IFS Green Budget 2017

In association with ICAEW and funded by the Nuffield Foundation.
With additional analysis from ICAEW and Oxford Economics.

#IFSGreenBudget  @TheIFS
Tax, legal form and the gig economy

Helen Miller

#IFSGreenBudget  @TheIFS
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 ...

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

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- At personal level, in higher rate tax band, money withdrawn as: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

0% starting rate of corporation tax introduced
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

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
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