Combining tax and national insurance

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Some facts and figures*:

1. Income tax (IT) raises around £150 billion a year, of which £130 billion is paid under PAYE (including the tax paid on pensions paid by employers). Rates for 2010-11 were 20%, 40% and 50%. Income tax is due on all income.

2. National insurance (NIC) raises just under £100 billion a year. In 2010-11employees paid 11% on earnings up to the higher-rate tax threshold, and 1% thereafter. Employers paid 12.8%. The rates for 2011-12 are each rising by 1%, to 12% /2% for employees, and 13.8% for employers. NIC is due only on earnings by workers under pensionable age.

Reason for proposing integration of IT and NIC

3. The issue has been brought back into focus by the Office of Tax Simplification report on small business taxation.
4. Their report said that it would remove anomalies which mean that decisions are taken purely for tax reasons – for example, operating a small business through a company and paying dividends rather than a salary to the owner, as this means no NIC is due, or operating as self-employed rather than an employee, where NI rates are lower.
5. It would also reduce the time and costs involved in payroll calculations for employers and HMRC alike, potentially saving some £50 million in administration costs each year.
6. In the past, proposals to integrate IT and NIC have fallen foul of the dependence on a full NIC contribution record to qualify for certain benefits, particularly the state pension.
7. The proposal for a universal flat rate pension would remove the major part of this objection.

Winners and losers

8. If employees' NIC and income tax were integrated, and set at a rate which collected the same total of £250 billion, employees under pensionable age would be the main beneficiaries, because the rate could be set at a lower level than the total of IT and NIC. This would be because there would also be losers.
9. Those who have mainly investment income (including being paid dividends instead of salaries from companies they own), and those over pensionable age whatever the source of their income, would pay the new higher combined rate instead of just income tax as at present.
10. The position of employers would depend on how the question of employers' NIC was dealt with.
11. Abolishing it and passing the burden directly on to the new integrated tax is unrealistic, as it would result in a basic rate of 35 – 40%.

**This is, necessarily, just a brief extract of some rates and allowances which apply for income tax and national insurance.*

12. Compensating for it by increasing other business taxes is also unrealistic, since the pressure is to reduce the headline rate of corporation tax.
13. The most likely outcome would be a separate tax on the total payroll cost (including benefits in kind), incurred by the employer. This, however, still means that being paid as self-employed or through company dividends is more tax advantageous; one of the main problems integration is meant to solve.

Problems and solutions

14. The presentational difficulty of announcing an integrated basic rate likely to be just under 30%, compared to the current 20% for income tax alone, is often seen as the major problem, but in our view other difficulties would soon become more important, only some of which appear to have solutions.
15. It would become more apparent that the current UK tax system, for employees under pensionable age at least, is much flatter than it appears. Rather than headline rates of 20%, 40% and 50%, the integrated rates might be nearer 29%, 41% and 51%.
16. The biggest group of losers would be pensioners, whose taxes would probably increase by 40-50% (i.e. if their liability was £1,000 now it would be £1,400 or £1,500 under the new rates). Three possible solutions would be:

- To maintain the current rates of tax on the income of those over pension age. However, the result would be to increase the integrated rates for those below pensionable age to around the combined level of IT and NIC – say 32%, 42% and 52%. It also introduces a further level of complexity.

- To increase the additional personal allowances currently given to those aged over 65 in order to 'give back' the extra tax deducted. However, pensioners with lower incomes would gain more than those with higher incomes.

- A radical simplification (which would need to be fully costed): leave pensioners with the same rates of tax and the same allowances as everyone else, but to make the state pension non-taxable.

17. The value of tax reliefs would be significantly increased for employees under pensionable age. For example, pension contributions paid by basic-rate tax employees would be relieved at the integrated rate (say 29%) rather than 20% as at present.
18. While this is a removal of an anomaly, since contributions paid through an employer scheme already escape national insurance, the effect of it needs to be factored into the calculations.
19. There would be a similar increase in the amount recovered by charities under Gift Aid.