

## 5. Income tax and National Insurance contributions

The Labour manifesto for the 2001 general election promised that ‘we will not raise the basic or top rates of income tax in the next Parliament’.<sup>1</sup> This pledge featured heavily in the party’s successful re-election campaign (and, indeed, the previous election campaign of 1997). However, the government refused to rule out increases in other taxes if re-elected, and in his first Budget Speech of the new parliament in April 2002, Chancellor Gordon Brown announced that National Insurance contributions (NICs) for employees, employers and the self-employed would go up with effect from April 2003.

The government estimates that the National Insurance (NI) increases will raise around £8.2 billion in 2003–04.<sup>2</sup> The Chancellor stated that the increases were necessary to fund the increases in NHS spending also announced in the April 2002 Budget. But increases in NICs of this magnitude, when set against the commitment not to raise income tax, raise several questions. Why did the government feel it necessary to make a pledge on income tax but not on NI? What is the justification for having NI as a separate tax from income tax? Have the two taxes become more alike? And how might the two systems develop in future?

In this chapter, we start by briefly discussing the historical relationship between NI and income tax. We then compare and contrast the current income tax system with the current NI regime and look at the distributional effects of the changes scheduled for April 2003. We finish by assessing what further reforms of the NI and income tax systems might be likely, and what might be economically desirable.

### 5.1 Income tax and National Insurance: a history of convergence

Income tax and National Insurance contributions have traditionally played quite separate roles in the tax system. Income tax was introduced in 1799 to raise revenue for general government expenditure. The present structure of the income tax system came into being in 1973: taxpayers have a tax-free personal allowance, and income above this level is taxed at progressively higher rates. In contrast, National Insurance started life in 1948 as a social insurance scheme based on the ‘contributory principle’ – that benefits received should

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<sup>1</sup> Page 10 of Labour Party, *Ambitions for Britain* (Labour’s manifesto 2001), London, 2001 ([www.labour.org.uk/ENG1.pdf](http://www.labour.org.uk/ENG1.pdf)).

<sup>2</sup> Source: authors’ calculations from HM Treasury, *Financial Statement and Budget Report*, HC592, Stationery Office, London, 2002 ([www.hm-treasury.gov.uk/budget/bud\\_index.cfm](http://www.hm-treasury.gov.uk/budget/bud_index.cfm)) and HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, London, 2002 ([www.hm-treasury.gov.uk/mediastore/otherfiles/adtrr02.pdf](http://www.hm-treasury.gov.uk/mediastore/otherfiles/adtrr02.pdf)).

reflect contributions paid. Workers and their employers paid contributions at a flat rate, independent of earnings, in return for entitlement to various flat-rate benefits. 1961 saw a major change as NICs became earnings-related for the first time. Since benefits received bore little relation to previous earnings, this constituted a weakening of the contributory principle and made NICs more like income tax. Since then, the two systems have moved closer together in many more ways – largely through reforms that have made NI operate more like income tax. Under the current system, NICs are levied as a percentage of employees' earnings and employers' labour costs above a lower weekly earnings limit. Box 5.1 gives an explanation of the jargon associated with the two systems.

**Box 5.1. A glossary of income tax and National Insurance terms**

The *personal allowance* is the income on which no income tax is paid. In 2003–04, it will be £4,615 per year, or £89 per week (higher for those aged 65 or over). Income immediately above this is taxed at the *starting rate*, currently 10%.

The *basic-rate threshold* is the level of taxable income (i.e. income above the personal allowance) at which the 10% rate stops and the *basic rate* of tax, currently 22%, starts to be paid. The threshold for 2003–04 will be announced in the next Budget, but the 'default' increase (in line with inflation) would set it at £1,960 per year, so that those with incomes above £6,575 per year, or £126 per week, would pay basic-rate tax.

Similarly, the *higher-rate threshold* is the level of taxable income at which the 40% *higher rate* of tax becomes payable. Default indexation would take the higher-rate threshold to around £30,500 in 2003–04; higher-rate taxpayers would be those with incomes above £35,115 per year, or £675 per week.

The *lower earnings limit (LEL)* is the level of earnings – £77 per week in 2003–04 – at which employees build up entitlement to NI (contributory) benefits. Employees do not actually start paying contributions, however, until the *primary threshold (PT)* is reached; employer contributions begin at the *secondary threshold (ST)* and self-employed contributions at the *lower profits limit (LPL)*. At the moment, the PT, ST and LPL are all equal to the income tax personal allowance, i.e. £89 per week in 2003–04.

Until April 2003, the *upper earnings limit (UEL)* and *upper profits limit (UPL)*, both £595 per week in 2003–04, are the level of earnings at which employees and the self-employed respectively stop paying contributions (employer contributions have no limit). From April 2003, however, contributions of 1% will be payable above the UEL and UPL.

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 2000.<sup>3</sup>

- 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<sup>4</sup> in 1999 (for employer contributions) and 2001 (for employee contributions).
- 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.
- The tax rates levied on the majority of taxpayers under the two systems have moved closer together. The basic rate of income tax has decreased from 33% in 1979 to 22% in 2002–03. Meanwhile, the rate of employee NICs rose from 6.5% to 10% between 1979 and 2002; it will rise to 11% in 2003. The standard rate of employer NICs rose from 10% to 11.8% between 1979 and 2002; it will rise to 12.8% in 2003.<sup>5</sup>
- The treatments of those with higher incomes have also become more similar. Before 1985, NICs were not payable on earnings above the weekly upper earnings limit. This was in contrast to income tax, where there was (and is) no such upper limit. However, the UEL on employer NICs was removed in 1985. For employee NICs, the UEL is still in place, but the additional 1 percentage point on employee NICs from April 2003 will apply to earnings above the UEL as well as earnings below it. 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. Not only are contributions increasingly earnings-related, as discussed above, but also benefits are increasingly related to current circumstances rather than past contributions. Most of the main benefits and tax credits are non-contributory, relying instead on means testing (e.g. housing benefit, working families' tax credit, income support and the minimum income guarantee), and their generosity has increased in recent years. Contributory benefits such as the basic state pension and contributory jobseeker's allowance, on the other hand, have mostly been frozen in real terms since the 1980s. Expenditure on contributory benefits has therefore fallen as a proportion of total government benefit (and tax credit) expenditure, from a

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<sup>3</sup> The introduction of the children's tax credit in 2001 reintroduced some joint assessment into the income tax system. The married couple's allowance still exists for people born before 6 April 1935.

<sup>4</sup> By 'weekly level', we mean the weekly equivalent, for someone working throughout the year, of the level of the annual income tax personal allowance.

<sup>5</sup> The employer and employee contribution rates given here apply to individuals contracted into the State Second Pension (S2P).

high of 76% in 1965–66 to an estimated 45% in 2003–04.<sup>6</sup> Furthermore, some so-called ‘contributory’ benefits can now be received by people who have not actually paid contributions: for example, since 1999, people with earnings between the LEL and the PT receive benefit entitlements despite not paying contributions; and since 2001, incapacity benefit has been available to non-contributors if they have been unable to work from a young age. Conversely, some ‘contributory’ benefits are not available to people who have contributed (since 2001, for example, incapacity benefit has been means-tested against an individual’s private pension income).

Taken as a whole, the changes to NICs and the income tax system detailed above have made the two systems much more similar. Nonetheless, there remain substantial differences between the two systems. In the next section, we look at these differences and examine what the combined structure means for effective marginal tax rates. We also take a detailed look at the distributional effect of the recently announced NI increases.

## 5.2 The system from April 2003

Despite the convergence of income tax and NICs over the years, there remain differences between them. The most obvious difference is in the rates and thresholds, shown in Table 5.1 (Box 5.2 lists the reforms announced in the 2002 Budget that take effect in April 2003). Both income tax and NICs become payable at the same level – £89 per week, or £4,615 per year – but while income tax has increasing marginal rates, the rate of NICs falls at higher levels of earnings.

**Table 5.1. Rates of income tax and National Insurance contributions, 2003–04**

Income tax <sup>a</sup>		National Insurance contributions			
Weekly income <sup>b</sup>	Tax rate (%)	Weekly earnings	Employee rate (%)	Employer rate (%)	Self-employed rate (%) <sup>c</sup>
£0–£89 <sup>d</sup>	0	£0–£89	0	0	0
£89–£126 <sup>e</sup>	10	£89–£595	11 <sup>f</sup>	12.8 <sup>f</sup>	8
£126–£675 <sup>e</sup>	22	£595–	1	12.8	1
£675– <sup>e</sup>	40				

<sup>a</sup> Gross of tax credits.

<sup>b</sup> Income tax is an annually-based system; this table therefore assumes year-round work.

<sup>c</sup> The self-employed also pay flat-rate contributions of £2 per week if their profits exceed £79.

<sup>d</sup> A higher tax-free allowance applies for those aged 65 or over with all thresholds moved up correspondingly; the extra allowance is tapered away at higher income levels.

<sup>e</sup> Assumes 1.7% indexation of basic- and higher-rate income tax thresholds and statutory rounding.

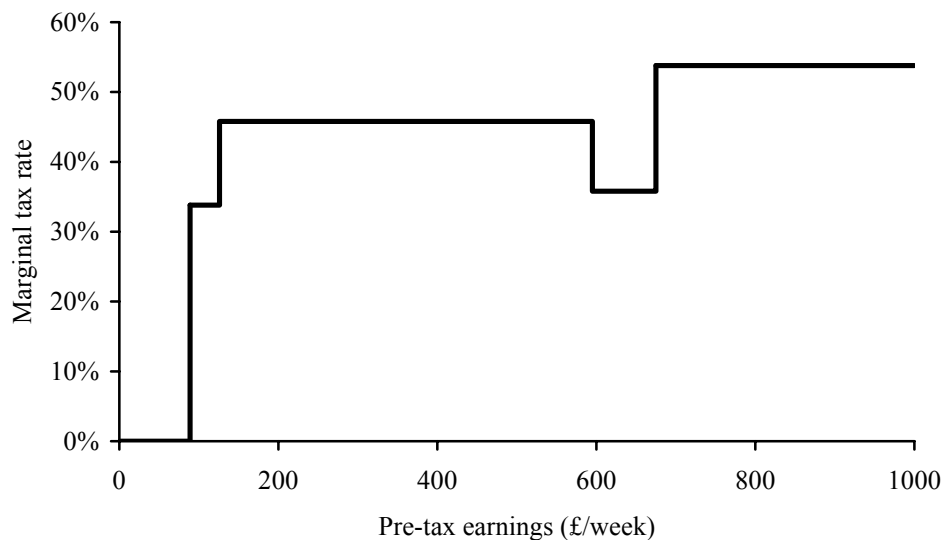
<sup>f</sup> If an employee is contracted out of the State Second Pension, a reduced rate applies.

<sup>6</sup> Source: authors’ calculations from Department for Work and Pensions, ‘Benefit Expenditure Tables’ ([www.dwp.gov.uk/asd/asd4/expenditure.htm](http://www.dwp.gov.uk/asd/asd4/expenditure.htm)).

**Box 5.2. Reforms to income tax and National Insurance contributions taking effect in April 2003**

- The employer rate of NICs will rise by 1 percentage point.
- The employee rate of NICs will rise by 1 percentage point. This increase will extend to earnings above the UEL, which were not previously subject to employee NICs.
- The self-employed rate of NICs will rise by 1 percentage point. This increase will extend to profits above the UPL, which were not previously subject to NICs.
- The PT, ST and UPL – the level at which NICs start to be paid – will be frozen at £89 per week, and so fall in real terms.
- The income tax personal allowance will be frozen at £4,615 in 2003–04, and so fall in real terms.

**Figure 5.1. Combined payroll tax schedule, 2003–04**



Notes: Assumes 1.7% indexation of basic- and higher-rate income tax thresholds and statutory rounding. Rates shown are for a childless employee under 60 years old, not contracted out of the State Second Pension, with no unearned income.

In so far as the main difference between income tax and NICs is the rate structure, we can simply add up the rates at different earnings levels to find a combined ‘payroll tax’ schedule; this is done in Figure 5.1, which combines income tax, employer NICs and employee NICs.<sup>7</sup>

<sup>7</sup> For Figure 5.1 and what follows, we assume that employees bear the full burden of both employee and employer NICs. The justification for this assumption is discussed in detail in Chapter 9.

Yet this is not quite the whole story: other differences remain. One is that income tax is assessed on an annual basis whereas NI is a weekly system. This may be important for people working less than a full year.

Another difference is the treatment of the self-employed. Earnings from self-employment are treated like any other earnings for income tax purposes. NICs, however, are much lower for the self-employed, as Table 5.1 shows: the contribution rate is lower than for employees, and there is no equivalent to the employer element. The self-employed do pay an additional flat-rate contribution of £2 per week and also have reduced benefit entitlement. But even after accounting for that, the government calculates that, in 2001–02, NI for the self-employed raised £2.4 billion less than it would have done had the Class 1 (employer/employee) system applied.<sup>8</sup>

The final difference between income tax and NICs is the tax base: NICs are a tax on earnings, income tax a tax on income. Income tax, then, has a broader base: it is payable on unearned income. The biggest single source of unearned income is pension income, but it also includes property income, interest from bank accounts, share dividends and many state benefits. These are subject to income tax but not to NICs.<sup>9</sup>

Figure 5.1, then, is not a complete representation of income taxation for anyone with unearned or self-employment income: the combined tax rates for these will be lower, since less (or no) NICs are paid. Despite these differences, income tax and NICs are now quite similar. By way of illustration, Figure 5.2 shows the distributional impact of the changes to NICs announced in the 2002 Budget – a freeze in the threshold at which NICs start to be paid, and an extra 1 percentage point on contributions for employers, employees and the self-employed (including on earnings above the UEL and UPL). Also shown is the impact of an equivalent change to income tax – a freeze in the personal allowance and an extra 2 percentage points on the lower, basic and higher rates.

As Figure 5.2 shows, the impacts of these two sets of reforms are similar, although not identical. The income tax rise would cost families more throughout the income distribution – we estimate that it would raise around £1.7 billion more than the reforms to NICs. The main reason is the taxation of unearned income – most of the extra revenue would come from people with higher incomes (and the richest tenth in particular), who not only have more unearned income but also pay tax on it at a higher rate.<sup>10</sup>

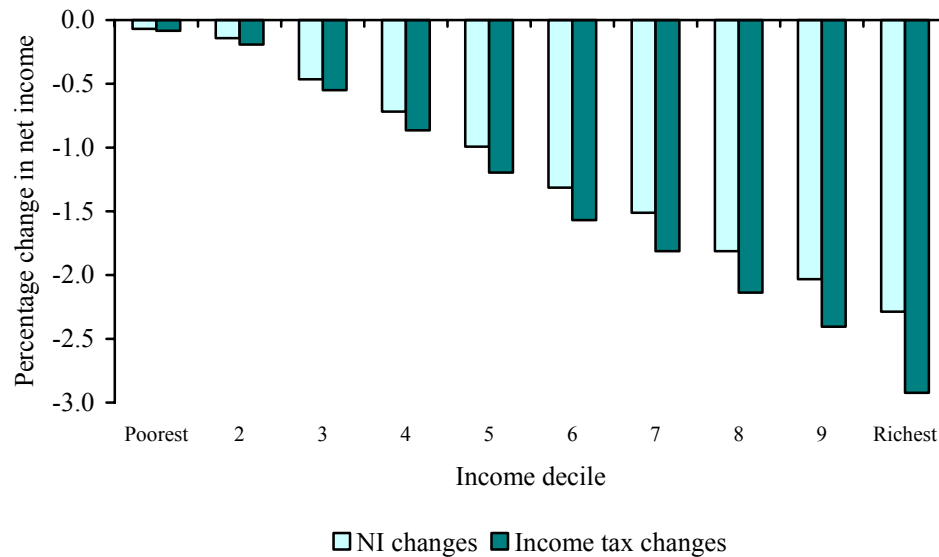
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<sup>8</sup> Source: HM Treasury, *Financial Statement and Budget Report*, HC592, Stationery Office, London, 2002 ([www.hm-treasury.gov.uk/budget/bud\\_index.cfm](http://www.hm-treasury.gov.uk/budget/bud_index.cfm)).

<sup>9</sup> The two systems also differ in their treatment of pension contributions: NICs are not paid on employers' pension contributions but are on individuals'; income tax, by contrast, is not paid on any contributions.

<sup>10</sup> Unearned income of higher-rate taxpayers is taxed at the higher rate. Basic-rate taxpayers, however, pay tax on their income from *savings* at a slightly reduced rate of 20%; we also increase this rate by 2 percentage points for this simulation, though it does not make a large difference to the overall results.

**Figure 5.2. Losses across the income distribution from National Insurance changes announced in the 2002 Budget, and from a package of similar changes to income tax**



Notes: Income deciles are derived by dividing all families into 10 equally sized groups according to income adjusted for family size using the McClements equivalence scale. Decile 1 contains the poorest tenth of the population, decile 2 the second poorest and so on, up to decile 10, which contains the richest tenth.

Source: IFS tax and benefit model, TAXBEN, run using data from the Family Resources Survey 2000–01.

The income tax reforms would also raise more money because of the different treatment of the self-employed. The self-employed will see a 1 percentage point rise in NICs, whereas they would have faced a 2 percentage point rise in their income tax rates had that option been chosen. Employees, by contrast, are affected by both the rise in the employee rate and the rise in the employer rate, and so pay 2 percentage points more in either case. The self-employed are disproportionately represented in the top income decile, which also helps explain why the income tax increase falls more heavily on the top decile than does the NI increase.

### 5.3 Options for further reform

As discussed in Chapter 3, the government may feel it has to raise taxes further in due course to strengthen the public finances. If it chooses to do this by raising payroll taxes, there are a number of routes it could take.<sup>11</sup>

One obvious option is a straightforward increase in NI rates of the kind announced in the 2002 Budget. The distributional impact of such a rise would

<sup>11</sup> It should be noted that changes to NI could not take effect immediately – a result of its weekly structure. Changes could, however, be pre-announced, as they were in the 2002 Budget.

be similar to that shown in Figure 5.2. An uncapped 1 percentage point rise in employee NI would raise about £3.8 billion.<sup>12</sup> The innovation in the last Budget of levying 1% employee NICs on earnings above the UEL also creates a precedent: there is ample scope for increases in this new ‘additional rate’ of NICs. A 1 percentage point increase above the UEL (and UPL) alone would raise around £0.8 billion, with the burden of the increase falling mainly on families in the top income decile. Abolishing the UEL (and UPL) altogether would be roughly equivalent to a 10 percentage point increase in the ‘additional’ rate, and would raise around £8.3 billion.<sup>13</sup>

Rises in income tax rates seem much less likely, primarily because of Labour’s manifesto pledge not to raise the basic or higher rates. The government could still raise money through income tax, however, by freezing or even reducing tax allowances and thresholds.

The 2002 Budget froze the personal allowance, and also the PT and ST to keep them all aligned in 2003–04. The Chancellor might plausibly do this again in 2004–05, raising about £0.8 billion. Most of the revenue would come from higher earners (since income tax allowances reduce the amount of income taxed at the highest rate paid by each taxpayer), but middle-income families would lose most as a proportion of income.

Reducing the basic-rate threshold seems unlikely because of a manifesto pledge that ‘we will extend the 10p tax band’.<sup>14</sup> That leaves the higher-rate threshold and the National Insurance UEL. At present, the higher-rate threshold is higher than the UEL. This causes a dip in the effective tax rate for income between £595 and £675 per week (as shown in Figure 5.1) for which it is hard to find an economic rationale. Aligning the UEL and the higher-rate threshold would correct this anomaly, and would be consistent with previous changes (such as the alignment of the NI thresholds with the income tax personal allowance). Indeed, the Chancellor moved in this direction by increasing the UEL by more than inflation in both April 2000 and April 2001, thus reducing the gap to the higher-rate threshold.

An alignment could be achieved either by raising the UEL to match the higher-rate threshold (so that income currently between the two would be subject to ‘standard’ NICs and basic-rate income tax, like the income below it) or by lowering the higher-rate threshold to match the UEL (so that income currently between the two would be subject to ‘additional’ NICs and higher-rate income tax, like the income above it). Either reform would be extremely progressive – the richest 10 per cent would provide two-thirds of the revenue, while the bottom half of the income distribution would be virtually unaffected – but they would raise very different amounts of revenue: increasing the UEL

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<sup>12</sup> A 1 percentage point rise in employer NI would raise slightly more – about £4 billion – because, unlike employee NI, it is payable in respect of employees who are at or above the state pension age.

<sup>13</sup> We assume that the UEL would be maintained (at its current level) in its role as a cap on the band of income where the contracted-out rebate applies, as it has been for employer NICs.

<sup>14</sup> Page 10 of Labour Party, *Ambitions for Britain* (Labour’s manifesto 2001), London, 2001 ([www.labour.org.uk/ENGL.pdf](http://www.labour.org.uk/ENGL.pdf)).



to the higher-rate threshold would raise around £1 billion, while reducing the higher-rate threshold to the UEL would raise a little over £2 billion.

The increasing similarity of income tax and NICs outlined in this chapter makes this discussion of future changes look rather strange from an economic perspective. Why, if the two are so similar, are increases in NICs widely perceived as more likely than increases in income tax? One answer is that Labour has a manifesto commitment not to raise income tax but no such commitment in respect of NICs. But that is, at best, a partial answer: why did Labour feel impelled to make a pledge in respect of one but not the other?

Clearly, the government either perceives the two taxes differently or thinks that the public perceives them differently. From a purely economic perspective, it makes little sense to be implacably opposed to a percentage point increase in the basic and higher rates of income tax, but at the same time to have no objection to a National Insurance increase with similar effects over most of the income distribution. The trend towards increased levels of NICs coupled with lower rates of income tax began almost thirty years ago and shows no sign of abating. What this demonstrates is that a pledge by the government or the opposition not to increase basic- or higher-rate income tax means very little in economic terms, as without a pledge not to increase NICs either, there is no barrier to the *overall* level of taxation on earnings increasing in the future.

On economic grounds, it would seem sensible in many ways to aim towards a complete integration of the income tax and NI systems. This would offer the advantages of transparency and administrative efficiency with few apparent drawbacks. The original rationale for separate systems – the ‘contributory principle’ underlying the NI system – is all but obsolete. There is no reason to suppose that the slow death of the contributory principle will reverse, or even halt, in the near future. For example, the basic state pension (easily the biggest contributory benefit) is set to increase in line with prices, whereas the government’s stated long-term aspiration is to increase the non-contributory minimum income guarantee (MIG) for those aged 60 or over in line with earnings. That means the basic state pension is due to become less important relative to the MIG, and contributions records will gradually become less relevant in determining the amount of benefits received by those aged 60 or over.

Nor do the other remaining differences between income tax and NI provide a strong justification for maintaining separate systems. Lower rates of taxation on unearned income and on self-employment income create a distortion in favour of these income sources, which is probably undesirable. Yet even if the government wishes to retain either or both of these anomalies, it would still be possible to do so within the income tax system (to have a lower rate of tax on pension income, for example). If the government believes that payroll taxes have different effects depending on whether they are levied on the employer or the employee, another option would be to integrate employee NI with income tax, leaving NI as a pure employer tax.

Given these arguments, the barrier to full integration of the two systems seems primarily political. Governments appear to believe that raising NICs is likely to be less costly to them in votes than raising income tax. It will be interesting

to see if the high-profile increases in NICs due to take effect in April change this political calculus. If they do not, full integration of NI and income tax remains much less likely than further gradual alignment, with equalisation of the UEL and higher-rate threshold perhaps the obvious next step.

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