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ECONOMIC PERSPECTIVES

National Insurance: How to Get Rid of a Bad Tax

Successive governments have attempted to conceal from the public the true nature of national insurance payments, which in 1979/1980 are expected to exceed £19,000m. Though termed 'contributions', implying their payment is voluntary, for employees they are a form of income tax; for employers they are a form of corporate tax. Governments make great play of any (real or illusory) reduction in income tax but the seemingly inexorable rise in national insurance 'contributions' is much less publicised. To government this source has always appeared a painless way of raising revenue without losing votes. As a result these contributions now exceed VAT payments by a significant amount and have grown from 44% of the income tax take in 1970 to 66% in 1979. Indeed employers contributions in the latter year (£9,189m) were only marginally less than the trading profits of companies and financial institutions!

National insurance is a thoroughly bad tax and ought to be replaced. Its disadvantages are legion. Firstly it is a regressive tax. That is, the richer you are, the smaller the proportion of your income you contribute. This arises because contributions are levied only on the first £200 of weekly income. So a man earning £20,000 pays no more than a man earning £11,000. This contravenes the accepted notion that personal taxation should bear most heavily on those best able to pay. The present contribution system does the opposite.

Secondly, national insurance reduces the competitiveness of British firms competing against foreign goods both at home and abroad. Insurance contributions raise the costs of British goods but are not payable by foreign firms.

Thirdly, national insurance contributions distort the labour market. They obviously weight most heavily on firms which are labour intensive, thus inducing businesses to economise on the amount of labour they employ. This seems a perverse effect at a time of high unemployment. More subtly, they induce intensive use of existing labour through overtime working, again at the expense of increased employment.

Finally, the national insurance scheme as administered presently undermines the automatic stabilising tendencies of the economy. Mechanisms which pump spending power into the economy during a recession and take it out during a boom are termed automatic stabilisers. The national insurance scheme, by making payments to an increasing number of unemployed during a slump, is frequently thought to fulfill this role by replacing lost spending power. This view is tenable only if the government is willing to run a deficit on the national insurance fund. The present government, by reducing the exchequer contribution to the fund from 18% to 14% and by increasing contributions, seem by contrast to be wedded to the notion of a self-financing system.

Given all these disadvantages, how could the scheme be replaced? The most obvious route would be to subsume contributions within the existing tax system. For the employee, contributions could be made payable through the income tax system. At present, this would imply a standard rate of 37% or alternatively one might spread the load across the various tax bands, thus making the system more progressive if desired. This proposal has the advantage that all compulsory deductions are combined into one clearly defined tax rate, thus considerably reducing the scope of the Chancellor to surreptitiously reduce take home pay.

Employers' existing contributions could be replaced by a change in the VAT system. One way of achieving this would be to widen the scope of the VAT system and/or increase the rate. For example, extending VAT at the current rate to those items currently exempt or zero rated would be sufficient to replace existing employers contributions. The competitiveness of British industry would thus be significantly improved, since VAT is levied on both domestic and foreign goods and can be recouped on UK exports.

Further economy-wide attractions of these changes include reduced administrative costs as the funds would be collected through the existing income tax and VAT network. Distortions in the labour market would also be reduced, the bias against labour intensive industry vanishing and the incentive to offer overtime work greatly diminished. To the government, though increasing the degree of scrutiny to which revenue raising measures are subjected, the proposed changes offer increased flexibility in pursuing genuinely countercyclical policies.

There are, of course, disadvantages. Most important of these would be the initial inflationary impact of the increase in VAT. But as employers came to gradually realise that there had not been any overall increase in their costs, domestic prices would subsequently grow more slowly. The price of imported goods would remain at the new, higher level. At most, the immediate effect of the proposal outlined above would be to raise the retail price index by 6%. In all probability the increase would be considerably less. Taken together, the objections seem lightweight when compared with the positive advantages of scrapping national insurance contributions. The present structure ought therefore to be changed. The difficulty will be to persuade the government that the public will no longer tolerate the use of the national insurance scheme as a source of easy revenue.

D N F Bell
F X Kirwan