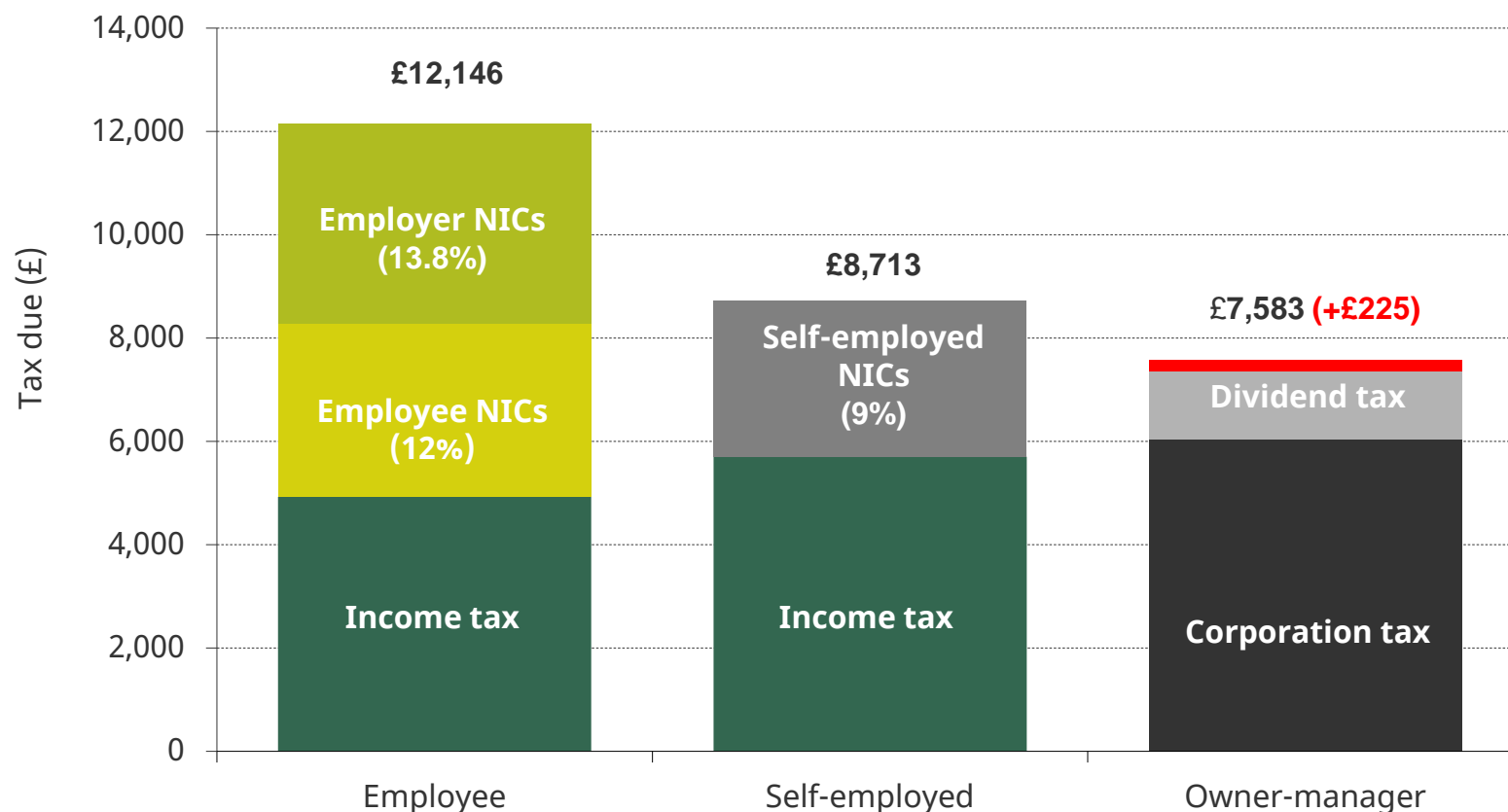


Different ways of working: problems with the tax system

Helen Miller

The tax system penalizes employment

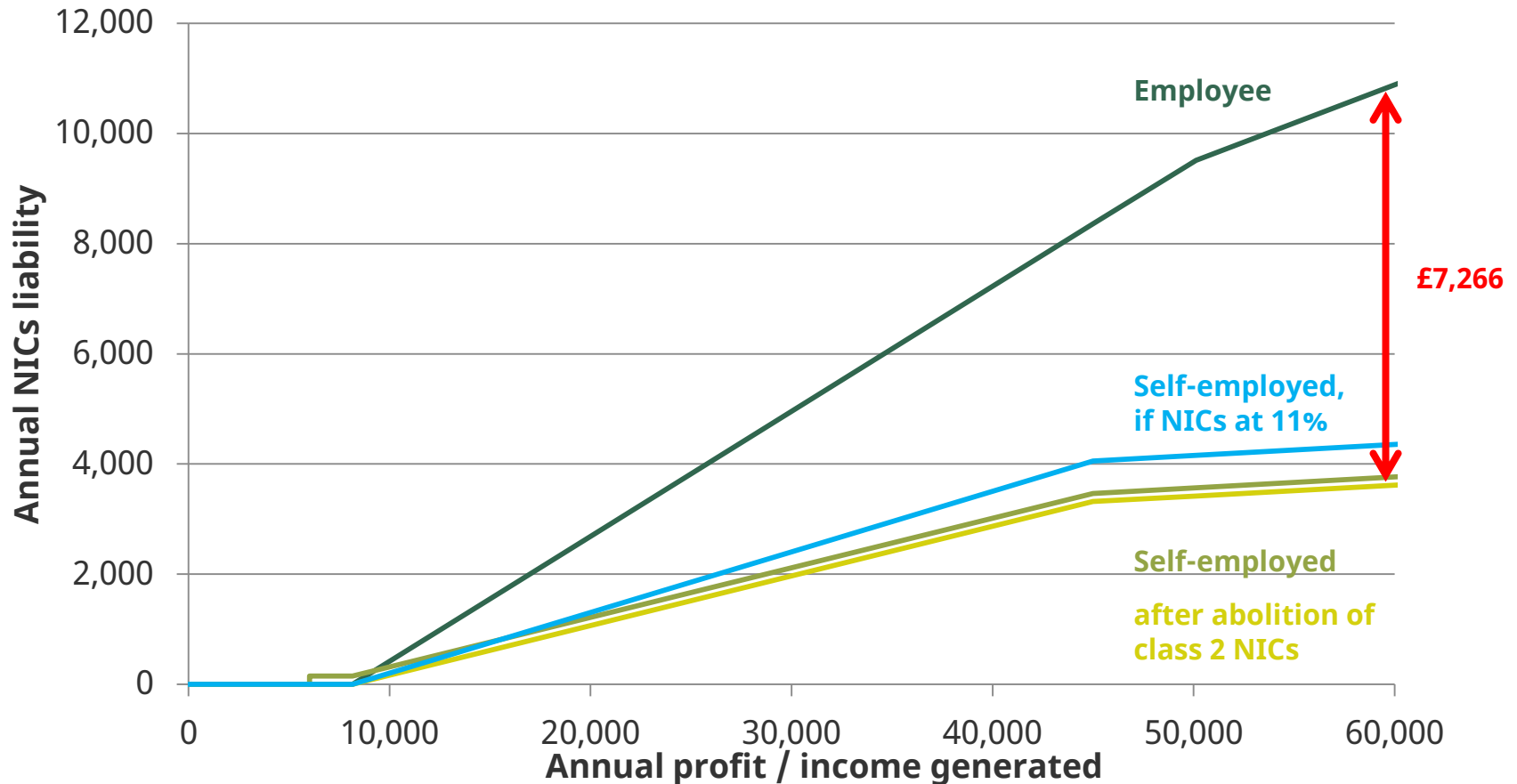
Tax due on a job generating £40,000, 2017–18



Notes: Income tax is slightly higher for the self-employed than for employees in this chart only because the latter are charged income tax on income *net* of Employer NICs. Red block shows effect of planned cut to dividend allowance, shown as if introduced in the 2017-18 system for illustration.

NICs much higher for employees than self-employed

National Insurance Contributions schedule, 2017-18



Notes: For illustration, the abolition of class 2 NICs and Class 4 NICs rates at 11% are shown as if introduced in the 2017-18 system. Employee schedule includes employer NICs.

Why are tax differentials a problem?

Fairness: similar individuals doing similar work can be taxed very differently

Efficiency: individuals' choices are distorted

- Clear evidence that tax affects choice of legal form & how to take income
- Opens avoidance opportunities & requires rules to police boundaries

More business owners means less tax revenue

Lower rates cost significant sums

- HMRC estimates that in 2016–17:
 - £5.1bn forgone through lower self-employed NICs
 - £1,240 per self-employed person
 - Self-employed NICs only raises £3.0bn
 - £6.0bn forgone through lower taxes on company owner-managers
 - £9,040 per company owner-manager

Costs are set to grow

- OBR estimates that by 2021-22 revenues will be lower by:
 - £3.5bn as a result of growth in incorporation
 - £1.0bn of result of growth in self-employment

Lower NICs do not reflect lower access to publicly-funded benefits

The self-employed get very similar state benefits to employees

- From April 2016 both accrue same rights to single tier state pension
- Self-employed don't get contribution-based JSA ...
- or statutory parental benefits
 - but can access Maternity Allowance

The NICs advantage is far bigger than differences in benefit entitlements

- Differences in benefits could justify less than 1 ppt difference in rates

There's no reason to use tax to try to correct for different employment rights

Self-employed don't get employment rights such as holiday & sick pay

- Argument: employment rights justify higher rates on employees

Employment rights are a transfer from employers to their employees, not a benefit given to employees by the government

- Make employment more attractive to the employee – higher tax offsets this
- Make employment **less** attractive to the employer – higher tax reinforces this

There is no net benefit to employment for tax to offset

Current system not well targeted at risk taking & entrepreneurship

Difficulty & risk associated with running a business do not in themselves justify favourable tax treatment

What is it that we want to support?

- Innovation, start-ups, investment, those on low incomes ...

Across-the-board lower rates are poorly targeted

- And come at cost of creating boundaries in tax system

There are better ways

Big picture solution

Remove distortion to investment by adjusting the tax base

- Money invested in a business should be tax deductible
 - means that breakeven investments not taxed

Align rates at the margin

- Align the NICs paid by self-employed with employers & employees combined
- Tax dividend income and capital gains under same rate schedule as earned income (including NICs), after accounting for corporation tax already paid

This solution treats the tax system as a system

Conclusions

Hard to think of a coherent policy aim to which the current system is the appropriate response

- Large tax differences between legal forms are unfair and inefficient ...
- not justified by differences in public benefits or employment rights
- and poorly targeted at entrepreneurship

Aligning treatment of employees/self-employed/owner-managers should at a minimum be the benchmark

- Preferable to trying to make sharper boundaries between legal forms

Separating tax issues from employment rights makes current challenges more manageable