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Principles and practice of taxing small business

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Principles and practice of taxing small business*

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Abstract

The UK taxes business income at much lower rates than employment income. In this paper we describe the problems caused by that differentiation and assess the main arguments used to defend it. We summarise the Mirrlees Review's proposals for radical reform that would align tax rates across legal forms while protecting incentives to save and invest. Finally, we consider the obstacles to implementing such a radical reform and suggest an approach to making progress in practice.

JEL classification: H20, H21, H25

Keywords: Tax, small business, self-employment, tax-motivated incorporation, entrepreneurship.

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1 Introduction

The UK imposes very different tax liabilities on income from work depending on legal form. Largely as a result of the fact that not all incomes are subject to National Insurance contributions (NICs) and some are subject to preferential rates, employees face a tax penalty relative to those who conduct work through their own business.

The way different incomes are treated for tax purposes is a problem. The system is unfair, complex and economically inefficient. These problems are not new and not unforeseen. Researchers have been highlighting the problems and predicting that they would grow, including as a result of changing work patterns that blur the lines between employment and self-employment, for more than two decades. As the problems have grown, so too have the costs, including the revenue cost to government. Official forecasts in 2017 implied that lower tax rates for the self-employed and company owner-managers relative to employees would cost about £15 billion in 2021–22.

This chapter reviews how the UK tax system treats different legal forms, how that has changed in the last two decades and how the problems have evolved with changing work patterns. We then turn to consider why, given that the problems are known, substantial, long running and growing, there has been so little progress in fixing them.

We suggest that part of the reason that the current system persists is widespread beliefs that the system is justified – i.e. that there are benefits that offset the costs imposed by differentiating tax by legal form. We set out why none of the common arguments holds up. Levying lower taxes on the self-employed cannot be justified by differences in publicly funded benefits (the differences are far smaller than the tax advantages) or by differences in employment rights (which do not act to skew the labour market towards employment). Lower tax rates are also poorly targeted at boosting entrepreneurship.

It has long been recognised that there is a great deal of heterogeneity within the small business population and that not all are 'entrepreneurial'. The latest research using HMRC tax records is allowing the population of the self-employed and company owner-managers to be described in much more detail, including highlighting that most business owners, while conducting perfectly respectable trades, are not employing others, investing or growing – let alone doing anything that produces positive 'spillovers' to wider society and that will therefore be underprovided by the market. The serves to demonstrate how poorly targeted the tax breaks are.

Another reason why there has been little progress towards a solution is that the leading solution proposed – which was set out in the IFS-led Mirrlees Review (Mirrlees et. al (2011) and which required substantial changes to both rates and bases of various taxes – is seen by many as too radical to be workable or even desirable.

This combination of factors – the beliefs that there is a valid reason to apply lower tax rates to business owners or that the solutions are not achievable – has led policymakers to respond to challenges by trying to modify and police the boundaries between legal forms. This approach has been ineffective because it does not tackle the underlying problem: that there are differences in tax rates across groups which cannot be clearly defined because there is no coherent principle underlying the distinction.

We conclude this chapter by discussing how we could approach improving the UK tax system. The first step has to be improving understanding of the system, the problems it creates and why it doesn't have advantages that some think it does. To succeed, reform proposals must recognise two factors. First,

the problems related to tax and legal form stem from the tax system and will only therefore be solved by fixing the tax system. Second, the taxation of employees, the self-employed and company owner-managers sits exactly at the point where many parts of the tax system come together; we must approach the tax system as a system and consider both tax rates and tax bases. This provides challenges, but also benefits. Policymakers around the world have long struggled with a perceived trade-off between, on the one hand, aligning capital income tax rates with labour tax rates to prevent tax avoidance, and on the other hand applying low tax rates to capital to preserve incentives to save and invest. The trade-off can be escaped by taxing aligning the overall marginal tax rate schedules for capital and labour income while also adjusting the tax *base* to preserve incentives to save and invest.

We propose that progress could be made by studying how manageable steps could be taken towards a solution and how different practical approaches could be taken to achieve economically equivalent outcomes.

2 The UK's tax penalty on employment

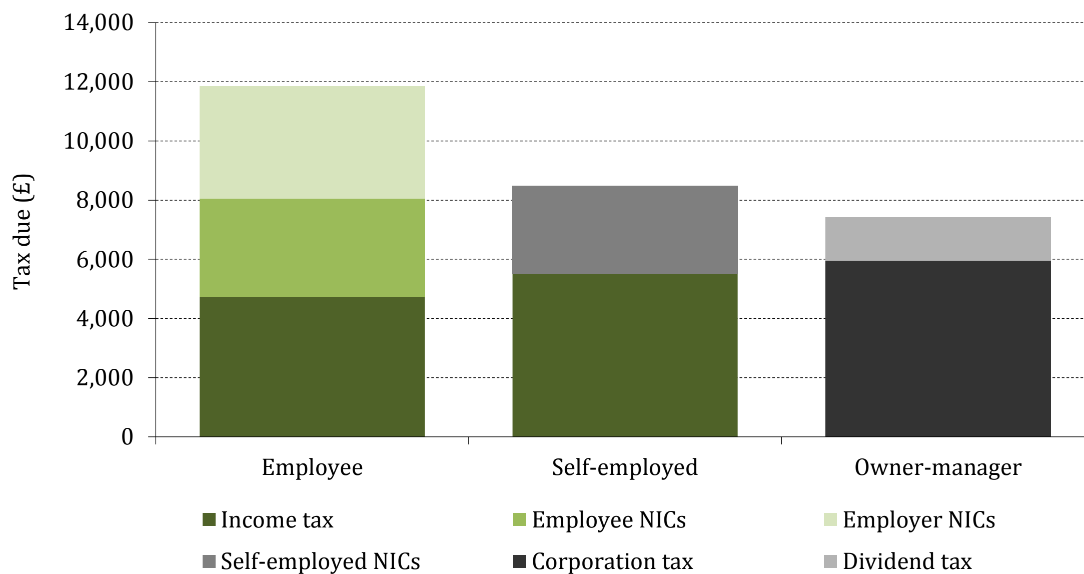
Different sources of income are subject to different taxes and rates of tax, which act to provide preferential rates to the self-employed and those operating though their own companies (see Figure 1). Employees' salaries are subject to income tax and to both employee and employer NICs, above certain thresholds.[1] The self-employed also pay income tax and NICs on their earnings, but self-employed NICs are lower than employee NICs and there is no equivalent of employer NICs for the self-employed.

Company owner-managers face different tax rates depending on how they choose to take their income, which can represent a mix of returns to labour effort and invested capital. Company owner-managers can achieve a lower tax rate than employees or the self-employed by taking income out of their company in the form of dividends or capital gains rather than wages. Specifically, as employees of their business, they can take a salary as a normal employee would, thus taking advantage of tax-free allowances in the National Insurance and income tax systems, as well as accruing rights towards the single-tier state pension. They can also pay themselves in dividends, which entails paying corporation tax on business profits (which are net of wages) and then paying income tax (but not NICs) on dividends at the personal level. The combined rates of tax on company profits and dividends are lower than the combined rates of income tax and NICs on salary. A company owner-manager looking to withdraw income from their company in a way that minimises their tax liability should pay themselves the NICs secondary threshold in salary and take any withdrawal above that in the form of dividends.[2] Below we highlight the current scale of tax differences across legal forms and how they have changed over time; Adam et. al (2017) sets this out in more detail.

[1] In discussing employees, we assume they are paid regular wages and not remunerated in other forms, such as stock options or benefits in kind, which are taxed differently.

[2] For those with stable salaries and no other income, earnings up to the NI secondary threshold are within the personal allowance and therefore not taxed, unless an individual has a high enough income that the personal allowance is withdrawn: the personal allowance is reduced by 50 pence for every pound of income above £100,000, gradually reducing it to zero for those with incomes above £125,000.

Figure 1. Tax due on total income generated of £40,000, 2019–20

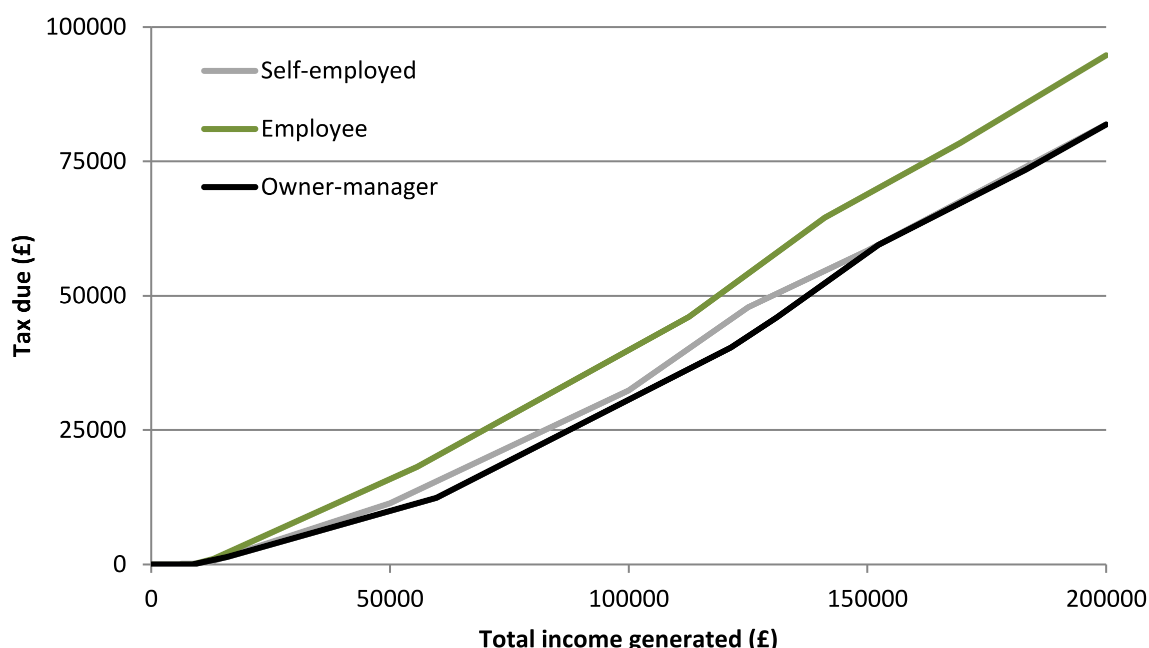


Note: The calculations assume: total income generated and paid out is equal to £40,000 for each legal form; the tax cost for employees includes employer NICs; company owner-managers take a salary equal to the NI secondary threshold and all post-tax profit as dividends. Income tax payments are lower for an employee than for a self-employed person because the employee's taxable earnings are lower as a result of employer NICs.

Figures 1 and 2 illustrate how the tax liability of individuals generating a certain amount of total income (set at £40,000 in Figure 1) varies by legal form; tax liability is highest for an employee and lowest for a company owner-manager at all levels of income. NICs treatment explains all of the difference between employees and the self-employed and the majority of the difference between both of these and company owner-managers. When calculating the tax payment for an employee, we include employer NICs, which, much like a wage, is a cost incurred by the employer to employ the individual.

For company owner-managers, we assume that income is taken out of the company in the current year (we return to discuss this below) and in the most tax-efficient way. Miller et al (2019), using HMRC tax records, show that the majority of company owner-managers follow the strategy of paying themselves a small salary and taking any other withdrawals in the form of dividends.

Figure 2: Tax due at different levels of income generated, 2019–20



Note: The same assumptions as in Figure 1 hold here at each stated income level.

The preferential treatment of business incomes has long been a part of the UK tax system. Figure 3 shows liabilities since 1999–2000 for the example of a £40,000 income level (expressed in 2019–20 prices and, as in Figures 1 and 2, assuming company owner-managers take out all income in the year it is earned). The relative treatment of different legal forms has varied over time with changes in income tax, NICs, dividend tax and corporation tax regimes. For example, the liability of company owner-managers fell in the early 2000s with the introduction of a 'starting rate' of corporation tax and increased when it was effectively abolished in 2004–05.[3] The difference in tax burdens between the self-employed and company owner-managers was at a low point in 2016–17 as a result of changes in the taxation of dividends but is due to increase again as the corporate tax rates falls to 17%.

These figures understate the tax advantages associated with self-employment and company owner-management. As well as lower headline tax rates, business owners generally have:

- more scope to deduct work-related expenses from their income than employees do (though there are exceptions to this);[4]
- opportunities to split business profits among multiple individuals, including by making their spouse a shareholder or partner;[5]

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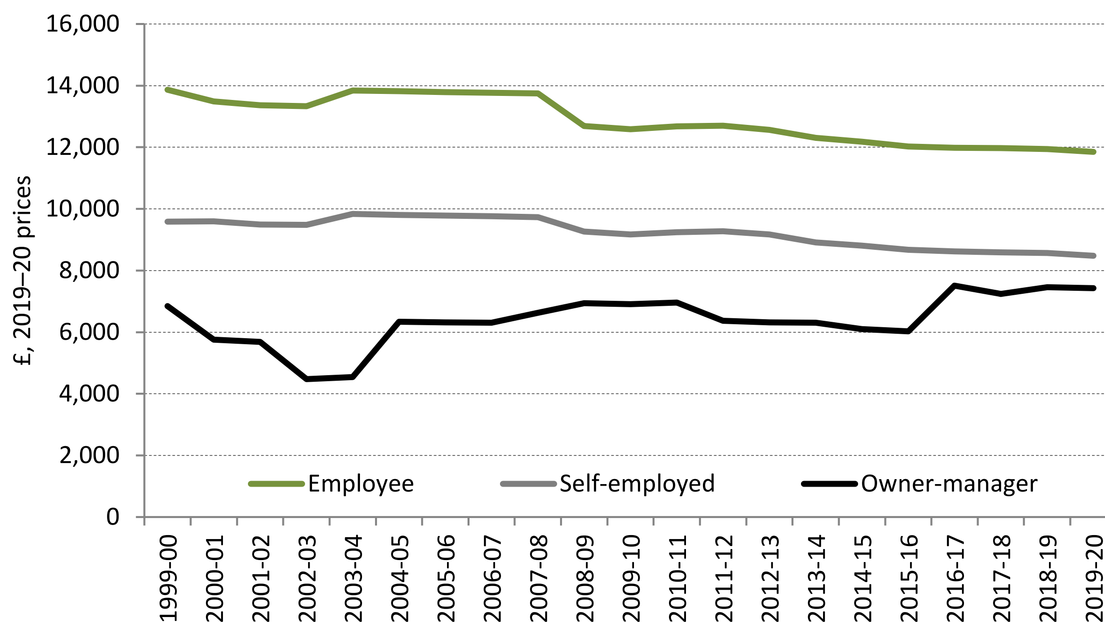
[3] A 'starting rate' of corporation tax meant that the first £10,000 of profit was subject to a lower tax rate, set at 10% in 2000–02 and 0% in 2002–06. In 2004–05 and 2005–06, profits distributed to shareholders were subject to a 19% tax rate (equivalent to the small companies' rate), which ended this tax advantage for most owner-managers.

[4] The core of this difference is that employees' expenses are only deductible if incurred 'wholly, exclusively and necessarily' in the performance of their duties, while self-employment expenses need only be incurred 'wholly and exclusively' for business purposes. But the difference in practical application is bigger than this difference in wording suggests.

[5] Cribb et al (2019) provide indirect evidence that the incentive to split income affects the structure of companies: 75% of two-person partnerships and 70% of two-director companies have one male and one female partner or director respectively (overall, the majority of business owners are male).

- more scope than employees to (legally) avoid or (illegally) evade taxes.

Figure 3: Tax due on total income generated of £40,000, over time (2019–20 prices)



Note: Converted to 2019–20 terms using the consumer price index (CPI). Takes into account differences in corporation tax, income tax, dividend tax and NICs rates and thresholds. Assumes company owner-manager takes a salary equal to the NICs secondary threshold and all post-tax profit as dividends, except in 2014–15 and 2015–16 (when the employment allowance applied to company owner-managers), in which years we assume the company owner-manager takes a salary equal to the personal allowance and distributes all post-tax profits as dividends. Assumes that the company owner-manager is the only employee of their company, and that the employee operates in a sufficiently large company that the employment allowance does not meaningfully affect their employer's NICs liability.

Company owner-managers can reduce their tax liability by adjusting when they take income out of a company. This is because, unlike profits from self-employment, corporate profits are subject to personal income tax only when they are distributed to shareholders. Company owner-managers can use the ability to retain income in their companies to defer paying personal tax on it, to shift their taxable income forward or back in response to policy changes, and to smooth their taxable income (and therefore tax payments) over time. For example, a company owner-manager who usually earns less than the higher-rate income tax threshold but occasionally earns more than that can avoid paying any higher-rate income tax if she retains earnings in the company when she earns more than the threshold and takes them out in a year when she earns less. Miller et al (2019) show that a large part of the overall responsiveness of company owner-managers to tax rates can be attributed to this type of income smoothing. That paper also shows that a significant number of company owner-managers retain significant amounts of money within their companies. There is a strong tax incentive to do this because income retained within a company and taken as capital gains when the shares are sold is subject to substantially lower tax liability as a result of entrepreneurs' relief – a preferential 10% rate of capital gains tax (CGT) that most company owner-managers qualify for (for comparison the dividend

tax rate for individuals in the higher-rate income tax band is 32.5%).[6] Entrepreneurs' relief was introduced in 2008–09 and exacerbates the difference between the taxation of labour and capital for precisely the group that has the greatest ability to switch their incomes between the labour and capital tax bases.

3 Growing problems caused by differentiating tax by legal form

There are four broad types of problem created by a tax system that differentiates tax treatment according to legal form. They are related to: fairness, economic efficiency, government revenue and administrative costs. None of these is a new problem and there have been predictions that the problems would grow with changing work patterns.[7] Here we discuss these problems, noting that, arguably, each has grown in recent years as a result of (at least one of) three related factors. First, the number of people choosing to work for their own business has been increasing. In fact, business owners (including both the self-employed and those owning closely held companies) have been the fastest growing part of the UK labour force since at least 2000; the number of companies with one or two directors increased by 60% between 2007–08 and 2014–15 (Cribb et al. (2019)).[8] Second, the have been some changes in nature of work, including as a result of digital platforms in the so-called 'gig economy' that facilitate matching of workers to customers.[9] Third, governments have taken additional steps to try to police the boundaries between legal forms (through 'IR35' legislation).

Issues of fairness – specifically, horizontal equity (that is, treating similar people similarly) – arise when two people earning similar incomes are taxed differently. There has always been (and will always be) a grey area between legal forms, such that the work of some employees is not distinctly different from that of some people working for their own business. This grey area has arguably grown as more people have provided their labour services to larger companies or agencies either while being sole traders or operating through 'personal service companies'.

The potential for unfairness is clear when two people earning similar incomes from similar work are taxed differently because they use different legal forms. Yet even when two people earn similar incomes from very *different* activities, it might be considered unfair to tax them differently. The crucial question in applying the principle of horizontal equity is always what dimensions, or criteria, are

[6] Entrepreneurs' relief is available on the first £10 million of otherwise taxable gains realised over an individual's lifetime. The eligible assets are: shares owned by employees or directors with at least 5% of the shares and voting rights; unincorporated businesses; and business assets sold after the closure of a business. Newly issued, unlisted company shares owned for at least three years by external investors now qualify for investors' relief, which is similar in many ways. Entrepreneurs' relief can also be used by the self-employed, although the opportunities here are more limited since it is more difficult for them to defer income for tax purposes. If the self-employed do amass such assets that are later sold, they will only be subject to capital gains tax (without an additional layer of corporation tax) such that the tax treatment is even more generous than for company owner-managers.

[7] See, for example, Freedman and Chamberlain (1997), Freedman (2001, 2003, 2006).

[8] In 2015–16, there were 4.9 million people operating through self-employment, up from 3.9 million in 2000–01. The majority (4.1 million) were sole traders. In 2014–15 there were 1.6 million owner-managers of companies with either one or two directors, up from 0.8 million in 2000–01. Companies with a sole director (most of whom also have only one shareholder) have accounted for all of the growth in owner-managed companies since 2006–07 when a legal change made being a one-director company possible. Statistics taken from Cribb et al. (2019), based on HMRC tax records.

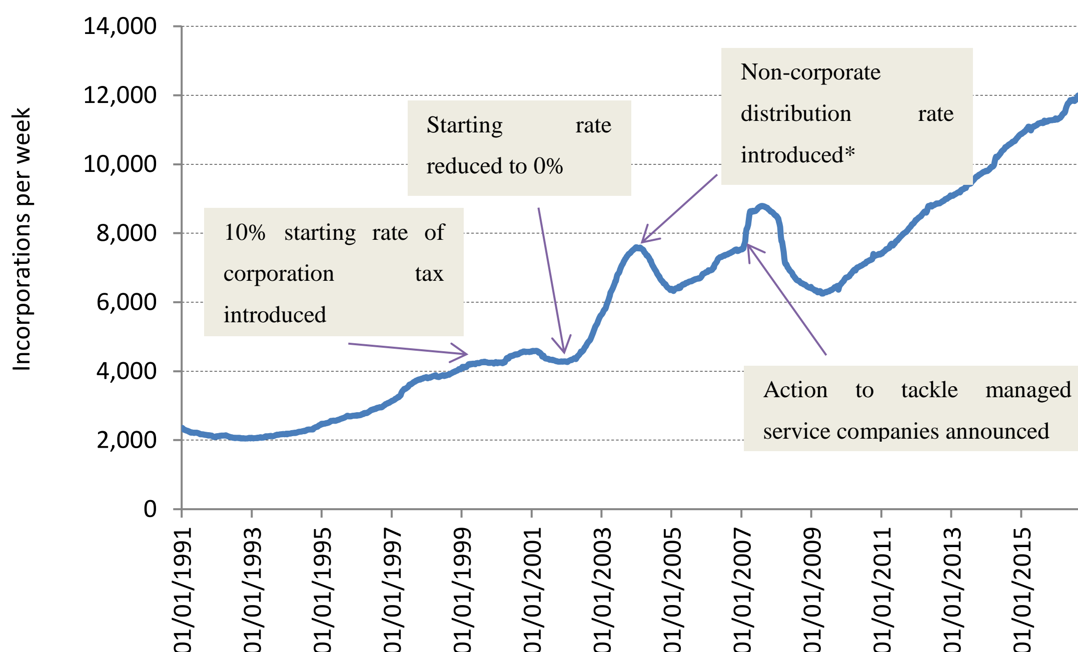
[9] The 'gig economy' cannot be directly measured. While there have been many salient examples of 'gig jobs' in recent years, such as Uber, the growth in business ownership is a wider phenomenon (Adam et al (2017), Cribb et al. (2019)). Katz and Krueger (2019) document the rise of alternative work arrangements in the USA and suggest possible explanations.

relevant in assessing whether people are 'similar'. It is doubtful that merely providing different kinds of services obviates the imperative for equal treatment if the services are equally valuable to the people paying for them. Unless there is some other difference between those earning business income and those earning employment income that justifies differential tax treatment – a question we consider in the next section – the current arrangement seem unfair on employees and employers.

Differential tax treatment creates economic inefficiency by distorting a range of individuals' choices. This ultimately reduces society's aggregate output and well-being, as where people change behaviour to reduce their tax liabilities, their financial gain in reduced tax payments is mirrored by an equal loss of revenue to the government while there is an additional (financial or non-financial) loss to the individuals from not doing as they would have preferred in the absence of taxation. The tax system clearly favours certain legal forms over others, and encourages individuals to behave in certain ways once they have chosen a legal form. There is substantial evidence that these incentives change behaviour.

The UK provides a clear illustration of how incorporation responds to incentives. Figure 4 shows the number of incorporations over time. Spikes occurred at times when the incentives, or at least the perceived incentives, to incorporate changed.[10] The increase in incorporations in response to the 0% starting rate of corporation tax in the early 2000s was predictable and, indeed, predicted by researchers at the IFS (Blow et. al (2002)).[11]

Figure 4: Incorporations per week since 1991 (52-week moving average)



** This effectively marked the end of the tax advantage of the starting rate for most company owner-managers. Source: Correspondence with Companies House.*

[10] For further discussion, see Crawford and Freedman (2010).

[11] The structure of companies has changed in response to legal reforms as well as tax incentives. Notably, the Companies Act 2006 removed the requirement for private companies to have a company secretary; since then companies with a sole director (of which ether were none before 2006) have accounted for all of the growth in owner-managed companies (Cribb et al. (2019)).

Increasing the number of new businesses was an explicit goal of the starting rate of corporation tax (see Freedman (2006) for a discussion). However, having more small companies should not automatically be seen as a positive outcome. This was ultimately recognised by the last Labour government, which unwound the starting rate following concerns that the rapid growth in new companies represented the effects of tax-motivated incorporation. Despite this stark lesson in why it is important not to conflate more incorporations with more entrepreneurship, it continues to be the case that growth in business ownership (including self-employment) is often held up as a success story (for example in the UK's 2017 Industrial Strategy (HM Government, 2017)).

As well as distorting choices over whether to work in a particular legal form, the UK tax system distorts the behaviour of those in a given legal form, including over how much to invest and how to withdraw income from a company. As highlighted above, recent research (Miller et al (2019)) uses HMRC tax records to show that company owner-managers readily switch between capital and labour tax bases. Income is almost always taken out of a company in the way that minimises tax payments (usually in the form of dividends if the income is being taken annually, or capital gains if the income is taken when a company is closed or sold). Despite the significant amount of money that is retained within companies – on average a sole director generating £150,000 each year retains £50,000 in the company – there is no evidence that tax-motivated retention leads to higher investment in assets for use in the business; instead the earnings are held in cash or equivalent assets.

These effects on behaviour matter. They mean that people are not doing what they would ideally like to, and resources are not being put to their most productive use. And to the extent that they reduce people's tax payments, they mean that tax rates elsewhere must be higher – increasing the cost to other taxpayers – to provide the revenue the government needs.

Government revenues are reduced substantially as a result of providing reduced tax rates for business owners, relative to the tax that would be levied if they were employees. Based on official statistics, it is possible to say the following:

- The cost of reduced rates of NICs for the self-employed (relative to employees) is expected to be £5.6 billion in 2019–20.[12] This equates to around £1,100 per self-employed person. Revenue raised from self-employed NICs in the same year is estimated at £3.4 billion,[13] i.e. less than 40% of what would be due if the self-employed and employed were treated comparably.
- The exchequer cost of applying lower tax rates to the population of closely held company owner-managers was forecast in 2017 to rise to over £9.5 billion by 2021–22.[14]

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[12] See HMRC, 'Estimated cost of structural tax reliefs', October 2019 (https://www.gov.uk/government/statistics/minor-tax-expenditures-and-structural-reliefs).

[13] Source: Appendix D of Government Actuary's Department, 'Report by the Government Actuary on the draft Social Security Benefits Up-rating Order 2019 and the draft Social Security (Contributions) (Rates, Limits and Thresholds Amendments and National Insurance Funds Payments) Regulations 2019 (https://www.gov.uk/government/publications/report-to-parliament-on-the-2019-re-rating-and-up-rating-orders).

[14] This forecast comprises two parts. In 2017 HMRC estimated that the cost, in 2021–22, of providing lower taxes to the existing population of closely-held companies (relative to taxing them as employees) would be more than £6 billion in 2021–22 (HM Treasury, Spring Budget 2017, footnote 3 (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/597467/spring_budget_2017_web.pdf)). The Office for Budget Responsibility forecast that this annual cost would rise by an addition £3.5 billion by 2021–22 as a result of a rise in owner-managed companies' share of the total workforce (OBR, November 2016, Box 4.1 (https://obr.uk/box/the-effect-of-incorporations-on-tax-receipts/)). These are the most recent published forecasts; changes

- In 2017–18 (the last year for which we have data on the number of claimants), the estimated cost of entrepreneurs' relief was £2.3 billion, or £53,500 per claimant.[15] Note that this tax advantage will typically relate to capital gains built up over many years (it is not the tax saving made each year by a claimant) and is the cost relative to the case in which these capital gains are taxed under the main capital gains tax regime (not relative to a world in which they are taxed as salary or dividend income).

Revenues will additionally be affected because evasion and avoidance are higher among business owners than employees (which also further exacerbate the problems of unfairness, inefficiency and diverted resources). HMRC estimates that the 'tax gap' for income tax, NICs and CGT in 2017–18 – the gap between the tax that 'ought' to be paid (as HMRC defines that) and the tax actually paid – was 1% or £2.9 billion for PAYE (which covers the vast majority of employees) but 15% or £7.4 billion for self-assessment taxpayers (including business owners). In 2015–16, 28% of sole traders and small partnerships under-declared tax, the majority by more than £1,000.[16]

The presence of boundaries in the tax system creates the need to devise, administer, comply with and police rules to distinguish the different legal forms. These in turn impose costs by diverting officials, taxpayers, accountants and occasionally the courts from more productive activities – all to a greater extent, the bigger the tax differential on either side of the boundary. The UK government's main tool for trying to prevent tax-motivated changes in legal form has been the 'IR35' rules, initially introduced in 2000, which essentially set out when corporate income should be treated as employment income for tax purposes (Freedman (2006)). These rules, despite creating additional administration and compliance costs, were largely seen as ineffective, and have repeatedly been reformed. In 2017, responsibility for enforcing the rules switched from the individuals operating companies to their engagers, if the latter were in the public sector. In 2020 this is due to be extended to the private sector. Wherever the boundaries dictated by IR35 and similar rules are placed, and however they are enforced, they face the fundamental underlying problem that there are grey areas that mean that different types of people cannot be placed neatly into categories. Moreover, it is not even clear which types of people/businesses the government thinks should or should not have access to preferential (i.e. business) tax rates.

4 Three arguments that don't support tax differences

The discussion above highlights that problems around fairness, economic efficiency, revenue loss and administrative costs arise because people are taxed very differently according to whether they are an employee, self-employed or working through their own company. However, there are many tax differentials across the system that we accept because there are benefits which outweigh the costs. In relation to legal form. those defending differential tax rates broadly tend to agree that genuinely

since then (such as the reduction in the dividend allowance from £5,000 to £2,000 and the shift in responsibility for complying with IR35 from the worker to the engager) might be expected to reduce these numbers somewhat, but the OBR's most recent Fiscal Risks Report concluded that the fiscal risk involved 'has not changed materially' (OBR, Fiscal Risks Report 2019, paragraph 4.24 (https://obr.uk/frr/fiscal-risks-report-july-2019/)).

[15] See HMRC, 'Estimated costs of non-structural tax reliefs', October 2019, https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs.

[16] See HMRC, 'Measuring tax gaps', August 2019 (https://www.gov.uk/government/collections/measuring-tax-gaps).

similar work should be taxed in the same way regardless of legal form, but argue that there are important differences between people in different legal forms that justify different tax treatment. There are three common arguments put forward in support of tax differences (i.e. in support of the idea that the benefits outweigh the costs): that lower tax rates reflect lower state benefit entitlements, lower employment rights, or the value of promoting entrepreneurship. Here we lay out why none of these arguments stands up to scrutiny. Even if there were no grey areas between legal forms and employees, the self-employed and company owner-managers were very different, we maintain that the current tax differentials across different legal forms would be unjustified.

First, **the argument for lower taxes on the self-employed to reflect their reduced benefit entitlements has merit in principle, but in practice the difference in entitlements is far too small to justify their current tax advantages**.

If the benefit system creates a bias in favour of employment over self-employment, there is a case for an offsetting tax rate differential to level the playing field. National Insurance is presented as a contributory system, with contributions paid in return for entitlements. In principle, lower NICs rates on the income of the self-employed can therefore be seen as a quid pro quo for lower entitlements.[17] However, today there are just two publicly funded 'contributory' benefits that employees can access but the self-employed cannot: contribution-based jobseeker's allowance and statutory maternity/paternity/adoption/shared parental pay. The value of these reduced entitlements is small: we estimate that they would only justify setting the self-employed NICs rate less than one percentage point lower than the combined employer and employee rates.

The difference in access to contributory benefits was larger in the past (although still smaller than the tax differences) but has shrunk substantially as benefits have been extended to the self-employed (and more broadly the contributory nature of NICs eroded). What was until recently the biggest difference in entitlements – the fact that the self-employed accrued rights to the basic state pension, but not to the earnings-related top-up (state second pension) – was removed in April 2016; now both the self-employed and employees accrue rights to a single-tier pension. Formerly 'contracted-out' (of the state second pension) employees must now pay the full rate of NICs in return for this entitlement, while the self-employed have seen an increase in entitlement with no such increase in their NICs rate. HMRC estimates that this reform increased the aggregate tax advantage of self-employment relative to employment by about £2 billion.[18]

In fact, the biggest disadvantage now faced by the self-employed in the benefits system comes from universal credit, a new benefit currently being rolled out (amid much delay) as a replacement for six major existing means-tested benefits and tax credits. Unlike its predecessors, universal credit treats the self-employed as earning at least a certain amount (after a year's grace period) even if they report actually earning less than that, and gives them correspondingly less support. This reduction in

[17] In so far as other tax and benefit policies also have the net effect of favouring one legal form over another, there is a similar case for offsetting it through differential tax rates to level the playing field. This applies, for example, to the rules that allow more generous deductibility of work-related expenses for the self-employed than for employees, and to tax-advantaged forms of remuneration, such as redundancy pay, that are only available to employees. Of course, the prior question is whether some legal forms should be favoured in the first place. As far as possible, it would be better to apply the same benefit entitlement rules, expense deductibility rules, etc. across different legal forms than to offset such differences with differential tax rates.

[18] See HMRC, 'Estimated cost of structural tax reliefs', October 2019 (https://www.gov.uk/government/statistics/minor-tax-expenditures-and-structural-reliefs).

entitlements is forecast to save the exchequer £1 billion a year by 2023–24:[19] a substantial amount, but still nowhere near big enough to justify the £5.6bn NICs advantage of self-employment. The combined main rates of employer and employee NICs is 22.7%.[20] At most, the lower universal credit entitlement might justify a self-employed NICs rate about 3 percentage points below this – still more than double the current 9% rate. Yet in any case the argument is (so far, at least) not made as often in respect of universal credit, perhaps because, rightly or wrongly, universal credit is not seen as part of a 'contributory' system in the same way as some other benefits.

Second, **lower tax rates for the self-employed cannot be used to offset differences in employment rights** between different legal forms.

A common – and understandable – misconception is that the self-employed should get lower taxes because they don't get employment rights (and conversely those who do get employment rights should be taxed at higher rates).[21] This logic behind this line of argument is incorrect and has always been incorrect.

The first thing to note is that employment rights are not a benefit given by the government to employees (i.e. are not like state benefit entitlements), but a benefit that the government requires employers to give to their employees. The second thing to note – and the reason, in a nutshell, why the logic fails – is that employment rights affect both sides of the labour market: employees and employers. Employment rights make employment more attractive (relative to self-employment) to the worker; but they simultaneously make it less attractive for employers to choose employees over the self-employed.[22] Employment rights are not favouring employment over self-employment overall in a way that might justify an offsetting tax differential; they merely redistribute between the two parties within an employment relationship. Because of this, employment rights don't (and can't) act to skew the labour market in favour of employment relative to self-employment. In contrast, our tax system does skew the market in favour of getting work done through self-employment. Add these two effects together and you have a situation that skews the market in favour of self-employment, not a market with a level playing field. Miller (2018) sets out this argument in detail, including showing that it does not depend on any specific assumption about how labour markets operate or how wages adjust.

Third, **lower tax rates for business owners cannot be justified as a way to incentivise entrepreneurship**.

People running their own businesses may be doing something fundamentally different from employees, including investing, employing others, innovating, taking risks and other such

[19] Source: Table 4.28 of Office for Budget Responsibility (2018), *Economic and Fiscal Outlook October 2018*, https://obr.uk/efo/economic-fiscal-outlook-october-2018/.

[20] This is appropriately measured as the total marginal tax rate on an additional pound paid out by the employer, not on an additional pound of nominal salary: that is, $(0.12 + 0.138) \div 1.138$.

[21] Employees are entitled to certain legal rights (sometimes only after a minimum employment period), including the relevant minimum wage, statutory minimum holiday, sick and redundancy pay, protection against unlawful discrimination and unfair dismissal, and statutory maternity/paternity/adoption/shared parental leave and pay. 'Workers' who are not employees have fewer rights. The self-employed are not covered by employment law. See Adam et al (2017) for a brief summary.

[22] Some rights or benefits can be provided in a way that is mutually beneficial for both employer and employee (because they are valued by employees and relatively cheap for employers to provide). For example, many employers provide healthcare, which they may be able to access at preferential rates relative to individual employees. But we would expect employers to provide these types of benefits regardless of whether they are mandated in employment law; employment laws don't instigate mutually beneficial trades.

'entrepreneurial' activities. In principle, one can make an argument in favour of using tax policy to address the market failures that can arise in relation to entrepreneurship. But blanket reductions in tax rates for all the self-employed and company owner-managers are poorly targeted at that objective.

The business owner-manager population encompasses a large variety of business models: people using a business legal form include everyone from taxi drivers, plumbers and local shop owners, to IT consultants, doctors and lawyers, to those running genuinely innovative businesses that will go on to grow and employ others. Recent analysis of HMRC tax records (Cribb et. al (2019)) shows that, to the extent that it is possible to describe the stereotypical closely-held business, it is not one that makes substantial investments or goes on to grow. Key findings include:

- Sole traders (the large majority of business owners) generated an average of £12,100 from their business in 2015–16, substantially below employees' average earnings (£30,100). Partners and company owner-managers have significantly higher average incomes than employees.
- Most sole traders do not employ anyone; around 70% have total business costs (including wages and capital investment) below £10,000. Median costs for owner-managed companies are £24,000, although with significant variation across different types of business. The share of both sole traders and owner-managed companies using any capital allowances has fallen substantially in the past decade.
- Most sole traders exit quickly: 60% have ceased trading within five years of setting up. The overall annual growth in self-employment is the net result of very large rates of entry and exit. For example, between 2014–15 and 2015–16 the sole trader population grew by almost 70,000, but this was a net effect of 650,000 sole traders starting up and 580,000 exiting.
- Remarkably, while the number of sole traders grew by 800,000 between 2007–08 and 2015–15, their *aggregate* profit fell over the same period. This was driven by large falls in profits of those sole traders who remained in business (i.e. it was not the result of low income among new businesses). The proportion of sole traders with profits above £40,000 halved between 2007–08 and 2015–16.

In any case, the mere fact of investing, taking risks or employing people does not justify preferential tax rates on the entrepreneur's income.

It is true that those running businesses sometimes employ people, and that we would like to reduce the extent to which taxation discourages employment. But if that is the aim, it would surely be better pursued by making it cheaper to hire people. It is a bizarre twist of logic to argue that the best way to promote employment is to impose higher tax rates on employment than on profits.

More seriously, it is important to note that (contrary to widespread belief) there should be no presumption for the government to promote investment or risk taking per se: if the market does not provide sufficiently high rewards for such activities, they should not be undertaken. But nor should the government aim to discourage these activities, and at present the UK tax system does discourage risk-taking and some forms of investment:

- The effect of the tax system on incentives to invest depends on how the investment is financed and the type of asset invested in. Broadly, there is neutral treatment of equity-financed investment covered by the Annual Investment Allowance (AIA); a disincentive for equity-financed

investment not covered by the AIA; and a subsidy to debt-financed investment covered by the AIA (Mirrlees et. al (2011)).

- The tax system discourages risk-taking because profits and losses are treated asymmetrically: the government penalises successful projects (by taxing the profits) more than it cushions unsuccessful ones (through loss offsets, which are incomplete, especially for new businesses that fail).[23]

Lower rates of tax on income do lessen these problems – the lower the tax rate, the less the peculiarities of the tax base matter for firms' tax liabilities – but they are an expensive and poorly targeted approach. Lower tax rates cannot eliminate the distortions entirely unless the tax rate falls to zero, and the giveaway from reduced tax rates tends to be concentrated on the most profitable investments, where additional incentives are least needed.

A better approach would be to address the underlying source of the problem directly. Fully symmetrical treatment of profits and losses is not practical, but reforming the current rules on loss offsets would be a sensible focus of policy reform. Likewise, removing the distortions to investment decisions requires adjusting the tax base – capital allowances and the treatment of debt and equity finance – not tax rates. Indeed, even if there were a policy goal to incentivise investment (i.e. to provide subsidies), this would be better achieved through the tax base than by giving lower tax rates.

Entrepreneurs' relief – a reduced (10%) rate of capital gains tax on owner-managed businesses – is particularly poorly targeted if the goal is to encourage entrepreneurs to make risky investments in their own business, for two main reasons. First, any incentive effects are only present for those who make a profit and can afford to retain profits in their business – and are larger for more profitable investments, targeting the money on those investments that would be worthwhile even in the absence of tax breaks rather than on the borderline-worthwhile investments where incentives really matter. Second, while the relief does increase the incentive to hold capital in the business, it does not increase the incentive to invest those retained earnings within the business. This is because it does not affect the relative incentives to invest in fixed assets *versus* holding the retained profits in cash. If, in the absence of a tax incentive to retain earnings, a business is undertaking the optimal amount of investment, there is no reason additional retained earnings would lead them to invest more: if additional investments are not profitable then they will prefer to keep the retained earnings in cash (or equivalent assets). Miller et al (2019) set this out in more detail and show empirically that there is no evidence that UK company owner-managers who retain more earnings as a result of tax incentives make more use of capital allowances.

The case for government intervention is strongest where markets fail to provide the appropriate incentives. For example, there may be too few new ideas tried out because innovators do not reap all of the rewards (some 'spill over' to other businesses that can learn from the experiences of the innovator); or some small and/or new firms may find it prohibitively expensive to raise external finance because potential lenders have less information than would-be borrowers about the firm's prospects. However, neither of these examples provides a compelling case for lower tax rates on business income.

[23] Losses can only be set against other income, with significant restrictions (which differ between companies and the self-employed) on what income they can be used to offset. Losses carried forward get no compensation for the delay and there is a risk that the losses can never be used.

Lower tax rates once a project is successful do little to help new firms to raise finance, or to address the immediate cash-flow concerns that are central to so many new businesses. Other approaches such as enhanced investment allowances or loan guarantees may be more effective.

And where there are spillovers, it is better if possible to target the specific activities that generate them, as the R&D tax credit, for example, attempts to do. This is not always possible: not all of the innovative activities that bring wider social benefits can be pinpointed and subsidised in that way. Yet most small businesses do not generate significant spillover benefits to wider society. From newsagents to IT contractors, they consist of people quietly going about the (perfectly honourable) business of making a living by providing valuable goods and services to others – much as most ordinary employees do. There is little evidence that the gains from using across-the-board lower rates to promote those socially beneficial activities that cannot be targeted more directly are big enough to justify scattering tax benefits so widely and creating the problems of boundaries in the tax system highlighted above.

Finally, we note that **one pragmatic argument for taxing the self-employed and company owner-managers at lower rates than employees is that the former two groups are more responsive to tax** (as shown by, for example, Adam et al. (2019)). The more a tax reduces taxable income, the lower the revenue yield from the tax, and the greater the loss of taxpayer welfare per pound of revenue raised. So it can be efficient to set lower tax rates for more responsive groups. The self-employed and company owner-managers are more responsive to tax in part because they have more ways to manipulate their incomes for tax purposes, rather than simply because of 'real' economic responses such as the amount of effort they put in (Miller et al. (2019)). The first way to deal with this, therefore, is to reduce the options that the self-employed and company owner-managers have to avoid (or evade) taxes – for example, by taxing capital gains at the same rates as ordinary income. Sensible policy changes would reduce the extent to which the self-employed and company owner-managers can escape tax more easily than employees, though not eliminate the difference in responsiveness entirely. But any potential efficiency gains that remained would have to be weighed against the costs of differentiation. And there are clearly equity concerns over a policy of providing lower tax rates to one group because they can more easily avoid or evade tax.

5 An old solution: fix the tax system

The problems highlighted above stem from the differential rates of tax placed on different legal forms. It is only by evening out relative tax rates that we can hope to solve those problems. This is not a new insight: Crawford and Freedman (2010), for example, concluded that 'alignment or equalization of tax rates across legal forms is necessary to achieve a sensible system for taxing small owner-managed businesses'.

Instead, there have been attempts to address these problems by writing and policing rules that determine what should fall on each side of a legal boundary. These approaches have been largely ineffective, in part because there are not neat definitions of which types of people/business should get preferential tax treatment, ether conceptually or in practice. If definitions around the boundaries are adjusted, the new definitions will quickly come under pressure.

More importantly, and as we have argued, the current tax system would not justified even if there were clear distinctions between legal forms. Even if all arguments about horizontal equity were put

to one side (because we were happy to give some groups lower tax rates than others) and even if there were no tax-motivated changes in legal form, there would still be other distortions to behaviour, including to how company owner-managers arranged their activities and to investment incentives, there would still be additional administration costs, and there would still be a revenue cost. It is hard to justify accepting any of these costs given that there is little justification for favouring one legal form over another in the first place. We have managed to create a system that is costly (in various dimensions) but that still disincentivises (some forms of) investment and provides very little support to some genuine entrepreneurship. That is, the costs can't even be argued to be the unfortunate side-effect of a system that is successfully targeting a worthwhile objective.

The solution to the problems laid out above is known. Building on the work of many others, this was brought together and laid out by Crawford and Freedman (2010) and more broadly by the Mirrlees Review of the UK tax system undertaken for the IFS (Mirrlees et al (2011)). One key message from that work is that any reforms in this area must be mindful that the taxation of employees, the self-employed and company owner-managers sits exactly at the point where many parts of the tax system come together. Incentives to switch between legal forms depend on the bases and rates of income tax (including the treatment of dividends), NICs, corporation tax and CGT. Changing any one of these has far-reaching effects: tax rates on earnings affect all employees, not just those who might otherwise set up a business; corporation tax affects all companies, from one-man bands to multinationals; taxation of dividends and capital gains affects portfolio shareholders and buy-to-let landlords as well as business owner-managers. Addressing this by introducing a special regime for 'small businesses' (however defined) would add another boundary to the tax system that would create problems of its own and not reflect any underlying principle. It might replace one big tax differential with two smaller ones, but the underlying problem would still be there. Such policies are sometimes better than nothing. But they are at best a sticking plaster rather than a solution to the underlying tensions in the tax system, and at worst can create more problems than they solve. The tax treatment of different legal forms should always be seen in the context of the whole tax system. Attempting to solve one narrow problem in isolation – such as by adjusting only the treatment of one legal form or of introducing different tax regimes for a subset of small businesses – is the policy equivalents of 'whack-a-mole': the particular problem may be fixed, but at the expense of another one popping up elsewhere in the system.

The Mirrlees Review proposes a design for the whole tax system which aligns the taxation of different legal forms as just one part of a broader plan. Essentially, it argues that the same overall tax rate schedule should apply to income from all sources, but with full allowances given (at both the personal and corporate tax levels) for amounts saved and invested to avoid discouraging those activities.

Aligning the treatment of different legal forms requires applying the same overall tax rate schedule to income derived from employment, self-employment and companies – bearing in mind that this overall rate schedule currently involves varying combinations of income tax, NICs, capital gains tax and corporation tax, depending on the income source. Broadly, this could be achieved by (i) aligning the NICs paid by self-employed individuals with those paid by employers and employees combined (preferably in the course of integrating NICs with personal income tax) and (ii) taxing dividend income and capital gains at the same rate schedule as earned income (including employee and employer NICs), with reduced tax rates for dividends and capital gains on shares to reflect corporation tax already paid. This process would include removing entrepreneurs' relief, though in many cases the reduced capital gains tax rates for shares would limit the increase in the tax rate that this entails. Note that alignment

does not necessarily require an increase in the corporation tax rate, which would raise valid concerns around making the UK less competitive. Instead, overall rate alignment could be achieved at the personal level by adjusting dividend and capital gains tax rates while keeping a relatively low corporation tax rate (which could be set with reference to multinationals). Aligning the treatment of these income sources would also mean reversing the recent trend towards having a large separate allowance in each tax, a feature that favours incorporation since a company owner-manager, unlike an ordinary employee, can benefit from additional tax-free allowances for dividends and capital gains as well as from the main income tax personal allowance.

One valid concern with aligning rates on total income is that, in isolation, higher tax rates on income from self-employment and companies (which reflect a mix of rewards for labour and capital) produce disincentives to save and invest. This in turn creates an apparent trade-off that policymakers around the world have struggled with for decades: one the one hand they want to align capital tax rates with labour tax rates to prevent tax avoidance that arises because labour income can be converted into capital income, but on the other hand they want low capital tax rates to preserve incentives to save and invest. The result has usually been an awkward compromise, with regular changes in tax rates (such as the roller coaster of UK capital gains tax rates – see Adam et al (2017)) as policymakers give different weight to those competing concerns. In most countries, capital income tends to be taxed at reduced rates relative to labour income (often with different forms of capital income taxed at different rates), leaving some disincentive effects and some scope for avoidance. However, the trade-off can be escaped by **aligning the overall tax rates for capital and labour income *while giving a full deduction for capital costs*.** Adjusting the tax base allows the incentives to save and invest to be preserved while also removing incentives to switch across tax bases.

In a nutshell, designing the tax base so as to avoid disincentives to save and invest is achieved by giving full allowances (at both personal and corporate tax levels) for amounts saved and invested. There are two ways to go about doing this:[24]

- Cash saved or invested can simply be deducted from taxable income/profits at the point it is saved/invested. This is the approach currently applied to pension contributions by the income tax system, and to business investment where 100% first-year allowances are available (as in the case of the AIA).
- A deduction could be given each year for an imputed risk-free rate of return to capital previously saved/invested. This is the rate-of-return allowance (RRA) treatment of saving and the allowance for corporate equity (ACE) treatment of business investment, neither of which has ever been used in the UK although both are now used in other countries.

Timing aside, these two treatments are equivalent. With stable tax rates, the stream of allowances given each year under the second approach is worth the same as the up-front deduction given under the first approach. Both avoid discouraging saving and investment, since an asset that (in the absence of taxation) yields just enough of a return to be worth the up-front cost will see the tax on income generated exactly offset (in present value terms) by the tax deduction for the investment cost. Only returns in excess of that level will yield a net tax liability, and since only a fraction of the excess will be taxed away, assets that yield such high returns will still be worthwhile investments. And in both cases

[24] These approaches and their properties – including other advantages not discussed here – are explained Mirrlees et al. (2011). For brevity, we do not discuss here how debt and equity finance should be treated – another thorny area that could be largely resolved as part of a reform like this.

the deduction depends only on the amount saved/invested, irrespective of the actual return it generates; each extra pound of income is taxed in full regardless of the form in which it is taken, so there is no tax incentive to choose one legal form over another or to dress up one form of income as another.

This solution does not solve all problems. It does not, for example, remove the ability or incentive for business owners to split income with family members. But it also solves many more problems than are highlighted in this chapter, including the bias towards debt financing, the sensitivity of savings incentives to inflation and the lock-in effect currently present in capital gains tax.

6 How to make an old solution work

Given that the problems with taxing legal forms in very different ways are large, long running, well known and growing and that no one seems happy with the current system, it is perhaps surprising that so little progress has been made in fixing the system. There would seem to be at least two broad reasons for this.

The first is misunderstanding. It is still a commonly held belief that lower rates of tax for business owners are justified by some combination of lower rates of benefit entitlement, a lack of employment rights or the desirability of promoting entrepreneurship. There is also misunderstanding about who business owners are. Broadly, debates tend to focus either on entrepreneurs or the low-income self-employed. This makes increasing tax rates on business income difficult, because there is widespread support for lower taxes on entrepreneurs and because tax rises on the self-employed can be portrayed as penalising those on low incomes (as was the case in 2017 when Chancellor Hammond 'U-turned' on his proposal to increase NICs on the self-employed as a result of political pressure (Miller (2017)). It is only by better understanding the heterogeneous nature of the business population that one can better appreciate how poorly targeted tax breaks are. Better empirical evidence – notably from HMRC tax records, which allow us to say much more about the business owner population than has been possible from surveys – and greater appreciation of the problems that can be causes by tax-motivated changes in legal form (for example when employers reshape the jobs they offer to the detriment of workers) may be steps towards raising awareness.

The second reason for a lack of progress is that the comprehensive solution proposed is seen as too radical (either to be worth it or to be feasible) and too theory-driven. Freedman (2008) notes that, in response to a suggestion that it would be worthwhile to examine approaches to small business that are quite different from the current system, Accountingweb commented that "*it seems dangerous to allow academics to decide tax policy as they lack hands on experience*". The Mirrlees Review has been described as 'academic'; it was not intended as a compliment.

However, the approaches to date – essentially tinkering with tax boundaries to try to prevent some forms of avoidance – have failed and will continue to fail because they do not address the underlying problem. The question, then, is how we can realistically transition to a more fundamental solution.

Current work at the IFS focuses on breaking the Mirrlees Review's radical reform proposals into smaller, more manageable steps. Even small steps can be hard politically, as evidenced by the 2017 U-turn on a minor change to NICs for the self-employed. Designing a pathway towards the end solution is also tricky because implementing only part of a full solution risks exacerbating some problems even

while alleviating others. However, packages of reforms can be designed for which the benefits outweigh the costs even if the ultimate intended destination is never reached. If the logic of the approach is agreed, there is ample scope for academics and practitioners to work together to find practical ways to improve the tax system.

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