TAX
FACULTY

Income Tax and NIC – four options: a hard choice

BRIEFING PAPER

TOWARDS A BETTER TAX SYSTEM INITIATIVE

TOWARDS A BETTER TAX SYSTEM

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Contents

FOREWORD	1
UNDERSTANDING THE LANDSCAPE	2
ATTEMPTS TO MERGE INCOME TAX AND NIC	4
WHAT SHOULD BE DONE?	5
MERGE: A FULL-SCALE MERGER	6
MANAGE: IMPROVE THE CURRENT POSITION	7
DEMERGE: SHOULD NIC RETURN TO ITS ROOTS?	8
MAKE DO: DOES THIS MATTER?	9
INITIAL CONCLUSIONS	10
APPENDIX 1: HISTORY OF NIC AND INCOME TAX	11
APPENDIX 2: NATIONAL INSURANCE FUND ESTIMATED ACCOUNTS 2015/16	14
APPENDIX 3: TAX AND SOCIAL SECURITY ARRANGEMENTS IN OTHER COUNTRIES	16

Foreword

This briefing paper has been produced by the ICAEW Tax Faculty in response to numerous calls that UK Income Tax and National Insurance Contributions (NIC) should be merged. In the paper we consider the reasons why this suggestion has been made and the advantages and disadvantages of such a merger.

Any merger raises many difficult questions and challenges that would need to be addressed and would have potentially far-reaching consequences for taxpayers and for government. However, this leads to a far larger issue: the future of National Insurance itself. As this impacts all of us, ICAEW wants to create a dialogue to discuss it. We will engage with interested parties from all walks of society through a series of discussions to deliberate the issue and consider possible futures.

This briefing note has been written for non-specialists to enable them to take part in our discussions and also to create a common framework for dialogue. We hope that people will find the paper informative and thought provoking and will want to contribute to our discussions.

Understanding the landscape

HOW DID WE GET TO WHERE WE ARE TODAY?

It is first important to understand how two very different payroll deduction systems, which were designed to achieve very different purposes, have become so closely linked that a merger has been suggested as the way forward.

A history of both Income Tax and NIC since 1939 is set out in appendix 1. What this shows is that Income Tax is a 'hot potato', attracting close political, public and media attention. In the last 30 years, though the headline rates of Income Tax have never been increased they have been reduced a number of times. That said, Income Tax receipts remain the single largest source of government revenue and the effect of fiscal drag has meant that more taxpayers are being drawn into the higher rates of tax.

The same cannot be said of NIC. This started life not as a tax but as a state insurance system for employees, where flat-rate contributions bought entitlement to certain flat-rate benefits. Probably as a result of this origin, NIC has enjoyed a semi-visible persona which has historically resulted in very little political debate or controversy. This difference in perception has allowed successive governments to use NIC as a mechanism for raising overall revenues by stealth: overtly raising NIC in preference to Income Tax while steadily amending the links between contributions and entitlements. However, in an age of austerity, tightening budgets and increased transparency, we do not think this is a sustainable position in the long term.

HOW MUCH DO INCOME TAX AND NIC RAISE?

Any debate about a merger of Income Tax and NIC needs to be framed in terms of the amounts they contribute to government receipts. NIC receipts are ring fenced and spent according to how law dictates rather than how ministers direct. We include in appendix 2 the estimated accounts for the National Insurance Fund (NIF) for 2015/16.

In the Summer Budget 2015, based on figures in the Red Book, total government receipts for 2015/16 are estimated to be £673bn – of which about £629bn are from taxes and duties. Income Tax receipts are estimated at £170bn and NIC £115bn, although the Government Actuary's January 2015 estimated figures were £110bn (see appendix 2). In comparison, value added tax (VAT) receipts are estimated at £116bn, corporation tax at £42bn and inheritance tax at £4bn.

Income Tax and NIC in 2015 will comprise nearly half of all tax revenues, and employers' NIC will form about 10% of total tax receipts. By any standards these represent huge sums and show how dependent the government is on revenue from Income Tax and NIC.

WHAT ARE THE PROBLEMS?

As Income Tax appeared to reduce in the 1980s, the scope and rates of NIC began to be expanded. The behavioural result was a shift to use methods of remuneration that, while still being taxed on the reducing rates of Income Tax, were not caught for NIC. A cat and mouse game then ensued with the scope of NIC being broadened.

For although Income Tax and NIC may seem to have all the appearance of being duplicate taxes on income, there are subtle but important differences. NIC reveals its origin of being insurance for working people of working age in that it is only payable on earned income of a cash or cash-equivalent nature. Therefore, NIC is not payable on income earned by those who have reached state retirement age or those under the age of 16. Importantly it is also not payable on investment income, including dividends.

These differences result in much tax planning involving the extraction of profits from a company, typically an owner-managed company, by way of dividends which are not subject to NIC rather than salary or bonus which are.

As we show in appendix 1, this has been possible because historically higher rates of Income Tax payable on investment income have been reduced to parity with earned income.

This, coupled with various other incremental changes to the tax system, has tilted the balance towards receiving investment income.

In seeking to tackle these emerging issues, the approach has been for legislators to address only the element directly affected. This 'sticking plaster' approach seeks to fix the narrow problems without addressing the root causes, greatly adding to the overall complexity of the UK tax system. We find ourselves today in a position where the Income Tax and NIC systems have come a long way from their origins and have become a much patched-up tax structure.

It is a system which needs more thoughtful and broader-based consideration. If we asked ourselves the question 'If we were to design a new tax and welfare system from scratch would we start from here?', the answer would surely be no. Appendix 3 gives examples of how other countries have addressed the mix of taxation and social welfare.

Summarising the story so far

- Income Tax and NIC started from different positions with different policy objectives and completely different administration systems.
- Historically, NICs were only levied on earned income and had a narrower definition of earnings. Income Tax was levied on all income including investment income and dividends.
- NIC rates have risen, in part due to rising cost pressures on the NIF, but also because successive governments have been reluctant to raise the headline rates of Income Tax and have instead raised the rates of NICs.
- The reality of being a 'pay as you go' scheme has resulted in the insurance element of NICs being reduced, although taxpayers still get their state pension and a small number of other state benefits based on their National Insurance contribution record. In reality the NIF, excluding its National Health Service (NHS) commitments, has become principally a vehicle for present-day state pension funding.
- Employers' NICs are now little more than a payroll tax which brings in 10% of the government's tax revenues – viewed in another way, employers' NICs pay for 70% of current state pensions.
- NICs are now administered by HM Revenue & Customs (HMRC).
- The rise in NIC rates and the different bases between Income Tax and NIC has resulted in considerable tax and NIC planning and associated countermeasures.

The result is a complex two-tier system that is not easy to understand, is administratively burdensome and which even now provides considerable scope for arbitrage between Income Tax and National Insurance.

Attempts to merge Income Tax and NIC

Given the superficial similarities between the two systems it will come as no surprise to find that merging the two has been discussed a number of times. Nigel Lawson considered it in 1986 but concluded that 'the benefits of a combined charge would be unlikely to justify the ensuing upheaval'.

More recently the Chancellor, George Osborne announced in the 2011 Budget that he wished to start a discussion on merging Income Tax with National Insurance. However, closer inspection showed that he was suggesting trying to merge the two at the operational level rather than an outright merger.

The coalition government sought to align Income Tax and NIC thresholds to help simplify the operation of the systems. However, with the increases in the personal allowance this laudable policy aim has resulted in the lowest Income Tax and NIC payment thresholds diverging once again, although this is not the case for the upper threshold.

A recent promising development was the joint administration of NIC for the self-employed, which saw the flat-rate Class 2 NIC join the profit-related Class 4 NIC within the self assessment system from April 2015. It is also likely that Class 2 will be abolished in the near future.

Work towards alignment of the two systems is progressing in a thoughtful way.

ARE THINGS BROKEN AND IN NEED OF REFORM?

Many people believe the current state of affairs is a mess, in dire need of reform and should recognise that for all intents and purposes NIC is a tax and consequently should be merged with Income Tax.

On the other hand, it can be argued that although NIC is complicated it is reasonably well understood by employers and, in spite of all the problems, brings in substantial revenues with little input from HMRC as most of the burden falls on employers.

What should be done?

First it is necessary to decide what we should do with the NIF. Should it be maintained as a ring-fenced fund or should it be subsumed with current tax receipts into the Consolidated Fund? The NIF was designed as a 'pay as you go' fund that tries to match revenues with current and future liabilities. Therefore, it currently has the advantage because it is underpinned, cash basis of accounting aside, by proper accounting principles which are likely to be lost in the Consolidated Fund. This proper accountability is important given there is an ageing population and increasing state pension liability, but fewer people making contributions.

Having established the stable foundation of the NIF, there appear to be the following four options.

- **Merge:** bite the bullet and go for a full-scale merger.
- **Manage:** accept that it's too difficult a problem to fix properly, but consider improvements that are more than just sticking plasters.
- **Demerge:** return NIC to its roots as a separate insurance-based system that buys benefits. Arguably the current 'auto enrolment' of employees into private pension arrangements is an attempt to do exactly that.
- **Make do:** continue with the system that has served us for over 65 years, knowing that it may not be wholly appropriate for the future.

Merge: a full-scale merger

Should we bite the bullet and merge the two systems? There are arguments both for and against a merger, and on paper a merger may look attractive.

Arguments in favour of a merger include:

- administrative simplicity and reduced cost over the medium to longer term;
- reduced scope for avoidance and arbitrage; and
- improved taxpayer appreciation about how much they pay to government.

Arguments against a merger include the following points.

- The headline rate of a merged tax would have to rise – this would require more political courage than any government has displayed in the last 30 years.
- A decision would still need to be made about the extent to which (if at all) payments earn a contribution record.
- Social security legislation for other non-pension contributory benefits would also need to be rewritten.
- Any changes made would inevitably result in winners and losers: politically this would be a difficult option unless it was part of a wider tax-cutting agenda. Given the current budget deficit a tax-cutting agenda looks unrealistic in the short to medium term.
- Grandfathering would probably be needed due to the long contribution history created, resulting in two sets of rules for many years to come.
- Social security bilateral agreements with all EU countries and about 17 other countries would need to be renegotiated. It took 15 years from 1995 to 2010 just to get the EU's 1971 regulations updated.
- Any fundamental reform such as a merger might have fiscal and behavioural consequences that would be difficult to predict, potentially putting government revenue flows at risk.
- Employers' NIC accounts for over half of all NIC and is 10% of all government revenue. How would this be replaced given that the amount is too large to recoup easily from other taxes? If a separate payroll tax were needed employers would still have to deal with two systems, therefore negating one of the main purposes of simplification.
- HMRC, Department for Work and Pensions (DWP) and commercial computer software systems would need to be completely rewritten.

The question of whether Income Tax and NIC should be merged is one that needs to be properly debated but, as policy choices go, it must rank as one of the hardest of all. It would be a major upheaval and transitional costs would be likely to be substantial. Many problems would need to be resolved and, although there is no reason to think that they would be insoluble, implementation would be likely to take many years. The case for a merger might be improved if a cross-party consensus supported it, but a merger would reduce government's flexibility to use NIC to increase total national tax revenues. Achieving any consensus for reform could be difficult.

Manage: improve the current position

If a merger might be a step too far, what else what might be done to improve things? Currently the government is seeking to bring Income Tax and NIC operationally closer together. We welcome this given that in the past ICAEW has suggested incremental, and we believe useful, changes to improve the operation of NIC.

As noted earlier in this briefing paper, one of the root problems of treating NIC as a tax, but still keeping its contributory origin, is the different treatment of unearned income. This includes for example, dividends in a small and medium enterprise (SME) context, and the ability to extract those dividends NIC-free from an owner-managed company. These problems have been known about for many years but piecemeal solutions have added to the complexity. Possible policy options to address this include:

- reintroducing an 'investment income surcharge';
- broadening the scope of NIC to include investment income;
- taxing 'close company' dividends and/or unincorporated businesses under separate tax rules and rates, much as savings and dividends income are treated today;
- reintroducing apportionment of close company profits;
- increasing the corporation tax rate; and
- reintroducing advance corporation tax for small companies.

Any policy changes require hard and unpopular choices to be made. In the Summer Budget of 2015 the Chancellor announced new Income Tax rates on dividends that will go part of the way to addressing some of these problems. This may be just the beginning of the story and many of these options would be likely to result in considerable tax increases for SMEs and their owners, and would not be popular with growth-creating small companies that successive UK governments have been keen to encourage.

Demerge: should NIC return to its roots?

Although the NIC system may appear to be a tax in all but name, it originally started out life as a state social scheme resonant of an insurance-based system. Even today it retains some of those features. There is a case to be made on transparency and acceptability grounds for returning NIC to its roots, namely as a contributory-based insurance system that buys certain benefits. In other words, could NIC and the NIF be restored to a ring-fenced social fund where contributions buy benefits and which could include an element of contributory pension provision?

Examples of this approach in other countries suggest that for this to be acceptable, pension funds would need to be individually ring fenced and not subject to government control. It would in effect be a state-sponsored pooled individual pension. This approach should help to restore credibility and acceptability to the NIC system, enhance the fund's visibility and reduce the potential for it to be used as a stealth tax (it would need an independent auditor and actuary). This would ensure a separate definable existence and purpose for the NIF.

As shown by the NIF accounts in appendix 2, the reality is that, after taking out the payment to the NHS, the NIF is principally a pension fund with some extra benefits. A decision would need to be made about how to deal with the payment from the NIF to the NHS.

Make do: does this matter?

Whatever way you look at this problem there are hard choices that need to be made, so it is not surprising that keeping the status quo has largely been the order of the day and could continue to be so. It must be observed that for all their faults the Income Tax and NIC systems have successfully served the nation for over 65 years. The NIF has managed, with support from the Consolidated Fund when needed, to meet the financial demands made upon it and there is no overwhelming public and political pressure to reform the current systems. In addition NIC is a well-accepted tax and at its current rates it is not seen as stifling economic growth or employment.

Therefore, if we accept that the administrative and legislative upheaval that would be caused by the other options would be substantial, is it reasonable to adopt a position based on the simple maxim that 'if it ain't broke don't fix it'? To continue on the post-war NIC path should be a conscious national choice rather than the default or inertia option.

We need to ask whether the current structure of National Insurance is sustainable. The system may not be broken but it is creaking and in its current form it may break. Put bluntly, the NIF funds state pensions and part of the NHS. Although the NIF does fund other benefits, these are very small amounts in comparison. With an ageing population, we can expect increasing pension and healthcare costs, resulting in ever greater demands being placed on the NIF over the next couple of decades.

General Election 2015 promises by the major parties not to raise the rates of NIC have shown that perhaps we have started to reach the limits of the acceptability of using NIC as a 'stealth tax'. We might have reached a point where the continual patching up of the tax system and the use of invisible NIC have begun to undermine taxpayers' trust and confidence in the wider tax and benefit system.

There is also growing pressure from stakeholders for greater transparency about how much tax and NIC are collected and how the monies are spent. The UK Government has rolled out 'taxpayer statements' but these may result in further calls for increased transparency.

It could be argued that the whole NIC infrastructure is a charade that masks what is in reality general government spending. After all, the current excess contributions held in the NIF are loaned at a low rate of interest to the Consolidated Fund to support general government expenditure.

At best the current system could muddle on, but the government's ability to raise NIC rates is likely to become ever more difficult and the system is likely to get yet more complicated, burdensome and unpopular. In summary, while there is clear appeal in maintaining the current structure and avoiding the upheaval of other options, this may not be sustainable.

Initial conclusions

The debate about Income Tax and NIC policy is one that will not go away, and affects individual taxpayers beyond just a merger of deductions on their payslip. We know from feedback from our members that much of this debate is poorly informed, reflecting perhaps a wider lack of detailed appreciation of the history of the issues.

Within this paper we have tried to frame the background and terms of the debate, how we have arrived at the position today and what behavioural influences are at work. We cannot pretend the choices are easy: indeed, if they were, governments would have addressed them already. But the current system is in danger of becoming unsustainable and we believe that the time is ripe for a thorough review and debate about the policy options.

There are no quick fixes or easy solutions, and substantive reform will require hard choices to be made which could have profound consequences for the UK and its citizens. However, we believe that there should be a proper debate and discussion about possible policy options.

We believe that to start on any meaningful reform, there first needs to be broad consensus that there are no easy solutions and that we need to think long term. ICAEW has prepared this paper to contribute to this debate and help decision makers. ICAEW will draw on its expertise in tax and transparency to help foster this debate and work with governments and stakeholders to see whether solutions can be identified that would provide worthwhile improvements.

Finally, the government is currently introducing two major amendments to UK state pension provision. Firstly auto enrolment into private pension schemes, and secondly the change to a higher flat-rate state pension. We suggest that any long-term action on Income Tax and NIC should only be taken after these changes have been fully introduced and evaluated.

Appendix 1: History of NIC and Income Tax

Last year was the 75th anniversary of the start of World War II and this is a good place to start consideration of how the two systems have evolved. In 1939 Income Tax had been levied for well over 100 years. For a married couple in that year, the Income Tax threshold was £225 pa. However, the average income was only £180 pa, with the result that only about one in five of the working age population paid Income Tax.

Separately, all people who worked paid NIC to provide for basic health and welfare benefits. NIC had started in 1911 and was paid at a flat rate regardless of earnings. It was in effect a state insurance scheme and most workers paid it. You paid your 'stamp' and earned a contribution record that entitled you to certain benefits. At that stage, Income Tax and National Insurance were completely separate.

The two systems were administered separately by different government departments: the Treasury (via the Inland Revenue) for Income Tax; while the post-war administration of NIC was administered by four different government departments in succession before coming under the Contributions Agency in 1991. The Contributions Agency was merged into the Inland Revenue in April 1999, which itself was merged into HMRC in 2005. The benefits regime would also have a roving history, with most benefits being largely administered by a third department at any particular time separate from the above-mentioned ministries and departments.

This completely separate treatment of NIC had already existed for a generation before the 1948 establishment of the 'cradle to grave' welfare state. The NIC changes at this date marked a major change. Indeed, it could be described as a nationalisation and expansion of the system in place up to that time where NIC had been passed on to various non-governmental organisations. The funding of the new NHS would henceforth be from general government spending, the Consolidated Fund.

However, a new NIF was to be used to pay all welfare, which one could generalise in saying was for when an individual could not work eg, unemployment, injury, maternity and, most importantly, retirement. The contribution was set at a weekly flat rate for all earners of 4s/11d, which at the time was approximately 5% of average earnings. This contribution level was calculated to be the level necessary to make the NIF self-supporting, but being flat rate was not linked to what a person actually earned, although benefits were also flat rate. What is interesting is that at the first Cabinet review of National Insurance funding in May 1950, there was already a requirement to increase the NIC rate to 5s/3d per week in 1951 to meet higher than expected demand on the fund. The reason for the initial regressive, rather than progressive, charge was the policy intention that benefits were to be earned by contributions in a similar manner to private insurance benefits being linked to premiums paid.

Over the decades the demands on the fund have grown, especially by increased pension provision and then from the 1990s when approximately 12%, a figure which has since grown to 20%, of NIC has been redirected to the NHS. The requirement for additional contributions saw them becoming an increasingly large proportion of average workers' earnings. NIC began to represent a larger burden on the low paid and so an element of earnings-related contribution was introduced in 1961. This was the 'Graduated Pension' scheme which might be described as a 'pay extra now and get an enhanced pension later' proposition. This was the hallmark of later state-pension-related NIC changes. The trend also towards making NIC more progressive increased so that by 1975, and ever since, NIC had become a wholly earnings-related charge except for a continuing remnant of a flat-rate charge applying for the self-employed. Over time with these step-by-step changes the clear link between NIC and paying premiums into an insurance scheme has withered away in the public mind. In reality qualifying for and determining the size of a taxpayer's state pension are still directly linked to the citizen's contribution record.

As increased pensions have had to be paid, the NIF has, leaving the NHS subsidy aside, become largely a state pension fund. In the formal accounts for the year ended 31 March 2014, £82.5bn was paid from the NIF on state pensions while all other contributions-based benefits amounted to only £6.4bn. Separately, approximately £100bn of welfare benefits were payable from general taxation in the Consolidated Fund on the basis of means-tested need rather than a contribution record. In addition tax credits of approximately £30bn were paid but were treated administratively more in the nature of a negative income tax.

THE SOARING INCREASE IN NIC

By 1975 NIC had increased from its 1948 flat rate to a tax of 5.5% on earnings between £572 and £3,588. Since NICs were first introduced in 1911, employers had also paid an NIC charge for each employee. This had also started out as a flat-rate charge and in effect meant that an employer was also contributing to an employee's state insurance scheme and hence their welfare.

However, by 1975 employer's NIC had become a charge of 8.5% between these same lower and upper limits. Such was the national need for revenues that by the end of Dennis Healey's chancellorship in 1979, the employee and employer NIC rates had risen to 6.5% and 10% respectively, and the latter had in effect become a 'payroll tax'. Thus in the late 1970s there was an almost 50% increase in overall contribution rates on individuals in just four years.

Healey went further and introduced a second employee-based payroll charge on employers which went direct to the Consolidated Fund. This was called National Insurance Surcharge (NIS) and was paid by employers from April 1977, first at 2% which was increased to 3.5% 18 months later. This was widely seen as a straight tax on jobs, rather like James Callaghan's unsuccessful introduction in 1966 of 'selective employment tax', whereby employers paid 25s per employee per week, with certain employers able to claim activity-based refunds. This rising cost to employers of employing staff has a contemporary resonance with the recent introduction of a National Insurance Employment Allowance and the rise in the starting age for employers' NIC from 16 to 21. These measures are an acknowledgement of the NIC costs on employing people, and provide incentives to employ younger people without triggering an additional payroll charge.

In 1979 the incoming Conservative government progressively abolished NIS while at the same time increasing employees' NIC and also marginally increasing employers' NIC. The result was that by 1985 NIC in respect of each employee was still at the same 1979 levels. The names may have changed but the revenues from NIC and related charges were too important to lose.

Therefore, by the mid-1980s both employers' and employees' NIC rates had risen sharply but, reflecting its origins as a contributory insurance system, NIC was only payable on earnings up to the upper earnings threshold, with no employers' or employees' contributions on earnings above that level. All this was about to change. From 6 October 1985 the upper earnings limit was removed for employers' NIC, so that employers' NIC was payable on all employees' earnings. The insurance principle had been dealt a mortal blow, and at a stroke the cost of employing staff who earned above the upper threshold increased considerably.

This single change has had far-reaching consequences. It confirmed that employers' NIC had become, in effect, a straight payroll tax. The original purpose of employers' NIC, namely that the employer was contributing to its employees' insurance fund and personal welfare, was effectively dead.

Employers began to plan to avoid NIC and it moved to the forefront of everyday tax planning, especially because the NIC rules for deciding what was subject to NIC were much narrower than the equivalent Income Tax rules while not adversely affecting benefit entitlement.

NIC planning began in earnest, focused around bonus payments, and a cat and mouse series of developments began between employers seeking to pay bonuses in ways that were not subject to NIC (fine wine and gold bars were two examples), with the then Inland Revenue and DSS introducing countermeasures. It should be noted that a benefit in kind culture in the UK is much larger than overseas. While the first Income Tax rules for benefits in kind were introduced in 1948, the practice became more widely established during the 1970s when employers wished to reward employees at a time of stringent pay restraint laws. While there was a considerable tightening up of the benefit in kind Income Tax rules in 1976, this trend has continued. So in succession we saw:

- NICs payable on benefits convertible to cash under the 'Readily Convertible Assets' regime;
- an NIC charge for employers on certain benefits in kind;

- a steady increase in both employees' and employers' NIC rates; and
- employees' NIC starting to be charged on all earnings above the upper earnings limit; first from 2003 at 1% and later 2% from 2011.

These changes closed the gap between capturing transactions for both Income Tax and NIC, but even today there remain some fundamental differences between the two systems that drive behaviour and planning. In particular, a key difference is that investment income, pertinently dividends, is not subject to NIC. This crucial difference drives much planning at the SME level.

To a greater or lesser degree the NIF has been underfunded throughout its existence. When the funding has looked healthy, extra demands have been placed on it and since 2008 the fund has consistently had an excess of annual payments over receipts. In appendix 2 the estimated accounts for 2015/16 show that fund reserves will have reduced to below two months' expenditure – the Government Actuary's recommended minimum. Therefore, the Consolidated Fund will have to top up the NIF under a mechanism called the 'Treasury Grant' for the first time in nearly two decades. To maintain the two-month reserve this could be as high as £4.8bn in 2014/15 and £6.6bn in 2015/16. With the abolition of contracted-out NIC from April 2016, NIC receipts are expected to substantially increase over the next few years.

INCOME TAX SINCE 1939

As noted earlier, in 1939 only about one in five of the working population actually paid Income Tax. As would be expected the war years saw a period of high taxation but the immediate post-war years saw only a very small decrease in those high tax levels. Over the following decades the rates of Income Tax fell but only slowly. Table 1 compares 1946/47, the first full tax year after the war, with the tax year of each 10th anniversary together with the current tax year.

Table 1: personal allowances and standard/basic rates of Income Tax since World War II

Tax year	46/47	56/57	66/67	76/77	86/87	96/97	06/07	14/15
	£	£	£	£	£	£	£	£
Single personal allowance	110	140	220	735	2,335	3,765	5,035	10,000
Standard/basic rate (earned)	39.4%	33%	31.9%	35%	29%	24%	22%	20%
Standard/basic rate (unearned)	45%	41.5%	41%	50%	29%	24%	22%	20%

The table has been necessarily simplified due to the changing and complex details of Income Tax over the decades and neither does it take account of inflation.

To show the impact of inflation in the post-war years, if we take the following example of four tax figures and increase them by the Retail Price Index (RPI) between April 1946 (RPI = 7.3) and April 2015 (RPI = 258.0), it does give us an interesting, if basic, view of post-war inflation, fiscal drag and wage increase over the period. Fiscal drag is the process where inflation pushes salaries into higher tax brackets when elements of a progressive tax system, in this case personal allowances and higher tax bands, are not adjusted for inflation. This results in more taxpayers being pushed into higher tax brackets and has the effect of raising government tax revenue without explicitly raising tax rates.

Table 2: the effects of inflation, fiscal drag and wage increase since World War II

	1946	2015	Actual 2015
	£	£	£
Personal allowance	110	3,778	10,600
Age allowance	500	17,171	10,660
Surtax/higher rate band commences	2,000	68,685	31,265
Average UK income	381	13,084	27,271 (2014)*

* Source: Annual Survey of Hours and Earnings, 2014 Provisional Results, Office for National Statistics.

The last table is admittedly simplistic but nevertheless revealing as to basic trends that have occurred during the post-war decades.

Appendix 2: National Insurance Fund estimated accounts 2015/16

RECEIPTS

	£m	£m	£m
Contributions			
Class 1 primary	45,307		
Less contracted out rebates	(1,598)		
		43,709	
Class 1 secondary	66,159		
Less contracted out rebates	(3,882)		
		62,277	
Class 1A and 1B		1,351	
Class 2		381	
Class 3		32	
Class 3A		433	
Class 4		2,220	
		110,403	
SSP, SMP, SAP & SPP payroll deductions		(2,553)	
			107,850
Treasury grant (Note 1)			NIL
Consolidated Fund (SSP, SMP, SAP & SPP recoveries)			2,545
State scheme premiums			49
Investment income			95
Other receipts (various recoveries)			34
			110,573

PAYMENTS

	£m
Retirement pensions	89,573
Widow's bereavement benefit	533
Incapacity benefit	8
Employment and support allowance	4,752
Maternity and similar allowances	433
Contribution based Jobseeker's Allowance (JSA)	317
Guardian's allowance	2
Pensioner's Christmas bonus	123
	95,741
Personal and stakeholder pension rebates and incentives	NIL
Redundancy payments	330
National Health Service (Note 2)	21,584
Northern Ireland transfers	386
Administration	939
Other net payments	175
	119,155

STATEMENT OF BALANCES

	£m
Opening balance	17,965
Excess of payments over receipts	(8,582)
Closing balance	9,383

Note 1 – it has been the practice in recent decades that there is a payment of a 'Treasury Grant' to the NIF when the fund is projected to fall below 1/6th (2 months) of estimated annual benefit expenditure. The Government Actuary estimates a shortfall of £6.6bn and therefore expects that a Treasury Grant of this amount will be needed for 2015/16. The estimate for 2014/15 is £4.8bn.

Note 2 – in practice this is retained by HM Treasury, and NIC receipts to the fund are net of this amount.

Source: Government Actuary's report of January 2015 on the draft Social Security Benefits Up-rating Order 2015; Welfare Benefits Up-rating Order 2015; and the draft Social Security (Contributions) (Re-rating and National Insurance Fund Payments) Order 2015.

Appendix 3: Tax and social security arrangements in other countries

What approaches have been used in other countries, what problems do they have and what lessons might we learn?

SINGAPORE

A modern young country, Singapore has developed a system of taxation and social security provision largely from scratch albeit from a small post-war colonial British origin.

Income Tax is quite modest by UK standards. It is levied at 2% from approximately £9,600[1] and progresses through six further bands to a final band of 20% from approximately £153,300.

The Singaporean citizen also pays a 20% deduction, plus 17% from their employer, into the taxpayer's individual Central Provident Fund (CPF) accounts. These are paid to a government body, the CPF, and in UK terms are more comparable to an Individual Savings Account (ISA) in nature than National Insurance. The taxpayer has personal ownership of their CPF accounts. The government guarantees a minimum interest rate per year, currently 2.5% to 4%, depending on the account. There is a flexible option for more adventurous investors to choose certain approved investment medium like unit trusts, bonds and even a gold fund.

The CPF accounts are for the individual's lifetime needs of tertiary education, standard medical care, house deposit, retirement pension and all other needs of post-working life. Any unused account balances at death are distributed as per the wishes of the deceased. In effect it is a combined retirement, medical and savings fund with a clear link between contribution and benefit.

There is no capital gains tax but there is a property tax based on the annual value of property owned. Finally there is stamp duty on both buying and selling a property.

Singapore has a private medical system that gives highly efficient cover to all citizens on only 4–5% of GDP as opposed to 9% in the UK. The payment of general practitioner and standard-type treatments are made from CPF. More extensive medical cover is provided by central government.

It does place a responsibility on the individual to manage their CPF accounts in a sensible manner but there are government safeguards so that citizens will have at least the minimum necessary for retirement provision.

The CPF accounts are rigidly ring fenced and not used as a political football. Worldwide it is a much envied system.

NEW ZEALAND

New Zealand has a longer British connection and has developed a system similar to the Singaporean but with a much lighter touch and with remuneration deductions weighted more toward Income Tax.

There are no personal allowances, and Income Tax progresses through four bands ranging from 10.5% on the first approximately £6,300[2] to 33% above approximately £31,400.

State benefits are all paid out of central tax revenues and this includes a flat-rate state pension similar in amount to our own. It is a 'pay as you go' system. There is no national insurance but since 2007 automatic payments are made into 'KiwiSaver', a flexible ISA-type savings plan. The individual can choose to contribute 3%, 4% or 8% of gross pay or to opt out of the scheme altogether. The employer contributes 3% of gross pay. Amounts can be taken out tax-free from state retirement age or within limits as a deposit on an individual's first property.

Medical general practitioners are private with most younger and middle age groups taking out private medical insurance, which could be argued is fulfilling the role of national insurance albeit in a private form. Hospital care is paid by the government.

[1] Exchange rate: 1 SGD = 0.479187 GBP, 12/6/15.

[2] Exchange rate: 1 NZD = 0.448720 GBP, 12/6/15.

There is also a compulsory 1.7% charge to the Accident Compensation Corporation (ACC), which is a compulsory injury insurance that covers the cost of non-work related injuries and is also deducted from salary or wage income.

These two examples make interesting comparisons. They show what could be done with either a fresh start or bold radical changes. This would be a brave and courageous political decision to take. It may be more practical to accept that we are where we are and consider similar systems to our own and make observations.

FRANCE

In its basic form the system in France is similar to that in the UK. There is both an Income Tax and National Insurance system although there are different revenue and expenditure emphases.

Income Tax has numerous family-oriented reliefs that mean the average earning family with the average number of children will not be liable to Income Tax – a position that broadly corresponds to what the position was in the UK at the outbreak of the Second World War. In fact, Income Tax in France only brings in a third of the revenue that it does in the UK as there is a greater emphasis on revenues from social security and indirect taxes.

Social security deductions are much higher and are paid by all taxpayers in a multi-deduction insurance system. French social security costs start from 21% for employees and from 33% for employers. The social security system was established in the late 1940s and was interestingly also influenced by the Beveridge Report. It was fashioned to address a broader social remit than in the UK and was expected to meet all health costs as well as pensions, family benefits and occupational accident and disease cases. The fund has run at a historical deficit which has been topped up from general taxation.

NETHERLANDS

The Netherlands appears to have an example of a unified Income Tax/NIC system. In 2015 Income Tax is levied in three progressive rate bands of 36.5%, 42% and 52%, and deducted at source. However, up to an upper earnings limit equivalent of approximately £24,300[3], fixed percentages of 31.15% of the deduction are paid as insurance premiums for health, old age pension and widow's benefits after collection. In addition employers pay insurance premiums of 19.38% on earnings of up to approximately £37,700 to cover health, unemployment, child care and disability. To the employee the impression is that just one deduction is made from their salary. The reality is that Income Tax and NIC are split at government rather than employer-payroll level.

As the Netherlands has separate administered Income Taxes for both savings and most property income, the above system applies to what we would call earned income in the UK.

IRELAND

It is interesting note that the Irish tax system, which has its origins in the UK system and has retained a similarity to it, has not amended its legislation to the same extent and does not encounter the range of issues faced by the UK. It has also expanded the scope of its social insurance contributions, known as Pay Related Social Insurance (PRSI), to include investment and pension income.

On employment income over approximately £13,300[3] pa, PRSI is set at 4% for taxpayers on their income after pension contributions. Employers pay 8.5% on earnings up to approximately £13,400 pa and 10.75% over this income level. This entitles the PRSI payer to social welfare and state pension and, while paying for state medical facilities, does not create an entitlement to medical services. Private pension and medical insurance premiums are fully deductible against Income Tax.

The Income Tax rate is 20% on the first approximately £24,500 for single taxpayers and between approximately £31,000 and £49,000 for married couples. The sole higher rate is 40%.

Interestingly, Ireland has a second Income Tax called the 'Universal Social Charge' which is set at a rate for 2015 of between 1.5% and 8% on incomes over approximately £8,700. The Irish Finance Minister who introduced it in 2011, the late Brian Lenihan, took the view that 'everyone makes some contribution, however small, to the provision of services'. This tax is charged on the same taxable income as for Income Tax but without any deductions or reliefs.

[3] Exchange rate: 1 EUR = 0.724397 GBP, 12/6/15.

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