IFS Green Budget 2017

In association with ICAEW and funded by the Nuffield Foundation.

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Tax, legal form and the gig economy

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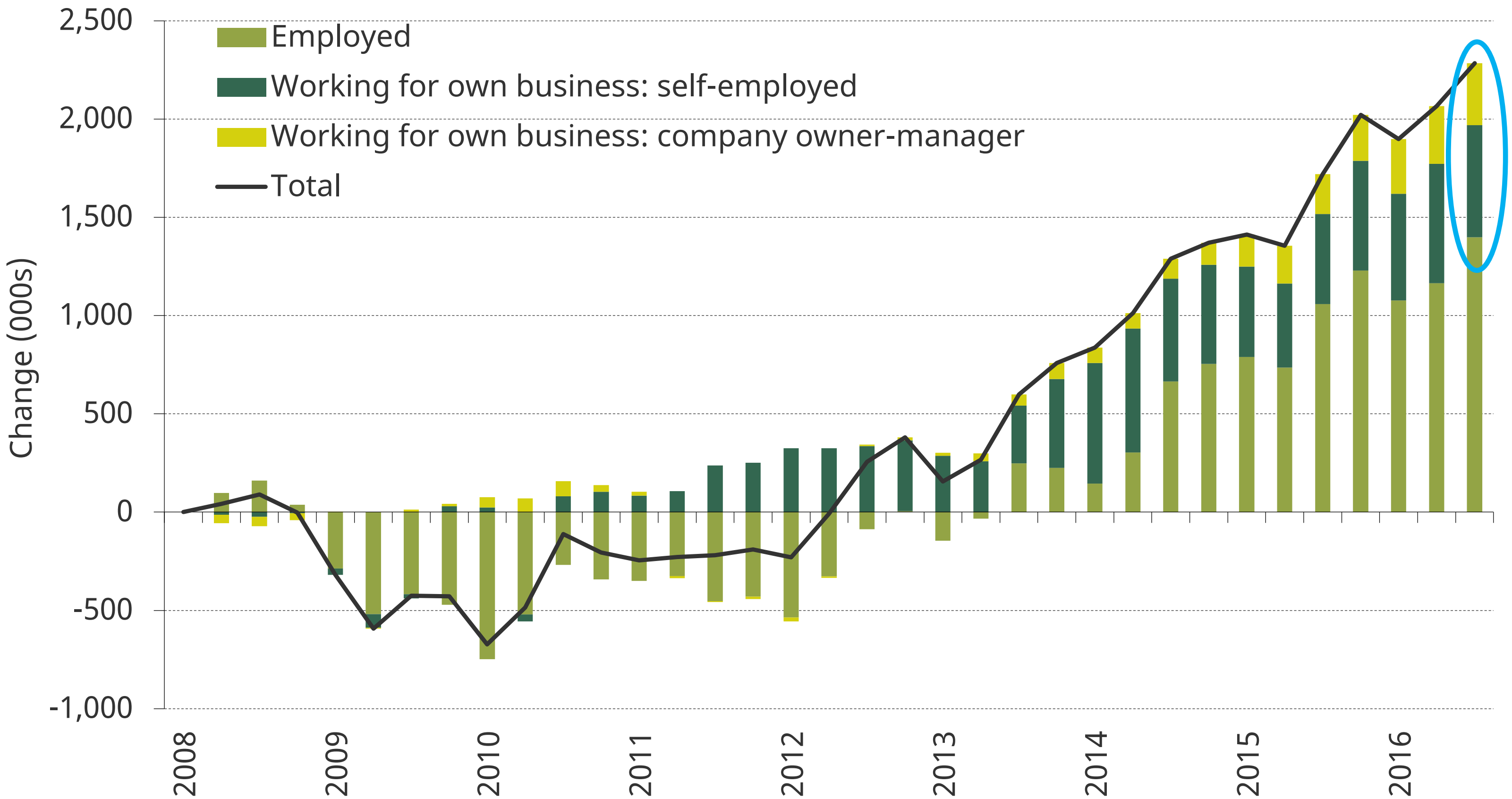
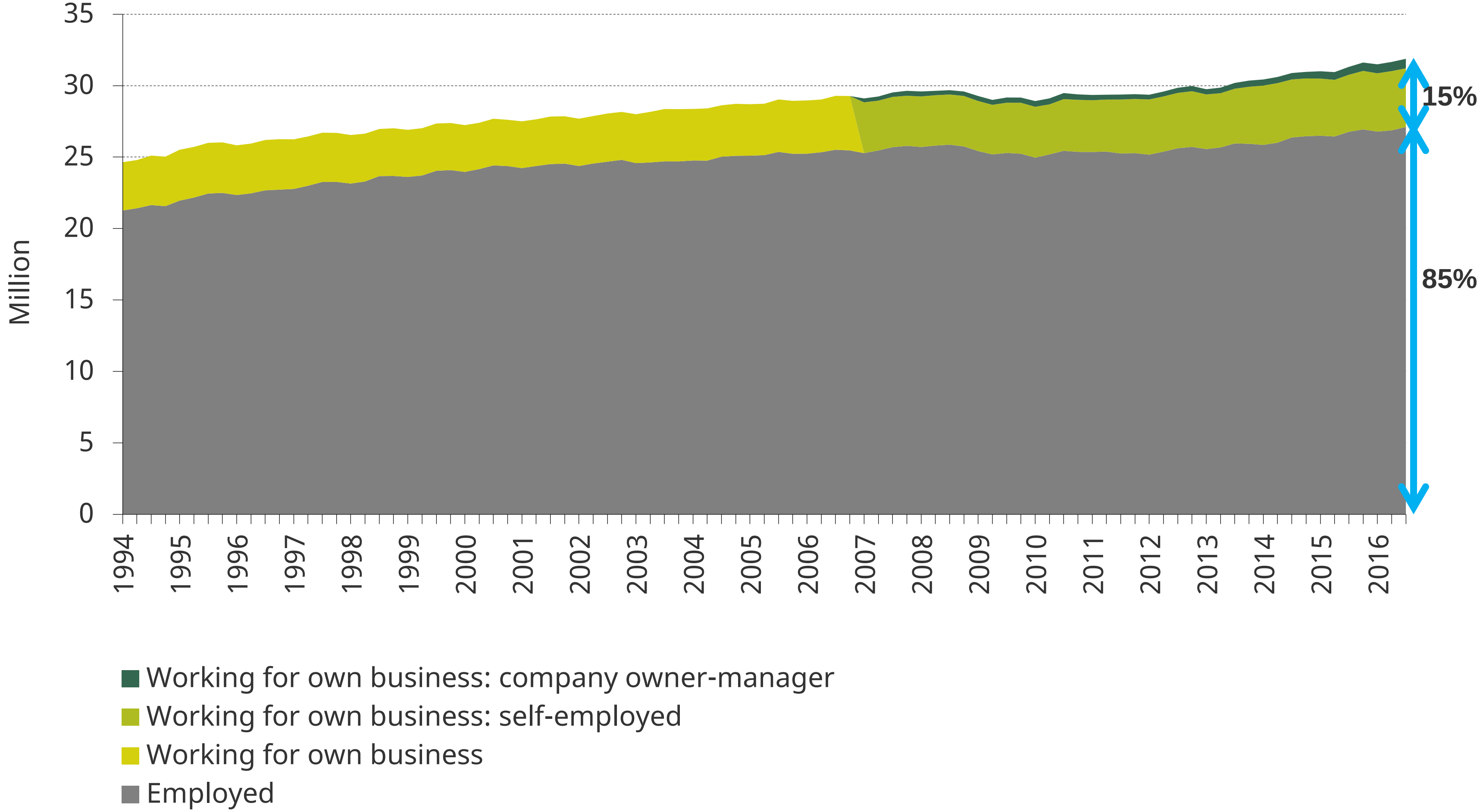
More individuals are working for their own business …



Source: Figure 7.2 of the Green Budget

… but employees are still the bulk of the workforce



Source: Figure 7.1 of the Green Budget

The tax system penalizes employment …

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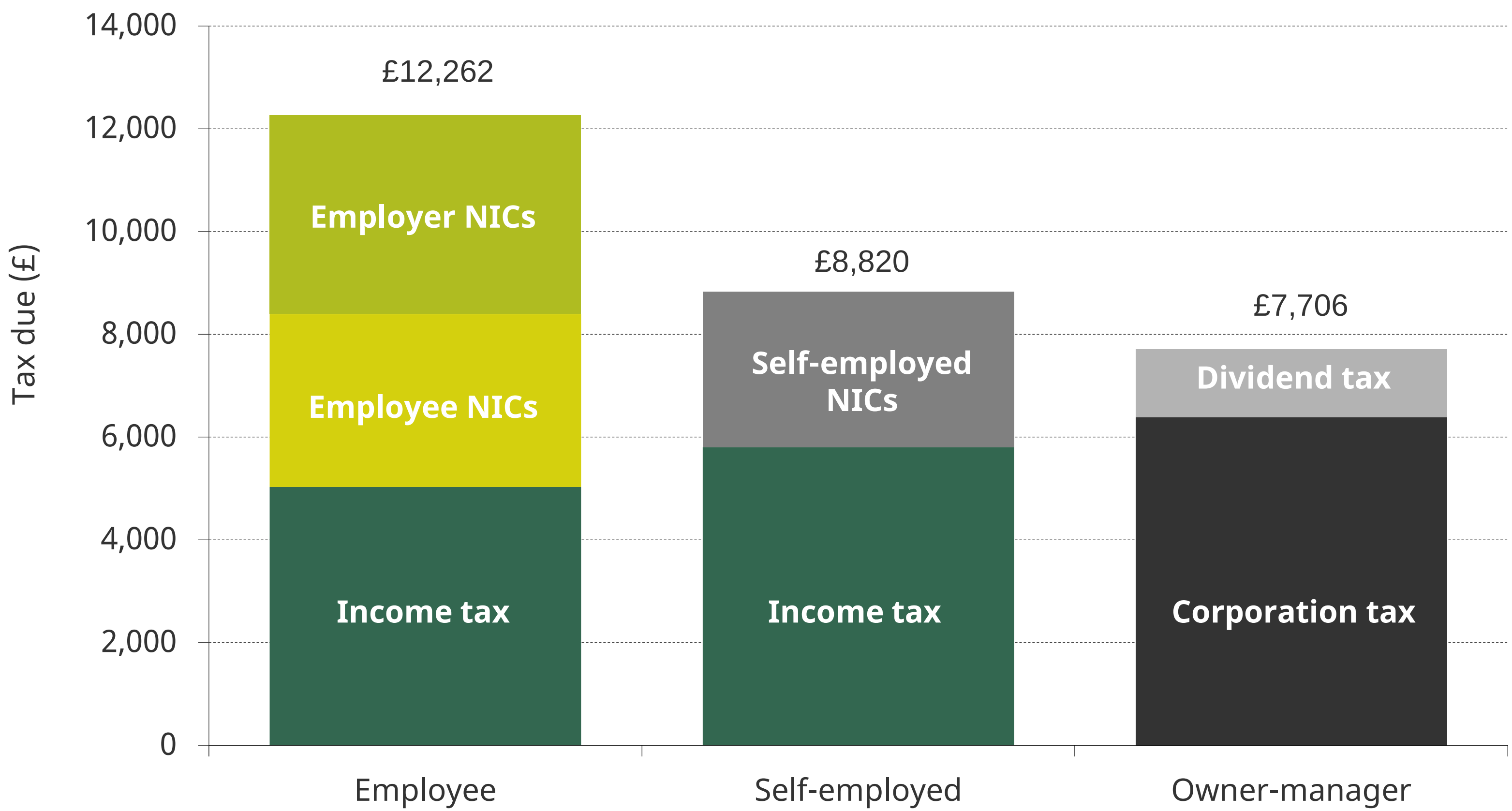
Tax due on total income of £40,000, 2016–17



Source: Figure 7.3 of the Green Budget. Notes: Income tax is slightly higher for the self-employed than for employees because the latter are charged income tax on income net of Employer NICs.

… and has been doing so for years

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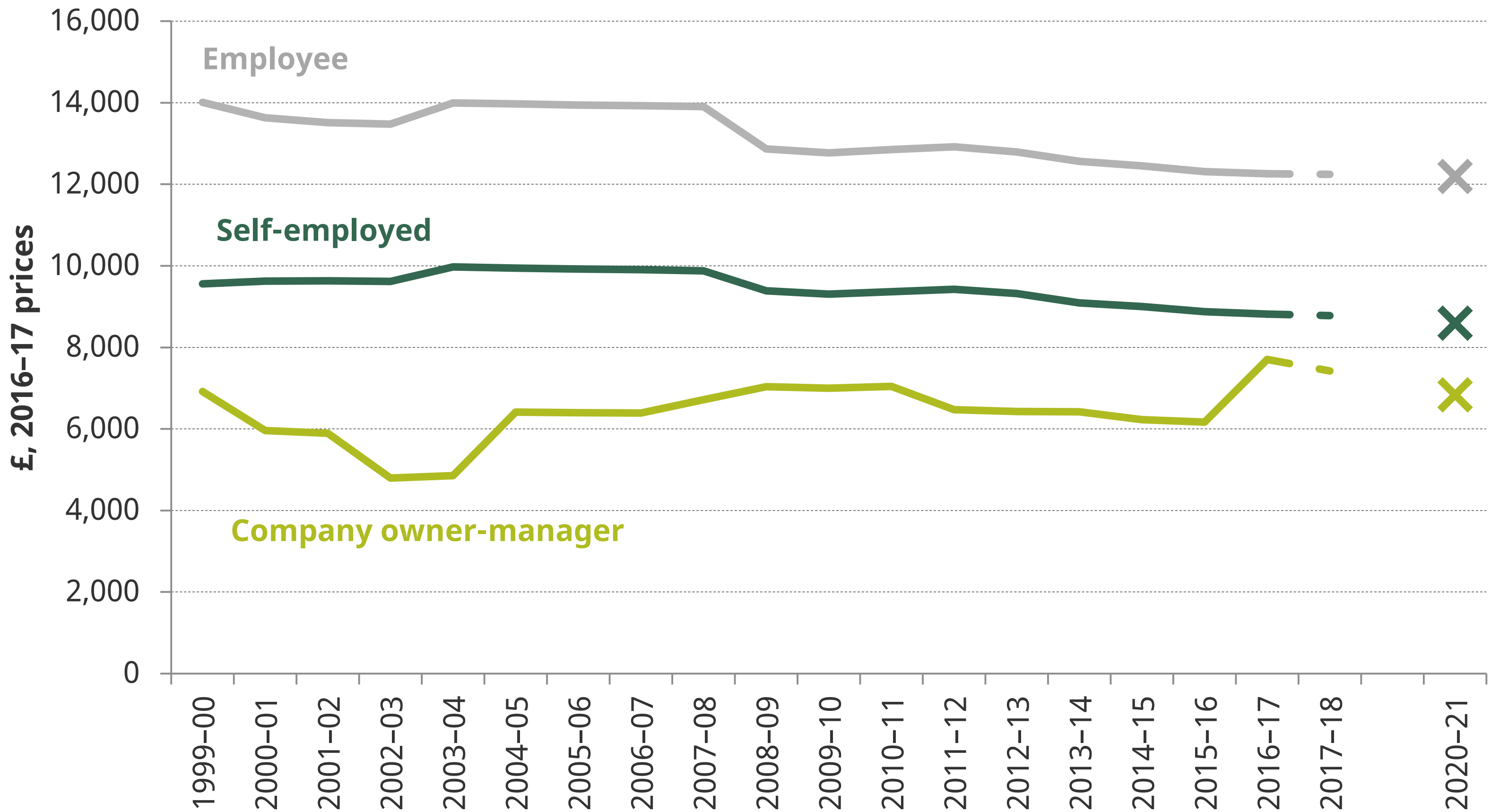
Tax due on total income of £40,000, over time (2016–17 prices)



Source: Figure 7.5 of the Green Budget

Running your own business has a range of other tax perks

Easy to access advantages:

- Split income with a spouse
- More scope to deduct work-related expenses from income

Tax avoidance (legal) or evasion (illegal)

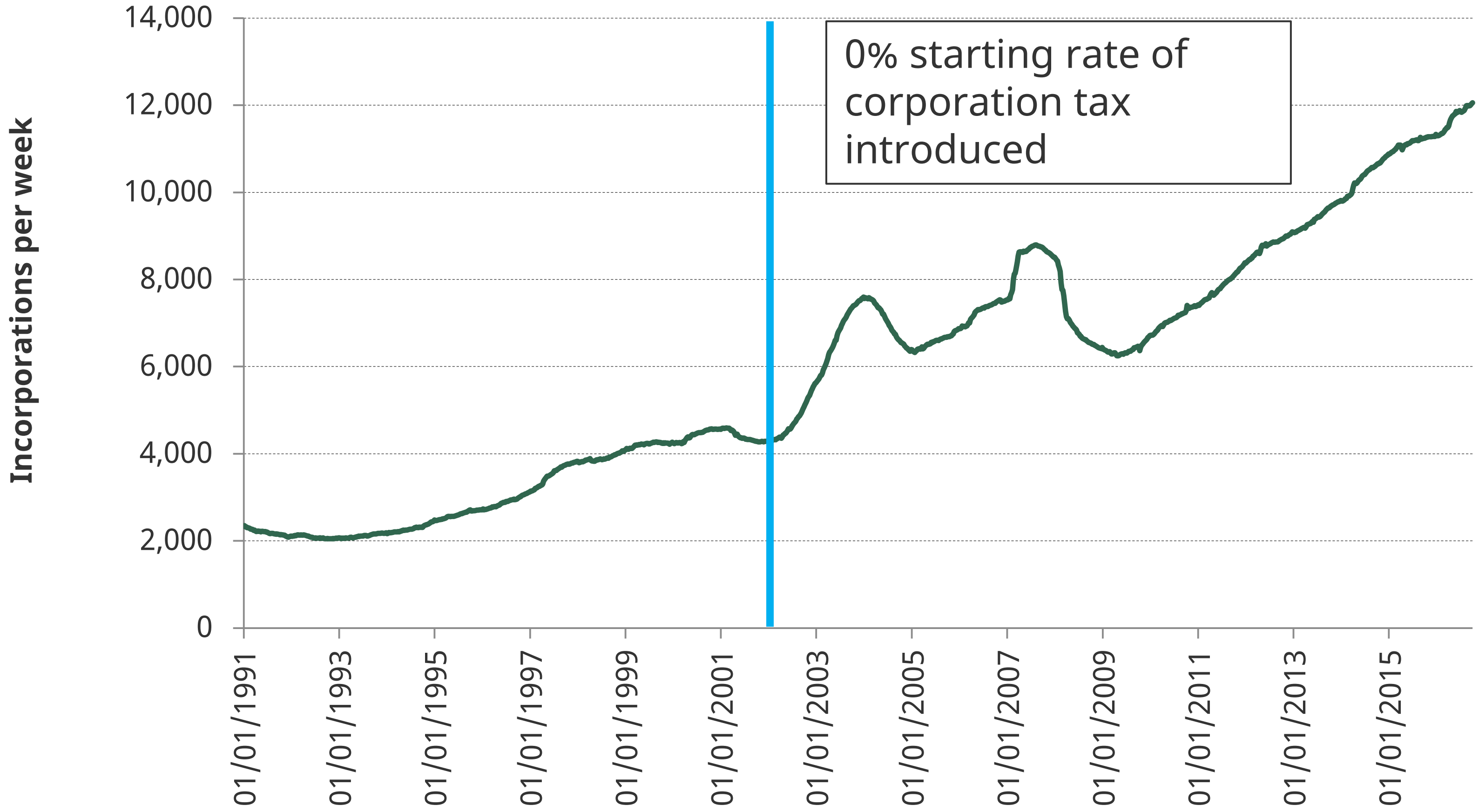
- HMRC estimates 30% of self-employed tax returns understate the amount of tax due

Retaining earnings in a company can bring even more benefits

- At personal level, in higher rate tax band, money withdrawn as:
  - dividends taxed at 32.5%
  - capital gains (under entrepreneurs' relief) at just 10%

People respond to incentives to incorporate

Incorporations per week



Source: Figure 7.6 of the Green Budget

Why are tax differentials a problem?

Why are tax differentials a problem?

Similar individuals doing similar work can be taxed very differently

- This is unfair
- It distorts individuals' choices, which can be inefficient
- Opens avoidance opportunities & requires rules to police boundaries

Genuine differences do not justify current treatment

Lower rates don't reflect lower access to publicly-funded benefits

Lower entitlement to publicly-funded benefits may justify lower rates in principle

But the self-employed get very similar benefits to employees

- E.g. from April 2016 both accrue same rights to single tier state pension

The NICs advantage is far bigger than differences in benefit entitlements

- HMRC estimates £5.1 billion (£1,240 per self-employed person) revenue forgone through lower NICs in 2016–17
- Self-employed NICs only raises £3.0 billion

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 affect employees and employers

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

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

- There is no net benefit to employment for tax to offset

Lower rates are poorly targeted at entrepreneurship

Difficulty & risk associated with entrepreneurship do not in themselves justify favourable tax treatment

Is the market failing to produce enough entrepreneurship?

If so, are across-the-board lower rates the best policy response?

- They are poorly targeted
- And come at cost of creating boundaries in tax system

The tax system *should* treat investment differently

Self-employed & owner-manager income is return to capital & labour

- The tax system should not discourage investment

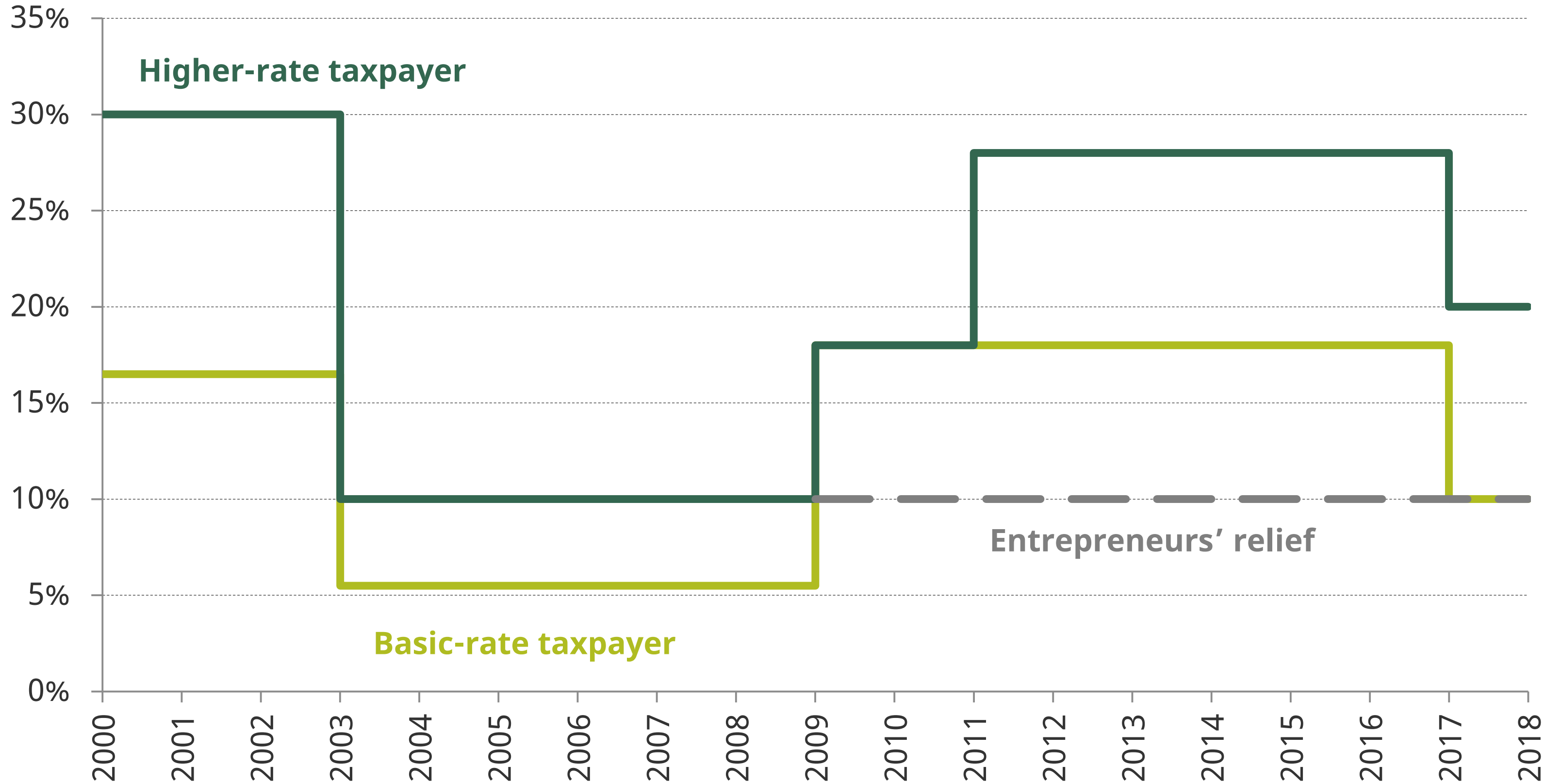
Using lower rates to avoid discouraging investment creates a trade-off

- Lower rates = lower distortion
- But also more incentive to convert labour income into capital income

The capital gains tax roller coaster

Institute for Fiscal Studies

Capital gains tax rates for a business asset held for 2 years, 2000–01 to 2018–19



Source: Figure 7.5 of the Green Budget

Big picture solution

Best way to remove distortion to investment is to adjust 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

Summary

There are large tax differences across legal forms

- This is unfair and inefficient
- Differences are not justified by differences in public benefits or employment rights
- Lower headline rates poorly targeted at entrepreneurship

A comprehensive solution is radical but worth it

Long-term vision for the tax system would be great first step

There will be losers and winners

- Keeping the current system allows inequities to persist
- The longer we wait the more losers there will be