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Fixing National Insurance: A better way to fund social care

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Key points

- **The government's new Health and Social Care Levy is unfair** because it will:
  - Continue to tax younger workers more than pensioners
  - Continue to tax earnings from work more than income from wealth
  - Preserve the regressive rate structure of National Insurance
  - Increase taxes on employment by more than for the self-employed

- Instead of introducing a new Levy, **it would be better to fix the gaps in our current National Insurance system**.

- **We recommend an alternative plan** that involves reforming National Insurance Contributions (NICs) so that they apply more equally across different types and levels of income:
  - **Extend NICs in full - not only the new Levy - on all investment income and on pension-age individuals** (although not pension income). This would raise £12 billion.
  - **Equalise the rates of NICs on higher earnings with the rates that are currently paid by lower earners**. This could raise an additional £20 billion.

- **Under our plan, the government could raise the same amount of revenue towards health and social care whilst also *cutting* the main rates of NICs by 1.25p, rather than raising rates by this amount.**

- Compared with the government's proposals, **under our plan more revenue would come from London and the South East, older people, and higher earners**.

- Raising taxes on younger and lower earners is a **political choice**; the revenue that the government needs could be raised from older people and higher earners.

1. Introduction

The government has proposed a new 'Health and Social Care Levy' to take effect from April 2022, which would add 1.25p to all rates of National Insurance Contributions (NICs). Unlike NICs, this new Levy would also apply to dividends, and (from April 2023) to people of pension age. The revenue will be ringfenced to fund health and social care.

In this report, we argue that instead of adding this new Levy on top of existing NICs, the government should have taken the opportunity to fix the gaps in our current National Insurance system. Our alternative plan for reforming NICs would raise more revenue than the government's proposed Levy and would make our tax system fairer at the same time.

Below, we review how NICs currently work and explain the problems with the government's proposed new Levy. Then we set out how our alternative plan would work, how much it would raise, and who would be affected.

2. Six facts about National Insurance

National Insurance Contributions (NICs) raise a lot of money: £143 billion in 2020-21, almost one quarter of all tax revenue. They are also relatively popular (compared with other taxes): polling evidence by YouGov shows that the public think of it as the second 'fairest' tax (after taxes on cigarettes and alcohol).[1]

However, there is a lot of misunderstanding about how NICs work, who pays them, and what they're used for. In fact, in their current form, NICs are one of the most arbitrary and unfair taxes in our system. Below, we set out the six facts that everyone needs to know about National Insurance:

Fact 1: National Insurance is not really 'insurance'. There's hardly any direct link between how much a person pays in, and what they get out from the system.

When NICs were first introduced, after the Second World War, there was a direct link between what people paid in and what they were entitled to get out, hence the label 'insurance'. However, the insurance element of NICs has now almost entirely disappeared: today, the amount that someone has paid in NICs makes virtually no difference to what they personally are entitled to receive from the NHS, or in state pension or welfare benefits.

Fact 2: National Insurance revenues are officially ringfenced for social security spending, but in practice they're used by the government just like any other tax.

It is a myth that the National Insurance Fund is used to pay for health and social care.[2] NICs are ringfenced in the 'National Insurance Fund', which notionally pays for social security spending (including the state pension) and is separate from the government's 'Consolidated Fund' used for all

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[1] Shakespeare, 2015.

[2] Some NICs revenue is notionally allocated to the NHS, but if less is raised than originally estimated then the target spending is topped up from general taxation. See further https://www.kingsfund.org.uk/projects/nhs-in-a-nutshell/how-nhs-funded.

other public expenditure. However, this is really just an accounting exercise. The funds in these two pots are effectively interchangeable: any shortfall in NICs can be made up from other taxes and any surplus gets loaned to the government for spending in other areas.

Fact 3: National Insurance is effectively an additional tax on income, except that it only applies to income from work, not income from wealth.

Despite the name, National Insurance Contributions are effectively just another tax on income. However, they are a peculiar kind of income tax because they only apply to certain types of income: earnings from employment and self-employment. In other words, people only pay NICs on the income that they get from working. Any income that is received from holding investments – such as dividends from shares, rent from property, and interest on savings – are currently exempt from NICs. This benefits those at the top of the income distribution who are more likely to receive these types of income.

Fact 4: National Insurance only applies to working-age people. People over the pension age are exempt, even if they continue working.

The liability to pay NICs stops once a person reaches the State Pension Age (SPA), which for most people is currently set at 66. Although employees who continue working after pension age still pay Employer NICs, they no longer have to pay the Employee contribution. For pensioners who are self-employed, NICs stop entirely. And while older people may previously have paid NICs throughout their lives, as NICs rates have been increasing this will have been at a lower rate than the current working-age population.

Fact 5: The highest earners pay a lower average rate of National Insurance than those on ordinary incomes. In this respect NICs are 'regressive'.

Whereas an employee who earns between £9,569 and £50,284 pays 12% in Employee NICs on each extra pound that they earn, once someone's earnings exceed £50,284 (the 'Upper Earnings Limit') this rate drops to just 2%.[3] This means that an employee earning £50k per year pays 9.7% of their income in Employee NICs (after accounting for the non-taxable allowance), whereas someone earning £100k pays 5.9%, and at £500k the rate is just 2.8%. The fact that investment income is skewed towards the top of the income distribution, and yet is exempt from NICs, further reduces the effective average tax rate of those with the highest incomes.

Fact 6: There are several other oddities and inequities within the National Insurance system, compared with Income Tax.

First, unlike Income Tax, there is a lower rate of NICs on the self-employed than on employees, both because their main rate is lower (9% instead of 12%) and because the self-employed do not pay any equivalent of Employer NICs.[4] Second, NICs start at a lower level than Income Tax: they kick in on

[3] The rate of Employer NICs stays the same rate of 13.8% on all income above (equivalent of) £8,840 per year.

[4] Employer NICs are paid by employers, but because they reduce the amount that the employer is willing to pay for the employee's services, ultimately much of the cost is borne by employees through lower wages. See further Adam, Phillips & Roantree (2019).

incomes above (the equivalent of) £9,568 per year,[5] compared with £12,570 for Income Tax. Third, unlike Income Tax, NICs are levied on a weekly rather than annual basis. This means that if an employee earns above £184 in a single week then they will pay NICs on anything above this amount, even if over the whole tax year, they earn less than the annual equivalent of £9,569.

3. The government's plan

The government is planning a new 'Health and Social Care Levy', which would apply on top of existing National Insurance Contributions (NICs). The Levy will be set at a rate of 1.25% and will apply to three types of income:

1. Any income on which NICs are already paid
2. Dividends
3. Earnings by people of pension age

The vast majority (over 90%) of the new revenue will come from applying the Levy to income on which NICs are already paid - this is the same as raising all existing NICs rates by 1.25p.

The Levy will also apply to dividends and (from April 2023) earnings by people of pension age, which are not currently liable to NICs. However, this is *not* the same as extending NICs to these sources of income, because pensioners and shareholders will only pay the 1.25p Levy, not the full rate of NICs.

Introducing this new Levy on top of existing NICs rates is unfair because it compounds all of the problems with our current National Insurance system. In particular, it will:

- **Continue to tax younger workers more than pensioners.** The Levy on people of pension age is only 1.25p, whereas younger earners must pay the full rate of NICs.

- **Continue to tax earnings from work more than income from wealth.** The Levy on dividends is only 1.25p, not the full rate of NICs paid on earnings. Rent from property and interest on bank accounts will escape the tax rise altogether.

- **Preserve the regressive rate structure of National Insurance.** Those with income over £50k will still pay less in NICs (including the Levy) as a proportion of their income, than lower earners.

- **Increase taxes on employment by more than for the self-employed.** The 1.25p rise in all rates of NICs is actually 1.25p on Employee NICs *plus* 1.25p on Employer NICs.

These problems are all avoidable, by taking steps to fix our broken National Insurance system instead of applying a new Levy on top. As well as raising more revenue, fixing these problems would make our tax system fairer and more efficient.

[5] This is the annualised equivalent of the 'Primary Threshold' for employment income, set at £184/week. For the self-employed, Class 2 contributions (£3.05 per week) are due once profits exceed £6,515. However, Class 4 contributions (at 9%) only apply to profits over £9,569.

4. What are the alternatives?

There are several other options that the government could have pursued instead of its new Health and Social Care Levy, each of which could raise at least as much revenue.

(1) Fix the gaps in National Insurance

This is the option that we recommend. Instead of a new Levy, we propose fixing some of the biggest gaps in our current system. Specifically, we propose removing the current NICs exemptions for investment income and people of pension age and equalising the rates paid on high earnings with the rates already paid by lower earners. Taken together, these reforms could raise around £30 billion. This new revenue would come mostly from those with incomes above £50k (from earnings and/or investment income) and from older, wealthier people, although it would not affect those receiving only pension income.

(2) Raise Income Tax rates

If for some reason the government felt constrained to tinker with existing tax rates rather than taking on deeper reforms, an increase in Income Tax would be better than the governments proposed Levy. This is because, unlike the Levy, Income Tax also applies to investment income other than dividends. As the Resolution Foundation has shown (Bell & Corlett, 2021), increasing Income Tax would be more progressive than an equivalent rise in existing NICs rates. And as the Institute for Fiscal Studies has shown (Adam, 2021), pensioner families would provide ten times more of the revenue from an Income Tax rise than from the NICs rise that will take effect in 2022-23.

(3) Increase taxes on wealth

In justifying its new Levy, the government has claimed that "Only a broad-based tax base like Income Tax, VAT or NICs can raise the sums needed for such a significant investment in health and social care" (HM Government, 2021). This is wrong. As we have shown in previous work, significant additional revenues can also be raised from reforming how we tax wealth, and income from wealth:

(a) Advani & Summers (2020) recommend **raising tax rates on capital gains** to match income tax, which would raise approximately £14 billion.

(b) Advani, Hughson & Tarrant (2020) model the effect of **plugging holes in Inheritance Tax** by removing exemptions, which would raise approximately £7.1 billion

(c) Advani, Chamberlain & Summers 2020 recommend **introducing a one-off tax on the ownership of wealth**. At a rate of 1% per year over five years, on personal wealth over £2 million, this could raise approximately £80 billion.

5. Our proposal: fixing the gaps in National Insurance

Instead of the government's new Levy, we propose an alternative package of reforms that would fix gaps in our current National Insurance system.

The effect of our proposal is to move towards more equal treatment of income across different sources and levels of income and across different age groups. It is similar to merging NICs with Income Tax to form a single tax on income, which has strong support amongst economists.[6] Our proposal does not constitute a full merger,[7] but it takes significant steps in this direction.

The three reforms are summarised below, with further details in the Appendix:

(1) Remove the current exemption for investment income

Investment income – including dividends from shares, rent from property, and interest from savings – is currently exempt from NICs. We would remove this exemption and apply NICs at the rates needed to achieve equal tax treatment with earnings from employment. The justification for this reform is that all income should be taxed in the same way, regardless of where it comes from.

In setting the appropriate rate of NICs, we need to take account of both Employee and Employer NICs. Although the headline rates of these taxes are 12% and 13.8% respectively, the combined *effective* rate of both taxes is 22.67%.[8] This rate assumes that the cost ('incidence') of Employer NICs is ultimately borne by employees.[9]

Dividends are (usually) paid out of profits that have already been subject to Corporation Tax and face a different – lower – rate of Income Tax than for other forms of income. When setting the appropriate rate of NICs on dividends, we take account of the Corporation Tax already paid, assuming that the incidence of this tax is borne entirely by shareholders.[10]

Following this approach, the NICs rates that we would levy on investment income are as follows:

TABLE 1. NICS RATES CHARGED ON INVESTMENT INCOME UNDER OUR REFORM

Annual income	Dividends	All other investment income
Below £9,659	0%	0%
£9,659 - 50,284	16.17%	22.67%
£50,285 - 150,000	2.38%	13.88%
Above £150,000	1.78%	13.88%

Notes: The income thresholds shown in this table are for 2021-22. For further details on how we calculate these rates, see Appendix A.

[6] See further: https://ifs.org.uk/taxlab/key-questions/should-income-tax-and-national-insurance-be-merged

[7] For example, our proposals would not correct the disparity in tax rates on employment and self-employment income or align the different non-taxable allowances under NICs and Income Tax, although we would also be in favour of both of these reforms.

[8] The combined effective rate is not just the simple sum of the headline rates because in each case the tax base is different. Employee NICs are charged on gross income *after* Employer NICs have been deducted, while Employer NICs are paid in addition to earnings. The rate of 22.67% is expressed as a percentage of the total cost to the individual's employer (which includes Employer NICs in addition to the individual's gross income).

[9] In Appendix C, we show alternative revenue estimates when rates are aligned on the basis of different assumptions about the incidence of Employer NICs.

[10] In Appendix D, we show alternative revenue estimates when rates are aligned on the basis of different assumptions about the incidence of Corporation Tax.

(2) Remove the current exemption for people of pension age

Individuals who are above the State Pension Age (SPA) are currently exempt from NICs, even if they continue working. We would remove this exemption so that these people paid NICs on the same basis as those of working age. This reform is justified because – as we highlighted above – in practice National Insurance is just another tax used to fund general expenditure, so there is no reason to exclude certain age groups.

Under our proposal, individuals older than the SPA would pay NICs on earnings from employment and self-employment, and also any investment income received – in line with our first reform. Pension income (i.e. income received from registered pension schemes) would continue to be exempt from NICs. There is a case for charging NICs on pension income but allowing all pension contributions to be made free of NICs:[11] however, we do not pursue that proposal here.

(3) Equalise the rate paid on high earnings (above £50k) with those paid by lower earners

Earnings above £50,284 are currently taxed a lower NICs rate of 2%. This threshold is known as the 'Upper Earnings Limit' (on employment income) or 'Upper Profits Limit' (on self-employment income). We would abolish both of these limits so that earnings above £50,284 were taxed at the same NICs rate that currently applies to lower earnings: 12% on employment income or 9% on self-employment income.

This reform entails a substantial tax increase of up to 10p on incomes above (approximately) £50k per year. For this reason, it is the most controversial of our proposed reforms. Ultimately, whether it is justified depends on how progressive one would like taxes on income to be. It is important to understand however, that as a result of the lower NICs rate on high earnings, our current taxes on income are much less progressive than would appear from looking just at Income Tax rates alone.

One likely objection to this reform is that when the top rate of Income Tax was raised from 40p to 50p in April 2010, it did not raise much additional revenue. However, in large part this was because individuals anticipated the reform by bringing forward dividend payments and bonuses.[12] These responses were avoidable if the reform had not been announced so far in advance of being implemented.

[11] See further Mirrlees et al (2011: ch14).

[12] See further Browne & Phillips (2017).

6. How much revenue would it raise?

The following table shows how much revenue could be raised from our proposed reforms to National Insurance and compares this with the revenue from implementing the government's plan. These are static estimates, not accounting for any behavioural response.

TABLE 2. REVENUE: OUR REFORM VS GOVERNMENT'S PLAN

	Revenue (£bil)
(i) Remove exemption for investment income	8.6
(ii) Remove exemption for pension-age individuals	3.2
(iii) Equalise rate on high earnings	19.7
Total revenue from our reform (i)-(iii)	**31.4**
Net revenue from our reform, after reducing main rates by 1.25p	15.4
Government's plan: additional Levy	**14.9**

Notes: Each reform assumes that the previous reform has been carried out (e.g. investment income included in all). Investment income is charged at the combined effective rate of Employee and Employer NICs (22.67% between Primary Threshold and Upper Earnings Limit (UEL); 13.88% above UEL).

Source: Authors' calculations based on the SPI 2016-17.

Our modelling shows that removing the NICs exemption for investment income – taxing this in line with employment income – would raise an additional £8.6 billion in tax revenue. If the exemption for people of pension age was also removed – taxing their employment, self-employment, and investment income – this would generate a further £3.2 billion. Together, these reforms would raise £11.8 billion.

Equalising the NICs rates on high earnings in line with the rates already paid by lower earners, could raise a further £20 billion. This would allow the government to *cut* the main rate of NICs by 1.25p and still raise roughly the same amount overall as would be raised by the government's planned new Levy.

These estimates highlight that fixing our existing National Insurance system is not just technical tinkering – our proposed reforms have the potential to raise serious revenue and provide a real alternative to the government's planned Levy.

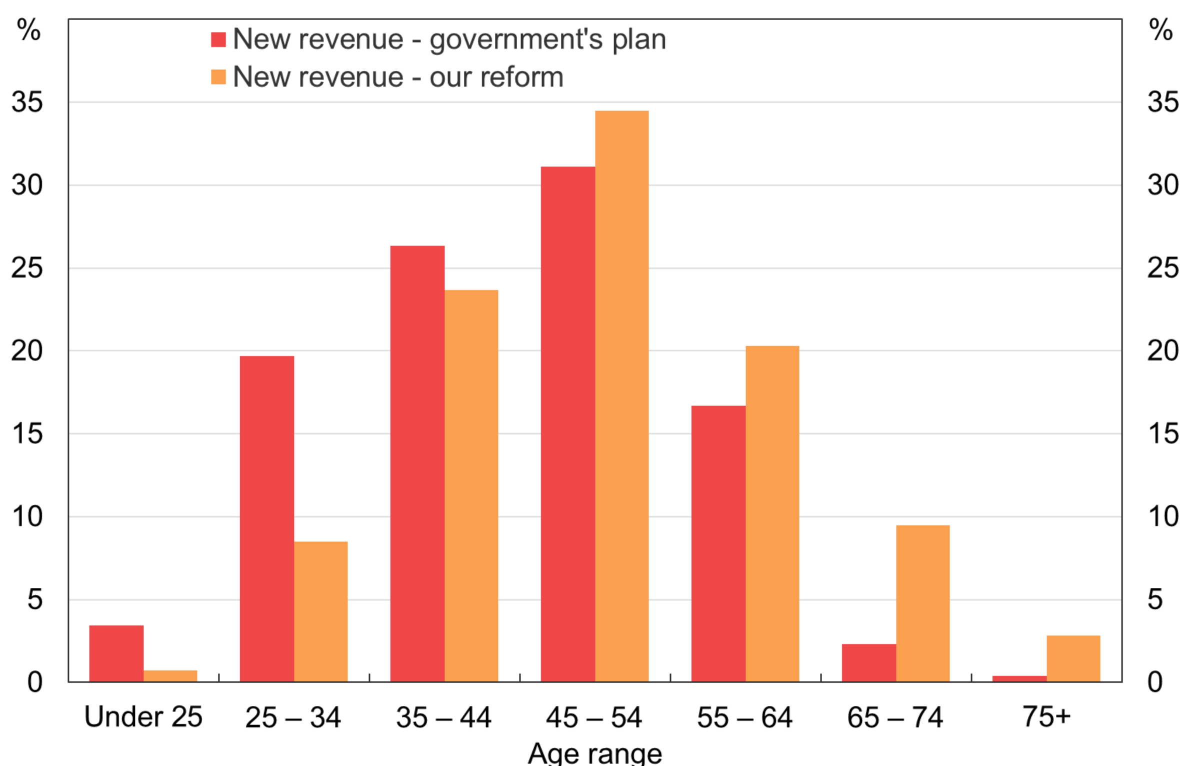
7. Who would pay?

Our proposal asks those earning income from wealth, and those above pension age, to contribute to the National Insurance system just as those of working-age earning employment or self-employment income do currently. Compared to the current situation, we argue that our proposed reform would be a fairer way to tax income.

Impact by age

As people of State Pension age, even those who are still working, are currently exempt from paying NICs, the burden of the tax falls heavily on younger people: half the revenue raised by the government's new Levy would come from people aged under 45 (Figure 1). Given that the aim of the reform is to pay for social care, it seems unfair to saddle the young with these costs. Our proposed reform would shift the balance further up the age distribution.

FIGURE 1. SHARE OF ADDITIONAL REVENUE PAID BY AGE GROUP



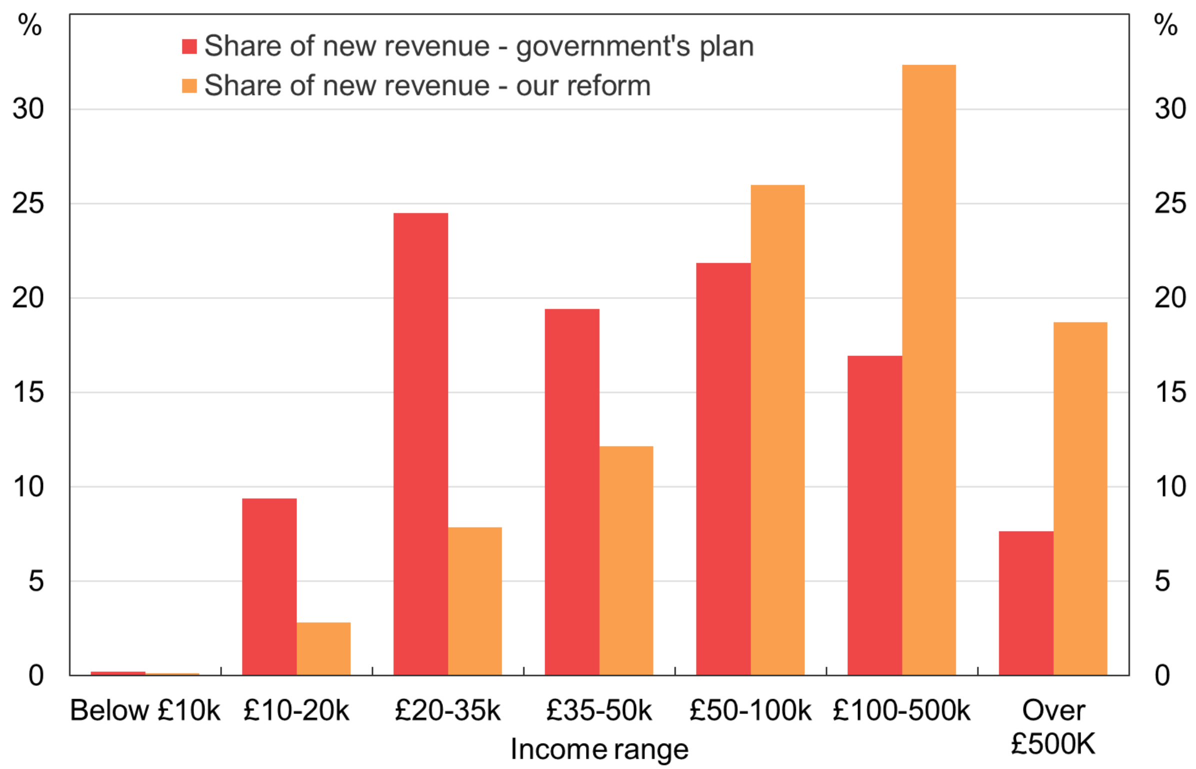
Notes: For details of data and methods, see Appendix A. For distributional impact of each component reform in isolation (compared with the status quo and raising NICs rates), see Appendix E.
Source: Authors' calculations based on HMRC administrative data, 2016-17.

Impact by income level

Currently, the burden of making National Insurance Contributions falls on those earning £20-50k per year: they contribute 50% of all revenue raised through NICs, despite only earning 42% of total income. Under the government's plan, those earning £20-50k would fund 44% of the additional revenue, with another 9% coming from people earning £10-20k (Figure 2). Under our reform, the

burden lies mainly on those earning more than £100,000 per year, who would contribute half of the additional revenue.

FIGURE 2. SHARE OF ADDITIONAL REVENUE PAID BY INCOME RANGE

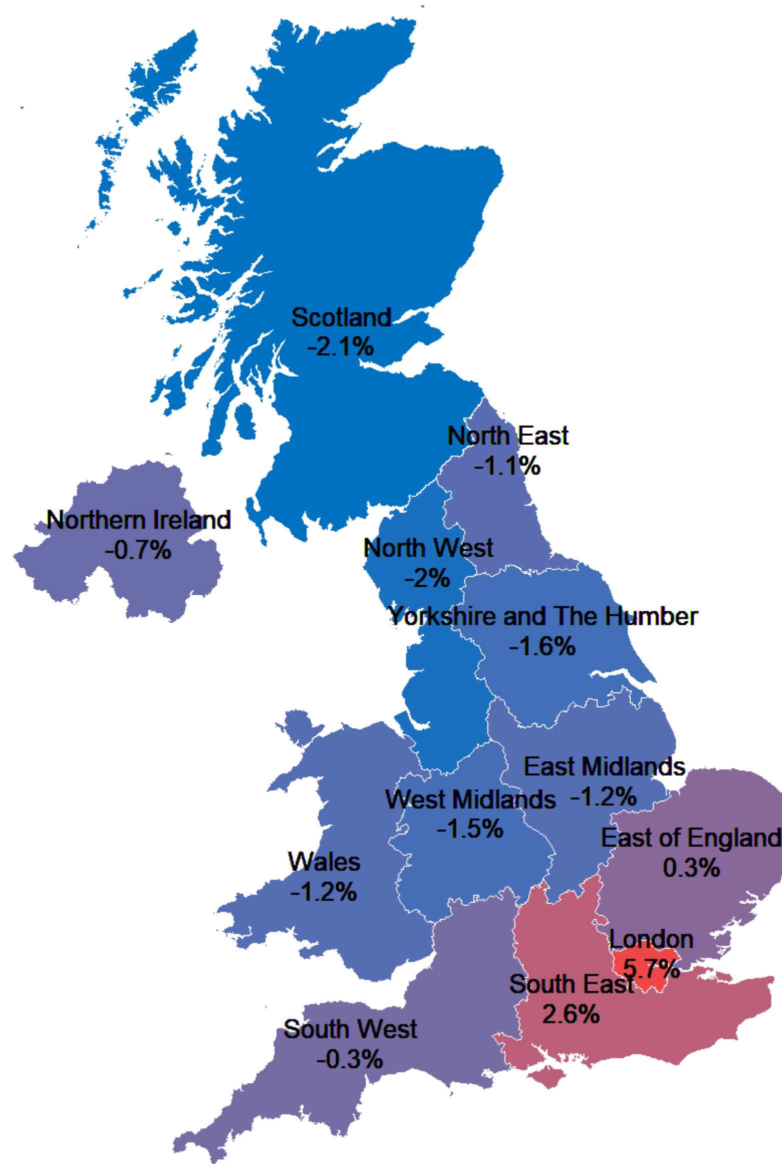


Notes: For details of data and methods, see Appendix A. For distributional impact of each component reform in isolation (compared with the status quo and raising NICs rates), see Appendix E.
Source: Authors' calculations based on HMRC administrative data, 2016-17.

Impact by region

Filling the gaps in the current NICs system would also fit better with the government's 'levelling up' agenda. Londoners would contribute 26.8% of the additional revenue raised under our reform, but only 21.1% under the government's plan – a difference of 5.7 percentage points (Figure 3). The full distribution across regions is shown in Appendix E.

FIGURE 3. ADDITIONAL SHARE OF REVENUE PAID UNDER OUR REFORM BY REGION



Notes: Figure shows difference between share of revenue coming from each region under our reform and share of revenue coming from each region if raising existing NICs rates. For details of data and methods, see Appendix A. For distributional impact of each component reform in isolation (compared with the status quo and raising NICs rates), see Appendix E.

Source: Authors' calculations based on HMRC administrative data, 2016-17.

8. Conclusion

The government's Health and Social Care Levy is a third tax on income, on top of Income Tax and National Insurance Contributions. Instead of fixing the gaps in our existing National Insurance system, the government has chosen to compound them by levying another NICs-like tax on top.

Our proposal would instead deal with some of the worst features of our current National Insurance system. Our plan to remove the NICs exemptions for investment income and people of pension age could alone raise £11.2 billion - roughly the same as the government's new Levy.

If the government also equalised the NICs rates paid on higher earnings with those currently paid on lower earnings, then this could raise an additional £20 billion. That sum could be put towards public services, or it could be used to fund a *cut* in the main rates of NICs of 1.25p - the same amount by which the government plans to increase rates.

Focusing tax rises on younger and lower earners is a political choice; it does not need to be this way.

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