The Taxing Wealth Report 2024

Every politician's guide to "How to pay for it"[1]

National insurance reform:

Reforming national insurance charges on higher levels of earned income

Brief summary

This note suggests that:

- The reduced rate of employee's and self-employed person's national insurance contribution payable by those earning more than £50,270 per annum from either of these sources can no longer be justified when the pretence that national insurance contributions are specific payments made to provide insurance cover for specified risks is no longer tenable and this charge is now a tax like any other within the UK tax system.
- This reduced rate of tax seriously undermines the vertical equity of the UK tax system by being explicitly regressive in nature.
- Along with other undesirable features within the national insurance system this reduction in rates for those on higher incomes undermines the integrity of the UK tax system and has encouraged tax avoidance and even abuse.
- Revenue of maybe £12.5 billion a year might be raised as a consequence of removing this reduced rate of contribution for higher earners, £11 billion of this sum coming from employees and maybe £1.5 billion from the self-employed. Because the data used to prepare these estimates was out of date these figures

[1] This note forms a part of 'The Taxing Wealth Report 2024' published by Finance for the Future LLP, which is UK LLP number OC329502, registered at 33 Kingsley Walk, Ely, Cambridgeshire, CB6 3BZ. See https://www.financeforthefuture.com/taxing-wealth/. This note was written by Richard Murphy FAcSS FCA FAIA (Hon), Professor of Accounting Practice, Sheffield University Management School, who is a director of Finance for the Future LLP.

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may be understated, a risk that is increased by the very cautious basis of estimation used.

The proposal	To charge employee's and self-employed people to national insurance at a single rate on all their earnings above the lower threshold at which such charges apply. This would remove the significant drop in the rate at which national insurance is charged that now happens when income from these sources reaches £50,270 per annum.
Reason for the proposal	1. To increase the prospect of vertical equity of taxation in the UK which the reduced national insurance contribution rate for those earning more than £50,270 a year in the UK clearly undermines. 2. To reduce the tax spillover effect that existing rates of national insurance create when compared to those charged under income tax rules. 3. To reduce the rate of tax avoidance in the UK. 4. To consequently improve the rate of tax compliance in the UK. 5. To raise additional tax revenues.
Estimated tax that might be raised as a result of the recommendation made	The behavioural consequence of this proposal is likely to be small, most especially if the opportunity to avoid national charges by the creation of an investment income surcharge, which will also be recommended in this report, is enacted. Few people will willingly reduce their contractually due incomes to avoid a tax charge despite the claim made by microeconomists that this is likely. The fact that most people have fixed financial commitments and lifestyles that they wish to maintain does in fact suggest that the

	opposite might well be the case. It is, therefore assumed that an overall neutral reaction to this change is likely. Assuming this to be the case then a sum of between £10.5 billion and £12 billion might be raised from those in employment as a result of this change, with a further £1.5 billion (or thereabouts) a year likely to be raised from the self-employed. An overall yield of £12.5 billion is, therefore, suggested to be likely to arise as a result of this change.
Ease of implementation	Simple. The change is technically straightforward.
Likely difficulties that might result from implementation	Few. The change is no more complicated than any other change in national insurance rate, and these are commonplace.
Likely time required to implement the change	Months in the year preceding the year of actual change.
Consultation period required.	Short.

Background

National Insurance is a complex tax. It was originally introduced by a Liberal government in 1911 as part of a range of measures that also saw the introduction of the first state old age pension in this country. It was, however, considerably expanded after the Second World War by the Labour government of that period that was seeking to provide a social safety net for the people of the UK as part of the new social contract that they were seeking to create between the working people of the UK and its government.

National insurance was created, as its name implies, as a state supplied insurance mechanism that guaranteed that in exchange for contributions made an employee or self-employed person might, depending upon their precise circumstances and contributions made, claim for unemployment benefits, some sickness and disability benefits and a state old age pension. It was also suggested that national insurance contributions should contribute towards the cost of the National Health Service.

The pretence that national insurance contributions now make direct payment for any pension, benefit or health care provided by the UK state has effectively been abandoned, although the entitlement to some such benefits is still dependent upon having made such contributions during the course of a working career. For all practical purposes, national is insurance is now just one of many taxes within the UK. In the tax year 2023/24 it is likely that national insurance will raise total contributions of £172 billion[2]. These will represent approximately 18.1% of all anticipated tax revenues during the course of that year.

National insurance charges are complicated and differ for those who are employed and self-employed. There is also an option for a person to make voluntary national insurance contributions when they are not working and to secure credits as if they were working in some situations.

Since the majority of national insurance contribution payments are made by those who are employed or their employers the rates for these people payable under what is called class one national insurance are summarised here:

	2023-24		
	Weekly	Monthly	Yearly
Primary threshold	£242	£1,048	£12,570
Upper earnings limit	£967	£4,189	£50,270

The rates of tax payable are as follows:

	2023-24
Employees' main rate (payable between the primary threshold and the upper earnings limit)	12.0%
Employees' lower rate (payable on earnings above upper earnings limit)	2.0%
Employers' rate	13.8%

In practice, what this combination of rates and thresholds means is that an employee starts paying national insurance when they earn more than £242 a week (£12,570 a year). The contribution due is payable at 12% on the excess over that sum. However, the rate of national insurance rate due falls to 2% when weekly earnings exceed £967 per week (£50,270 a year).

These rates have, it should be noted, been co-ordinated with income tax rates for the first time in 2023-24. Income tax rates in that year are:

[2] https://obr.uk/economic-and-fiscal-outlooks/

Personal allowances	2023-24	Cumulative bands
Personal allowance (PA)	£12,570	£12,570
Basic rate band:	£37,700	£50,270
Higher rate band:	£37,701-£125,140	£50271 to £137,710
Additional rate band:	£125,140 or more	In excess of £137,711

What is clear from comparing these tables is that:

1. When the income tax rate increases from 20% to 40% the natioanl insurance rate on employees falls from 12% to 2%.
2. Whereas the income tax rate then increases again, albeit at significantly higher levels of income, the national insurance rate never does.

It is also worth noting that:

3. At no time is there a national insurance charge on anything but income from work. All other income is exempt from this change.

The consequence is that however well motivated national insurance charges were when first introduced they now create considerable problems within the UK tax system and for the concepts of both horizontal and vertical tax equity. In particular:

a. There is no horizontal equity[3] with regard to national insurance charges on income below £50,270 per annum when earnings from employment and self-employment are subject to those charges and those from anything else are not.

b. The vertical equity[4] of the combined income tax and national insurance charge is distorted by the impact of a fall in the national insurance rate on income above £50,270 per annum.

c. There is no logic to the cut in the national insurance rate at £50,270 per annum on the basis of vertical equity when this tax is considered in isolation.

[3] Horizontal tax equity requires that all incomes of similar amount be taxed the same sum irrespective of where that income comes from.

[4] Vertical tax equity requires that as a person's income increases the amount of tax paid on it will always increase irrespective of its source, with a progressive tax system resulting as a consequence.

d. The interaction of national insurance and income tax now creates misleading impressions of overall tax rates whilst appearing to deliver a subsidy to those on higher levels of income earned from work.

e. There are strong tax spillover effects[5] in favour of income arising from unearned sources and from capital gains as a result of national insurance not being charged on these sources. This has been particularly seen in the growth of the one-person consulting limited liability company that supplies a person's labour on a contractual basis, seeking to turn the status of that profit from earned into unearned income by the payment of dividends out of profits with the sole aim of avoiding national insurance charges as a result.

Issues with regard to the spillover effects arising from national insurance charges only arising on earned income are dealt with in a separate recommendation. The issue addressed here relates to the reduction in the national insurance contribution charge from 12% to 2% on incomes earned from employment or self-employment exceeding £50,270 per annum.

Recommendation

It is recommended that the rate of employee national insurance contribution be fixed at 12% on any rate of income from employment or self-employment exceeding £12,570 per annum.

The reasons for this recommendation are:

1) Vertical tax equity requires that there be no cuts in tax rate on higher rates of income once a rate has been charged on a lower rate of income.

2) Given that national insurance is now just a tax like any other the argument that additional contributions from those on higher incomes are not required for insurance purposes cannot be justified.

3) Those with higher incomes have greater capacity to pay this tax than do those with lower incomes and yet a lower rate is asked of them.

4) The charge might raise significant tax revenues.

[5] Tax spillovers are the consequences of the interactions between different tax systems or different parts of the same tax system that can often (sometimes unintentionally) reduce tax revenues and the size of a tax base.

Analysis of the potential additional income that this change might generate is hindered by the lack of recent data on which to base the calculation from HM Revenue & Customs. That is used here is based on data[6] from 2020/21 and might as a result significantly understate the additional tax that might be raised.

That data suggests that in 2020/21:

a) Around 18.3 million people had employment income of less than £50,000 a year.

b) Approximately 3.3 million people had employment income of more than that sum in that year.

c) Between them those with earnings of less than £50,000 a year enjoyed combined income of approximately £402 billion at an average of £22,000 of taxable income each (people not paying tax are not included in these figures).

d) Between them those with earnings of more than £50,000 a year enjoyed combined income of at least £268 billion at an average of £82,000 of taxable income each, which figure is likely to be a serious underestimate because a very cautious basis of extrapolation of data has been used.

e) If those earning more than £50,000 were required to pay an additional 10% national insurance contribution on their incomes from employment that charge might come to £10.4 billion a year. It is stressed that this is estimated using out of date data (which is nonetheless likely to be the best currently available) and on a very cautious basis of calculation. Because of inflation since 2020/21 it is possible that this sum might easily exceed £12 billion now.

f) This change would also have impact on the self-employed from whom it is likely that another £1.5 billion in tax revenue could be raised as a result of broadly equivalent changes.

[6] https://www.gov.uk/government/statistics/income-tax-liabilities-of-starting-savers-basic-and-higher-rate-taxpayers-by-largest-source-of-income-2010-to-2011 which despite its web page address does include more up to date information.