Different ways of working: problems with the tax system

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The tax system penalizes employment

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

£12,146

Employer NICs (13.8%)

£8,713

Self-employed NICs (9%)

£7,583 (+£225)

Dividend tax

Income tax

Corporation tax

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.

Different ways of working: problems with the tax system
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