PAYE: our most important tax system

Employment Tax



21 February 2025

Since its introduction over 80 years ago, PAYE has continued to evolve. Where is it heading next?

The single most important tax system in the UK is, of course, the Pay As You Earn system. In 2023-24, PAYE brought in some £409 billion, or about 42% of national accounts taxes. The 2024-25 figure is expected to be £423 billion, or 41% of total taxes – affected, of course, by the reduction in individual National Insurance contributions enacted by the last government.

How did we get here?

Our current PAYE system commenced in 1944, as the Treasury worried that the growth in employment income during the Second World War meant that a proper withholding was needed. Before the war, about 10% of adults paid income tax; after the war that had climbed to about 30%. About a million employers started to withhold tax from 16 million employees under the new system.

Right from the start, PAYE was determined by a tax code setting out which additions and deductions should be made from employment income. Everything then had to be rounded as, without computers, precise calculations (in pounds, shillings and pence!) would have been impossibly cumbersome.

The next big step was in 1975, when National Insurance began to be collected through the PAYE system. Before that, National Insurance was paid by buying stamps and sticking them to the employee's card, which was then sent to the giant National Insurance centre at Longbenton for processing. This meant that for the first time the amount of National Insurance varied by income, replacing the flat rate stamps.

Twelve regional PAYE databases were set up in 1984 to replace a system of paper records (computing power meant that a single system wasn't possible). Twenty-five years later, in June 2009, HMRC introduced the new National Insurance and PAYE System (NPS), replacing the 12 databases with a single database of employees and pension recipients.

When holding all the data in a single place, reconciling an individual's tax liability with that tax withheld should have become an automatic process, replacing the manual process previously needed. Unfortunately, the introduction did not go well. The new system was delayed by a year for testing, which meant that the annual reconciliation exercise was delayed, too. The result was that over 6 million taxpayers found out late that they had over or underpayments – and in 2010 there were nearly 18 million open cases that took HMRC over two years to reconcile. In the end, billions in tax revenue were written off, at some damage to the reputation of the newly formed HMRC.

The next big step was the announcement in 2010 of a move to Real Time Information (RTI), where employers pass information about employees every time a payment is made – not just at year end. HMRC worked closely with employers, professional bodies and others involved to help make sure that RTI was a success. It was probably the first and best example of collaborative working when introducing a major new tax system. Much was made at the time of the need for high quality data, which RTI was intended to produce, but it was necessary for HMRC to reconcile its existing data with that held by some 2 million employers.

Where are we going?

The next move is to introduce the mandatory payrolling of benefits in kind, set for April 2026. The aim is to get rid of separate benefits reporting and the need to recover tax on them through adjusting the tax code. This was an idea supported both by the Office of Tax Simplification and HMRC's independent Administrative Burdens Advisory Board (ABAB). However, ABAB urged HMRC to delay the introduction until it has resolved the data needed to be supplied by employers and payroll systems, come up with methods for taxing and reporting accommodation and loan benefits, and given at least 18 months' notice so that software, payroll systems and employers can prepare and adapt (see tinyurl.com/5dte4tej).

The Tax Code remains one of the vital parts of the UK system, intended to remove the need for most employees to file tax returns. However, it is one of the least understood parts of the system, despite HMRC's efforts to express the concepts in simple language. Finding simpler approaches could help people to at least check that they recognise the entries in the tax code, even if they don't quite follow how it leads to the right amount of tax being collected.

The other open challenge is how to improve the process for the several million people who start and leave jobs every year. Leaving at the end of the monthly pay period, starting at the beginning of the next one, and completing accurately the necessary information in the starter checklist or the P45 should mean that the correct amount of tax is deducted in the year. Unfortunately, it doesn't always work that way, and millions do end up with over or under deductions and incorrect tax codes which need to be updated. Finding ways to improve this would bring big benefits for employees, employers and for HMRC.

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