by taper relief, which in the case of business assets held for at least two years is 75% of the gain otherwise taxable. This results in an effective tax rate on business assets for higher-rate taxpayers of only 10%. Non-business assets receive less generous taper relief. Assets acquired before 1998 may also be eligible for indexation allowance, which increases their cost base in line with inflation as measured by the Retail Prices Index. The yield from capital gains tax is comparatively small; it is forecast to bring in £4.8 billion in 2007-08.[2]

In the 2007 Budget the Government announced it will abolish the starting rate for non-savings income from April 2008, cut the basic rate to 20% from April 2008, and raise the effective higher rate threshold (i.e. the basic rate limit that applies to taxable income plus the basic personal allowance) to £43,000 in April 2009. The Government also proposed substantial and controversial changes to the taxation of capital gains in the October 2007 Pre Budget Report. From April 2008, taper relief and indexation allowance are to be abolished, and a single capital gains tax rate of 18% applied above the annual exemption.

(b) Filing and Payment

Most Income Tax is deducted at source: by employers through the Pay-As-You-Earn (PAYE) system, or by banks etc. for any interest payments. The PAYE system is cumulative: when calculating tax due each week or month, the employer considers income not simply for the period in question but for the whole of the tax year to date. Tax due on total cumulative income is calculated and tax paid thus far is deducted, giving a figure for tax due this week or month. For those with stable incomes, this system will be little different from a non-cumulative system (in which only income in the current period is considered). For those with volatile incomes, however, the cumulative system means that, at the end of the tax year, the correct amount of tax should have been deducted, whereas under a non-cumulative system, an end-of-year adjustment might be necessary. To enable employers to deduct the right amount of tax, HM Revenue and Customs supplies them with a 'tax code' for each employee, which describes the allowances to which the employee is entitled. If individual circumstances change (starting to receive a pension, for example), the Revenue issues a new tax code for that individual. Income tax deducted from employees' wages is remitted to HMRC each month; smaller businesses can pass on the tax quarterly. At the end of the tax year, the employer must make a return to HMRC (a P14 form for each employee and a P35 form covering all employees) summarising payments to employees and deductions made from the payments. The employer also must provide this information to each employee on form P60.

[2] Source: Table C8 of HM Treasury (2007a).

The sophistication of the cumulative PAYE systems means that most taxpayers do not need to file year-end Income Tax returns. Those with more complicated affairs, however, such as the self-employed, those with very high incomes, company directors and landlords, must fill in a self-assessment tax return, setting down their incomes from different sources and any tax-privileged spending such as pension contributions or gifts to charity. Taxpayers may send their returns to HM Revenue and Customs before 30 September each year, and HM Revenue and Customs will calculate the tax owed, given the information on income sources provided by the taxpayer. Alternatively, for those wishing to calculate their own tax bill, the deadline is the following 31 January, which is also the deadline for payment of the balance of tax not deducted at source. For taxpayers who do not have tax deducted at source (such as the self-employed), Income Tax is collected in half-yearly instalments during the tax year based on the taxpayer's prior year's income, with a final payment based on actual income required by the 31 January tax return filing deadline.

2. National Insurance

National Insurance contributions (NICs) act like a tax on earnings, but their payment entitles individuals to certain ('contributory') social security benefits.

Some contributions (22 per cent of the total in 2005–06) are allocated to the National Health Service (NHS); the remainder are paid into the NI Fund and used to finance contributory benefits. The NI Fund is not a true fund in the sense that it has no significant balance available for investment: current contributions finance current benefits, with the fund merely being a device to prevent cash-flow problems. NICs are forecast to raise £96.5 billion in 2007-08, second only to Income Tax as a source of government revenues.[3]

There are six categories ('classes') of NICs. The type and amount of NICs levied primarily depends upon whether the taxpayer is employed or self-employed, and on the amount of earnings. Where a taxpayer is both an employee and self-employed, he or she may have to pay more than one class of contribution, subject to an annual maximum.[4] Individuals aged under 16 or above state pension age are exempt from NICs (and may not pay voluntary (Class 3) NICs), except that employer contributions (Class 1 (secondary), Class 1A and Class 1B NICs) are payable in respect of employees above state pension age. NICs are not deductible from income for Income Tax purposes.

(a) NICs for Employees

By far the most important category of NICs is Class 1. Employees pay primary Class 1 NICs of 11% on the excess of their earnings over the Primary Threshold (PT) of £100 per week, up to the Upper Earnings Limit (UEL) of £670 per week, and a further 1% on earnings above the UEL. Employees with earnings over the Lower Earnings Threshold (LEL) of £87 per week qualify for contributory benefits even though no

[3] Source: Table C8 of HM Treasury (2007a).
[4] The procedure for calculating the annual maximum is described in some detail at http://www.hmrc.gov.uk/manuals/nimmanual/nim01163.htm

contributions are actually paid until the PT is reached. If the employee 'contracts out' of the State Second Pension the primary Class 1 rate is reduced by 1.6%.[5] A special married woman's reduced rate of 4.85% is available on earnings between the PT and UEL in exchange for lower benefit entitlement, but since May 1977 this option has been available only to married women paying it almost continuously since that date, which is now a very small number.

In addition, employers pay secondary Class 1 NICs at a rate of 12.8% on an employee's earnings in excess of the Secondary Threshold (ST) of £100, but with no upper limit. Where the employee has contracted out of the State Second Pension, the secondary Class 1 rate on earnings between the LEL and UEL is reduced by either 3.7% (if the employee is enrolled in a salary-related employer pension scheme) or 1.4% (a money purchase scheme). Since employer contributions bear no relation to benefits provided under the NI scheme, these contributions are in effect simply a payroll tax. Class 1 contributions (primary and secondary) are collected through the PAYE system and account for the vast majority of total NIC receipts.

Some forms of employee benefits in kind (broadly, those that can be sold or traded) are treated as earnings for both employer and employee NICs calculations. Others are not subject to employee NICs, but are subject to 12.8% 'Class 1A' employer contributions. Employers also pay Class 1B NICs of 12.8% on PAYE settlement agreements (arrangements negotiated between employers and HMRC whereby employers agree to pay tax on earnings or benefits which would otherwise fall to be paid by their employees). Like secondary Class 1 contributions, Class 1A and 1B contributions have no upper limit and do not give rise to any additional benefit entitlements for the employee.

Like Income Tax, NICs are deducted from employees' wages and are paid to HMRC quarterly or monthly. Unlike Income Tax, however, NICs for employees are assessed separately in each pay period (usually a week or a month), irrespective of earnings in the rest of the year. The employer must make a year-end NIC return to HMRC (also on forms P14 and P35) and individual reports to its employees (on form P60).

(b) NICs for the self-employed

Self-employed persons over 16 years of age and under the pensionable age pay Class 2 contributions at a flat rate of £2.20 per week (subject to a small earnings exception of £4,635) and Class 4 contributions of 8% of their annual profits between the lower profits limit (LPL) of £5,225 and upper profits limit (UPL) of £34,840, plus a further 1% on profits above the UPL.

A self-employed individual's Class 2 contribution record determines his or her entitlement for basic state pension, bereavement, maternity, and incapacity benefits. Most self-employed earners are not entitled to other benefits available to employed earners making Class 1 contributions, notably contribution-based jobseeker's

---

[5] If the employee is contracted out into a money purchase pension scheme, the government pays additional age-related rebates into the pension fund to reflect the fact that a larger private pension contribution is needed at later ages to yield the same pension income as would be yielded by the State Second Pension if the employee were contracted in.

allowance and the State Second Pension.[6] Class 4 contributions give rise to no additional benefit entitlement.

(c) Voluntary NICs

Finally, individuals can make voluntary Class 3 contributions of £7.80 per week to maintain a contribution record in respect of certain long-term benefits (basic state pension and bereavement benefits). In practice very few individuals choose to make Class 3 contributions.

B. HISTORY OF SEPARATE ORIGINS AND GRADUAL CONVERGENCE

1. History of Alignment of Income Tax and NI

Income tax and National Insurance were introduced at different times for different purposes and looked very different from each other. Income tax was first introduced in 1799 to raise revenue for general government expenditure. Its current structure, with progressively higher rates applying to income above a personal allowance, was introduced in 1973.

National Insurance was first introduced as a basic social insurance scheme in the UK in 1911 and was overhauled significantly expanded in 1948 following the wartime Beveridge Report. It was based on the 'contributory principle' that benefits received should reflect contributions paid. Workers and their employers paid flat-rate NICs while in work in return for entitlement to various flat-rate benefits when the individual was unemployed, ill or retired. This changed fundamentally in 1961 when NICs became earnings-related, making them look rather more like an Income Tax. Since then, the two systems have moved closer together in many more ways. The following are some of the most important reforms that have contributed to the convergence of NI and Income Tax:

- In 1990, the Income Tax system moved from a joint system of assessment (where a married woman's income was treated as her husband's income for tax purposes) to an individual system, where both partners pay tax separately. This moved Income Tax closer to the NI system, which is based on individual earnings. Further to this, the married couple's Income Tax allowance was abolished in April 2000 except for people already aged 65 or over at that date.
- Income tax and NICs thresholds have been gradually aligned. The levels of weekly earnings at which employees and employers start paying NICs were aligned with the weekly level of the Income Tax personal allowance[7] in 1999 (for employer contributions) and 2001 (for employee contributions). And Budget 2007 announced that the NI Upper Earnings Limit (and Upper Profits

[6] Share fishermen and overseas volunteer development workers have the option of paying higher Class 2 contributions in return for enhanced benefit entitlement, including jobseeker's allowance.
[7] By 'weekly level', we mean the weekly equivalent, for someone working throughout the year, of the level of the annual Income Tax personal allowance.

Limit for the self-employed) will be similarly aligned with the higher rate Income Tax threshold from April 2009.

- Both employee and employer NICs used to have a ‘kink’ in the contributions schedule whereby, as weekly earnings passed the lower earnings threshold, contributions became payable on *the whole of* weekly earnings, not just earnings above the threshold. This kink was finally eliminated in 1999; contributions are now payable only on earnings above the threshold. This is equivalent to the treatment of income in the Income Tax system.
- NICs used to be distinguished by an overall cap on contributions, which had no equivalent in Income Tax. However, the UEL on employer NICs was removed in 1985, and the cap on employee and self-employed NICs was removed in 2003 with the introduction of 1% NICs above the UEL and UPL, although this is still much lower than the rate below the UEL. Meanwhile, the series of progressively higher Income Tax rates (ranging from 40% to 83%) that existed before 1988 have given way to a single 40% higher rate.
- The contributory principle of NI has been eroded over time as the link between contributions paid and benefit entitlement has become steadily weaker. This is discussed further in Section IV.A. Responsibility for NICs policy has been moved from the Department of Work and Pensions to join Income Tax policy in HM Treasury and HM Revenue and Customs (HMRC); NI operational functions have been moved from the separate Contributions Agency to HMRC; and NICs decisions can now be appealed to the same tribunal as Income Tax decisions (the tax commissioners).
- The definitions of earnings have been somewhat aligned, most notably with the extension of certain classes of NICs to benefits in kind that were already subject to Income Tax.

There have also been numerous more minor technical alignments, particularly in recent years: see Annex B of HM Treasury (2007b).

C. REMAINING DIFFERENCES BETWEEN INCOME TAX AND NI

While Income Tax and NI have steadily converged, and now look quite similar, there remain important differences between them:

(a) NI remains a contributory system, though in practice the links between contributions and benefits are weak

(b) While Income Tax is charged only individuals, NICs have an employer charge as well as an employee charge

(c) There remain significant differences in the bases of the two charges: they differ in the definition of earnings, the period of assessment, the treatment of multiple employments, self-employment, savings and pensions, the provisions applying to young, old and married taxpayers, and several other respects.

(d) The administrative procedures associated with the two systems are different.

These differences are the main focus of this report, and they are described and discussed in detail in Section IV.

D. PREVIOUS RECOMMENDATIONS AND VIEWS ON INTEGRATION

The literature on social insurance and the contributory principle is divided between advocates and opponents of the principle. The literature specifically addressing Income Tax-NI integration, though, is almost universally supportive. As long ago as 1978, the British Tax Review published an article entitled "National Insurance Contributions – A Second Income Tax", which concluded:

> "in places the disparities between income tax and national insurance contributions are distinctions without differences, and…in other places the disparities may be unnecessary and unfair…In practice even more than in theory the contribution system is merely an adapted form of the income tax system, and its separate status is to some extent a mere illusion."[8]

This sets the tone for much of the literature that follows. Dilnot, Kay and Morris (1984) proposed the integration of Income Tax and NICs as part of a broader integration of the tax and social security system. Webb (1992) is the most thorough analysis of integration to date, and concluded:

> "A comprehensive integration of the systems of income tax and National Insurance contributions would produce a major improvement to the structure of the personal direct tax system in the UK. The tax system would be more coherent, the scope for removing structural anomalies would be greater, and the scope for tax avoidance would be reduced…now is the time to begin moving towards that objective."

Dilnot (1995) argues that integration would be desirable and that "the main continuing barrier to income and social security tax integration is politics and public perceptions." Reed and Dixon (2005) also advocate integration.

Reports by business groups (British Chambers of Commerce, 2004) and professional groups (Chartered Institute of Taxation, 1998) both suggest that full integration is likely to be the ideal long-term goal, but then both elect to focus on incremental technical steps towards alignment in the shorter term.

Similarly, three reports for the government on technical payroll areas reported widespread positive views on a merger but do not pursue it as their remits were too narrow:

- Centre for Fiscal Studies University of Bath (1998, p.90, para. 6.5.2) noted that employers were keen on integration, but said that such policy matters were outside its remit.

[8] Williams (1978)

- Better Regulation Task Force (2000, pp.20-21) found that stakeholders generally said they could not, or could no longer, understand the reason for having two separate charges for tax and NI. The tax force determined that it was important that the Government be made aware of the consensus in favour of such a merger amongst both the representative bodies and the individuals who contributed their views to the report, and while noting that a full-scale merger of the two systems could only be a long-term goal, commented that a merger would have "really big regulatory gains." It stopped there, however, on the grounds that such policy matters were beyond its remit, and focussed instead on more technical alignment issues.

- Carter (2001) is a review of the burden of employers' payroll obligations and is restricted to technical issues, but notes (p.16, para. 5.1) that many employers and employer representatives bemoaned the Carter Review's narrow terms of reference and called for radical simplification of the tax system.

A fourth, Taylor (1998), had a broader remit but chose not to investigate a merger: p.13, para. 2.13, notes that the suggestion had been made and is "understandable", but then merely notes the radicalism of the idea and concludes that it is "more worthwhile" to focus on reforms that do not raise "such major policy questions".

Taken together, these strongly suggest a pattern of support for integration in the academic literature and in the tax practitioner and business communities. This impression received further support from a survey of businesses conducted by the Tax Reform Commission (established by the Conservative Party and chaired by Lord Forsyth) in conjunction with the Confederation of British Industry, and Institute of Directors and the British Chambers of Commerce, which found that 65% of respondents agreed or strongly agreed with the proposition: "a system which combines national insurance and income tax using rates so as to leave the total tax burden unchanged would be beneficial to my business." Several survey respondents also volunteered a merger of Income Tax and NICs as the tax reform they would most like to see. The Tax Reform Commission itself proposed considering a phased merger of NICs and Income Tax.[9]

Government publications all reject the idea: most fully in HMSO (1986), and most recently in Inland Revenue (2000), which notes the suggestion of integration and lists some of the questions it would raise, but then states that "the Government is not persuaded that radical reform of the tax and NICs systems is the best way of delivering worthwhile simplifications for employers."

Despite this weight of opinion, successive governments have been steadfastly unpersuaded of the case for integration. Inland Revenue (2000), for example, notes the suggestion of integration, lists some of the questions it would raise, and then states that "the Government is not persuaded that radical reform of the tax and NICs systems is the best way of delivering worthwhile simplifications for employers."

[9] Tax Reform Commission (2006)

The fullest Government analysis of integration remains that of a Green Paper issued by the Thatcher government in 1986, one chapter of which examined at some length the merits of integrating Income Tax and employees' NICs (it was assumed employers' contributions to the National Insurance Fund would remain in any event).[10] The Green Paper began by noting that it had frequently been suggested that it would be more efficient if the existing two charges on earnings with their different but overlapping bases were replaced with one combined charge [para 7.2]. The main arguments cited in favour of integration were that it would simplify the overall structure of the administrative system and would reduce the compliance burdens which employers faced in dealing with two separate systems. However, these benefits had to be weighed against the major distributional effects of such a change, the need to find a satisfactory way of upholding the contributory principle and the need for a new separate charge for employers' NICs.

In terms of distributional effects, the Green Paper identified the 'losers' under integration would be those taxpayers with income not currently subject to employee NICs, such as those with earnings above the UEL, investment income, state and occupational pensions. Elderly taxpayers and other pensioners were considered to be the largest group likely to suffer disadvantage, since they did not (and do not) pay NICs. While the paper's authors conceded that distributional effects were not in themselves a conclusive argument against tax changes, they concluded that wide-ranging shifts on the lines described above would be hard to justify on either economic or social grounds [para 7.7].

Next, the Green Paper argued that the contributory principle would be seriously weakened by a combined charge applied to all income [para 7.9].

The Green Paper then considered whether a combined charge with limited coverage would be able to mitigate the distributional consequences while still remaining faithful to the contributory principle [para 7.14]. The options considered were exempting persons/income from coverage (e.g. the elderly), charging different rates (e.g. lower rate on investment income), or making it so that the persons who paid the combined charge were in essence those who paid Income Tax and employees' NIC under the existing system, which would mean a higher combined rate, and higher tax for those with income above the UEL. While this limited charge was thought to be less damaging to contributory principle, it was rejected on the basis that some of the same difficulties would probably remain and, more importantly, it would undermine the main aim of the combined charge: simplicity.

Ultimately, the Green Paper concluded that the benefits of a combined Income Tax and employees' NIC charge would be unlikely to justify the ensuing upheaval, and integration was not pursued.

In Budget 2006, the Government said it would review the case for closer alignment of Income Tax and NI, with a view to improving the outcome for the low paid and to reduce burdens on employers, especially smaller employers.[11] In October 2007 HM Treasury released the results of its review.[12] Taking the current policy framework as a

[10] HMSO (1986).
[11] HM Treasury (2006), para 5.87.
[12] HM Treasury (2007b)

given, the review examined the case for making NICs operate more like Income Tax, in particular by moving to an annual basis of assessment and cumulative collection for NICs. The review concluded that the benefits from such alignment did not outweigh the costs, and thus recommended against it. In particular, the review concluded that net savings for employers would be smaller than might be expected owing to widespread and increasing use of computerised payroll systems.

However, a few areas were identified where improvements could be made to the current system to reduce the administrative burden on employers:

- collecting tax on benefits in kind and expenses through the payroll;

- improving and aligning information and guidance on tax and NICs; and

- improving collection of NICs for the self-employed.

Given the results of HM Treasury's review, it now appears unlikely that any substantial further piecemeal alignment of the two systems will be made. However, it is important to note that the review looked at a single reform in isolation (moving NICs to a cumulative annual basis) and declined to consider any reform that had wider policy implications. The role of this project, in contrast, is explicitly to consider the policy framework as a whole, and it may be that radical reform has more to commend it than adjustment of a single feature of the system.

III. POTENTIAL GAINS FROM INTEGRATION

The key potential gain from integrating the Income Tax and NI systems is simplicity. Simplification has two components – greater transparency and reduced administrative and compliance costs. Each of these is discussed in turn below.

Aside from the gains from integration per se, the rethink associated with integration gives an opportunity to consider afresh which is the better approach where Income Tax and NI currently differ and apply it consistently. This could have benefits in terms of reducing avoidance as well as administration and compliance costs. More generally, it would be an opportunity to rationalise the system and bring it back to first principles, to make the system fundamentally fairer and more efficient. Such opportunities for rationalisation are considered in later sections of this report, but we do not list them as benefits of integration as such, because they could in principle be pursued independently.

A. TRANSPARENCY

Income Tax and NICs are very similar taxes. But they are not identical, and their combined effect is a function of their combined rates and their different bases, which makes it rather obscure. Integrating Income Tax and NI would make the overall rate structure of labour income taxes more obvious.[13] Moreover, the balance of taxation between earnings and savings income, self-employed and employees, under- and over-pension age, etc, would be more explicit and easier to debate, rather than (as at the moment) an opaque consequence of the balance between Income Tax and NICs, determined by the political attractions of raising NICs rather than Income Tax.

Section IV.A explains that the hypothecation associated with NI is virtually meaningless, and that the contributory nature of NI has become largely a fiction, in the sense that the link between contributions paid and benefits received – particularly at the margin – is vanishingly weak. There is some evidence, however, that people believe these links to be stronger than they really are (Stafford, 1998). This may lead them to misunderstand the effects of policy: to believe that NICs are 'buying them' guaranteed benefits or an improved NHS in a way that Income Tax is not, for example, and perhaps to be more willing to pay NICs than to pay Income Tax. While it could be argued that taxpayers' paying more willingly should be welcomed, achieving that through maintaining an illusion surely should not be, and an integration that improved taxpayers' understanding must be desirable.

The case for integration in terms of transparency is perhaps best illustrated by the case of the 2001 Labour Party general election manifesto and the 2002 Budget. The 2001 manifesto included a pledge not to increase rates of Income Tax, but no such pledge on NICs. If the two taxes were truly identical, such a pledge would have been wholly meaningless. But the taxes were different, so the victorious Labour government could deny claims that it was reneging on the spirit, if not the letter, of its manifesto pledge when in the 2002 Budget it announced an increase in NICs rates to take effect the

[13] The combined rate schedule is already becoming somewhat more transparent as the thresholds are aligned, though to some extent this alignment is illusory as long as the tax bases remain different.

following year. A NICs rise, unlike an Income Tax rise, did not hurt savers and pensioners, it was argued. It is doubtful whether it had been clear to voters that the manifesto pledge was in effect restricted to such groups, but an integrated system would not allow for such confusion and suspicion, which can generate only mistrust. Furthermore, the announced NICs increase was presented as "to pay for the NHS". In the context of the 2002 Budget, it could just as easily have been described as "to pay for new tax credits" or "to help reduce Government borrowing". The Government's preferred description gained widespread acceptance partly because of the perception of a direct link between NICs and the NHS. No meaningful link exists (as explained in Section IV.A), and insofar as misapprehension influenced the perception of the reform, it hindered a balanced understanding of policy.

B. ADMINISTRATION AND COMPLIANCE COSTS

The existence of two separate systems entails substantial costs: compliance costs for employers, employees and the self-employed, and administration costs for government. Integrating the two systems has the potential to reduce these burdens substantially.

1. Employers

For employers, calculating two earnings figures and two payments to deduct for each employee represents a sizeable administrative burden. Earnings must be calculated differently for the different charges, taking into account the different treatments of pension contributions, charitable donations, expenses and various types of benefits in kind; even were the earnings figure in a particular pay period the same, Income Tax must be withheld on a cumulative annual basis whereas NICs is based only on the individual pay period; Income Tax is calculated using a tax code whereas NICs have the paraphernalia of table letters; there are different reporting requirements with the two systems, and different procedures for correcting errors. The complexities of dealing with new or departing employees and with employees with more than one job are different in the two cases. Dealing with all this has become much less onerous since widespread computerisation, but is still significant, especially for small firms, as will be illustrated below. And while computerisation has helped ease the burden of calculation, changes in the economy, such as individuals' moving jobs more frequently, have made troublesome cases more common.

Several studies have considered the potential compliance cost benefits for employers from increased alignment or integration of the Income Tax and NI systems. A 1998 report by the Centre for Fiscal Studies at the University of Bath (widely known as the 'Bath Report') on employer tax compliance costs recommended, on the assumption that PAYE and NI would not be amalgamated (though employer calls for such a merger were noted[14]), that the then Inland Revenue and Contributions Agency go as far as they possibly can in achieving consistency and uniformity across PAYE and

[14] Centre for Fiscal Studies, University of Bath (1998), para 5.6.2.

NIC operations, so as to minimise compliance costs to employers. [15] In particular, the report recommended that the treatment of benefits in kind should be common across PAYE and NI Class1A contributions.[16] As discussed above, increased alignment has occurred, though significant differences in the tax and NI treatment of benefits in kind still remain and are discussed in Section IV.C.1(a).

The Bath Report also concluded that the costs of complying with payroll tax regulations fell disproportionately on small businesses in that the 'bottom' 30% (by PAYE and NICs collected) bear 75% of the compliance costs.[17] Compliance costs per employee for 1995-96 were estimated to be £288 per annum for employers in the 1-4 employee size band but only £5 per annum for those with more than 5000 employees.[18] Finally, the Bath Report emphasised that for the very smallest payrolls costs may be extremely high because even the smallest employer has to become familiar with his or her tax obligations, set up a system, store tax documentation, deal with enquiries and so on; [19] this conclusion is just as appropriate today as it was in 1998. While the findings are interesting, since the 1990s computerisation has continued apace and many changes in employer payroll tax regulations have taken place– additional Income Tax and NI alignment has occurred, the Inland Revenue and Contribution Agency merged, responsibility for administering working tax credit came and went – so the Bath Report pound cost figures are likely to be somewhat out of date.

On the heels of the Bath Report, the Better Regulation Task Force considered a number of ways in which employer payroll tax costs could be reduced, particularly for small business.[20] Interestingly, the tax force's report stated that while the then recent partial alignment of tax and NI treatment of benefits in kind advanced equity between cash pay and non-cash benefits, the alignment was viewed by employers as *increasing* their overall burden, not least because it substantially increased their NICs:[21] taxpayers do not always welcome alignment where it means they have to pay more! Employers' burdens in this respect have only increased since then. Of greater interest, the report also concluded that substantial regulatory gains that could be achieved by merging PAYE and NICs into a single charge.

A recent study of the tax administrative burden of UK businesses conducted by KPMG provides a more-up-date picture of the compliance costs for employers under the separate Income Tax and NI systems. KPMG concluded that the administrative burden of employer taxes is £759 million annually, or 15% of the total burden placed on business.[22] KPMG found that about one third of the total burden is payments for

[15] Ibid., para 6.3.
[16] Ibid., para 6.3.8.
[17] Ibid., para 3.3.1.
[18] Ibid., para 3.3.2. The Report alsot noted that these costs were offset by significant cash-flow benefits from having the use of withheld Income Tax and NICs for a period of time before remittance. These are genuine benefits from administering these taxes; however, they are a rather different type of compliance cost issue, and not the type that might be affected by integration of Income Tax and NI.
[19] Bath Report, para 3.3.3.
[20] Better Regulation Task Force, 'Payroll Review', March 2000, available online at http://www.brc.gov.uk/downloads/pdf/payroll.pdf (hereinafter the 'BRTF Report').
[21] BRTF Report, p 20.
[22] KPMG, 'Administrative Burdens – HMRC Measurement Project Report, Report by Tax Area, Part 11: Employer Taxes', 20 March 2006, p 10 (hereinafter the 'KMPG Report on Employer Taxes'). The full KPMG Report is available online at http://www.hmrc.gov.uk/better-regulation/kpmg.htm.

third-party services; larger businesses will often use specialist service providers to handle their PAYE/NIC processes while many smaller businesses will use their accountant to provide this service.[23] The high burden figure is at least in part due to the fact that all businesses with employees have to comply with the main employer tax obligations. The key burdens for employers were found to relate to returning information to HMRC on forms – the P11D (annual return for expenses and benefits in kind) and the P35 and P14 (annual returns for PAYE/NICs).[24] Furthermore, from interviews conducted with businesses, KPMG observed that employer taxes are a common area for business complaint, and that businesses feel that the system is too complex, a common irritation being the two sets of rules that apply to PAYE and NICs.[25] As was the case with the Bath Report and Better Regulation Task Force findings, many businesses suggested harmonising aspects of the employer tax rules as one way to reduce the tax administrative burden; in particular, KPMG found that alignment of PAYE with NI was 'a very strong theme'.[26]

Importantly for present purposes, the KPMG report separated the cost of PAYE and NICs information obligations on employers, with NICs obligations measured in terms of their incremental burden over and above the PAYE burden.[27] This provides a helpful indication of at least some of the additional administrative burden on employers attributable to maintaining separate Income Tax and NI systems, and thus the potential administrative benefits from amalgamating the two systems. With respect to the P35/P14 returns, the administrative burden associated with PAYE was estimated to be £131.22 million, while the additional administrative burden from NIC was estimated to be £78.15 million.[28] Other significant administrative burdens attributed solely to NIC information obligations related to monthly payment of NICs (£43.03 million) and inspection of employers' NICs records (£25.14 million).[29] Overall, the administrative burden specifically attributed to just these three NICs information obligations comprised almost 20% of the total employer tax administrative burden of £759 million.

It might appear that the apparently higher burden of PAYE than NICs is a measure of how much cheaper it is to administer NICs than PAYE, and therefore gives guidance as to the magnitude of savings that would arise by making an integrated system 'look like' NICs rather than PAYE. This is not quite the case, however: since employers were asked for the incremental burden of NICs over and above PAYE, costs incurred once for running both systems would not be included in the NICs burden. We have some guidance as to how much would be saved by abolishing NICs and retaining PAYE; however, we do not know how much would be saved by abolishing PAYE and retaining NICs, since some costs that are incurred under PAYE (and therefore not counted as incremental costs of NICs) might nevertheless need to be retained if PAYE were abolished and NICs retained.

[23] KPMG Report on Employer Taxes, p 4.
[24] KPMG Report on Employer Taxes, p 14.
[25] KPMG Report on Employer Taxes, p 4.
[26] KPMG, 'Administrative Burdens – HMRC Measurement Project Report, vol 1', 20 March 2006, para 5.2. and KPMG Report on Employer Taxes, p 23.
[27] KPMG Report on Employer Taxes, p 9.
[28] KPMG Report on Employer Taxes, p 14, Table 6.
[29] KPMG Report on Employer Taxes, p 14, Table 6.

In summary, it is beyond doubt that running a separate Income Tax and NI system is costlier than running only one. Just how much could be saved is not as clear. The best estimate of potential savings for employers under an integrated system would appear to be the approximately £179 million annual incremental cost of NICs identified by the KMPG study.[30] This total is perhaps surprisingly low. It is important to recognise, however, that the Standard Cost Model used in the KPMG study captures only a narrow measure of compliance costs, excluding, for example, costs associated with working out what must be complied with, dealing with changes, and tax planning, whichcould be significant.

2. Employees

Because primary responsibility for complying with both the Income Tax and NICs systems falls on employers, the benefits for employees from an integrated Income Taxcharge would be smaller. For those people who check that their PAYE code is correct, that the right amount of tax has been deducted at source, etc, it would clearly be easier to do this once than twice. Moreover, one system instead of two would probably mean less chance for mistakes, whose correction entails hassle for the individual (as well as the employer and HMRC). A merged system would not remove the need for self-assessment, so there is no reason to believe that the burden of self-assessment would change. However, the full implications of integration would depend on how it is done: for example, the choice of how to define the tax base could significantly affect the numbers needing to self-assess.

3. The Self-Employed

Little data is available on the compliance costs of the current system for the self-employed. The regime for the self-employed differs from that for employees in several ways, some of which make it more complicated but others of which make it simpler – the self-employed may suffer less than employers from dealing with areas such as expenses, benefits in kind and share schemes, for example However, the inherently greater or lesser complexity of the system is probably much less important than the economies of scale available to large employers but not available to the self-employed. The self-employed face all the costs of having to understand and operate the system just in order to pay themselves; large employers, in contrast, can share these fixed costs between many employees and take advantage of tools such as computerisation and dedicated payroll departments to minimise the burden of dealing with each additional employee.

[30] Source: Unpublished KPMG data supplied by HMRC.

4. Government

The most obvious cost to the Government imposed by having two separate systems is the duplication of work when processing returns, checking that the right amount of tax has been remitted, undertaking investigations, and so on. But far larger than this is the cost associated with the contributory system of NI. The Government must maintain the contribution record of each individual in order to calculate benefit entitlements decades after the contributions were paid. And the National Insurance Fund must be maintained, invested, audited, etc. separately from general Exchequer revenues. Precise figures are difficult to come by, but if some or all of these activities were deemed unnecessary the potential savings could be extremely large.

IV. REMAINING DIFFERENCES: BARRIERS TO INTEGRATION?

This section identifies and examines the key remaining differences between Income Tax and NI, with a view to determining the extent to which these differences represent a barrier to integration of Income Tax and NI.

A. THE CONTRIBUTORY PRINCIPLE

Historically and politically, by far the most important difference between Income Tax and National Insurance is that NI has embodied the 'contributory principle': a link between contributions and benefit entitlements.

The Beveridge Report envisaged a 'true' social insurance scheme, with an actuarial link between contributions paid and benefit entitlements for each individual.[31] This actuarial link was quickly broken, and the relationship has become steadily weaker over the years to the point where it is barely recognizable at all. Some people receive entitlements without paying NICs (because of, for example, the gap between the LEL and the earnings threshold, home responsibilities protection for carers, credits for periods spent unemployed or on disability benefits, and the availability of incapacity benefit to those without contributions records if disabled from a young age); others see no benefits from paying additional contributions (because, for example, incapacity benefit is means-tested on private pension income, NICs paid in a given year can be insufficient to generate an additional year's pension entitlement, means-tested benefits erode the incremental value of contributory entitlements, and contributors might already have a full contribution record). Employer Class 1, 1A and 1B NICs and self-employed Class 4 NICs give rise to no entitlements; they simply raise revenue. Throughout the many reforms to both contributions and benefits that have taken place over the years, minimal attention has been paid to the actuarial fairness of the link between the two.

The present Government seems to interpret the contributory principle in a different way, with entitlements not actuarially reflecting NICs payments but rewarding broader economic or social contributions (such as working or caring) made to society as a whole. However, it is hard to interpret the current system as fitting even with this rather vaguer objective: as Johnson and Stears (1996) put it, "why somebody earning £50 a week should be excluded from benefit when the unemployed are not is a question to which it is hard to find a coherent answer."

An argument often made in defence of the contributory principle is that it protects benefit entitlements: if people feel they have paid their dues and earned their pension rights, it is very difficult for governments to break their implied pension promises, and this provides welcome security for workers planning for their retirement. But it is not clear that this is true: governments *have* changed benefit levels (and contribution conditions) for people who have already paid contributions – most famously by

[31] Beveridge (1942). For discussions of this and subsequent developments, and the debates over the role of the contributory principle, see Dilnot, Kay and Morris (1984), Creedy and Disney (1985), Bennett (1993), House of Commons Social Security Committee (2000) and Hills (2003).

linking the basic state pension level to prices rather than earnings. And, to quote Richard Disney:

> 'You can make the argument, "I have paid contributions all my life. I ought to get more pension." Why not make the same argument: "I have paid Income Tax all my life. Why do I not get a pension I deserve?" To me, they are almost identical statements.'[32]

The false sense of security induced by the misplaced feeling that future benefit levels are protected may indeed be rather dangerous. The honouring of past pension promises is a matter of current political pressures, not contractual obligation.

The hypothecation of NI revenue is even more illusory: since the uses of the contributions neither constrain nor are constrained by the revenue from contributions, it is entirely a matter of meaningless labelling. A set of very complicated rules determine which parts of which classes of contributions are notionally allocated to the NHS; but this constitutes only a small part of NHS funding, and if the Government wishes to increase NHS spending it can do so from general taxation. Contributory benefits are notionally financed from the NI Fund, but in years where the Fund was not sufficient to finance benefits, the Fund was topped up from general taxation revenues, and in years (as now) when contributions substantially exceed outlays, the Fund builds up a surplus, largely invested in gilts: the Government is simply lending itself money. These exercises in shifting money from one arm of Government to another maintain a notionally separate Fund, but merely serve to illustrate that NI contributions and NI expenditure proceed on essentially independent paths. The Government could equally well declare that a quarter of NICs revenue goes towards financing defence spending, and no-one would notice the difference.

There are arguments to be made in favour of a genuine social insurance scheme, but that is emphatically not what the UK has now (and this report does not consider how one might be introduced). Indeed, Johnson and Stears (1996) argue that since the vast majority of future retirees will be entitled to full state pension anyway (because of increased female employment rates and the extension of home responsibilities protection etc), the contributory system is becoming a tool that achieves almost nothing. HM Treasury (2007b) reports that by 2025 over 90% of people reaching state pension age will be entitled to full state pension, and presumably many of the remaining 10% will also have almost-full state pension entitlements: is it worth maintaining all the complex, opaque and burdensome machinery of the contributory system in order to exclude the remaining few people from entitlement? Given the peculiarity of the rules determining exclusion, as discussed above, it is far from clear how many of these people we would really want to exclude in any case.

In this context, it is natural to argue that (unless the UK is to move towards a genuine social insurance scheme) the pretence of a contributory principle should be abandoned. Removal of the contributory system would require some alternative to be put in place for determining state pension entitlement: it could not be left a matter only of age, or else foreigners would have a large incentive to retire to Britain, which (aside from any considerations of fairness) would be prohibitively expensive for the UK Exchequer.

---

[32] Quoted in House of Commons Social Security Committee (2000).

The obvious solution is to base entitlement on years of residence (or citizenship, or something similar). This could certainly be implemented for building up entitlements in future years. However, it would not be easy, and may be impossible, to apply a residence test retrospectively for past years of accrual: the Government does not currently keep records of individuals' past residence in the country, for example. Various records could help to establish residence in particular past years (for example, having paid any Income Tax or NICs in that year); but ultimately, if an individual has paid no Income Tax or NICs in a particular year, the Government has no reliable way of finding out whether he or she was not in the country or just not working. The only viable options, therefore, would be either to assume that all existing residents had lived their entire lives to date in the UK – which would be feasible but rather expensive – or to continue to use existing contribution records to calculate entitlements accrued in past years. If the latter option were taken, the contribution conditions could still be reformed – to give entitlement to anyone who paid *any* contributions in a given year, for example. But retrospectively relaxing (or indeed abolishing) the contribution conditions in this way, as well as being costly, could be seen as unfair on certain groups, such as women who chose not to opt for the married women's reduced rate of NICs despite being entitled to do so.

Using residence to establish future accruals but contribution records to establish past accruals would mean a transition several decades long, since those who have now been in the labour market for only a few years would still have their pensions determined by their contributions records to date. It would therefore represent much less of a simplification than if residence or current circumstances alone could be used to determine entitlements. But it would nevertheless represent a substantial administrative saving, and increase in transparency, relative to the labyrinthine system.

Politically, the prospects for overtly abandoning the contributory system as described above look slim. The Government has rejected calls for a citizen's or resident's pension from the Pensions Commission and the National Association of Pension Funds, amongst others. The continuation, and perhaps gradual further decline, of the vestiges of a contributory system appears more likely. In that context, a key question for this report is whether the current contributory system (or something similar) could be maintained under a merged Income Tax / NI regime without making the new tax prohibitively complicated.

There seem to be no serious obstacles to devising a set of contribution conditions based on a merged tax that closely mimic the current rules. If a merged tax applied to savings income as well as earnings, for example, it would still be possible to base contribution records on the tax paid on employment income alone. However, in this area as in others, integration of Income Tax and NI would provide a good opportunity to rethink whether the current rules are what we would ideally like to achieve, and to reform them if not.

B. PAYMENT OF NICS BY EMPLOYERS

Responsibility for paying Income Tax and employee NICs legally rests with the individual; however, employers are also legally liable to pay NICs on their employees' earnings. Discussions of integrating Income Tax and NICs often assume that Income Tax and employee NICs would be merged, leaving employer NICs in place separately.[33] But literally merging Income Tax and NI into a truly single system could be interpreted as meaning levying only one charge, not separate ones on employer and employee. Is this desirable and feasible? Alternatively, if integration proceeded in other areas while maintaining separate employer and employee taxes, how much of the benefit of integration would be lost?

Our starting point here is to note what is the wrong way to think about this issue. This is emphatically *not* a question of the appropriate balance of taxation between businesses and individuals. Many people are led to think in these terms by the different names of the taxes and the different legal liability. But basic economic theory asserts that in the long run these things are irrelevant to the effective incidence of the tax – who is ultimately made worse off by it. To determine the effective incidence of a tax, we must look through the corporate veil and realise that only people – the company's shareholders (through lower profits), employees (through lower wages) and customers (through higher prices) – ultimately feel the pain. How the burden of a tax is shared between these groups may be complicated, depending on market structures and so on. But the distribution of the ultimate burden does not depend on the name of the tax, who has legal liability, or who is responsible for remitting it. Employees care about their take-home pay, and employers care about the cost of hiring someone; it is these that ultimately determine outcomes, not whether the wedge in between is labelled an "employer" or "employee" tax: that just affects what point in between employer cost and take-home pay we label "earnings". A shift between identical employee and employer taxes should in the long run lead to a corresponding adjustment in earnings to leave take-home pay and employer cost unchanged. This conclusion follows directly from the premises that prices (in this case the price of labour) are determined by the interaction of supply and demand and.that money illusion (people's misperception of how much £1 can buy when the value of the currency changes) does not last forever.

Noting the long-run irrelevance of the balance between employer and employee taxes on earnings is not to belittle the issues that would be associated with a shift from one to the other. As Keynes famously wrote: "in the long run we're all dead."[34] The "short run" might last a very long time, and the problems during that period might potentially be quite large. The point is that arguments over the merits of keeping separate employer and employee taxes ought not to be about employers and employees each paying their fair share – though it is important to recognise that the public debate might well be framed in those terms. The principled debate should rather be about whether the benefits of integration justify the short-run dislocation.

The potential benefits from one integrated charge, as for integration as a whole, are transparency and a reduction in administration and compliance costs.

The administrative and compliance cost savings from moving to a single integrated charge are obvious: it is clearly easer to operate one system than two. But the magnitude of the savings is much less clear. The cost of having two separate taxes can be reduced, either by making the extra tax very simple, or by aligning the two taxes. If

[33] See, for example, HMSO (1986).
[34] Keynes (1923)

the tax bases were identical, there would be relatively little cost to applying two rate schedules and writing two cheques instead of one, whereas at the moment there are significant differences between earnings assessed for employer NICs and employee NICs, as well as much bigger differences from Income Tax. Removing the employer tax altogether, or (failing that) simplifying it, could also makes other practical problems much easier to resolve: see, for example, the discussions in Sections III.C.3 and III.C.6.

The transparency benefit of a single, integrated Income Tax-NI charge would be in making people aware of the full tax wedge imposed on their earnings, by bringing together the three charges (Income Tax, employee NICs and employer NICs) into a single rate schedule. If the rates "sound high", all the more reason to do it, since that implies that they are currently being levied without people realising their implications. And if people do not already appreciate that employer NICs damage their employment prospects and reduce their take-home pay just like Income Tax, then once again, all the more reason to make it explicit. Such transparency might not be in a governing party's self-interest, but from a neutral standpoint it is surely a worthwhile objective. In addition, integration would help to clarify the level of taxation of earnings as compared with savings, as discussed in Section IV.C.5.

A serious limitation to the transparency benefits from abolishing employer NICs is the complexity of the required compensating increase in employee taxes. The correct adjustment does not consist simply of adding 12.8% to all existing rates. To see this, note that we could levy 87.2% Income Tax and 12.8% employer NICs on a worker's earnings, and despite the heavy taxation the worker would still receive something. However, if we replaced that system with a 100% Income Tax the worker would receive no net pay at all. This is because (a) employee taxes are levied on a tax-inclusive base (taken out of earnings), whereas employer taxes are levied on a tax-exclusive base (paid on top of earnings); and (b) employer and employee taxes apply multiplicatively, not additively. 12.8% on a tax-exclusive basis is equivalent to 11.35% on a tax-inclusive basis (0.128 / 1.128 = 0.1135).[35] But we cannot simply add 11.35% to employee NICs, because the taxes are multiplicative: we levy employee NICs (and levy Income Tax, and means-test tax credits) *on what remains after deducting 11.35% from the total cost paid by the employer*. For someone facing no employee taxes, we could neutralise the abolition of 12.8% employer NICs by imposing an 11.35% employee tax; but for someone already facing 41% employee taxes the abolition of employee NICs would be neutralised by a 6.7% employee tax (0.1135 x 0.59 = 0.067).[36] Because rates of Income Tax, employee NICs and tax credit withdrawal are applied additively to the same base, it is the combined rates of

[35] A more widely known example of the conversion between tax-inclusive and tax-exclusive bases is that a 17.5% VAT (expressed as a percentage of the VAT-exclusive price) is equivalent to a tax of 14.9% on the retail sale price (including the tax), or (in the absence of saving) a 14.9% Income Tax. A 100% VAT, a 50% Income Tax and a 100% employer NICs all have the same effect of halving purchasing power. The reasoning and calculation are exactly the same in each case.

[36] Again there is a parallel with VAT. For someone earning £100 and paying no Income Tax, introducing a 100% VAT would be equivalent to introducing a 50% Income Tax (either would leave him buying half as much as if the tax were not there); but for someone earning £100 and already paying 50% of it in Income Tax (leaving him with £50 to spend), introducing a 100% VAT would be equivalent to raising his Income Tax rate to 75% (again, either additional tax halves his purchasing power) – a rise of 25 percentage points, not 50 percentage points as for the non-taxpayer. So if we wished to abolish a 100% VAT and increase Income Tax instead, should we increase the rate of Income Tax by 50p or by 25p?

these that need to be taken into account. <u>Levying 12.8% employer NICs above a threshold is equivalent to increasing earnings (except the part below the threshold) by 12.8% and then levying an 11.35% tax on *what remains after* applying Income Tax, employee NICs and tax credit withdrawal to the new (higher) earnings figure.</u> Thus there is unfortunately no single number by which we could raise the employee tax rates to compensate exactly for abolishing employer NICs: each current rate must be adjusted separately, with smaller rises to higher rates. It should also be noted that all thresholds above the tax-free earnings threshold would need to rise by 12.8% to keep pace with higher notional earnings.

For simple cases, we can achieve a neutral shift by applying a different increase to each rate, along with threshold adjustments. This has become simpler and more accurate following the simplifications announced in Budget 2007 (abolishing the 10% Income Tax band and aligning the UEL with the effective higher rate threshold). Applied to the hypothetical system that applies all the Budget 2007 announcements to the 2007–08 system, the appropriate changes would be:

- increase the main rate of employee NICs from 11% to 18.8%
- increase the rate of employee NICs above the UEL from 1% to 7.7%
- increase the effective UEL and higher rate threshold from £40,550 to £45,070 (formally, the UEL rises from £780 to £865 and basic rate limit from £35,325 to 39,845)
- reduce the main tax credit withdrawal rate from 39% to 34.6%
- reduce the higher tax credit withdrawal rate from 6.7% to 5.9%
- increase the main tax credit threshold from £6,380 to £6,530
- increase the child-tax-credit-only threshold from £15,175 to £16,450
- increase the second tax credit threshold from £50,000 to £55,730

For a single earner with no other income, increasing her earnings-above-£5,225 by 12.8%, abolishing employer NICs and introducing the above changes would leave both her cost to her employer and her disposable income unchanged. However, for people whose income for tax and tax credit purposes is different from that for NICs purposes, the changes are not quite equivalent: people with significant savings income could gain, while because of joint assessment two-earner couples on tax credits would gain up to £231 per year (assuming all income is from earnings).

The complexity of the adjustment outlined above arises because of the opaque nature of the existing regime, not because of complexity in the new regime. The end result of these adjustments would be a simpler-looking system than the current one. But this analysis does make clear that, however transparent the new system, the process of getting there from the existing system might be difficult and far from transparent.

As mentioned above, the potential benefits of moving to a single integrated charge in terms of reduced costs and increased transparency must be weighed against the dislocation associated with transition. The immediate effect of a shift from employer to employee taxes – before anything has time to adjust – is that take-home pay would fall and employers' profits increase. Earnings would rise in response to this, essentially by 12.8% (slightly less, in fact: the part of earnings above the tax-free earnings threshold would rise by 12.8%) so that they matched what earnings plus employer NICs had been before. But note that for this actually to happen, all existing employment contracts would have to be revised.

The government also would presumably increase the minimum wage by 12.8% (but again, only increase that part – if any – above what they assume to be the hourly equivalent of the earnings threshold). If the increased employee tax applied to social security benefits (see Section IV.C.5), the government would have to increase the rates of those benefits accordingly. By default, benefit rates that are linked to average earnings (such as the pension credit guarantee credit) would increase sharply; the government would have to actively prevent this if it did not want real increases. The obvious way to approach reform would be a pre-announced gradual shift – say 2 percentage points per year – before merging them, to allow time for adjustment. But as illustrated above, each adjustment to the tax system would be (perhaps surprisingly) complicated, and the whole process could build up resentment and tensions over stealth taxes and employers taking advantage.

The less obvious but more transparent alternative would be to shift all at once, and clearly and openly explain what is happening and that all wages (less the part below the personal allowance) should go up by the entire amount of employer NICs so as to express them in a different metric while leaving real incomes unchanged. This would be akin to the process followed for decimalisation or adoption of the euro: certainly not trouble-free changeovers – far from it – but not complete disasters to avoid repeating at all costs either.

This discussion so far has been about the possibility of removing employer taxes and using only taxes on individuals. But a consequence of the long-run irrelevance of formal incidence is that we could equally well move all taxes over to being formally employer taxes, rather than employee taxes – abolish Income Tax and employee NICs and raise all the revenue through employer NICs. This might help achieve transparency through forcing people to recognise the fallacy of formal incidence. Nobody could simplistically believe that they were now untaxed and employers were 'paying' virtually all taxes, so it might become natural to think in terms of how wages are affected by the rate of tax levied on my employer. This strange-sounding proposal actually has considerable advantages. But there are practical disadvantages: transition issues that are the mirror-image of those discussed above, and difficulty dealing with anyone with significant income other than from their main job – from second jobs, savings, etc.

The problems associated with shifting to an entirely employee-based (or entirely employer-based) tax look quite large. Notwithstanding the benefits of a single tax, the difficulty in trying to facilitate a one-off rise in earnings without too many knock-on effects, combined with the opacity of the required adjustments to employee taxes and tax credits, above and beyond the political and presentational difficulties, suggest that it may not be worth attempting. Moreover, it is probably too much to expect politicians seeking election to argue for the outright replacement of a major tax "on businesses" with an equivalent tax "on employees". One possibility would be to keep an employer tax, but to minimise the cost of administering and complying with it by radically simplifying it. For example, it could be a flat rate payroll tax with no untaxed band of income for each employee and an earnings base that matched the integrated Income Tax-NICs base. Thus the employer would just need to calculate their total payroll for the year – on a basis to which they were accustomed – and apply a flat rate to it. There would be no need to apportion items such as benefits in kind or pension contributions between employees, or worry about employees who worked for part of the year or had second jobs. This possibility, along with the possibility of keeping employer NICs as it currently stands or abolishing it altogether, is part of the context for the discussion of aligning the tax bases in the sections that follow.

C. THE TAX BASE

In this section we examine in some detail a few examples of the kind of complexity still remaining in the Income Tax and NI systems even after the substantial alignment that has taken place over the years. If the two charges are to be merged, further alignment of the tax base will be required. Even short of full Income Tax-NI integration, differences in the tax base between the two systems at the very least provide examples of the potential benefits still remaining from further alignment.

1. Definition of Earnings

The Income Tax (Earnings and Pensions) Act 2003 (hereafter ITEPA) levies Income Tax on 'earnings' from employment (formerly 'emoluments' in the old Schedule E language that predated the Tax Law Rewrite Project's work). 'Earnings' is broadly defined in ITEPA s.62 as (a) any salary, wages or fees, (b) any gratuity or other profit or incidental benefit of any kind obtained by the employee if it is money or money's worth, or (c) anything else that constitutes an emolument of the employment. For NI purposes, on the other hand, 'earnings' is defined as 'any remuneration or profit derived from an employment'.[37] This definition covers both employed earners and self-employed earners;[38] although remuneration would seem to relate to employed earners and profits to self-employed earners, it is not necessarily limited in this way. For example, Tiley & Collison (2007) argue that some benefits-in-kind and expense allowances constitute 'profits' from employment, and are subject to NICs on that basis.[39] In addition, certain statutory payments (sick pay, maternity pay, etc), sickness payments, payments for restrictive covenants, and gains arising from shares and share options schemes are specifically included in the definition of remuneration for contribution purposes.

Although the definitions of earnings for Income Tax and NI purpose are broadly similar, they are not identical. As noted above, ITEPA taxes earnings 'from an employment',[40] whilst NIC are charged on gross earnings 'derived from

[37] CITE.
[38] SSCBA 1992, s.3(1).
[39] Tiley & Collison (2007), para 50:01.
[40] ITEPA 2003, ss 7(3)(a) and 9(2) (formerly ICTA 1988, s 19).

employment'.[41] Does this (apparently) slight difference in describing the source of the earnings give rise to any substantive differences? Whitehouse (2005) argues that until recently it was widely accepted that there was no material difference between the rules which apply for the purposes of evaluating source in the case of the charge to tax under what was, in pre-ITEPA terms, an emolument, on the one hand, and earnings for NI, on the other.[42] However, according to Whitehouse, the situation appears to have changed following the merger of the Contributions Agency with Inland Revenue (now HMRC) in 1999.

Whitehouse cites two examples to support his contention that 'the fresh administrative mind had some new ideas'. First, in *Tullett & Tokyo v Secretary of State for Social Security*,[43] rather than the customary review of the Schedule E case law, Collins J. was urged by Counsel for the Crown not to approach NIC 'wearing Income Tax spectacles'. Secondly, the HMRC NI Manual subtly refers (at para 2010) to the fact that 'earnings' and 'emoluments' are 'broadly similar', indicating that in HMRC's view at least some differences must exist. Whitehouse concludes:

> 'It can no longer be assumed that the terms "earnings" and "emoluments" … are synonymous. HMRC does now occasionally suggest that "derived from" connotes a more remote causal link to the employment than "from". This is no doubt a rather strained construction and one where it is difficult to identify a rationale to justify its consequences. However, what is more significant is that HMRC is perfectly prepared to look again at the longstanding assumptions that have been made and to overturn them.'[44]

The possibility of increasing divergence between Income Tax and NI on the employment earnings base is a worrying development, and runs counter to the history of increased alignment of the two charges. We believe that using different definitions of earnings subject to Income Tax and NICs creates unnecessary complexity for employers, increasing confusion and administrative costs. It also may give rise to unexpected results, with some forms of compensation falling within the charge to Income Tax or NICs but perhaps not both.

(a) Benefits in Kind

Notwithstanding the (slightly) different definitions of earnings subject to Income Tax and NI, it is evident from the discussion above that the types of earnings subject to NICs have been steadily moving towards full alignment with the Income Tax treatment. One area where this can be clearly seen is the treatment of employee benefits. Most taxable benefits are now subject to some form of NICs – Class 1 or in most cases Class 1A (and thus subject to employer's NICs only).[45] Interestingly, whether a particular benefit gives rise to Class 1 or Class 1A contributions can depend on how the benefit is provided. The HMRC booklet on Class 1A NICs cites the

---

[41] SSCBA 1992, s 3(1).
[42] Whitehouse, M 'Transfer of Functions' *Tax Journal* 30 May 2005, pp.15-16.
[43] [2000] ALL ER (D) 739.
[44] Whitehouse (2005) p 15.
[45] An exceptional example of a taxable benefit not subject to Class 1 NICs and specifically excluded from Class 1A NICs is cars provided to disabled employees: see HMRC National Insurance Manual, para NIM 14510, available online at http://www.hmrc.gov.uk/manuals/nimmanual/NIM14510.htm

example of private health care – if the employer pays for private health care insurance taken out by the employee Class 1 NICs will apply, but if the employer takes out the insurance and pays it only Class 1A NICs will be due.[46] Such a difference in NIC treatment is difficult to justify on equity and neutrality grounds, and unduly increases complexity.

In any event, most taxable benefits now will give rise to at least some form of NIC charge. Similarly, most non-taxable benefits will attract no NIC liability, including tax-exempt benefits as well as benefits covered by a PAYE settlement agreement, dispensation or an extra-statutory concession.[47] Nevertheless, some differences remain, though the logic for drawing the distinctions in the way they have been drawn is difficult to fathom. One good example is the treatment of mixed personal and business use of employer assets loaned to employees.

For Income Tax purposes, the employee is regarded as receiving a taxable benefit when assets are supplied by his or her employer for personal use without any transfer of property in the asset. The taxable benefit is valued at the higher of the annual value of the use of the asset (20% of the asset's market value when first provided by the employer) and the annual hire charge paid by the employer (including related expenses).[48] This value is also subject to employer Class 1A NICs.[49] In the case of an asset (such as a computer) used partly for business purposes and partly privately, when the private use is significant the employer must report the whole of the value on the P11D annual return of benefits and expenses; the employee can then claim a deduction for the business use of the asset under ITEPA s.336.[50] For NICs, however, the employer will be subject to Class 1A contributions on the *entire value*; apportionment is not permitted for mixed-use assets.[51]

In summary, notwithstanding recent steps towards greater alignment, the current treatment of benefits under the Income Tax and NI systems reflects the piecemeal way tax and NICs have extended to cover benefits over time. One glance at the long and bewildering chart in HRMC payroll deduction guide CWG2 summarising the differences in P11D reporting requirements for PAYE and NIC purposes is enough to make one wonder what reasons could justify such complexity.[52] The rules could benefit from further alignment and clarification. The present differences give rise to more favourable treatment for some benefits as compared to others (and also cash earnings), in some cases merely because the benefit has been delivered in one way rather than another, economically equivalent one. Such treatment is horizontally inequitable, economically distortionary, and unnecessarily increases the compliance burden on employers (and particularly small employers).

---

[46] HMRC Booklet CWG5, 'Class 1A National Insurance contributions on benefits in kind: A guide for employers' (2006) para 11, available online at http://www.hmrc.gov.uk/guidance/cwg5.pdf.
[47] HMRC Booklet CWG5, 'Class 1A National Insurance contributions on benefits in kind: A guide for employers' (2006) para 7, available online at http://www.hmrc.gov.uk/guidance/cwg5.pdf.
[48] ITEPA 2003, s 205.
[49] SSCBA 1992, s 10(1)(a).
[50] See Redston (2006).
[51] *Ibid*, citing SSCBA 1992, s 10(7A) and HMRC Booklet CWG5, 'Class 1A National Insurance contributions on benefits in kind: A guide for employers' (2005) para 13, available online at http://www.hmrc.gov.uk/guidance/cwg5.pdf.
[52] HMRC Booklet CWG2, 'Employer's Further Guide to PAYE and NICs' (2006) pp 80-84, available online at http://www.hmrc.gov.uk/guidance/cwg2.pdf.

(b) Gratuities

Another form of earnings for which the Income Tax and NICs bases clearly diverge is gratuities. Gratuities are specifically included in the definition of earnings subject to Income Tax: ITEPA s.62(2)(b). PAYE is applicable where the employer (or an employee) operates an arrangement for sharing gratuities among employees; if cash tips are paid directly to employees by customers PAYE is not applicable, and the gratuity is taxable directly on the employee (though there is some question as to the extent to which such tax is actually paid in practice).[53] Further, the cases have determined that the mere fact the donor of gift is not the employer does not prevent the gift from being an emolument and taxable on that basis.[54] Thus, a standard tip to a waitress or cab driver would be subject to tax. However, a voluntary payment made in circumstances which show that it is given to the employee by reason of his or her personal qualities or attainments (e.g., a benefit match for a retiring professional cricketer) may escape Income Tax.[55] Non-cash gifts from third parties up to £250 per annum per donor are now specifically exempt from Income Tax if certain conditions are met, including that the gift is not made in recognition of particular services performed (or to be performed) by the employee in the course of employment.[56]

In contrast, 'gratuities and offerings' are specifically exempted from NICs under the Contributions Regulations so long as one of two conditions is met – either (i) the payment is not made directly or indirectly by the employer and does not represent sums previously paid to the employer, or (ii) the employer does not *allocate* the payment, directly or indirectly, to the earner.[57] In *Channel 5 TV Group Ltd v Moreheard*,[58] the Special Commissioners held that 'gratuity' for this purpose meant 'a voluntary payment given in return for services rendered where the amount of the payment depended on the donor and where there was no obligation on the part of the donor to make the payment'. For many employees, the NICs treatment of gratuities will be much more generous than the Income Tax treatment. Most notably, a standard tip paid by a customer directly to a taxi driver or waitress that is subject to Income Tax (though not PAYE) will not be subject to NICs at all. If instead a non-discretionary service charge is automatically included in the customer's bill and then distributed to the employees by the employer, the amounts so distributed are subject to both PAYE and NICs.[59]

HMRC recently reversed its position on the NIC treatment of gratuities distributed through troncs in the catering and services industries.[60] Troncs are special arrangements used to pool and distribute tips usually run by one of the employees (referred to as a troncmaster) independently of the employer's influence. For Income Tax purposes, troncmasters are required to deduct PAYE. Until recently, HMRC had taken a broad view of what constituted an allocation by the employer for NIC

---

[53] HMRC Booklet CWG2, 'Employer's Further Guide to PAYE and NICs' (2006) p.32, available online at http://www.hmrc.gov.uk/guidance/cwg2.pdf.
[54] See e.g. *Calvert v Wainwright* [1947] All ER 282.
[55] *Moorhouse v Dooland* [1955] Ch 284.
[56] ITEPA 2003, s.324.
[57] Social Security (Contributions) Regulations 2001, SI 2001/1004, Sch 3, Part X, para 5.
[58] [2003] STC (SCD) 327.
[59] HMRC Booklet CWG2, 'Employer's Further Guide to PAYE and NICs' (2006) p.32-33, available online at http://www.hmrc.gov.uk/guidance/cwg2.pdf.
[60] See HMRC guidance at http://www.hmrc.gov.uk/employers/tips-gratuities.htm.

purposes.[61] For example, if management influenced the appointment or imposed a troncmaster, HMRC considered that to be interference with the running of the tronc and the NIC exemption was lost.[62] Furthermore, the February 2005 version of HMRC booklet E24 advised that where payments of gratuities form part of contractual pay or are used to meet obligations under national minimum wage legislation, they are liable for NICs <u>even if they are allocated to employees by a tronc run independently of the employer</u>.[63] However, in the face of strong opposition from employees and employers in the catering and service sectors, and apparently after receiving further legal advice, HMRC recently decided to back down and will no longer be seeking NICs on such tronc-administered gratuities.[64] HMRC is revising its guidance in booklet E24 and other publications accordingly.

HMRC's new position means that an even greater proportion of gratuities will be subject to Income Tax but not NICs. As was the case with taxable benefits, on neutrality and horizontal equity grounds this difference in treatment for gratuities under Income Tax and NI is difficult to justify. In industries such as catering and hospitality tips may constitute a significant portion of a worker's total remuneration. Why should those earnings be free from NICs while the typical cash earnings of other employees are not?

(c) Deductible expenses

While it is notoriously difficult for employees to claim deductions from their earnings for Income Tax purposes, some specific statutory deductions are nevertheless available, most notably travelling expenses, but also fixed allowances and professional memberships. Claims for other employment expenses may be made so long as the expenses satisfy the strict general deductibility test in ITEPA s.336. In order to be deductible under s.336, the expense must be 'wholly, exclusively and necessarily' incurred in the performance of the duties of employment.

Turning to NI, in many cases reimbursements paid to employees in relation to employment expenses will be disregarded from liability for Class 1 NICs. These expenses include professional membership fees. In addition to the particular exclusions for different types of expenses and allowances paragraph 9 of Part VIII of Schedule 3 provides for the exclusion of 'any specific and distinct payment of, or contribution towards, expenses which an employed earner actually incurs in carrying out his employment.'[65] However, as with mixed-use employee benefits, employer payments for items which have both a private and a business element are problematic for NICs.[66] In addition, no relief against NICs is available for employment-related expenses incurred by the employee but <u>not</u> reimbursed by the employer: there is

[61] Whiting (2005).
[62] Ibid.
[63] HMRC Booklet E24, 'Tips, Gratuities, Service Charges and Troncs' (2005) available online at http://www.hmrc.gov.uk/helpsheets/e24.pdf.
[64] Harry Wallop, 'Taxman admits defeat on tips' *Daily Telegraph* 20 October 2006.
[65] Paragraph 9 of Part VIII of Schedule 3 to the Social Security (Contributions) Regulations 2001, SI 2001/1004. See also HMRC National Insurance Manual, para NIM05000, available online at http://www.hmrc.gov.uk/manuals/nimmanual/nim05000.htm.
[66] HMRC NIM05010, available online at http://www.hmrc.gov.uk/manuals/nimmanual/NIM05010.htm.

simply no mechanism for such expenses to be picked up in the non-cumulative, pay period structure of NI.

If expenses, such as travelling expenses and professional memberships, are deductible for Income Tax purposes even when not reimbursed by the employer, the question becomes whether such reliefs should be available in computing NIC liability. A good example of the inequity in NIC treatment as compared to tax treatment is in relation to entertainers' agents' fees. Those entertainers who are treated as employees for Income Tax purposes are allowed a deduction against their employment earnings for fees paid to their agents.[67] Such fees can represent a significant expense that entertainers incur as part of their earning process.[68] NICs, however, are levied on the gross earnings of entertainers, without relief for their agents' fees. This treatment appears unduly harsh: the principle of deducting expenses to calculate taxable income is a sound and widely accepted one, and there is no obvious reason that it should not apply here. Although primary contributions are reduced to 1% on earnings over the UEL, thus mitigating the harshness to a certain extent for high-income earners, the employer's secondary contributions will continue to be levied at the usual rate without limit. This could represent a very significant liability in the case of highly-paid entertainers.

(d) Conclusion

The obvious conclusion to draw in respect of the different earnings definitions for Income Tax and NI is that alignment here should be pursued as a priority even if integration goes no further, since differences have no obvious rationale and working out two different earnings measures unnecessarily increases the burden on employers. As noted above, this is an area where substantial alignment has occurred, but much more could be done.

2. Period of Assessment.

Class 1 NICs are due in each pay period (a week or a month for most employees) on earnings in that pay period. Each pay period is assessed individually and without regard to the previous earnings record of the employee. The rules governing earnings periods for NIC purposes are complicated.[69] Liability to Income Tax, on the other hand, is measured by reference to income over the tax year running from 6 April to 5 April. An individual is not liable to Income Tax unless his or her total income for the year exceeds his or her allowances. For employees, Income Tax is deducted under PAYE on a cumulative basis according to the employee's PAYE code. Tax deducted in each pay period takes account of earnings and allowances that have accrued from the start of the year. Unless otherwise notified, banks deduct basic rate tax from interest income. If the system works properly, for taxpayers with relatively simple affairs the correct amount of tax is withheld from the employee's earnings without the need to file a tax return.

---

67 ITEPA 2003, ss 328, 329, 352.

68 See, for example, the 'Richard and Judy' case *Madeley and another v Revenue and Customs Commissioners* [2006] STC (SCD) 513.

69 See the extensive HMRC guidance on earnings periods in the National Insurance Manual, para NIM08000, available online at http://www.hmrc.gov.uk/manuals/nimmanual/nim08000.htm.

NIC liability arises when earnings are paid; Income Tax is levied on an earned rather than paid basis. This distinction is particularly noticeable with respect to the treatment of expense reimbursements. For Income Tax purposes, expenses are reported on an annual return; however, for NICs purposes any liability which may arise with respect to expense payments does so at the time the employer pays the expenses.[70]

Integrating Income Tax and NI would entail moving over to an entirely annual or entirely pay-period period of assessment. Specifically, there are three models for how a merged charge might operate:

(i) an entirely pay-period basis for assessment, with liability determined only by income within the pay period and exact deduction in the pay period. This is how NICs currently operates.

(ii) an annual basis for assessment with exact cumulative deduction at source. This is how Income Tax currently operates.

(iii) an annual basis for assessment with approximate deduction at source on a period-by-period basis and a year-end reconciliation for all taxpayers to ensure the correct amount is ultimately paid for the year as a whole. This is how income tax currently operates in most other countries.

We believe that the first of these is the least satisfactory whether judged in terms of fairness, economic efficiency or practicality. Short assessment periods mean that tax liabilities are crucially affected by the timing as well as the level of an individual's income, which seems both unfair and distortionary. To see this, note that the current NICs system rewards people whose earnings are bunched into a few pay periods to take advantage of the UEL, but also those who earn up to the earnings threshold in every period. For example, an employer with gross earnings of £15,000 in a year, would pay least NICs if he or she earned exactly £100 in each of 51 weeks and the remaining £9,900 in the 52nd week. This admittedly extreme arrangement incurs a total annual employee NICs liability of £155 for an employee contracted in, compared with £1,076 if the employee earned £288.46 in every week, a saving of £920 per year (the employer NICs liability is £1,254 in either case). It seems grossly unfair that two individuals with the same annual earnings should face such different liabilities simply because one person's earnings are bunched and the other's are smoothed over the year. Such substantial differences in liabilities could also lead to distortions in people's behaviour. There may be some distortion to work patterns – not necessarily individuals choosing between the two in this calculating fashion, but among people on the margin of whether to accept a particular job, one person may be tempted to take a job with volatile earnings (rather than stay at home or continue looking) while another refuses a job with steady pay. A student might decide not take a summer job because the NICs deducted from pay make it not financially worthwhile, whereas if NICs were assessed on an annual basis then the earnings might fall below the earnings threshold and the job be worthwhile. Perhaps more importantly in practice, this idea might be widely exploited by the use of 'Christmas bonus' schemes in preference to regular pay: a simple tax avoidance scheme which is clearly undesirable for the government

[70] See HMRC National Insurance Manual, para NIM05600, available online at http://www.hmrc.gov.uk/manuals/nimmanual/nim05600.htm.

and which the employer and employee may prefer not to have to bother with as well. The ease with which a self-employed person could distort the timing of reported income (and expenses) in search of NIC savings is perhaps one reason why Class 4 NICs, unlike Class 1, operate on an annual basis.

It might be thought that these disadvantages of a short assessment period are counterbalanced by a practical advantage: that if liabilities are fully determined within each pay period, there is no need for either a cumulative calculation each period or an end-of-year assessment, and there is no need for co-ordination between two employers and HMRC (via P45 and P46 forms) when an employee moves jobs within a tax year. When looking at NICs, this may be true, though there are arguments in the other direction (for example, errors that occur in a pay period can be corrected later on relatively easily under cumulation or end-of-year reconciliation, but are much harder to correct in a system like NICs that is set up to be precise within a particular period). But pay-period assessment can work relatively well for NICs only because NICs are calculated only on earnings from a single employment, which is relatively simple to deal with. The difficulty of monitoring the timing of self-employment income has already been mentioned, and it might be difficult to tax savings and investment income other than on an annual basis. Perhaps even more importantly, sub-annual assessment looks extremely difficult when incomes from more than one source – two jobs, say, or employment and savings income – need to be added together and a progressive schedule applied (perhaps one reason why NICs combines pay-period assessment with largely per-job rather than per-person liability). It is simply not realistic to expect to co-ordinate income from multiple sources on a week-to-week or month-to-month basis in order to deduct the right amount of tax in each period.

Thus considerations of principle and practice both point towards an annual assessment period for an integrated charge. This leaves open the question of whether an annually based tax should be operated as a cumulative system, like the present Income Tax, or by pay period deductions (like NICs) but with a year-end reconciliation to identify and resolve any under- or over-payments of tax for the year as a whole. On the one hand, cumulative deduction means most taxpayers pay the right amount of tax without requiring any effort at all on their part; on the other hand, PAYE is more work for employers, works perfectly for ever fewer people as economic activity becomes more complicated, and some argue that it is healthy for democracy that citizens to fill in (or at least sign off) a tax return each year. These are well-worn arguments and we see no need to try to resolve them here; the key point is that integration would imply NICs joining Income Tax as an annually based charge, and the debate over whether PAYE should be replaced by universal self-assessment can continue as it has for years.

Moving NICs to an annual basis would be progressive: as mentioned above, pay-period-based NICs is unfavourable to low-income people with volatile earnings (since a single period above the earnings threshold generates NICs liability even if year-round earnings are low) and favourable to relatively high-income people with volatile earnings (since they might be above the UEL in some periods even if their average earnings are below it)

Moving NICs to an entirely annual basis would also require some relatively minor technical changes, such as redefining to benefit contribution conditions, but these need pose no major difficulties. HM Treasury (2007b) provides a detailed analysis of one model for making NICs annual, and concludes that the cost savings would not be large enough to justify the transitional costs. However, it is important to note that the Treasury report looks only administration and compliance costs – ignoring the equity and economic efficiency issues raised above and the potential gains in terms of transparency – and it looks only at the single reform in isolation, rather than as part of a broader integration. The benefits of moving NICs to an annual basis may indeed be much less if it remains a separate tax with a different earnings definition, different reporting requirements, the full contributory system, and so on, than if it is merged with Income Tax altogether.

3. Unit of Assessment: the Person or the Job?

Income Tax depends on an individual's total earnings from all employments. If an individual has more than one job, the tax deducted by second and subsequent employers is adjusted so that the correct amount of tax is taken in total (though this process often goes wrong in practice). By contrast, NICs is largely assessed separately for each employment. The amount of NICs an employer deducts does not normally take into account any other jobs the employee may have. Consequently, individuals benefit from an additional tax-free earnings band (the Earnings Threshold) for each job they have, though the situation with the UEL is more complicated and outlined below.

This may have important ramifications for employees with multiple employments, such as entertainers. As discussed in the following section, entertainers are generally classified as employees under the NI Categorisation Regulations, even in situations where the entertainer undertakes a series of unrelated, possibly short-term engagements. Each engagement constitutes a separate employment for NI purposes, which may require the entertainer to pay more than the annual maximum (discussed further below). One exception is where the employer carries on business in association with another employer(s); in such a case the employer must add together the earnings from each job and work out NICs on the total, unless it is 'not reasonably practicable' to do so.[71]

Employees with more than one employment who expect to earn in excess of the UEL in at least one of their employments can apply to HMRC for permission to 'defer' some of their contributions liability. The term 'defer' is a misnomer as permission results in exemption from payment, not mere deferral. Where permission is granted, the employee pays a reduced Class 1 primary rate of 1% on all earnings from the ET to the UEL and the additional employee rate of 1% on all earnings above the UEL in the deferred employment(s).[72] In effect, therefore, for such employees the UEL acts as a limit on the amount of *total* earnings that are subject to the main rate of employee NICs, not just as a limit on the amount of earnings in each job. Employers' (secondary) Class 1 contributions are payable at the usual rate. Such relief is not

[71] One example of when it might be 'not reasonably practicable' to add earnings together would be where the employer operates a computerised payroll system which is unable to handle this calculation such that the employer would have to manually do it: see HMRC Booklet CWG2, 'Employer's Further Guide to PAYE and NICs' (2006) p. 38, available online at http://www.hmrc.gov.uk/guidance/cwg2.pdf.

[72] HMRC Booklet CWG2, 'Employer's Further Guide to PAYE and NICs' (2006) p. 56, available online at http://www.hmrc.gov.uk/guidance/cwg2.pdf.

available, however, where the employee's total earnings from all employments exceed the UEL but the UEL is not exceeded in any one employment. As a result, an employee with more than one unassociated employment can end up triggering a liability greater than that for an employee earning the same amount of earnings but from just one employment.

In principle, per-person assessment seems preferable to per-job assessment. For both fairness and economic efficiency reasons, the tax system should be neutral as to whether someone earns a given amount through one job or two. Generally speaking, NICs currently favours multiple jobs, as employees get one earnings threshold per job but a UEL for earnings across all jobs (with the exception mentioned above where someone has multiple jobs, individually below the UEL but collectively above the UEL – in that case the person could be better off in a single job with the same total earnings). On the other hand, per-job assessment is easier for employers to administer. Employers do not need to be concerned with what else their employees are doing, and employers do not need to interact with other employers and/or HMRC in order to calculate and deduct the right amount of tax.

The choice between per-person and per-job is one area where the distinction between employer and employee NICs really matters. If there were a single secondary earnings threshold across all jobs for an individual, how should it be allocated between employers? For employee taxes, it makes little difference which is treated as the 'main' job: the cost to each employer is the same, and the overall earnings and tax of each individual is the same. However, with employer taxes, by default the allocation of the earnings threshold affects the cost to the employer. In theory, the allocation of the tax-free band could be irrelevant as for employee taxes, but that would require earnings in each job to adjust according to how the earnings threshold was allocated. In effect, this would mean pay being overtly negotiated in terms of earnings-plus-employer-NICs.In practice it seems unrealistic to expect the earnings offered with a particular job to depend on whether it would be the worker's principal employment as far as HMRC was concerned. If an employer tax is to operate on a per-person basis, therefore, the mechanism chosen for allocating the earnings threshold across employers – for example, allocating it to the job with the highest pay, or proportionately to earnings across the individual's jobs – would matter. As well as inevitably giving rise to administrative complexities, any such mechanism would give employers a direct financial interest in reducing what their employees earned in other jobs, which seems undesirable. If an employer tax is to be retained, this strengthens the case for continuing to levy it on a per-job basis.

4. Self-Employment

(i) Who is Self-employed? Categorisation Issues

Income from an office or employment is subject to tax under ITEPA[73], whilst self-employed earnings are taxed under ITTOIA[74]. In the vast majority of cases, categorising a worker as either an employee or as self-employed for Income Tax

[73] Income Tax (Earnings and Pensions) Act 2003, s.1
[74] Income Tax (Trading and Other Income) Act 2005, Part 2.

purposes is not difficult. There are fundamental differences in the activities of a sole trader who owns and manages a corner shop, on the one hand, and an employee who works 35 hours a week in a large supermarket for an hourly wage. These fundamental differences might also be thought to justify different tax treatment (e.g. a wider scope for claiming deductions for the self-employed, withholding of tax at source for the employed). Nevertheless, there are some workers who will fall somewhere in the middle of the spectrum, in a grey area between those who are clearly employed and those who are clearly self-employed. Changing work patterns, developments in technology and communications, the rise in importance of the service sector, the increasing numbers of skilled and mobile professionals and other factors have expanded this grey area in recent times.[75] For many more workers than before, categorisation as either employee or self-employed for tax purposes has become a much more difficult exercise. Nevertheless, such categorisation must be done.

ITEPA s.4 states that employment includes in particular 'any employment under a contract of service'. In seeking to determine whether a contract of service (as opposed to a contract for services) exists in a particular case, the courts have developed a number of tests,[76] including the control, integration, economic reality and mutuality of obligations tests.[77] Although the common law tests for employment are well-known, their application does not provide a clear answer in all cases. HMRC provides some guidance on the application of the common law tests in its Employment Income Manual[78] and booklet IR 56[79], though this guidance has been criticised for minimising the importance of cases in which taxpayers have been found to be self-employed.[80] ITEPA also deems certain categories of agency workers to be employees.[81]

Recently, HMRC introduced an online software tool – the Employment Status Indicator – to assist businesses in determining whether a worker is an employee or self-employed for tax purposes. The ESI asks a series of questions about the worker's duties and working conditions. Based on the answers received, the ESI provides an indication of employment status, along with a reference number. This indication is not a definitive or legally-binding opinion, though the determination generally is binding on HMRC staff provided the questions have been correctly answered.[82] As some judgment is required in formulating answers, this caveat would seem to leave HMRC enough scope in practice for refusing to be bound by a particular ESI determination. HMRC intends that in the near future an enhanced version of the ESI will be able to give a legally binding decision.[83]

Categorisation issues also arise under the NI system, which distinguishes 'employed earners' from 'self-employed earners'. The vast majority of workers who are treated

---

[75] For a more detailed discussion on this point see Freedman (2001).
[76] See, e.g., *Davies v Braithwaite* (1932) 18 TC 198, *Fall v Hitchen* [1973] STC 66, *Hall v Lorimer* [1994] STC 23.
[77] For a more detailed discussion see Tiley Revenue Law (5th ed) ch 13 and Freedman (2001) ch 3.
[78] HMRC Employment Income Manual, available online at http://www.hmrc.gov.uk/manuals/eimanual/index.htm
[79] HMRC Leaflet IR 56, 'Employed or Self-Employed?' (2004) available online at http://www.hmrc.gov.uk/pdfs/ir56.pdf.
[80] Tiley & Collison (2007) para 7:11.
[81] ITEPA 2003, ss 44-47.
[82] http://www.hmrc.gov.uk/calcs/esi.htm.
[83] HMRC Operational Impact Assessment for Employment Status Indicator, available online at http://www.hmrc.gov.uk/oia/oia-esi.pdf.

as employees for Income Tax purposes are also classified as employed earners for NI purposes under the same common law tests; however, some important differences do exist. Under the NI rules, an 'employed earner' is anyone who is gainfully employed in Great Britain under a contract of service or in an office with emoluments chargeable to Income Tax as general earnings.[84] In addition, the Treasury is authorised to introduce regulations treating persons in certain difficult-to-classify occupations as employed or self-employed earners (or even non-earners) for NI purposes, whether or not they would be so classified under the common law tests on their particular facts, and irrespective of their treatment under the Income Tax.[85] For example, under the Categorisation Regulations,[86] examiners, moderators, and invigilators are classified as self-employed so long as their work is to be performed in less than 12 months.[87] Employments of spouses and close relatives, and employments as a returning officer, counting officer, member of a visiting force, international headquarters or defence organisation are regarded as non-earner's employment and disregarded for contribution purposes.[88]

More commonly, the NI Categorisation Regulations deem the relevant workers to be employed earners for NI purposes, and provide rules for determining the secondary contributor. In some cases this treatment may accord with Income Tax treatment. For example, most agency workers are deemed employed earners under rules similar to those found in ITEPA.[89] In other cases, the NI categorisation may well differ from the Income Tax one. Examples of occupations with prescribed treatment under the NI Categorisation Regulations include entertainers, construction workers, ministers of religion, part-time or visiting lecturers/teachers/instructors (as mentioned above), and office cleaners.[90] The Income Tax and NI treatment of some of these problematic occupations, particularly entertainers, are discussed in more detail in the following paragraphs.

<u>Entertainers</u>

Actors, musicians and other entertainers have frequently posed difficult categorisation problems for both the Income Tax and NI systems. Several of the leading Income Tax cases on whether a taxpayer is an employee or self-employed involve entertainers, including *Davies v Braithwaite* (actress) and *Fall v Hitchen* (ballet dancer). In *Davies v Braithwaite*, the court viewed the totality of the professional engagements entered into by the actress Lilian Braithwaite in arriving at the conclusion that earnings from a performance in New York were taxable under Schedule D, Case II. The court held that the New York performance was merely one engagement in her profession as actress. In contrast, the court in *Fall v Hitchen* focused on the terms of the particular engagement at issue in holding that the taxpayer, a ballet dancer employed by Sadler's Wells under a standard Esher contract, was taxable under Schedule E.

---

[84] SSCBA 1992, s 2(1)(a).
[85] SSCBA 1992, s 2(2)(b).
[86] Social Security (Categorisation of Earners) Regulations 1978, SI 1978/1689, hereinafter the 'Categorisation Regulations'.
[87] Categorisation Regulations, Sch 1, Part I, para 4.
[88] Categorisation Regulations, Sch 1, Part III, para 7-13.
[89] Categorisation Regulations, Sch 1, Par I, para 2, Col (A).
[90] Additional guidance on the tax and NI categorisation of problematic occupations can be found in the HMRC Employment Status Manual at section ESM4000 onwards, available online at http://www.hmrc.gov.uk/manuals/esmmanual/ESM4000.htm.

For a time HMRC took the position (relying on *Fall v Hitchen*) that most entertainers, and especially those working under industry standard Equity contracts, were to be treated as employees for Income Tax purposes.[91] However, HMRC has since relaxed this position and is now more likely to accept that an entertainer is self-employed.[92] HMRC will consider employment status to be more appropriate in circumstances where an artist is engaged for a regular salary to perform in a series of different productions over a period of time in such roles as may be from time to time stipulated by the engager, with a minimum period of notice before termination of the contract, as would be the case for permanent members of some orchestras and permanent members of an opera, ballet or theatre company.[93] In any event, performers who had been dealt with under ICTA Schedule D prior to 6 April 1987 can continue to be taxed on that basis, if not by law then by concession.[94]

While the common law tests determine an entertainer's employment status as employed or (increasingly more likely) self-employed for Income Tax purposes, the Categorisation Regulations generally govern the entertainer's status under the present NI regime. Prior to 15 July 1998, the Department of Social Security, which at that time administered the NI system, took the view that actors and musicians were nearly always employees for NI purposes, relying on the degree of control over the performer typically found in the relevant contracts (particularly the standard union contracts) and because those contracts required personal service to be performed.[95] Consequently, the DSS expected the producer of the performance to deduct and remit Class 1 NICs, irrespective of the Income Tax treatment, except where it was a clear cut case of Schedule D status. However, some entertainers were accepted as self-employed for both tax and NI purposes, e.g., freelance orchestra workers.

This position changed in July 1998, when the DSS admitted that its general position towards entertainers was unsustainable in law.[96] The Categorisation Regulations subsequently introduced between July 1988 and April 2003 ensured that most entertainers would be treated as if they were employees for NI purposes (again irrespective of their status for Income Tax purposes as determined under the usual case law). Under the present NI regime, the Categorisation Regulations apply, and Class 1 NICs are payable, unless the entertainer's remuneration does not involve *any* amount of 'salary'.[97] 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.[98] '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

[91] Freedman (2001), para 4:58.
[92] ESM4121, available online at http://www.hmrc.gov.uk/manuals/esmmanual/ESM4121.htm. HMRC relies in part on an unreported ruling of the Special Commissioners that live theatre work performed by the actors Sam West and Alec McCowan was taxable under ICTA Schedule D and not Schedule E.
[93] ESM4121, available online at http://www.hmrc.gov.uk/manuals/esmmanual/ESM4121.htm.
[94] Extra statutory concession A75. See also ESM4122, available online at http://www.hmrc.gov.uk/manuals/esmmanual/ESM4122.htm.
[95] Tolley's Practical NIC Service , Lexis Nexis Tolley (October 2006) para 34.2.
[96] Press Release 98/202, dated 15 July 1998.
[97] Social Security (Categorisation of Earners) (Amendment) Regulations 2003, SI 2003/736. See the discussion of the impact of the 2003 regulations in Inland Revenue Tax Bulletin 65.
[98] Inland Revenue Tax Bulletin 65. See also 'Revenue News: Chaotic concerto' *Taxation* 17 November 2005, p.171.

at a specific period or interval, and computed by reference to the amount of time for which work has been performed.[99] If the Categorisation Regulations apply, all payments under an engagement (including residuals and royalties) are subject to NIC, not merely the salary element.

The advantage for entertainers from making Class 1 NICs is that they can qualify for contribution-based jobseeker's allowance when they are between engagements (which would not be case if they were instead making Class 2 and Class 4 self-employed contributions). Indeed, the rules in question were reportedly changed in 1998 at the request of the actor's union Equity in order to enable non-working actors to claim the allowance.[100] However, this change created a trap for some employers. Recently, it was reported that several UK orchestras faced bankruptcy over HMRC claims for backdated NICs arising from a failure on the part of the orchestras to properly appreciate and respond to the 1998 changes.[101] Since 1998, the orchestras had failed to deduct and remit Class 1 NICs in respect of their freelance musicians who were treated as self-employed for Income Tax purposes but met the tests for employed earners under the NI Categorisation Regulations. Interestingly, the union representing the orchestra workers said that it had never lobbied for the right of its members to be able to claim jobseeker's allowance because apparently musicians, unlike actors, are rarely unemployed.[102]

Other Special Cases

Labour-only contractors, especially those in the construction industry, are another group of workers who have posed a categorisation challenge for Income Tax and NI. As with entertainers, the two systems do not always treat such persons in an identical fashion. Moreover, a number of additional special categorisation rules apply for NI but not for Income Tax.[103] Ministers of religion who are not otherwise employed earners are treated as such for NI unless the minister's remuneration (excluding benefits in kind such as free living accommodation) does not consist wholly or mainly of salary.[104] This test is similar to the one formerly applied to entertainers. Office and other non-domestic cleaners are deemed to be employed earners,[105] as are cleaners of telephone kiosks. Part-time or visiting lecturers/teachers/instructors[106] not otherwise found to be employed earners are also generally treated as employed earners under the Categorisation Regulations. ITEPA has no equivalent legislative deeming provisions for these special cases, with the result that status for Income Tax and NI can differ. Conversely, a special Income Tax provision treats employees who are deep sea divers as self-employed for Income Tax purposes, but not for NI,[107] putting them in a situation similar to that enjoyed by entertainers. Temporary, casual or freelance

---

[99] Categorisation Regulations, Sch 1, para 5A inserted by Social Security (Categorisation of Earners) (Amendment) Regulations 2003, SI 2003/736.
[100] 'Revenue News: Chaotic concerto' *Taxation* 17 November 2005, p.171.
[101] 'Britain's orchestras face bankruptcy over £33m national insurance debt' *The Independent* 31 October 2005.
[102] 'Revenue News: Chaotic concerto' *Taxation* 17 November 2005, p.171.
[103] HMRC leaflet CA26 'National Insurance contributions for examiners, moderators and invigilators, lecturers, teachers and instructors'.
[104] Categorisation Regulations, Sch 1, Part I, para 5.
[105] Categorisation Regulations, Sch 1, Part I, para 1.
[106] Categorisation Regulations, Sch 1, Part I, para 4.
[107] ITTOIA 2005, s.15 (formerly ICTA 1988, s.314). See also HMRC leaflet IR 56, noting the Income Tax-NI difference.

workers in a specified grade in the film or television industry are also eligible for self-employment treatment for Income Tax but not for NI.[108]

Summary of Categorisation Issues

The vast majority of workers will be classified in the same way (employed or self-employed) under both Income Tax and NI. However, as the above examples make clear some categorisation differences do exist for a number of occupations. Whether an entertainer is an employee or self-employed, for example, is determined for Income Tax purposes under the common law tests, but under the Categorisation Regulations for NI purposes. This may well result in an entertainer being treated as self-employed for Income Tax purposes, but as an employed earner for NI. Freedman (2001) notes that at least the non-alignment of tax and NI is express and statutory, giving effect to a deliberate policy decision to subsidise frequently unemployed performers by allowing them to claim non-means-tested jobseeker's allowance.[109]

However, can the benefits from different treatment for some groups (e.g., entertainers) outweigh the costs, particularly in terms of the additional complexity and potential confusion, as evidenced by the orchestras' trap? More importantly, is such special treatment equitable? As Freedman (2001) describes it, a particular group (actors) with a well-organised, high-profile union has managed to obtain a 'special deal' for its members, while other groups that might have similar claims to some form of hybrid treatment (e.g., homeworkers, possibly) are not being afforded the same opportunity.[110] Chartered Institute of Taxation (1998) called for the abolition of the Categorisation Regulations on the basis that there was no obvious reason why employment status for occupations such as office cleaners, lecturers, and telephone sanitisers should not be determined under general principles.[111]

(ii) Differential Treatment of the Self-employed

For present purposes, the categorisation of employed and self-employed workers only matters because the two are treated differently for Income Tax and especially NICs. Removing the differences between employees and the self-employed in Income Tax and NI treatment could go some way to reducing the significance of the employee/self-employed classification problems discussed above. So long as the self-employed are treated more favourably for Income Tax and NI purposes than similarly-situated employees, individuals falling into the grey area on the employment/self-employment categorisation continuum will have a strong incentive to argue for self-employed status. While we must be wary of determining the position of the vast majority for the sake of settling a few hard cases, this raises the more fundamental point: can and should differential treatment persist under an integrated system, or should an integrated Income Tax-NI system treat employment and self-employment income the same?

It is a generally accepted that the Income Tax system treats the self-employed more favourably than employees.[112] The different treatment is usually explained in terms of

[108] Simon's Direct Tax Service, para E4.234. See also HMRC leaflet IR-56.
[109] Freedman (2001), para 4:63.
[110] Freedman (2001), para 4.64.
[111] Chartered Institute of Taxation 'Tax/NICs Harmonisation' 23 December 1998, p 15.
[112] Freedman and Chamberlain (1997).

the harshness of the rules applicable to employees – particularly the immediate withholding of tax from earnings under PAYE combined with stricter rules governing deductibility of employee expenses – although alternatively it could be argued that the treatment of the self-employed is overly generous.

Furthermore, it is clear that self-employed persons fare better under the NI system than employees. Thus, the two systems are consistent in their (favourable) approach to the self-employed. But the preferential treatment is much greater for NI than for Income Tax. The self-employed pay a Class 4 contribution rate of 8% on their profits, plus the low £2.20 per week flat Class 2 charge, compared to the standard Class 1 primary rate of 12% paid by employees. Moreover, for the self-employed there is no equivalent charge to the employer Class 1 secondary contributions.[113]

Lower contribution rates for the self-employed have a counterpart in reduced entitlement to contributory benefits: as discussed in Section II.A.2, they are not entitled to contribution-based jobseeker's allowance, for example. However, even after accounting for this reduced benefit entitlement, the Government estimates that in 2007–08 the Treasury will take in £1.9 million less in NIC from the self-employed than it would have done had the Class 1 primary and secondary contribution system applied.[114]

Is preferential treatment desirable? The starting point is that, other things being equal, it is unfair to treat the self-employed better than employees. Why should individuals carrying on essentially the same activity and deriving similar income from it exhibit large differences in liability to pay Income Tax just because one does so as self-employed? The non-neutrality is also inefficient: it distorts the structure of economy, leading to people being self-employed who should really be employees. One's choice of activity, and the legal form taken, should be made for commercial rather than tax reasons.

Arguments for justifying more favourable tax treatment of the self-employed commonly relate to encouraging entrepreneurship or compensating for high compliance costs. However, such arguments do not withstand close scrutiny. Reducing compliance costs, where possible, is a laudable goal. However, if compliance costs are inherently high for a given form of activity or legal form then it should be unappealing and the tax system should not incentivise people to do things which involve these wasteful burdens. On entrepreneurship, it is not clear that tax breaks for the self-employed are well targeted to encourage activities with significant positive spillover effects to the rest of society: 'entrepreneurial activities' whose spillovers may justify artificial encouragement are more likely to be things like investment and innovation, which are better addressed by tools such as capital allowances, R&D tax credits and patent protection. If there are no spillovers to self-employment per se, there is no reason to interfere with the incentives provided by the market and artificially encourage entrepreneurship – as with compliance costs, if it is unappealing to pursue a certain activity then people should not do so.

[113] By way of contrast, in Canada, the self-employed pay Canada Pension Plan contributions on net business income at a rate equal to a *combined* employee and employer rate.
[114] HM Treasury (2007c).

There are, however, arguments which might justify favourable treatment of the self-employed. First and foremost, there is what we could call the ‘dual margin’ problem: we need to think not only about people deciding whether to be employees or self-employed, but also of people deciding whether to be self-employed or incorporated – and this is also a decision we would rather not distort. At the moment, the self-employed are treated more favourably than employees, but less favourably than if incorporated. So taxing the self-employed more heavily may ameliorate one problem but worsen the other. This dilemma is unavoidable as long as small companies’ profits and dividends are taxed less heavily than employees and people are free to choose the form in which they operate.

There may be considerable room to shift exactly where the problem boundary is – most simply, by making the treatment of the self-employed more similar to either employees or companies, or in a more sophisticated way, by changing the legal distinctions (eg creating two categories of ‘self-employed’ which are taxed differently, or changing the way ‘small companies’ are defined and taxed). To some extent, legal restrictions on the form in which people can choose to operate (such as IR35) can help here. But if there is a strong financial incentive to operate in one legal form rather than another, there will always be efforts to circumvent these legal distinctions and they will always be difficult to police. And it is important to note that legal restrictions can only get one so far. At best, they can solve the problem of people doing essentially the same job but in a different legal form. However, there is also the problem of distorting the underlying behaviour. People decide whether to work for someone else, work for themselves or set up a business: even if a system could give these various choices careful non-overlapping definitions and police them perfectly, the system still should not distort this ‘genuine’ decision.

A second practical argument for preferential taxation of the self-employed is the difficulty threat of evasion. It is much more difficult to verify the income of a self-employed individual than of an employee, and there is therefore significant potential for them to under-report their incomes. Of course, most self-employed individuals will honestly declare their incomes whatever tax rate is imposed, and those who are dishonest may under-report their incomes even at low tax rates; but to the extent that higher tax rates increase the incentive to evade tax, there is a danger that attempting to tax the self-employed as heavily as employees might result in increased evasion eroding the revenue provided by those who remain honest.

Finally, the self-employed have a reduced entitlement to contributory benefits, although, as noted above, the reduced NICs they pay more than make up for lost benefits. Keeping a contributory system might justify at least some reduction in taxation of the self-employed if there are good reasons for denying them equal benefit entitlement. It should be noted that, unlike with the other two arguments above, lower taxation of the self-employed in this case need not be an unavoidable but fundamentally unfair and distortionary discrepancy: the expected net benefit of being self-employed could be zero. However, there would still be some selection issues – people who expected to pay above-average contributions and demand below-average benefits would prefer to be self-employed.

5. Savings, investments and state benefits

NICs are charged only on earned income. Income Tax applies to other forms of income as well: to certain state benefits and to income from savings, investments and property (though savings held is ISAs are tax-exempt; pensions are discussed in the next section). Where investment returns are realised in the form of capital gains rather than income, capital gains tax applies (except within ISAs and pension funds), albeit at a lower rate than Income Tax and with a large annual exemption and an exemption for primary residences.

Much had been written on whether savings income should be taxed like other income. This is most evident in the literature on the merits of a comprehensive income tax versus an expenditure tax, and raises issues beyond the scope of this paper.[115] Briefly, common intuition is often that income from all sources should be taxed the same, or, alternatively, that capital income should be taxed more heavily because savers tend to be richer. However, there is a strong argument for not taxing saving where it just represents shifting the time at which earnings are spent. According to this argument, the untaxed interest rate is the market exchange rate between money today and money tomorrow. Further, the tax system should not distort that market, and if a government wants to tax rich people more it should do so by (more) progressive taxation of how much they earn or spend, not by penalising those who choose to defer their consumption. There are also complicated theoretical arguments that suggest that the ideal tax rate on savings might be neither zero nor the same as on earnings, but a different rate entirely.[116] Finally, it should also be noted that savings invested in the corporate sector may face corporation tax, though the effect of interacting personal and corporate taxes is extremely complex to trace through, particularly with international capital markets where companies may be taxed in one jurisdiction (or several) and their shareholders in another.

But in any case, for present purposes we believe we should not, and need not, reach a judgement between taxing savings like earnings or not taxing them at all. Nor should we, or need we, restrict governments to these polar options. The history of the UK tax system provides ample demonstration of how different rates can be applied to earnings and saving:

- Current 20% lower rate, and soon-to-be 10% starting rate, applying to savings income only
- 10% and 32.5% rates on dividends, along with the dividend tax credit system
- Composite rate on building society (and later bank) deposits
- Investment income surcharge
- Earned income relief

[115] But see, for example, Institute for Fiscal Studies (1978), Kay and King (1990), Boadway and Wildasin (1994) and Auerbach (2006).
[116] See Banks, Diamond and Mirrlees (forthcoming).

- Numerous regimes for taxing capital gains, all of which have treated them differently from all other forms of income.

Integration could thus proceed without needing to change the relative taxation of earnings and savings, by, for example, setting a combined basic rate of 31% on earnings but continuing to levy 20% at source on interest-bearing deposits.

The key point is that this form of integration, even if it kept the existing differences between the effective tax rates on earnings and savings, would be highly desirable in its own right. At the moment the relative taxation of earnings and savings is determined opaquely by the combination of Income Tax (rates of which may be different for savings income anyway) and NICs, the relative rates of which are influenced by many other factors. Integration would make it clear that 31% and 20% are the true tax rates, and force the government to defend these rates in open policy debate if they think they are the right levels. On this point, it is also relevant whether a separate employer tax is retained. This would be just another tax on earnings, so the true rate in the example would be higher than 31%, and not as simple as 31% + 12.8% either (as discussed above). And, as noted above, there are also other taxes such as corporation tax to consider. Integration would not be a panacea, suddently making the full nature of tax system visible at a glance; but it would certainly be a step in the right direction.

State benefits raise rather different issues from saving. Taxing benefits merely recycles government spending back to the government: a flat 10% tax on a benefit is equivalent to reducing the rate of benefit by 10%. The choice between these two options, therefore, hinges on the fact that taxes are not flat. A taxable benefit is worth less to those with high marginal tax rates than to those with low marginal tax rates. Making a benefit bigger but taxable is essentially a way to implement a means test, albeit it in quite a restricted way but without needing all the usual machinery of form-filling and income assessment. In any case, for present purposes this is not terribly important. The government should be able to decide whether or not it wants currently taxable state benefits to be subject to an integrated charge, and adjust the benefit rate up or down accordingly. The basis for this decision would presumably be whether it wants the benefit to be subject to the implicit means test.

6. Pension Contributions and Pension Income

Income Tax and NICs treat private pensions very differently:

- neither is charged on investment returns (interest, dividends and capital gains) within pension funds;
- pension income is subject to Income Tax but not NICs; and
- pension contributions are deductible for Income Tax, but not deductible for NICs unless made by employers.

The approach taken for NICs where pension contributions are made by employees and the approach taken for Income Tax are both individually defensible. NICs treats employee pension contributions like any other form of saving: the amount the individual chooses to save is irrelevant to assessed earnings, and savings income is not subject to NICs. On the other hand, Income Tax treats pensions (whether funded by employer or employee contributions) as deferred earnings: the government forgoes taxing the remuneration when it is earned, and instead taxes it as earnings when withdrawn from the shelter of the fund. It is as if the employer and employee agree that, instead of paying the employee when her or she provides his or her services, the employer promises to pay a salary several decades later (along with the investment returns earned in the mean time). Indeed, in the case of defined benefit occupational pensions, which dominated private pension provision until recently, this is almost a literal description of what happens.

The NICs treatment of employer pension contributions is less justifiable. Because contributions do not form part of any employee's assessed earnings when they are paid into the fund, and pension income paid out of the fund is not charged to NICs either, employer pensions contributions are a form of remuneration that escapes NICs altogether. Even when employee benefits in kind were not charged to NICs, this treatment seemed hard to justify as pensions were still cash remuneration, albeit deferred. Now that the attempt is made to tax almost all forms of remuneration, this gaping hole is even more striking.

Most governments want to incentivise pension saving, and they must provide particular incentives to persuade people to save in a form which makes the savings virtually inaccessible for most of their working lives (currently until age 50 in the UK, rising to 55 in 2010, except in special cases) and then forces them to annuitise their accumulated savings (by age 75 in the UK). But the NICs treatment of employer pension contributions is not a sensible way to design pension saving incentives. It is undesirable for the incentive to be so opaque: anecdotal evidence suggests that many people are unaware of this as a major incentive to take remuneration in the form of employer pension contributions; it is undesirable for the strength of the incentive for pension saving to be determined as an accidental side-effect of current NICs rates; and it is undesirable for the incentive to favour employer contributions over employee contributions. Some firms already operate 'salary sacrifice' schemes, whereby employees agree to a reduction in salary in return for the employer's making pension contributions that the employee would otherwise have made, in effect relabelling employee pension contributions as employer contributions in order to reduce NICs liability. Such schemes can benefit both employee and employer if they share the NICs savings, and the fact that such schemes are not more popular is perhaps testament to how little understood this NICs break is. If incentives for pension saving are to be provided beyond the Income Tax and NICs exemption of returns within the fund, such incentives should take a different form.

The only satisfactory long-term solution, therefore, is for remuneration that is paid into pension funds – whether by the employer or the employee – to be subject to each of Income Tax, employee NICs and employer NICs (or any integrated replacement) once, whether that means it is taxed as income at the point it is paid into the fund or taxed as income when it is withdrawn from the fund. At first glance, it might seem obvious what should be done – the government should pick whichever of the Income Tax treatment and the NICs treatment of employee contributions it prefers, and apply that treatment across the board, to both Income Tax and NICs (or an integrated system), and to both employer and employee pension contributions. In practice, however, there are several difficulties with any simple route forward.

Suppose first that the government wished to move entirely to a regime like that currently used for NICs on employee pension contributions, so that contributions would not be deductible from earnings but pension income would be untaxed. For employer pension contributions, this would mean identifying the contribution made in respect of each employee and adding it to their taxable earnings so that contributions would be taxed at the appropriate rate for each individual, their marginal rate of Income Tax-NICs. But in practice this would be very difficult to implement for employer contributions to defined benefit pension scheme, because such contributions are not made in respect of any particular scheme member. The employer simply makes whatever contribution they (and the scheme trustees, on actuarial advice) decide is appropriate to meet the scheme's future liabilities. Instead of trying directly to divide the value of contributions between employees, an alternative approach would be to try to value the additional pension rights each employee has accrued in the relevant period, and subtract any employee contribution to impute the employer contribution. This is the approach already used in company accounts, where directors' total remuneration must be reported. However, in practice such valuations are extremely difficult and laden with assumptions, and it is not clear what should be done when, for example, an employer is contributing to the fund but no new pension rights are being accrued.

Now suppose that the government wished to move entirely to a regime like that used for Income Tax, so that contributions would be deducted from earnings but pension Income Taxed. If there were no employer tax, this might be feasible. But if some form of employer tax were kept, we would have the mirror-image problem to that discussed above. Where an employee contributes to a pension, the system would mean giving a NICs rebate to the relevant employer; however, an employee contributing to a personal pension might have several employers or none, and the government has no way of assigning the rebate to a particular employer. Moreover, there is an even bigger problem because it would be unfeasible to levy an employer tax at the point that pension income is received, for the simple reason that the employer might not exist by the time the pension was in payment. (Indeed, if the employer did exist the directors might be tempted to liquidate the company and re-form it under a different name in order to avoid liability.)

If the government's task were only to ensure that appropriate Income Tax and employee NICs were levied on measurable cash amounts that employees and their employers paid into a pension fund for the individual employee to buy an annuity for retirement (a "defined contribution" scheme), they might just make the choice between including contributions in taxable earnings and excluding contributions but taxing pension income instead. What causes the problems described above is the desire to operate an employer tax and to cope with "defined-benefit" pensions.

Take first the issue of defined-benefit pensions. Consider an employer who rewards his employees, not by paying them extra salary, but by promising to pay them, each year from retirement age until they die, one per cent of whatever the salary they earn in their final year with the firm (a "defined-benefit" pension). Clearly we would wish to tax this remuneration, and there are two ways in which we could do so. We could tax the IOU when it is earned each year by the worker. But valuing the pension promise is extremely difficult, because it depends on the worker's expected future earnings progression, dates of retirement and death, assumed investment returns, and so on. Alternatively, we could forgo taxing the IOU and instead tax the cash payments when they are eventually made. This seems much simpler and more satisfactory, and it suggests that employer-funded defined benefit pensions should be taxed when paid rather than when earned.

Now suppose that the employer changes his offer slightly: instead of promising to pay one hundredth of final salary each year, the employer promises to pay one sixtieth, but only on condition that the employee also contributes £1,000 to the fund from which her pension will eventually come. Unlike with the employer contribution to the fund, the employee contribution could be taxed quite easily: we simply do not deduct the £1,000 from the employee's assessed earnings for the year. But when it comes to taxing the pension income, we could not tax the employer-funded part without taxing the employee-funded part, since it would be impossible to say how much of the pension is attributable to each. So, having decided to tax employer contributions when received rather than when earned, we have little choice but to tax employee contributions likewise. This leads us to a regime that works like Income Tax does now, at least for defined-benefit pensions, and perhaps also (for consistency and simplicity) for defined-contribution pensions.

Now consider the complications that arise if we also wish to levy an employer tax. Whether the pension is defined-contribution or defined-benefit, basing an employer tax on the amount ultimately paid out to the individual now looks unfeasible, for the simple reason that the employer might no longer be in business by then. The nearest alternative would be to take the tax out of pension fund or pension income rather than tax the employer – in effect, replacing the employer tax with an employee tax, but only for earnings deferred until retirement. For defined-contribution pensions, the other side of this regime is also a problem. If we were to charge employer NICs on pension income, we would also need to deduct pension contributions from the earnings on which employer NICs was assessed. However, an employee contributing to a personal pension might have several employers or none, and the government has no way of assigning the rebate to a particular employer.

Might it be possible to levy an employer tax on pension contributions rather than pension income, even while deducting contributions and taxing pension income instead for employee taxes? For defined contribution pensions, this seems feasible. For defined benefit schemes, the difficulty of valuing pension promises still makes taxing the remuneration at the time it is earned look unappealing. But it would be possible if we were prepared to apply a flat rate to all employees (which in the current system means applying the main 12.8% rate to pension contributions even if earnings are below the earnings threshold). We would not need to value the pension promises made to each employee; we could just charge the flat-rate tax on the total contributions made by the employer into the pension fund.

The various difficulties applying to particular taxes on particular types of contribution to particular types of pension scheme are summarised in Table A overleaf. The discussion so far seems to point to the following solutions:

- If employer NICs were abolished altogether, an integrated system could work like Income Tax, with contributions deductible and pension income taxed.

Table A: Income Tax and NIC treatment of pension contributions

		Defined benefit		Defined contribution	
		Employee contribution	Employer contribution	Employee contribution	Employer contribution
On contribution	Employee NICs and income tax		Difficult to tax: contributions “for” particular employees undefined	Difficult to tax unless prepared to give basic/standard-rate relief to non-taxpayers	
	Employer NICs		Difficult to tax unless prepared to tax non-taxpayers: contributions “for” particular employees undefined	Difficult to relieve: need to assign contributions to particular employers	
On withdrawal	Employee NICs and income tax				
	Employer NICs	Difficult to tax: employer might not exist		Difficult to tax: employer might not exist	

Currently subject to income tax

Currently subject to NICs

- If an employer tax were retained, either at a flat rate or with a flat rate applying to earnings paid into pension funds, the employee tax could work as above, while employer tax could be levied on contributions (ie employer contributions would be added to assessed earnings and employee contributions would not be deducted) but not pension income. There appears to be no fully satisfactory solution that allows a tax-free earnings band within employer NICs to apply to pension contributions.

All this, however, has been presented as if setting up a new pension and tax system from scratch tomorrow. A massive issue is transition: the gap between an individual's contributions and her pension income can be several decades, and there are huge numbers of people (in fact most of the population) who have built up pension rights, whose contributions were taxed/exempt under the existing system and were made in expectation of a particular regime for taxing the income.

Consider the second of the bullet-pointed options above. First, levying an employer tax on future pension contributions does not prevent employer contributions made so far from escaping tax altogether. Second, and perhaps more importantly, existing pensioners, and those who have largely built up their pension rights, would unexpectedly face a higher rate of tax on their pension income than they had previously thought, as the equivalent of employer NICs as well as Income Tax is levied on it. This is essentially a windfall tax on pension funds. This does have significant advantages – it raises substantial revenue with very little (if any) distortion to behaviour – but could reasonably be criticised on a number of grounds:

- It is unfair: these people have already paid employee NICs on their contributions, now they have to pay it again on the income coming from the fund, straightforward double taxation. Had they known this reform would happen, they would probably not have saved in this way.

- It hurts many middle-income pensioners for whom it is too late to earn or save more.

The final report of this project will consider this transition issue in more detail, but the scale of the problem should not be understated. A further difficulty with the problems above is the treatment of the self-employed: a system that involved exempting pension contributions and taxing pension income would face the difficulty of how to tax the pension income of individuals who were formerly self-employed (for some or all of their working lives) if we wish to continue taxing the self-employed less heavily than employees (see Section IV.C.4 for discussion of this). This problem does not arise in the current system because we only apply this mechanism to Income Tax, the rates of which are the same for the self-employed as employees, not to NICs.The problems addressed in this section are problems with the current system. It is important to recognise that the case for integration of Income Tax and NI does not rest on this analysis. As with the taxation of savings discussed in the previous section, it would be possible to proceed with integration but to keep the current tax treatment of pensions, unsatisfactory though it is, largely unchanged. This would involve taxing *both* pension contributions *and* pension income, but each at a reduced rate: employee contributions (but not employer contributions) would be taxed at rates equivalent to the current NICs rates, while pension income would be taxed at rates equivalent to the current Income Tax rates. This would be more complicated than the alternative systems described above, though not obviously more complicated than the current system. And as with the taxation of savings, making transparent the hybrid treatment that is implicit in the current system could only help to focus the policy debate.

7. The Young, the Old and the Married

(i) Young People

Whatever a person's earnings, if he or she is under 16 years of age then no Class 1 (primary or secondary), Class 2, or Class 4 NICs are payable (nor is he or she entitled to make the voluntary Class 3 contributions). No such young person's exemption is available for Income Tax, however. One can see the attractiveness of exempting young employees on their earnings from paper routes and babysitting, for example, but of course those earnings would not attract NICs in any event so long as they were below the earnings threshold. The argument for tax breaks on the basis of age alone are weak, but were the taxes to be integrated, the Government could decide whether to exempt under-16s without any great difficulties either way.

(ii) Older People

Older people get preferential treatment for both NI and Income Tax. Individuals over state pension age (65 for men, 60 for women born before 6 April 1950 rising on a sliding scale to 65 for women born after 6 April 1955) are not subject to NICs, although Class 1 secondary contributions are still payable by employers with respect to employees over state pension age, and moreover the employer's contributions are payable at the not-contracted-out rate even if the employer operates a contracted-out pension scheme. On the Income Tax side, individuals between the ages of 65 and 74 are entitled to claim a larger personal allowance of £7,550 and those aged 75 and older can claim £7,690. If income exceeds a certain threshold (£20,900 in 2007–08), then these higher personal allowances are reduced by 50 pence for every pound of income above the threshold, gradually reducing it to a minimum level equal to the allowance for the under-65s.

The merits of preferential treatment of older persons is a thorny issue. Many issues are relevant here: debates on pensions adequacy and on age discrimination (e.g. the need to encourage employment of older workers), the contributory principle (older workers have already 'paid their bit'), and the interaction with the taxation of savings income and especially pensions. The empirical labour supply literature suggests that lower tax rates on older workers may be efficient if their working decisions are more responsive. We do not attempt to resolve all these issues here. But any of the three existing regimes (virtually no recognition for employer NICs, complete exemption for employee NICs, higher allowances for Income Tax) could be applied to a merged tax, albeit with minor complications in some cases (for example, complete exemption is relatively easy to implement for an earnings tax but is more complicated for a merged tax that is to be deducted at source from interest income). One could even construct a hybrid regime that maintains the effect of the status quo (i.e. with both higher allowances and a reduced rate for older workers).

(iii) Married Couples

NICs has operated largely on an individual basis since its inception, with little in the way of special recognition for married couples. The is one notable exception to this is the married women's reduced rate, which allows a reduced rate of 4.85% employee NICs on earnings between the PT and the UEL in exchange for lower benefit entitlement.[117] However, since May 1977 this option has been available only to women who have remained married and working (except for a break of a single tax year) since that date, which is now a very small number.

Income Tax, by contrast, was jointly assessed for married couples for many years: a married woman's income was treated as belonging to her husband for purposes of computing his liability to Income Tax.[118] The 1988 Finance Act introduced independent taxation of married women with effect from 6 April 1990. Some benefits to married taxpayers previously available under the Income Tax system remain, but are gradually being phased out: most notably, the married couple's allowance (described in Section II.A.1(a)). And many other Income Tax and Capital Gains Tax provisions continue to make reference to the taxpayer's spouse (and other relations) in determining the taxpayer's liability.[119] Examples include:

- absent an election, income from jointly-owned property is deemed to arise in equal shares to each spouse,[120]
- for purposes of determining if a company is controlled by a person, the definition of "associate" includes the person's spouse,[121]
- spouses while living together may claim only one main residence exemption for capital gains tax between them,[122] and
- transfers of capital assets between spouses living together generally take place at the amount giving rise to no gain/no loss.[123]

With effect from 5 December 2005, the Civil Partnership Act 2004 extended the treatment of married couples under Income Tax to include registered same-sex couples. Cohabiting couples are not treated as spouses for Income Tax purposes, regardless of the length of time they have been cohabitating or whether the couple have had children together.

The main policy provisions for married couples – the married couple's allowance in Income Tax and the married women's reduced rate in NICs – are gradually disappearing. Integration may provide an opportunity to deal them a death blow, but if desired they could be retained in a merged system. The other provisions for married couples in Income Tax (and Capital Gains Tax) arise because Income Tax, unlike

[117] Self-employed women who would be eligible to pay the reduced rate if employed are not obliged to pay Class 2 contributions.
[118] Then ICTA 1988, s 279.
[119] See Bowler (2007) for a full discussion.
[120] ICTA 1988, ss. 282A and 282B.
[121] TA 1988, ss. 416 and 417.
[122] TCGA 1992, s. 222.
[123] TCGA 1992, s. 58.

NICs, applies to savings: they mostly relate to the need to formulate rules for jointly-owned property or transfers of assets between spouses. If a merged tax were to apply to savings, some such rules would be needed – whether like the current rules or different – but this need not pose a significant barrier to integration.

8. Other Reliefs

Several other reliefs are available for Income Tax but not NICs (or vice versa): examples include blind person's allowance and relief for charitable giving within Income Tax. Applying these reliefs to one charge but not the other is akin to giving partial relief (or applying a reduced rate) in a merged tax. The implication is much the same as for savings and pensions: integration would provide a good opportunity to review whether these reliefs should apply across the board or not at all; but it would also be possible – at the cost of some complexity – to give partial relief, equivalent to the current system, and allow transparent debate as to whether such a reduced rate is really the optimal policy choice.

9. International Issues

The regulations governing the applicability of Income Tax and NICs to individuals seconded to/from the UK, etc, are determined by a combination of UK law, EU law and bilateral treaties, and are somewhat different between Income Tax and NICs. This poses potential difficulties for a merged tax. For individuals who would currently be liable for one charge but not the other, a dilemma arises: under an integrated system, should they be liable for the full tax, no tax, or a special schedule designed to mimic being subject to only one of the current taxes? None of these seems very satisfactory. It would clearly be preferable to align the rules in the existing system as far as possible to eliminate such cases. However, it is not clear how far the UK could pursue this unilaterally. The final report of this project will examine these questions in more detail. However, it is worth remarking that Australia and New Zealand, neither of which has a separate social security tax like NICs, seem to have found satisfactory solutions to this problem (albeit not in an EU context), suggesting that it may not be insurmountable.

The second international issue that arises is one already dealt with in Section IV.A: the need to find some replacement for contributory conditions, if those are abolished, to restrict access to benefits and prevent internationally mobile individuals from taking advantage of the UK's generosity. Once again, Australia and New Zealand appear to have managed this: both use years of residence to determine eligibility for benefits.

D. PROCEDURAL DIFFERENCES

A good example of how the Income Tax and NI systems operate differently on a procedural and administrative level, even many years after the merger of the Inland Revenue and Contributions Agency, is the handling of underpayments of tax and NICs. For Income Tax, generally the employer has to pay any underpayment of tax resulting from a mistake in PAYE deduction. However, a direction can be made for the employee to pay an underpayment if HMRC is satisfied that the employer took reasonable care and that the underpayment arose from an error made in good faith.[124] For NICs the general rule is the same as for Income Tax – the employer is responsible for any underpayment. However, employers are entitled to recover the underpayment from the employee by making extra deductions from future payments to the employee in the tax year in which the mistake arose, and (so long as the error was made in good faith) the following tax year. The extra amount that can be deducted each payment is limited to the normal amount of employee NIC due on the payment.[125] If this limit means that the employer is unable to recover the full amount of the underpayment by the end of the second tax year then the employer must pay the balance.

Whitehouse (2005) provides examples of two additional procedural differences between NICs and Income Tax. First, since NICs are formally neither a tax nor a duty, proceedings for recovery of unpaid NICs are subject to the Limitations Act 1980, while collection proceedings for unpaid Income Tax are not.[126] As a result, HMRC must either ask taxpayers to sign 'acknowledgements of debt' or commence protective County Court proceedings with the six-year period, or else risk the NICs debt becoming statute barred. There does not appear to be any logical justification for treating the collection of NICs and Income Tax debts differently in this respect. Second, although Whitehouse notes that the procedure for appealing NICs decisions is sensibly aligned with Income Tax appeals, Regulation 7A of the Special Commissioners (Jurisdiction and Procedure) Regulations permits the Presiding Special Commissioner to deal with appeals by adopting a "lead case" arrangement (analogous to a group litigation order in the High Court), and this rule applies only to NICs appeals, not to Income Tax). As Whitehouse concludes, it is odd that Regulation 7A would appear not to allow an appeal raising, for example, a PAYE issue to be dealt with under the lead case arrangements that may be in place to deal with NIC issues, particularly given that the issues may involve consideration of largely the same point.

[124] HMRC Booklet CWG2, 'Employer's Further Guide to PAYE and NICs' (2006) p 17, available online at http://www.hmrc.gov.uk/guidance/cwg2.pdf.
[125] Ibid.
[126] The Limitation Act does not apply to proceedings for recovery by the Crown of "tax or duty or interest on any tax or duty" (s 37(2)). The fact that NICs are not formally a tax also means that NICs are not subject to the normal Finance Bill procedures, so that (for example) National Insurance reforms are not subject to the Parliamentary convention preventing the House of Lords voting on financial measures.

V. CONCLUSIONS

This paper has highlighted both the potential benefits from integrating Income Tax and National Insurance and the differences that remain between Income Tax and NI making integration more difficult. In most cases, these differences do not seem to form prohibitive barriers to integration. Indeed, in many cases the existing differences could be retained as features of a merged tax: reduced rates of tax on particular forms of income, for example, or benefit entitlements based on tax paid on earnings only. Keeping many such features would make a merged tax far more complicated, however, to the point where the benefits of integration become rather doubtful. Yet in many cases integration could facilitate bold policy options that would be welcome in their own right as well as allowing for a simpler merged tax. Substantive reform would entail significant transition costs, and we postpone to the final report making recommendations as to what kind of reform (if any) would justify this upheaval.

REFERENCES

Adam, S. and H. Reed (2003), "Income Tax and National Insurance Contributions", in R. Chote, C. Emmerson and H. Simpson (eds.), The IFS Green Budget: January 2003, Commentary 92, London: Institute for Fiscal Studies.

Auerbach. A. (2006), "The Future of Capital Income Taxation", Fiscal Studies 27(4) 399-420.

Bailey, S. J. (2001), Public Sector Economics: Theory, policy and practice, Basingstoke: Palgrave Macmillan.

Banks, Diamond and Mirrlees (forthcoming), "The Base for Direct Taxation", chapter in the Mirrlees Review.

Bennett, F. (1993), Social Insurance – Reform or Abolition? Commission on Social Justice, IPPR.

Bennyworth, Rebecca (2005), "Employers and Tax Credits – The End of the Story – Almost" Accountingweb.com, 21 Nov 2005.

Better Regulation Task Force (2000), Payroll Review, Cabinet Office.

Beveridge, W. H. (1942), Social Insurance and Allied Services, Cmnd. 5404, London: HMSO.

Boadway, R. and D. Wildasin (1994), "Taxation and Savings: a survey", Fiscal Studies 15(3) 19-63.

Bowler. T. (2007), Taxation of the Family, IFS Tax Law Review Committee Discussion Paper No. 6, London: Institute for Fiscal Studies.

British Chambers of Commerce (2004), A New Tax Horizon: How to simplify Britain's payroll tax system, British Chambers of Commerce.

Centre for Fiscal Studies University of Bath (1998), The Tax Compliance Costs for Employers of PAYE and National Insurance in 1995-96, Inland Revenue Economics Papers No.3.

Chartered Institute of Taxation (1998), Report on Tax/NICs Harmonisation.

Carter, P. (2001), Review of Payroll Services, Inland Revenue.

Clasen, J. (2001), "Social Insurance and the Contributory Principle: A paradox in contemporary British social policy", Social Policy and Administration 35(6) 641-657.

Creedy, J. and R. Disney (1985), Social Insurance in Transition: An Economic Analysis, Oxford: Oxford University Press.

Davis, E.H.. and A.W. Dilnot (1985), "The Restructuring of National Insurance Contributions in the 1985 Budget" Fiscal Studies, 6(2) 52-60.

Department of Social Security (1993), Deregulation Review: Report of the Tax/NICs working group.

Dilnot, A.W. (1995), "Integrating Tax and Social Security" in C. Sandford (ed.) More key issues in tax reform, Trowbridge: Redwood Books.

Dilnot, A.W., J.A. Kay and C. N. Morris (1984), The Reform of Social Security, Oxford: Oxford University Press.

Dilnot, A. and S.Webb (1988), "Reforming National Insurance Contributions" Fiscal Studies, 9(4) 1-24.

Dilnot, A. and S.Webb (1989), "Reforming National Insurance Contributions: a Progress Report" Fiscal Studies, 10(2) 39-47.

Freedman, J. (2001), Employed or Self-Employed? Tax classification of workers and the changing labour market, Tax Law Review Committee Discussion Paper No. 1, London: Institute for Fiscal Studies.

Freedman, J. (2000) "Limited Liability: Large Company Theory and Small Firms" 63 Modern Law Review 317.

Freedman, J. and E. Chamberlain (1997), "Horizontal Equity and the Taxation of Employed and Self-Employed Workers", Fiscal Studies 18(1) 87-118.

Grier, D.A. (2002), "Integrating the Tax Burden of the Federal Income and Payroll Taxes on Labor Income" Virginia Tax Review, 22(1).

Hills, J. (2003), Inclusion or Insurance? National Insurance and the future of the contributory principle, Centre for Analysis of Social Exclusion Paper 68.

HMRC (2005), Tax Bulletin 79.

HMSO (1986), The Reform of Personal Taxation, Green Paper, Cmnd 9756, London: HMSO.

HM Treasury (2006), Financial Statement and Budget Report, London: HMSO. Available at www.hm-treasury.gov.uk/budget/budget_06/bud_bud06_index.cfm.

HM Treasury (2007a), Pre-Budget Report and Comprehensive Spending Review, Cm 7227, London: HMSO. Available at http://www.hm-treasury.gov.uk/pbr_csr/report/pbr_csr07_repindex.cfm.

HM Treasury (2007b), Income Tax and National Insurance Alignment: An Evidence-Based Assessment, London: HMSO. Available at http://www.hm-treasury.gov.uk/media/B/B/pbr_csr07_incometax713.pdf

HM Treasury (2007c), Tax ready reckoner and tax reliefs. Available at http://www.hm-treasury.gov.uk/media/1/F/pbr_csr07_taxreadyreckoner.pdf

House of Commons Social Security Committee (2000), The Contributory Principle, Fifth Report, 1999–00, London: HMSO.

Inland Revenue (2000), Simplifying National Insurance Contributions for Employers: A technical discussion paper, Inland Revenue.

Institute for Fiscal Studies (1978), The Structure and Reform of Direct Taxation: Report of a committee chaired by Professor J.E. Meade, London: Allen and Unwin.

James, S. and C. Nobes (2004), The Economics of Taxation: Principles, policy and practice, 7th edition, Harlow: Prentice Hall.

Johnson and Stears (1996), “Should the Basic State Pension be a Contributory Benefit?”, Fiscal Studies 17(1) 105-112.

Kay, J.A. and M.A. King (1990), The British Tax System, 5th edition, Oxford: Oxford University Press.

Keynes, J.M. (1923), A Tract on Monetary Reform, London: Macmillan.

Library of House of Commons research paper 02/32, The National Insurance Contributions Bill.

Liebman, J.B. (2002), “Should Taxes Be Based on Lifetime Income? Vickrey Taxation revisited”, mimeo.

National Association of Pension Funds (2005), “Towards a Citizen’s Pension – Final Report”.

National Audit Office (NAO), “HMRC: Filing of Income Tax Self Assessment Returns” Report by the Comptroller and Auditor General, June 2005.

Redston, A (2006), ‘Mobile telephones and computers—section 60 and 61’ British Tax Review 544.

Skinner, D. and M. Robson (1992), “National Insurance Contributions: Anomalies and reforms”, Fiscal Studies 13(3) 112-125.

Stafford, B. (1998), National Insurance and the Contributory Principle, Department of Social Security In-House Report No. 39, London: Corporate Document Services.

Symons, E. and I. Walker (1986), “The Reform of Personal Taxation: A Brief Analysis” Fiscal Studies 7(2), 38-47.

Taylor, M. (1998) Work Incentives: A report by Martin Taylor, The Modernisation of Britain’s Tax and Benefit System No. 2, HM Treasury.

Tax Reform Commission (2006), Tax Matters: Reforming the Tax System, available at http://www.taxreformcommission.com

Tiley & Collison (2007), UK Tax Guide 2007–08, London: LexisNexis Butterworths.

Tolley’s (2005), National Insurance Contributions 2005-06.

Vickrey, W. (1939), “Averaging of Income for Income Tax Purposes”, Journal of Political Economy 47 379-397.

Whitehouse, M (2005), “Transfer of Functions” The Tax Journal 30 May 2005, pp.15-16.

Whiting, J. (2005), “Tips and Troncs: Indigestion for the Revenue?” The Tax Journal 7 March 2005.

Williams, D. (1978), “National Insurance Contributions – A Second Income Tax” British Tax Review, 84-98.