

7. Tax, legal form and the gig economy

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Key findings

The labour market is changing in interesting ways, but not fundamentally (yet).

Employees make up the majority (85%) of the workforce. But there has been growth in individuals working for themselves (either through self-employment or as a company owner-manager). Over a quarter (27%) of the workforce are part-time, higher than a decade ago. Roughly the same proportion (3.7%) as 10 years ago have a second job, which is now slightly more likely to be working for themselves.

The 'gig economy' is somewhat new but hard to spot in the data.

Workers in the 'gig economy' are distinct from previous generations of individuals who worked for themselves and 'gigged', largely due to the use of digital platforms. Current data are not designed to capture many features associated with the gig economy.

The self-employed should be distinguished from owner-managers of companies.

The self-employed and company owner-managers, while often considered as one group, differ in interesting and systematic ways. For example, company owner-managers are, on average, better educated, more likely to work full-time and tend to work in different industries. They are also treated very differently by the tax and legal systems.

The tax advantage that comes with self-employment equates to a subsidy of £1,240 per person per year.

The self-employed pay lower National Insurance contributions than employees. This amounts to £1,240 per self-employed person per year. In principle, lower access to social security benefits may justify some tax reduction, but in practice, the differences in benefit entitlements are small.

¹ Thanks to Agnes Norris Keiller for excellent assistance with LFS analysis.

Company owner-managers get the most generous tax deal.	Company owner-managers can pay themselves in (more lightly taxed) dividends, and possibly capital gains, rather than just wages. Along with the self-employed, they also have more opportunities to avoid or evade taxes.
The massive tax advantages that come with working for your own business are not new and not justified.	The tax system has long encouraged people to work for their own business rather than be an employee. Lower tax rates are not justified by differences in employment rights or compliance burdens and are not well targeted at encouraging entrepreneurship.
Differing taxes based on how people work (their legal form) are unfair and inefficient.	Similar individuals can face very different tax burdens. This is unfair and creates economic inefficiency. Some people set up a business when, absent tax, they would be an employee. Much time and effort goes into policing the boundaries between legal forms.
The tax system should be reformed to align taxation of income across legal forms while not discouraging capital investment.	Saving and investment should be deductible from the tax base. Each extra pound of income earned should then be taxed at the same overall rates for employees, the self-employed and company owner-managers. This would simultaneously deal with many problems that plague the tax system.

7.1 Introduction

It has become commonplace to state that the labour market is fundamentally changing and that secure employment positions are being replaced with independent contract relationships that are more flexible but that also come with intermittent and less secure income streams and fewer rights. But to what extent is this true? This chapter sets out how the labour market is changing, discusses why the differential tax treatment of employees, the self-employed and company owner-managers is a growing problem and maps out how the treatment could be made more sensible.

The majority (84.7%) of the UK's workforce is still made up of employees, 93.6% of whom are in permanent positions. But, since 2008, there has been a substantial growth in the number of individuals who are self-employed. There has been even faster growth in the number of individuals owning and managing incorporated businesses. The proportion of the workforce taking on second jobs alongside their employment has changed very little in recent years, although second jobs are now slightly more likely to take the form of individuals working for themselves.

The most visible part of recent changes has come from the 'gig economy'. This is not a well-defined concept. The term, coined in reference to the way that musicians traditionally operate, is used to capture a new type of work. In general, it tends to be used to refer to individuals who are operating as an independent small business (usually through self-employment) rather than through an employment contract, performing work that can be broken down into separate tasks ('gigs') and using a digital platform operated by a large company to match them to customers. The best-known example of this is, perhaps, Uber, a company that provides a platform (an app) that matches taxi drivers to passengers. In Section 7.2, we discuss the extent to which these types of workers are genuinely distinct in any important sense from previous generations of the self-employed – many of whom also undertook comparable 'gigs' and used platforms run by third parties – and set out what can (and cannot) be said about this group using currently available data.

Much of the attention on the gig economy has, understandably, been on two (related) issues regarding individuals' welfare. The first is whether some individuals are actually operating like employees, but have been pushed into self-employment (or company ownership) by large companies that are looking to avoid the legal obligations that come with an employment contract, such as the national minimum wage, statutory sick and holiday pay, fair dismissal and immigration checks. The determination of when an employment status exists is a matter of employment law, and has been at the heart of some recent court cases. The second issue is whether some individuals are choosing self-employment because they lack employment opportunities and that, rather than reflecting the road to freedom and creativity, the growth in self-employment more likely marks the start of a more precarious and stressful way of working. In this case, an important question is why the market favours individuals working for their own business rather than as employees of large companies; large companies exist precisely because it is usually more efficient for individuals to come together as part of a large company than to operate many small businesses with contractual relationships between them (there are economies of scale and scope). Part of the answer may lie in employment laws that effectively make employees more expensive for employers. There is also almost certainly a role for new technologies that make operating an independent business more viable. These issues are being explored by the Matthew Taylor Review into Employment Practices in the Modern Economy.²

The rise of individuals working for their own business and the consequences of new forms of working are also intimately linked to the tax system. Employees' income is taxed at a higher rate than the incomes of the self-employed because the former are subject to National Insurance contributions (NICs) at a higher rate and are additionally subject to employer NICs. One argument in favour of preferential treatment is that the self-employed have reduced entitlement to some social security benefits. But the difference in access to benefits is nowhere near enough to account for the NICs difference: HM Revenue and Customs (HMRC) estimates that the effective NICs subsidy to the self-employed relative to the employed exceeds the value of their reduced benefit entitlement by £5.1 billion, or £1,240 per self-employed person, in 2016–17 – particularly striking since the total NICs they do pay is only £3.0 billion. Furthermore, HMRC estimates that the self-employed account for £5 billion of the £7 billion uncollected 'tax gap' for self-assessment income tax, NICs and capital gains tax combined. Company owner-managers can get even lower tax rates than the self-employed because they can choose to take income out of

² <https://www.gov.uk/government/groups/employment-practices-in-the-modern-economy>.

their company in the form of (more lightly taxed) dividends rather than as wages. This means that a person generating £40,000 of income per year can receive £32,294 after tax if they are the owner-manager of a small company or £31,180 if they are self-employed; but an employee whose employer is willing to pay the equivalent £40,000 to hire them will have only £27,738 left after tax (meaning the employee faces a 31% average tax rate, compared with 22% for the self-employed person and 19% for the company owner-manager). In fact, individuals working for their own business can achieve even lower rates if they can retain income in their businesses and later realise that income in the form of capital gains when the business is sold or dissolved. Under entrepreneurs' relief, which many company owner-managers will qualify for, capital gains are taxed at just 10%. In 2014–15, the estimated cost of entrepreneurs' relief was £3.5 billion, which averaged £74,500 per claimant. On top of these tax advantages, the self-employed and company owner-managers also have greater opportunities to (legally) avoid or (illegally) evade taxes than employees. Finally, the VAT system adds one more cherry on this cake. Companies with a turnover below £83,000 are exempt from VAT. This can create a tax difference depending on whether activities are provided by a large company or many small companies (e.g. one taxi firm operating with employees is more likely to be subject to VAT than if the same number of journeys is provided by many independent taxi drivers). Section 7.3 sets out the tax differences between legal forms.

The differential tax treatment of different legal forms means that similar individuals can face very different tax burdens. This is unfair, adds complexity and creates economic inefficiency. Of course, there can also be real differences between employees and individuals working for their own business. Importantly, the income of individuals working for their own business can represent a mix of returns to labour effort and invested capital. The cost of investment should be deductible from the tax base. But, as we set out in Section 7.4, it is difficult to make a case that differential tax rates should be used to reflect other differences (such as whether individuals take risks). Given the problems created, there should be a high bar for allowing differential tax rates across legal forms.

Concerns over the appropriate tax treatment of employees, the self-employed and company owner-managers are not new. But they are now at the forefront of policy discussion. One reason for this sudden interest is that the Office for Budget Responsibility (OBR) has quantified the cost of the ongoing shift towards working through a small company. It forecasts that the rapid expected growth in owner-managed companies will lead revenues to be £3.5 billion lower in 2021–22 than if the small company population and employment grew at the same rate (assuming that the overall change in the size of the workforce remained the same). In his 2016 Autumn Statement speech, Chancellor Philip Hammond highlighted that 'the government will consider how we can ensure that the taxation of different ways of working is fair between different individuals, and sustains the tax-base as the economy undergoes rapid change'.³

This area is ripe for reform. What the government could most usefully do is set out a long-term vision for where the tax system is headed, that simultaneously dealt with boundaries between all legal forms and that was mindful of the fact that the taxation of the self-employed and company owner-managers sits at the apex of many parts of the tax system. Because of the latter, one cannot consider their taxation without also considering the taxation of savings and investments more generally, and the taxation of large companies.

³ <http://www.gov.uk/government/speeches/autumn-statement-2016-philip-hammonds-speech>.

We make the case for aligning tax rates for employees, the self-employed and company owner-managers while giving full allowances for saving and investment. In Section 7.5, we discuss how this could be achieved. Section 7.6 concludes.

7.2 Changes in work patterns

In this chapter, we consider three legal forms: employees, the self-employed and company owner-managers. These groups each face different tax treatments and are the main ways in which an individual can sell their labour. They do, however, mask some heterogeneity. For example, employment law also defines a ‘worker’ category that, for the purpose of employment rights, lies between an employee and a self-employed person (see Box 7.1).

Employees are still the bulk of the workforce, but more individuals are working for their own business

Out of a workforce of 31.3 million people in the UK in 2015–16, 26.5 million (84.7%) are employees while 4.6 million (14.7%) are working for their own business.⁴ We can divide individuals working for their own business between those who report being sole directors of their own limited company (576,000 or 12.5%) and others (4.0 million, or 87.5%). Broadly, this divides this group between company owner-managers and self-employed individuals (including partnerships), although the split is not perfect. In particular, the group that we will refer to as the self-employed includes a small proportion of owners of companies with multiple directors. We discuss data limitations in Box 7.2. With this caveat in mind, we refer to these groups as company owner-managers and the self-employed, and cite independent data sources to corroborate recent trends.

Changes to the overall composition of the workforce (Figure 7.1) may not seem especially stark, but recent trends have led to a marked increase in individuals working for their own business. The share of the workforce working for their own business (14.7%) is at its highest level since at least 1994 (when it was 13.7%) and has increased from a low point of 11.8% in 2000–01. This growth in the number of individuals working for their own business can be seen in Figure 7.2, which shows that since 2008, 39% of the cumulative increase in the workforce (shown in the black line) has resulted from an increase in the number of individuals working for their own business. Of this 39% cumulative increase, just over one-third (36%) is attributable to an increase in company owner-managers and just under two-thirds (64%) is an increase in self-employment. This translates into a larger proportional increase in the company owner-manager population, which has almost doubled since 2008. The growth in the number of companies, and specifically those with a single director, is corroborated with data on corporate tax records and firm accounts, as shown by the OBR.⁵ While it is not the case that recent trends have dramatically altered the composition of the workforce – direct employment remains by far the most common way to work – there has nevertheless been a shift towards individuals running their own businesses over the past six years.

⁴ Here we classify employees as those whose main form of work is as an employee (and business owners likewise). Employees may also be self-employed in a second job (see below). Around 199,000 people, 0.6% of the workforce, are classified as ‘unpaid family workers’ or ‘in training’.

⁵ See box 4.1 in Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2016*, <http://budgetresponsibility.org.uk/efo/economic-and-fiscal-outlook-november-2016/>. Since 2007, one-director companies account for all of the increase in the owner-manager population.

Box 7.1. Legal forms

Tax law distinguishes between employees and individuals working for their own unincorporated business (self-employed sole trader or partnership) or incorporated business (a company). Employment law additionally distinguishes ‘workers’, which, for the purpose of employment rights, lie between employees and self-employed people.^a

Employee: Employees have an employment contract with an employer that dictates their activities. They 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.

Worker: Employment law also sets out a broader ‘worker’ status (all employees are workers, but not vice versa). Workers have rights (including relevant minimum wage and holiday pay) but, in general, they have fewer rights than employees (including no redundancy pay or protection against unlawful dismissal). Individuals engaged in casual or irregular work (e.g. those on zero-hour contracts) are likely to be classified as workers but not employees. A recent court ruling stated that Uber drivers should be considered as workers rather than self-employed. For tax purposes, workers will often be classed as self-employed. There is debate over whether the worker status remains meaningful.^b

Self-employment (unincorporated business): A self-employed sole trader works for themselves, running their own (unincorporated) business and bearing full personal responsibility for any debt or losses. They can hold business assets and employ others. The business has no separate legal personality. When a self-employed individual interacts with other businesses (say as a contractor performing work), they are protected by health and safety law and, in some cases, against discrimination, but are not covered by employment law. Partnerships are a form of unincorporated business (which, in the chapter, we also refer to as self-employed). General partnerships are similar to self-employed sole traders (with the partners liable to the full extent of the partners’ personal assets). Limited liability partnerships (LLPs) are a hybrid form, which combine partnership (i.e. self-employed) tax treatment with a measure of limited liability like companies. They are unincorporated but registered and one partner must have unlimited liability, although that partner may be a limited liability company.

Company (incorporated business): Limited liability companies are legal entities that are capable of enjoying rights and of being subject to duties distinct from those enjoyed or borne by shareholders, even if there is only one shareholder. The shareholders are owners of the shares and not the underlying business assets. Limited liability refers to the shareholder. The company is liable to the full extent of its assets.

^a <https://www.gov.uk/employment-status/overview>.

^b See A. Adams, J. Freedman and J. Prassl, ‘Different ways of working’, mimeo, forthcoming.

Box 7.2. Data on the self-employed and company owner-managers

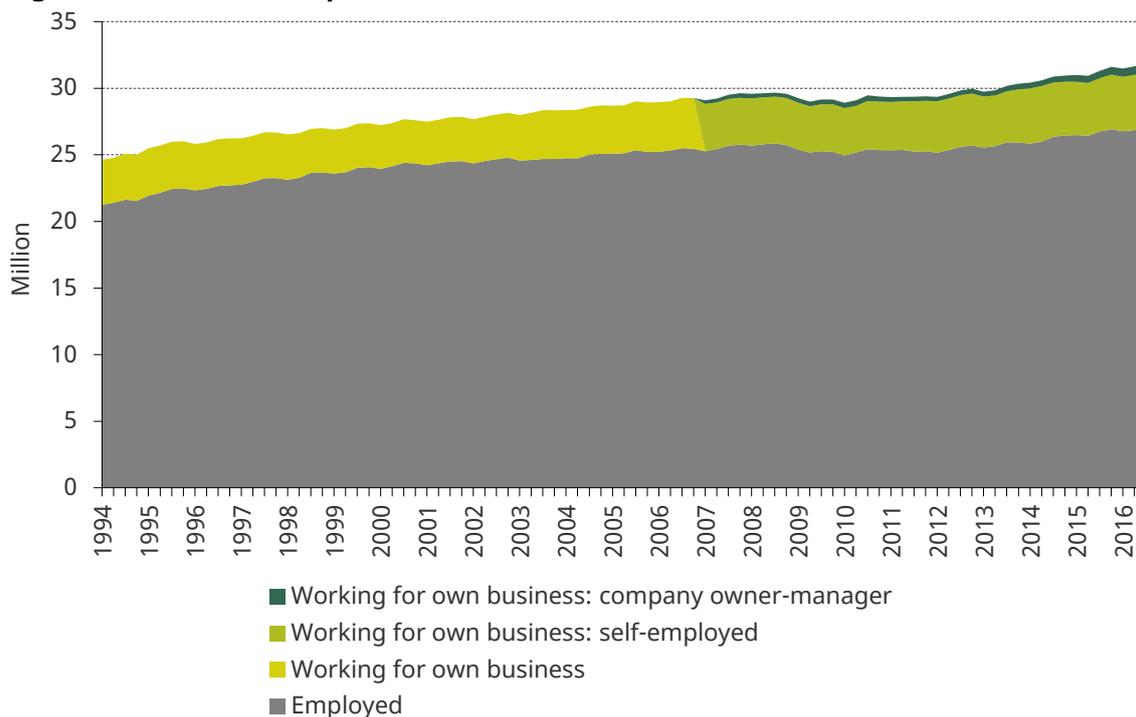
There are no data that allow us to classify individuals accurately according to their employment status and tax status. In addition, the data we do have do not reveal all of the information that may be of interest in relation to the gig economy, although we note that there are new surveys and data sources emerging on these issues.

Analysis in this section uses the Labour Force Survey (LFS), a representative survey of the UK population that asks individuals to report their employment circumstances. Those who report running their own business are additionally asked whether they are the sole director of their own limited company. Those running their own business who do not report that they are incorporated and sole directors can be (i) self-employed (operating either as sole traders or partners) or (ii) one of several directors of their company. The data do not allow the latter group to be separately identified. Commonly in analysis of the LFS, the self-employed and company owner-managers are considered together and jointly referred to as 'the self-employed'. Here, we explicitly choose not to do this because in tax parlance self-employment strictly means something quite different from company owner-management, and we think it interesting to consider trends in each separately, not least because the tax treatments are significantly different.

Four pieces of evidence give us confidence that the split between the self-employed and company owner-managers that we use, while imperfect, captures the broad size of different groups and the changes over time. First, independent data from the Business Register, while not directly comparable to those from the LFS, suggest that the numbers of owner-managed companies we observe are of broadly the correct magnitude.^a Second, the same data show that the number of unincorporated businesses is substantially higher than the number of small companies, such that we would expect owner-managed companies with multiple directors to be a small fraction of the category that we refer to as the self-employed. Third, we expect that some individuals who are directors of companies with multiple directors actually classify themselves as sole directors (and are therefore in the category we refer to as company owner-managers). As evidence for this, there are non-trivial numbers of individuals in this group prior to 2006, at which point it was a legal requirement that all companies have more than one director. Finally, evidence from the OBR (cited in the main text) uses data from tax records to show that the growth in owner-managed companies since 2007–08 has come entirely from one-director companies (the group that we accurately identify) and not from multiple-director companies. In ongoing work, we are also using tax records to count and analyse the self-employed and company owner-managers.

^a The LFS reports 664,000 sole directors in 2016, some of whom will employ others. The Business Register records 818,000 companies that employed one worker (assumed to be an owner and director), some of which will have multiple directors. The overlap between these two groups is likely to be large and comprises companies with one director and no other employees.

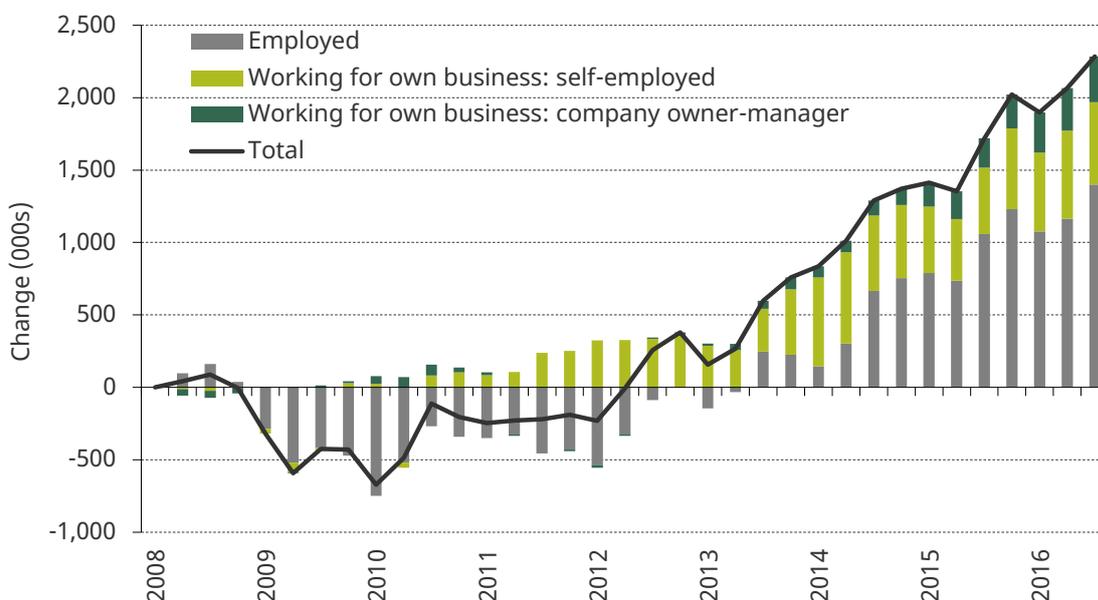
Figure 7.1. Size and composition of the workforce since 1994



Note: Not seasonally adjusted. Individuals with more than one job are classified according to their main job. The employed category includes individuals classified as 'unpaid family workers' or 'in training'.

Source: Labour Force Survey.

Figure 7.2. Cumulative change in size of workforce since 2008 Q1



Note: Not seasonally adjusted. In each quarter, the cumulative change is calculated as the difference between the number of individuals in the current quarter and the number of individuals in 2008 Q1 in each category. The employed category includes individuals classified as 'unpaid family workers' or 'in training'.

Source: Labour Force Survey.

Double jobbing

The figures mentioned in this section thus far have referred to individuals' main jobs. The vast majority of individuals (over 95% in all legal forms) have just one job. However, as Table 7.1 shows, a small proportion of those in paid work take on more than one job and we can categorise individuals according to whether their second job is as an employee or working for their own business. There are two interesting points to note:

- There have been only very small changes in the proportions of individuals taking on second jobs. For example, more or less the same proportion of employees had second jobs in 2015–16 (3.5%) as in 2007–08 (3.7%). Although note that given that the number of employees is rising overall, this still implies that there are more individuals with second jobs (just not more as a proportion of total employees).
- Across all legal forms, there has been a slight growth in the proportion of individuals who work for their own business as a second occupation. At the same time, the proportion with a second job as an employee has fallen slightly across all legal forms.

To summarise, small changes in the proportion of individuals with second jobs comprise two opposing, but still small, trends – a smaller proportion of those in paid work have second jobs in employment, but more have second jobs being self-employed or as a company owner-manager.

Table 7.1. Activity of those in paid work, 2007–08 and 2015–16

	2007–08	2015–16
Total in paid work	29.3m	31.1m
Employees	25.4m	26.5m
One job	96.3%	96.4%
Second job as employee	2.6%	2.3%
Second job working for own business	1.1%	1.2%
Self-employed	3.5m	4.0m
One job	95.2%	95.0%
Second job as employee	2.4%	2.3%
Second job working for own business	2.4%	2.6%
Company owner-managers	324,000	576,000
One job	97.0%	96.7%
Second job as employee	1.5%	1.2%
Second job working for own business	1.5%	2.0%

Note: 'Total in paid work' excludes unpaid family workers and those in training. 'Second job working for own business' could be a self-employed second job or a company owner-manager second job. These cannot be distinguished in the data. Percentages may not sum (i) because, for a small proportion of those with second jobs, we do not know what form their second job takes and (ii) because of rounding.

Source: Labour Force Survey.

Characteristics of individuals in different legal forms

There has been a rise in part-time working, which is now more prevalent than it was a decade ago.⁶ Indeed, a higher proportion of those in paid work are working part-time than at any point from 1994 to 2010, although the proportion was higher between 2010 and 2014. In 2007–08, 25% of those in paid work, 7.4 million people, were working part-time (figures are shown in Table 7.2). Employees and the self-employed were equally likely to work part-time, while company owner-managers were substantially less likely (just under 12% were part-time). In 2015–16, 27% of those in paid work (8.3 million people) worked part-time. Company owner-managers remained the least likely group to work part-time, though the proportion working part-time had increased rapidly since 2007 (from 12% to 18%). And the self-employed were now more likely than employees to work part-time (31% of the self-employed compared with 26% of employees worked part-time).

These changes have been accompanied by small changes in the extent to which employees are working in permanent positions. The proportion of employees with permanent positions has fallen from 94.1% in 2007–08 (24.0 million people) to 93.6% in 2015–16 (24.8 million people). This partly reflects the fact that more employees are part-time, and part-time workers are less likely to have permanent positions, although full-time employees are also now slightly less likely to be permanent.

Table 7.2 compares some of the main characteristics of individuals according to the legal form of their main work, including how they have changed since 2007–08. Both the self-employed and company owner-managers are disproportionately male and are older on average than employees. Bank of England analysis suggests that an ageing population, combined with the fact that older people are more likely to work for their own business, can explain a substantial proportion of the increase in the number of individuals working for their own business since the recession.⁷ Since 2007, the whole workforce, but especially individuals working for their own business, has become older and more likely to be female.

The proportion of individuals with a degree has risen across the board. But the gap between company owner-managers, who were already more likely to hold a degree in 2007–08, and others had widened further by 2015–16. The 2015–16 self-employed group are more educated, on average, than the self-employed have been previously, but remain less educated relative to employees and company owner-managers.

We also examine the main industries in which individuals in different legal forms work. In 2007–08, 24% of the self-employed and 23% of company owner-managers worked in construction, an industry in which being self-employed or a company owner-manager is common practice (over 40% of individuals operating in the construction industry work for their own business). Other prominent industries for the self-employed included retail trade, land transport (e.g. taxi drivers) and legal and accountancy services. Company owner-managers were most prominent in industries such as IT and head office

⁶ There has been a particularly sharp rise in the number of low-wage men working part-time. See C. Belfield, R. Blundell, J. Cribb, A. Hood, R. Joyce and A. Norris Keiller, 'Two decades of income inequality in Britain: the role of wages, household earnings and redistribution', IFS report summary, 2017, <https://www.ifs.org.uk/publications/8849>.

⁷ S. Tatomin, 'Self-employment: what can we learn from recent developments?', *Bank of England Quarterly Bulletin*, 2015 Q1, 56–66, <http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2015/q105.pdf>.

Table 7.2. Characteristics of individuals in different legal forms, 2007–08 and 2015–16

	All in paid work		Employees		Self-employed		Company owner-managers	
	07–08	15–16	07–08	15–16	07–08	15–16	07–08	15–16
Part-time workers, %	25.1	26.7	25.2	26.2	25.3	31.2	11.8	17.5
Average age, years	40.3	41.3	39.5	40.3	45.7	47.0	44.8	47.1
% male	54.0	53.3	51.2	50.7	71.7	66.8	82.2	77.3
% with a degree	24.1	33.5	24.2	33.6	22.7	31.1	29.6	42.2

Note: 'All in paid work' excludes unpaid family workers and those in training. Figures refer to financial years. Part-time is defined as working less than 30 hours per week.

Source: Labour Force Survey.

management and consultancy. In 2015–16, construction remained important for both groups (20.1% of the self-employed and 16.5% of company owner-managers). Growth was fastest for the self-employed in building and landscape services, while the company owner-manager population grew most in professional scientific and technical services. Beyond construction, broadly company owner-managers are more likely to be consultants, while the self-employed are more likely to be tradesmen.

In summary, the self-employed and company owner-managers tend to operate in different industries, and company owner-managers are, on average, better educated and more likely to work full-time than the self-employed. Acknowledgement of these differences is lost when these two groups are considered as one (which is how they are presented in aggregate Office for National Statistics (ONS) statistics, for example). It is possible that the rises of these two groups are due to different forces and have different policy implications. As we will emphasise in Section 7.3, the two groups are also subject to very different tax treatments.

What is the 'gig economy', is it new and where is it in the figures?

As highlighted in the introduction, the recent rise in individuals working for their own business, and especially self-employment, is often associated with the growth of the 'gig economy'. There is no clear way to determine which jobs are part of the gig economy, but one of the characteristic features is the use of third-party digital platforms. Effectively, there are companies that provide a platform (usually a web-based tool) that allows individuals selling services to be matched with customers. Prominent examples of this include Uber, Deliveroo, Elance, Etsy and TaskRabbit, which provide platforms for, respectively, taxi drivers, fast-food deliverers, freelance writers, 'makers' and those providing handyman services. In examples such as these, the individuals providing services are not employees of the company and are often self-employed, possibly incorporated, for tax purposes. In some cases, they are deemed to be 'workers' in employment law (see Box 7.1) and there have been court cases to determine employment status. Section 7.4 discusses why the tax system should not be designed to reflect differences in rights across legal forms.

In many respects, the gig economy is not as new as some might imagine. Self-employment is clearly not a new concept. Nor is the idea of a platform that matches consumers to service providers. For example, hairdressing salons often do not employ hairdressers. Instead, in many cases, they provide the platform (the salon) in which the customer is matched to a self-employed hairdresser. But the large-scale digital matching platforms, made possible by technological advances, do reflect a difference between the gig economy and previous forms of working. The platforms increase the ease with which consumers and suppliers can be matched and, at least in principle, provide the latter a greater opportunity to work flexibly and to take on tasks as a second job.

Our traditional sources of data (most notably including the surveys collected by the ONS) are not set up to capture the gig economy or even many of the characteristics of different forms of employment.⁸ This section has provided some indicative evidence of the rise of the gig economy: more individuals are moving into working for their own business, including as a second job alongside employment. However, the industries in which growth in self-employment has been most prominent are not those most associated with the gig economy, suggesting that there is a broader-based change in working patterns under way. Small-scale (relative to nationally-representative) surveys are starting to provide some more direct evidence of the gig economy. For example, a McKinsey survey found that 15% of ‘independent workers’ across Europe and the US have used a digital platform.⁹

7.3 How are different legal forms taxed?

The income of employees is taxed more heavily than that of the self-employed because the latter face lower National Insurance contributions. Company owner-managers can achieve a lower rate than both because they can take income out of their company in the form of dividends rather than wages (the former are taxed less heavily). This section sets out these differences, and discusses the various other ways through which individuals working for their own business can arrange their affairs to reduce tax payments.

Taxation of different income sources

Different sources of income are subject to different taxes and rates of tax (see Table 7.3). Employees’ salaries are subject to income tax and (employee and employer) NICs, above certain thresholds.¹⁰ 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. We return in Section 7.4 to show that lower NICs cannot be fully accounted for by self-employed individuals’ lower benefit entitlements.

Company owner-managers face different tax rates depending on how they choose to take their income. This income can represent a mix of returns to labour effort and invested

⁸ The LFS does ask individuals if they are working on ‘zero-hour contracts’, an issue that has gained attention in the context of changing employment relationships. However, there are a number of problems with the resulting data. For a discussion, see A. Adams, M. Freedland and J. Prassl, ‘The “zero-hours contract”: regulating casual work, or legitimating precarity?’, European Labour Law Network (ELLN), Working Paper 5/2015.

⁹ See J. Manyika, S. Lund, J. Bughin, K. Robinson, J. Mischke and D. Mahajan, *Independent Work: Choice, Necessity, and the Gig Economy*, McKinsey Global Institute report, October 2016, <http://www.mckinsey.com/global-themes/employment-and-growth/independent-work-choice-necessity-and-the-gig-economy>.

¹⁰ Throughout this section, we assume that employees are paid regular wages, and not remunerated in other forms, such as stock options or non-wage benefits, which are taxed differently.

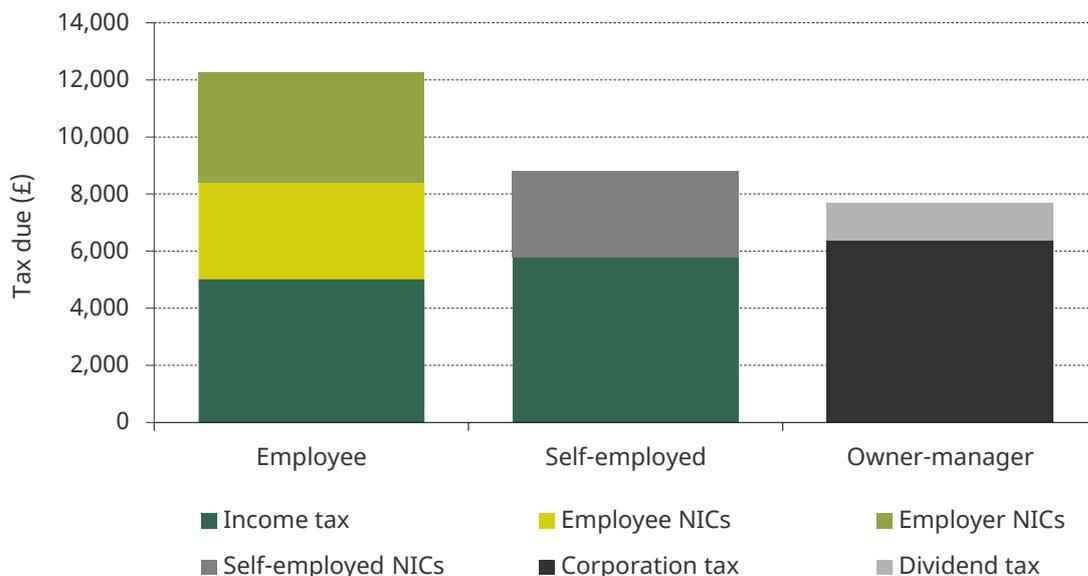
capital. Owner-managers can reduce their tax liability by recharacterising labour returns as (typically, more lightly taxed) capital returns, and pay themselves in either dividends or capital gains. Specifically, as employees of their business, they can take a salary as a normal employee would, thus taking advantage of tax-free allowances in the National Insurance and income tax systems, as well as accruing rights towards the new single-tier state pension. However, they can also pay themselves in dividends. This 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 first £5,000 per year of dividends above the personal allowance is untaxed, while any remaining dividends are taxed at 7.5% in the basic-rate income tax band (treating dividends as the top slice of income), 32.5% in the higher-rate band and 38.1% in the additional-rate band. These rates, in combination with the corporation tax rate, 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 NI secondary threshold in salary and take any withdrawal above that in dividends.¹¹ We return below to discuss how company owner-managers can retain income in the company and take income out as capital gains.

Table 7.3. Differences in tax regime across legal forms

Employee	Self-employed	Company owner-manager
Income tax charged on salary (above personal allowance).	Income tax charged on unincorporated business profits (above personal allowance).	Income tax and employee and employer NICs on salary as for employees, taken out of pre-tax corporate profit. Qualify for employment allowance if more than one employee.
Employee NICs charged on salary (above primary threshold).	Self-employed NICs charged on business profits (above lower profits limit) at a rate lower than employee NICs. No equivalent to employer NICs.	Corporation tax on company profits (after salary deducted), including capital gains realised by the company.
Employer NICs paid by employer at a flat rate on all employees' salaries (above secondary threshold). Employment allowance reduces liability by £3,000 for each employer (assuming they have more than one employee).	Capital gains tax (above annual allowance) on the disposal of business assets, at a reduced rate if qualifying for entrepreneurs' relief.	Income tax on dividends (distributed out of post-corporation-tax profits) above dividend allowance. Capital gains tax (above annual allowance) on sale of shares, at reduced rate if qualifying for entrepreneurs' relief.

¹¹ Wages up to the NI secondary threshold are within the personal allowance and therefore not taxed, unless an individual earns 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 £122,000.

Figure 7.3. Tax due on total income of £40,000, 2016–17

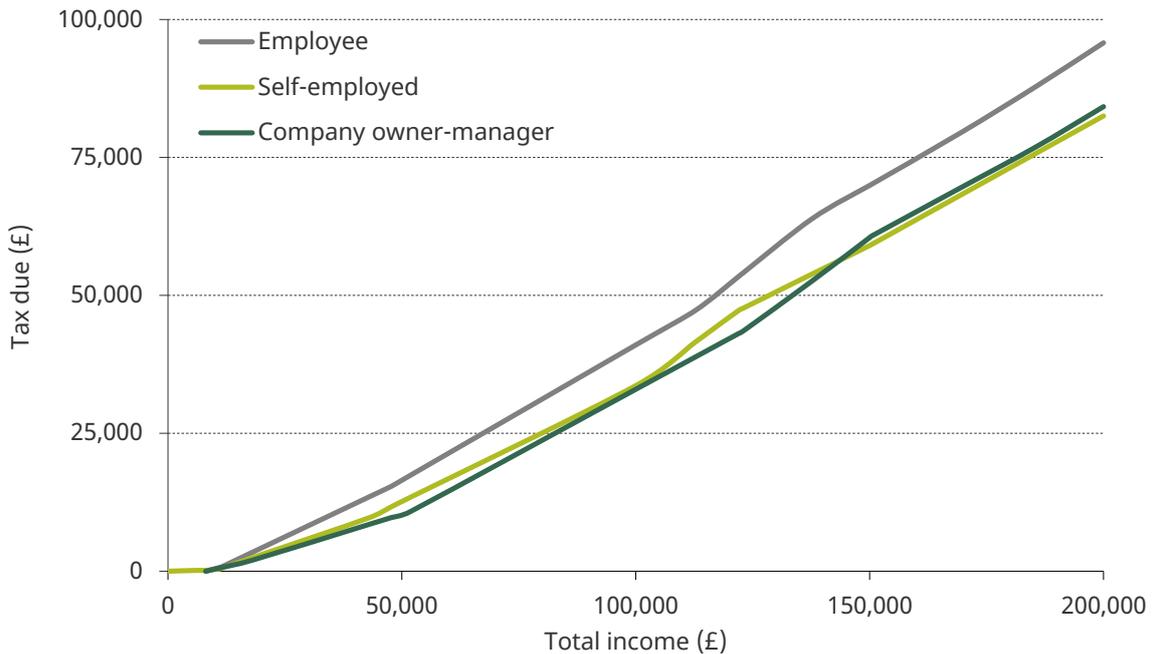


Note: The calculations assume: total income generated and paid out is equal to £40,000 for each legal form; the tax cost for employees includes employer NICs; company owner-managers take a salary equal to the NI secondary threshold and all post-tax profit as dividends. Income tax payments are lower for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

Figures 7.3 and 7.4 illustrate how the tax treatment of different income sources affects the total tax liability of individuals generating a certain amount of total income (set at £40,000 in Figure 7.3), and paying out that income in the year it is generated, in each of the legal forms for the tax year 2016–17. 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 most tax-efficient way and (for now) that it is all taken out in the current year. Figure 7.3 shows that on a total income of £40,000, the tax liability is highest for an employee and lowest for a company owner-manager. NICs treatment explains all of the difference between employees and the self-employed and the majority of the difference between both and company owner-managers.

Employees are taxed at a higher level than individuals working for their own business at all levels of income (shown in Figure 7.4). It is this difference that means that the rise in the number of individuals choosing to work for their own business, rather than be employees of others’ businesses, has a cost to the exchequer (see Box 7.3). There is some variation in the relative tax advantage of company owner-managers and the self-employed depending on income level. This is because self-employment profits are taxed less heavily than dividends (taking into account corporate and personal taxes) in the higher- and additional-rate bands.

These figures may in fact understate the tax advantages associated with self-employment or company owner-management. For example, the self-employed generally have more scope to deduct work-related expenses from their income than employees do (though

Figure 7.4. Tax due at different income levels, 2016–17

Note: See note to Figure 7.3. Here, the same assumptions hold at each stated income level.

there are exceptions to this).¹² We return below to discuss other ways in which individuals working for their own business can reduce their tax liability further.

Differences in tax regimes over time

The different tax treatment of legal forms has long been a part of the UK tax system, with the relative levels varying over time. The difference in tax burdens between the self-employed and company owner-managers is actually lower, at most income levels, in 2016–17 than it has been since at least the late 1990s, and lower than it is set to be in coming years. Figure 7.5 shows liabilities since 1999 for a particular example income level (chosen as £40,000 in 2016–17 prices and, as in Figure 7.4, assuming company owner-managers take out all income in the year it is earned). Changes over time in the liabilities and in the difference between them reflect changes in the income tax, NICs, dividend tax and corporation tax regimes.¹³ The main changes that apply to the example in Figure 7.5 are as follows:

- In 2008–09, the basic rate of income tax was cut from 22% to 20%, and the 10% starting rate was abolished (except for savings income). Since 2011–12, the personal allowance has increased faster than inflation.¹⁴ The effect of these changes varies depending on an individual's income level. For the example in

¹² 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.

¹³ From April 2017, self-employed individuals will have an additional £1,000 annual allowance to set against their trading income, but if they choose to claim it they will no longer be able to deduct expenses for tax purposes. This allowance is not included in the figures in this chapter.

¹⁴ Those earning above £122,000 in 2016–17 do not benefit from a higher personal allowance, and indeed have had their personal allowance removed: see footnote 11 for explanation.

Figure 7.5, they explain the majority of the fall in tax liability for employees and the self-employed since 2008–09. They do not affect our example company owner-manager because (i) she is assumed to pay herself a salary below the personal allowance and (ii) before 2016–17, dividends were taxed at the same effective rate (i.e. with no tax at the personal level) below the personal allowance and within the basic-rate band (such that changes in the personal allowance did not lead to changes in tax on dividends).

Box 7.3. The exchequer cost of greater incorporation

The tax advantages for company owner-managers mean that if more individuals choose to work for their own companies rather than as employees of other's companies, there is a considerable cost to the exchequer. The OBR forecasts growth in the number of small companies (which is largely driven by growth in owner-managed companies) to outstrip employment growth substantially between 2015–16 and 2021–22.^a This is based predominantly on the assumption that the trend for the small company population to grow substantially faster than employment will continue. The small company population has increased at a rate of around 7% a year since 1990. The OBR judges that the increase over the next five years will be slightly below this. But this still implies much faster growth in incorporations than the expected 0.4% growth in employees.

The OBR has quantified the cost of growth in the small company population outstripping employment growth. It forecasts that revenues will be £3.5 billion lower in 2021–22 than if the small company population and employment grew at the same rate (assuming that the overall change in the size of the workforce remained the same). The cost would have been even higher had the tax on dividends not been increased in 2016–17.

Note that this revenue cost does not reflect a judgement that the labour market is changing more quickly than it was before (for reasons related to the rise of the gig economy or otherwise). The OBR is simply quantifying the cost of a long-term trend continuing for another six years. The cost could turn out to be higher if there has been, or is in future, an increase in the underlying propensity of individuals to incorporate rather than work as employees.

There have been changes in methodology that led the OBR to revise up the forecast growth of small companies and therefore the associated revenue cost. Upward revisions in both the March 2016 and the November 2016 Economic and Fiscal Outlook reduced forecast exchequer revenues by £3.2 billion in 2020–21. This means that the majority of the costs to the exchequer from incorporation expected over the next five years have only been reflected in forecasts within the last year or so.

^a See box 4.1 in Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2016*, <http://budgetresponsibility.org.uk/efo/economic-and-fiscal-outlook-november-2016/>.

- A 'starting rate' of corporation introduced in the early 2000s meant that the first £10,000 of profit was subject to a lower tax rate, set at 10% in 2000–02 and 0% in 2002–06.¹⁵ The liability of company owner-managers fell with the introduction of the starting rate and increased when it was effectively abolished in 2004–05.
- The tax rate paid by small companies (those with profits below £300,000) is, from 2015–16, merged with the main rate of corporation tax. This rate is set to fall – from 20% today to 17% by 2020–21 – reducing company owner-managers' tax liability.¹⁶
- From 2016–17, the first £5,000 of dividends above the personal allowance is untaxed regardless of a taxpayer's marginal rate. Above that, dividends are taxed at 7.5%, 32.5% and 38.1% in the basic-, higher- and additional-rate bands respectively. (Previously, dividends were taxed at effective rates of 0%, 25% and 30.56% in the respective bands.) This represents a tax rise for basic-rate taxpayers taking more than £5,000 of dividends, higher-rate taxpayers taking more than £21,667 in dividends and additional-rate taxpayers taking more than £25,265. This reform has reduced the tax advantage for many company owner-managers.¹⁷ The tax liability of a company owner-manager looking to withdraw £40,000 (as shown in Figure 7.5) is £1,537 higher in 2016–17 than in 2015–16, mostly as a result of the change. For any company owner-manager earning more than £27,000 (in 2016–17 prices), their tax liability is actually higher in 2016–17 than at any time since at least 1999–2000 as a result of dividend tax reform.¹⁸
- An 'employment allowance' was introduced in April 2014 and reduced employers' NICs liability by up to £2,000.¹⁹ This was a bigger advantage for smaller companies, and as a result benefited mainly employees of small companies (assuming that lower employer NICs are reflected in increased wages) and company owner-managers (assuming they had no or few other employees). As of 2016–17, the allowance has been increased to £3,000, but it does not apply to companies with only one employee, which may exclude many company owner-managers from enjoying this tax break.

¹⁵ 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.

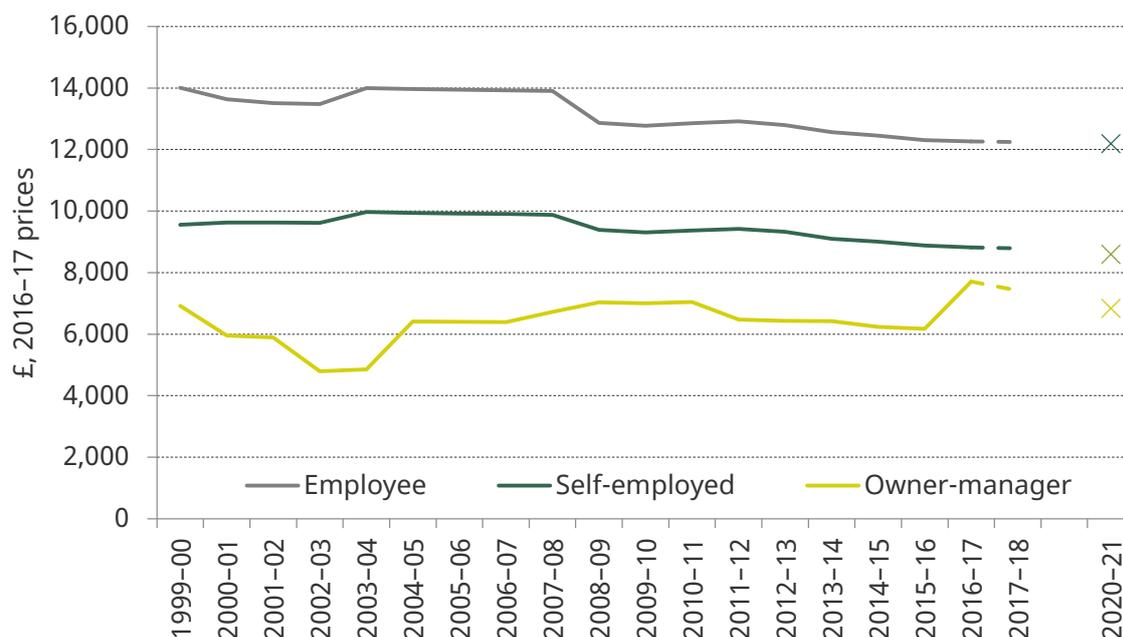
¹⁶ While some owner-managed companies may not have been subject to the small company tax regime, in practice most will have had profits below £300,000. Since 2015–16, the corporation tax rate has been the same for all companies regardless of profit level.

¹⁷ A further significance of the reform to dividends is that, for the first time in recent history, basic-rate tax will be charged on dividend income. Previously, the absence of basic-rate tax on dividends saved many people (generally those owning some shares but with otherwise simple tax affairs, rather than company owner-managers) from having to fill in a tax return. Changing this was seen as a large administrative barrier to the alignment of tax rates across different income sources (an option we consider in Section 7.5). However, the introduction of a 7.5% basic rate of tax on dividends, combined with a large dividend allowance to limit the increase in the number of people paying tax on dividends and therefore needing to fill in a tax return, largely removes this barrier.

¹⁸ For further explanation of these changes, see T. Pope and T. Waters, 'A survey of the UK tax system', IFS Briefing Note 9, November 2016, <https://www.ifs.org.uk/bns/bn09.pdf>.

¹⁹ This encourages owner-managers to take a salary equal to the income tax personal allowance rather than the National Insurance secondary threshold.

Figure 7.5. Tax due on total income of £40,000, over time (2016–17 prices)



Note: Deflated using the Consumer Prices Index (CPI). Takes into account differences in corporation tax, income tax, dividend tax and National Insurance rates and thresholds. Assumes company owner-manager takes a salary equal to the NI 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 company owner-managers are 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.

Additional tax advantages to incorporation and self-employment

In Figures 7.3–7.5, we assumed that an individual, having generated a certain amount of pre-tax income over a year, accessed the after-tax income in that year. But individuals working for their own business can access the proceeds in various other ways, which may allow them to reduce their tax payments. The following subsections are a (non-exhaustive) set of additional ways in which tax can be reduced.

We also note that there are two features of the system that act in the opposite direction (i.e. are more beneficial for employees). First, if they are willing to tie up the money until age 55, employees (including company owner-managers) get the most favourable tax treatment of all by getting the business to make an employer pension contribution rather than paying them income immediately. Second, the self-employed are treated less generously by the benefits system than employees. See Box 7.4.

Retaining earnings in the company

Company owner-managers can reduce their tax charge 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.²⁰ Imagine an individual who earns an annual income around the higher-rate income tax threshold but in some years earns a little more and in some years a little less.

²⁰ Corporate profits are subject to corporation tax in the year that the profit is earned.

She can avoid paying higher-rate income tax if, when she earns more than the threshold, she retains earnings in the company and pays them out in a year when she earns less. Company owner-managers also have greater flexibility to change the timing of income withdrawal in response to policy reforms (we return below to show that this happened when the 50% marginal tax rate was introduced in 2010–11). The ability to smooth income (and therefore tax payments) over time and in response to policy change is an additional benefit of incorporation.

Box 7.4. Advantages for employees

Pension contributions: Money paid into a private pension (up to annual and lifetime limits) is not subject to income tax at that point, and crucially, if the pension contribution comes from the firm rather than the employee, there is no (employer or employee) NICs due either. Investments within the pension fund are free of personal tax on the returns; and while money taken out of the pension from age 55 is mostly subject to income tax, the first 25% is free of income tax and all of it is free of NICs. Employer pension contributions are thus a form of remuneration (indeed, the only major form of remuneration) that escapes NICs entirely, an astonishingly generous treatment.

This is not an option available to the self-employed, who must make any pension contributions themselves (there is no employer) out of income that is subject to self-employed NICs. Thus to the extent that people can use pensions in this way, employees are treated as favourably as company owner-managers, and it is self-employment that is relatively penalised – though for higher earners the penalty is only small since the self-employed NICs rate on earnings above the upper profits limit is only 2%.

Employer pension contributions can be thought of as just the most important example of a wider issue where some tax-privileged remuneration may be only (or more readily) available to employees: other examples include provision of certain sports facilities, medical check-ups, childcare vouchers and redundancy payments. To the extent that these are used, they can again favour employment relative to self-employment.

‘Contributory’ social security benefits: Unlike employees, the self-employed are not entitled to contribution-based jobseeker’s allowance or statutory maternity/paternity/adoption/shared parental pay. We discuss this in Section 7.4.

Universal credit: For the purposes of the means test in universal credit – a major new benefit gradually being rolled out to replace six existing means-tested benefits and tax credits for working-age claimants – the self-employed are (after the first 12 months in business) assumed to be earning at least a certain amount in each month, equivalent to the applicable minimum wage times the minimum number of hours the government thinks it reasonable for them to work – even if they are in fact earning less than that amount. In other words, a self-employed individual cannot receive more universal credit in a month than an (otherwise similar) employee earning the minimum wage. This is a disincentive to choose self-employment for people who think that their earnings might be low, either in general or in some months as their income fluctuates.

Tax rates can be reduced further if income is retained within a company and taken as capital gains. Retained earnings effectively boost the value of a company. When a company owner-manager sells or liquidates their company (possibly upon retirement), the retained earnings are taxed as capital gains. That is, retained earnings are first subject to corporation tax at the company level and then capital gains tax at the personal level. If the company owner-manager meets certain conditions (and most will), the disposal of the business will be subject to entrepreneurs' relief.²¹ This relief was introduced in 2008–09 (replacing the previous taper relief) and gives a reduced rate of capital gains tax of 10% on the first £10 million of otherwise taxable gains realised over an individual's lifetime (the standard rate on business assets is 10% for basic-rate taxpayers and 20% for higher- or additional-rate taxpayers). (Box 7.5 later summarises the history of capital gains tax.)

Entrepreneurs' relief can confer a large tax advantage to high-earning owner-managers. Both dividends and capital gains are withdrawn from post-corporation tax profits. For an individual in the higher-rate income tax band, dividends attract a further 32.5% tax rate within the income tax system, while capital gains qualifying for entrepreneurs' relief are taxed at just 10%. If individuals are willing to defer withdrawing income until they are able to take capital gains, they can therefore enjoy a substantially lower tax liability. The benefit is partly mitigated by the fact that any increases in the cash value of retained earnings, even those that simply compensate for inflation, will be taxed at both the corporate and personal level. Nonetheless, if high-earning owner-managers have the flexibility to take capital gains rather than withdrawing income as dividends, they can still pay substantially less tax. This is mainly an advantage for higher-income individuals, since the basic rate of tax on dividends (7.5%) is lower than the capital gains tax rate (10%).

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 (there will have been no corporation tax or income tax paid). Under entrepreneurs' relief, this means gains are taxed at only 10%. In this case, the tax treatment is even more generous than for company owner-managers.

In 2014–15 (the last year for which we have data on the number of claimants), the estimated cost of entrepreneurs' relief was £3.5 billion, or £74,500 per claimant.²² 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 capital gains are taxed under the main capital gains tax regime rather than entrepreneurs' relief (and not relative to a world in which they are taxed as salary or dividend income).

Even more generous treatment is available to business assets that are bequeathed. Those inheriting assets are deemed to acquire them at their market value at the date of death, so rises in the value of assets prior to death are not subject to capital gains tax. This means that substantial business income may be subject to no personal tax at all if the

²¹ Eligible assets: shares owned by employees or directors with at least 5% of the shares and voting rights; unincorporated businesses; business assets sold after the closure of a business; newly issued, unlisted company shares owned for at least three years by external investors.

²² See HMRC, 'Estimated costs of principal tax reliefs', December 2016, <https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs> and https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/562694/Table_14.4.pdf.

business is bequeathed. Unincorporated businesses and shares in unlisted companies are generally exempt from inheritance tax as well.

Splitting income with family members

Company owner-managers and the self-employed can split business profits among multiple individuals, reducing their overall tax liability since marginal tax rates rise with individual income. In particular, a company owner-manager could shift income to their spouse by paying them a wage and/or making them a shareholder. If the spouse has no other source of income, the amount of tax paid on the £40,000 withdrawal in Figure 7.3 can be reduced by 30% from £7,705 to £5,376.²³ Similarly, a self-employed individual could make their spouse a partner in the unincorporated business, reducing their liability by 32% from £8,820 to £6,040.²⁴ There are laws that look to prevent this type of behaviour in certain cases ('settlement provisions'),²⁵ but they do not prevent all forms of income splitting (in many cases, such behaviour is perfectly legal) and, in practice, it is difficult to identify avoidance or evasion.

Opportunities for avoidance and evasion

Relative to employees, the self-employed and company owner-managers often have additional leeway that allows them to (legally) avoid or (illegally) evade taxes. In terms of avoidance, the greater complexity of business activities offers more scope to arrange their affairs in tax-advantaged ways: sharing with spouses and shifting income across years are simple examples. In terms of evasion, the key difference is that employees are subject to third-party reporting: for the most part, the tax on their earnings is deducted by employers through the Pay As You Earn (PAYE) system and the earnings and tax are reported by the employer to the government, so it would require collusion by the employer to under-report earnings (or over-report deductions). A lack of such third-party reporting means that there are more opportunities for the self-employed and company owner-managers not to declare, and therefore not be taxed on, some income.²⁶ They also have greater scope to declare falsely which tax year income arises (shifting income across years can reduce tax liability) or to claim falsely that personal assets, such as a laptop or phone, are business assets and reduce tax by deducting the cost from profits.

It is not only income that is more difficult to verify for the self-employed and company owner-managers: it is also hours of work. Eligibility for working tax credit requires working a minimum number of hours per week (16, 24 or 30, depending on family circumstances); compared with someone employed by a third party, someone working for themselves could more easily pretend to work more hours than they really do.²⁷

²³ This is achieved by paying both individuals the secondary threshold and distributing the remainder in dividends (where the shareholding is split 50/50).

²⁴ As partners with equal shares, they would each be taxed on half of the business profits. Due to the progressivity of the tax system, this would reduce the amount of tax paid.

²⁵ See <https://www.gov.uk/government/publications/trusts-and-settlements-income-treated-as-the-settlors-hs270-self-assessment-helpsheet/fasf>.

²⁶ As a way of countering this in the construction industry – the most common industry in which to find people working through their own business, as we saw in Section 7.2 – the government operates the Construction Industry Scheme, whereby contractors must deduct tax on subcontractors' behalf and pass it on to HMRC, thus creating third-party involvement.

²⁷ This possibility will gradually end as working tax credit is replaced by universal credit, which largely avoids the use of hours-of-work rules to determine entitlement.

Of course, most self-employed individuals and company owner-managers will honestly declare their incomes and hours of work. And the government tries hard to collect the tax it thinks it is owed. Tax evasion is illegal, and there are ever more rules in place to try to prevent tax avoidance (reducing tax in ways that are legal but not within the spirit of the law). However, the risk of getting caught may be relatively small compared with the tax advantage. And even in cases where individuals are audited, it may be difficult for HMRC to prove wrongdoing. Every year HMRC produces estimates of the 'tax gap' – the difference between the amount of revenue that should have been raised and the amount that was actually raised.²⁸ It estimates that the tax gap for self-assessment income tax, NICs and capital gains tax combined was around £7 billion in 2014–15. Of that amount, £5 billion was judged to have arisen from 'business taxpayers' (the self-employed). Around 30% of self-employed tax returns are estimated to understate the amount of tax due, while this is only true of 12% of the remainder of self-assessment returns (which largely belong to higher- and additional-rate taxpayers).

The effect of tax on choices

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. These are not just theoretical incentives that could, in principle, affect decisions. There is substantial evidence that these incentives do indeed change behaviour.

The UK provides a clear illustration that incorporation responds to incentives. Figure 7.6 shows the number of incorporations over time. Spikes occurred at times when the incentives, or at least the perceived incentives, to incorporate changed.²⁹ The increase in response to the starting rate of corporation tax in the early 2000s (mentioned above) was predictable and, indeed, predicted.³⁰ The OBR reports analysis of the likely change in incorporations (based on previous trends) and suggests that the number of incorporations is responsive to changes in the tax system.³¹

There is also good evidence that the incomes of company owner-managers respond more to incentives in the tax system than employees' incomes. If people can readily adjust their incomes in response to tax incentives, we would expect to see many people locating around points such as the higher-rate income tax threshold, where the marginal tax rate increases: people who think it worth earning more when the additional income is taxed at 20% (or 0% in the case of dividends), but not when it is taxed at 40% (or 25% in the case of dividends), will choose to earn up to the higher-rate threshold but no more. Figure 7.7 shows that company owner-managers do indeed 'bunch' around the higher-rate

²⁸ This includes not just outright evasion but also innocent error and some forms of avoidance or debatable behaviour. See HMRC, *Measuring Tax Gaps 2016 Edition*, October 2016, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/561312/HMRC-measuring-tax-gaps-2016.pdf.

²⁹ For further discussion, see C. Crawford and J. Freedman, 'Small business taxation', in S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba (eds), *Dimensions of Tax Design: The Mirrlees Review*, Oxford University Press for IFS, Oxford, 2010, <https://www.ifs.org.uk/publications/7184>.

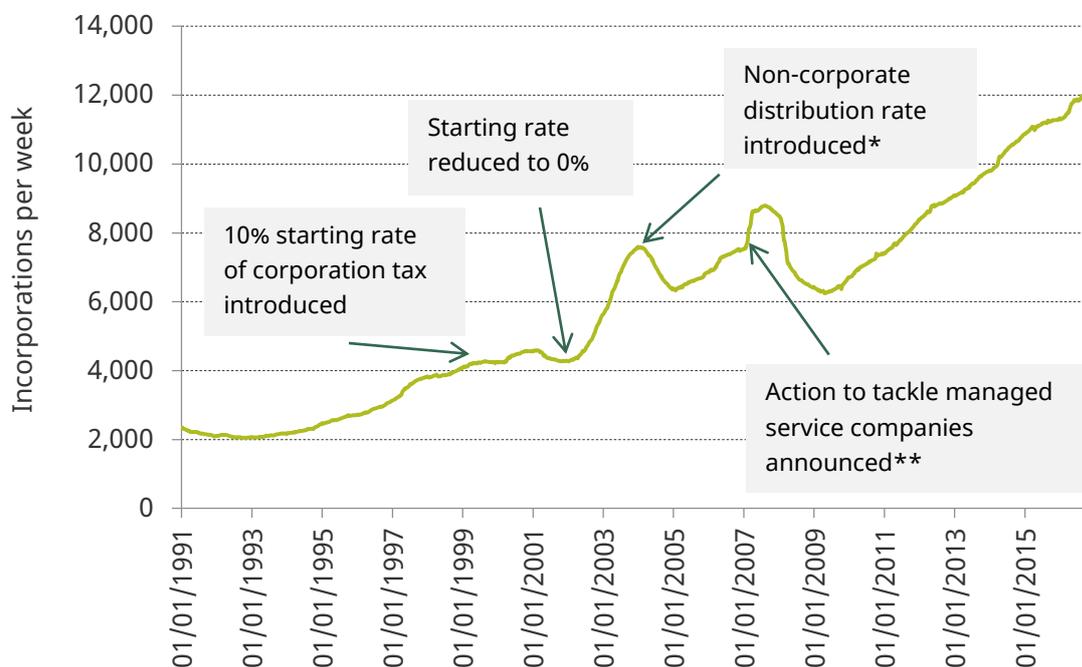
³⁰ See L. Blow, M. Hawkins, A. Klemm, J. McCrae and H. Simpson, 'Budget 2002: business taxation measures', IFS Briefing Note 24, 2002, <https://www.ifs.org.uk/publications/1774>.

³¹ Box 4.1 in Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2016*, <http://budgetresponsibility.org.uk/efo/economic-and-fiscal-outlook-november-2016/>.

threshold. This is true to a lesser extent for the self-employed, but there is almost no bunching among employees. The same is true at other such thresholds.³²

One major reason company owner-managers are more able to respond to tax incentives is their flexibility to choose when to take income out of their company. When the government announced in advance that the income tax rate on incomes above £150,000 was going to increase from 40% to 50% (or from 25% to 30.56% for dividends) in 2010–11, people expecting to have incomes above that level had an incentive to take income before that year. Figure 7.8 shows that there was a sharp jump in dividend income among this high-income group in 2009–10, the year before the tax rise, and then a drop when the tax was increased in 2010–11. In contrast, there is little sign of employment income being brought forward in that way.

Figure 7.6. Incorporations per week since 1991 (52-week moving average)



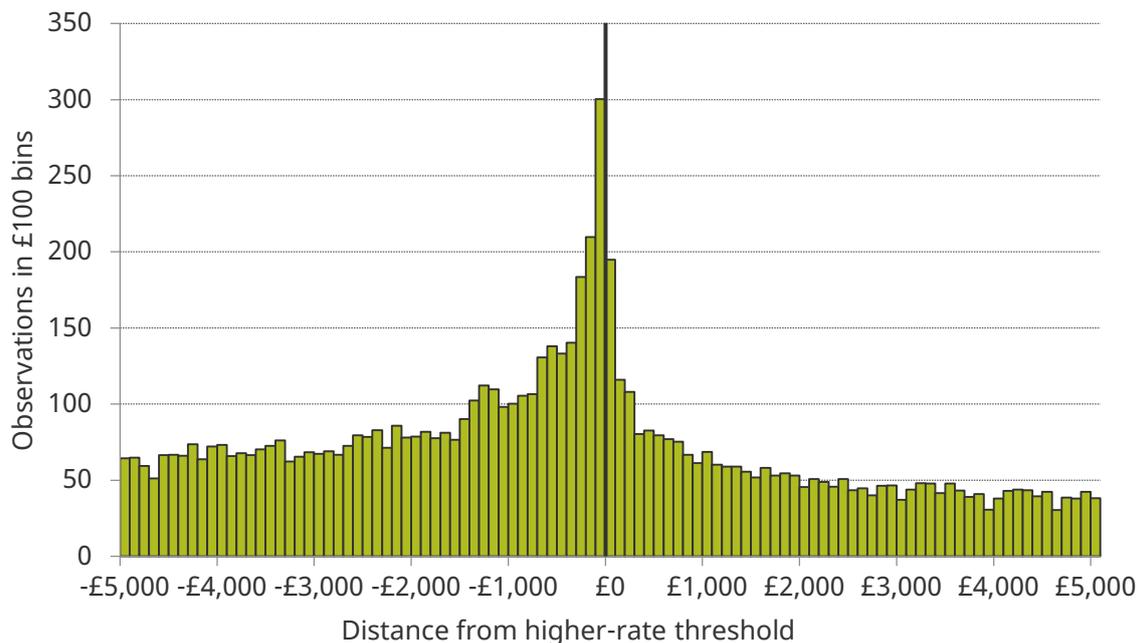
* This effectively marked the end of the tax advantage of the starting rate for most company owner-managers. See footnote 15.

** For more details on the response of incorporations to this measure, see C. Crawford and J. Freedman, 'Small business taxation', in S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba (eds), *Dimensions of Tax Design: The Mirrlees Review*, Oxford University Press for IFS, Oxford, 2010, <https://www.ifs.org.uk/publications/7184>.

Source: Correspondence with Companies House.

³² There is also evidence that small companies often reported profits at the £10,000 threshold when the starting rate was in place. See M. Devereux, L. Liu and S. Loretz, 'The elasticity of corporate taxable income: new evidence from UK tax records', *American Economic Journal: Economic Policy*, 2014, 6(2), 19–53. Firms partly achieved this 'bunching' by claiming more capital allowances, including in ways that may represent avoidance or evasion behaviour rather than genuine productive investment. See A. Brockmeyer, 'The investment effect of taxation: evidence from a corporate tax kink', *Fiscal Studies*, 2014, 35, 477–509.

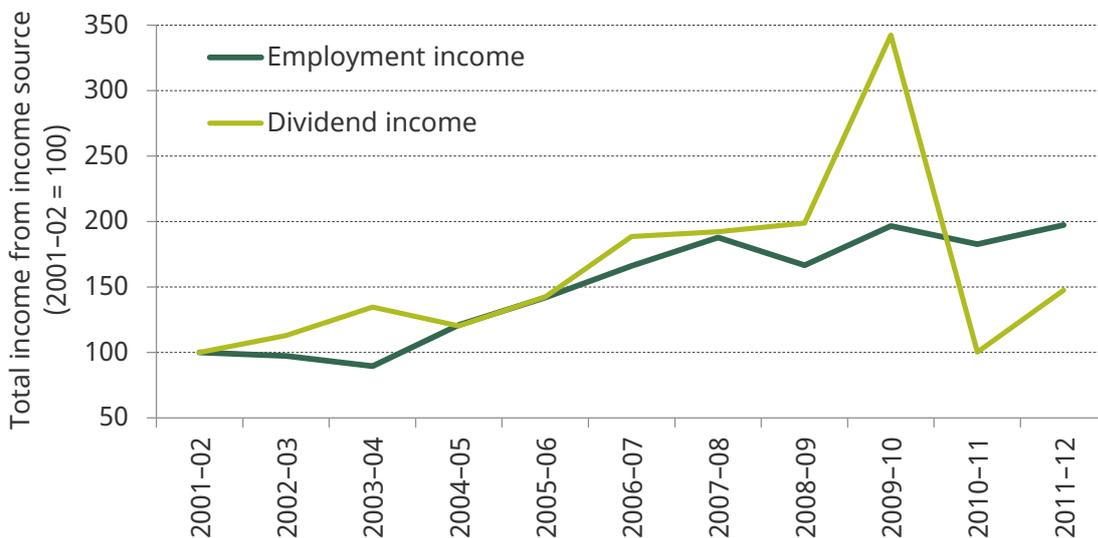
Figure 7.7. Bunching at the income tax higher-rate threshold among company owner-managers, 2003-04 to 2007-08



Note: Distance from higher-rate threshold measured in 2007-08 prices.

Source: S. Adam, J. Browne, D. Phillips and B. Roantree, 'Frictions and the elasticity of taxable income: evidence from bunching at tax thresholds in the UK', mimeo, forthcoming, based on data from the Survey of Personal Incomes (a sample of income tax records).

Figure 7.8. Trends in different income sources for group affected by 50% income tax rate



Note: More individuals had to file tax returns in 2010-11, leading to slightly understated income falls in that year.

Source: J. Browne and D. Phillips, 'Estimating the size and nature of responses to changes in income tax rates on top incomes in the UK: a panel analysis', mimeo, forthcoming, based on SA302 (income tax return) data.

7.4 Should the self-employed and company owner-managers be taxed less heavily than employees?

The fact that similar individuals doing similar work can be taxed very differently according to whether they are an employee, self-employed or running an incorporated company is a problem. So, too, is the fact that company owner-managers can achieve very different tax rates depending on how they take income out of their companies. These distinctions clearly raise issues of fairness. They also distort individuals' choices, which can reduce economic efficiency as some people are induced to run their own businesses when, if incentives were not distorted by the tax system, they would rather be employed by others. The need to devise, administer, comply with and monitor rules to distinguish the different legal forms imposes costs of a different kind, diverting officials, taxpayers, accountants and occasionally the courts from more productive activities. Finally, the distinctions inevitably open up possibilities for avoidance and evasion – further exacerbating these problems of unfairness, inefficiency and diverted resources.

Given these factors, many people would agree that genuinely similar individuals doing genuinely similar work should be taxed in the same way regardless of legal form – though some might argue for using lower tax rates to compensate for other disadvantages that the government itself attaches to different legal forms (such as lower employment rights or reduced state benefit entitlements). A different argument for tax differentiation is that, while in some cases (such as computer programmers or taxi drivers) similar individuals might do similar activities in different legal forms, often people running their own businesses are doing something fundamentally different from employees, including investing, innovating, taking risks and other such entrepreneurial behaviour. These may merit preferential tax treatment. We discuss both of these arguments for different treatment below.

A more 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 (their taxable incomes are more 'elastic'). 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). 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 had more elastic incomes than employees, though not eliminate the difference 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.

Should lower taxes be used to offset other disadvantages?

As well as differences in tax rates, different legal forms are treated differentially by many other parts of government policy. Might lower tax rates for the self-employed and company owner-managers be justified as compensating for other ways in which the government disadvantages these forms? In summary, there is an argument for lower

taxes to reflect the fact that the self-employed have reduced entitlement to some social security benefits, but in practice this difference is now relatively small. We argue that the tax system should not be used to offset differences in employment rights or compliance burdens between different legal forms.

Publicly-funded benefits

A common argument in favour of lower NICs rates on the income of the self-employed is that they have reduced entitlement to publicly-funded benefits compared with employees. In principle, that is a reasonable argument: 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.³³ However, in practice, the difference in entitlements between employees and the self-employed is now relatively small. Unlike employees, the self-employed are not entitled to contribution-based jobseeker's allowance or statutory maternity/paternity/adoption/shared parental pay. But what used to be the biggest difference in entitlements has now been removed. Previously, the self-employed accrued rights to the basic state pension, but not to the earnings-related top-up (state second pension). Employees could choose to build up entitlement to the state second pension or to 'contract out' of it in exchange for a commensurately reduced rate of NICs on their earnings. The new single-tier pension being rolled out from April 2016 will instead apply equally to the self-employed and all employees; but while formerly contracted-out employees must now pay the full rate of NICs in return for this entitlement, the self-employed are seeing their entitlement increase with no such increase in their NICs rate.

The NICs advantage of self-employment over employment was already far bigger than could be justified by any difference in benefit entitlements, and this reform to state pensions has increased the disparity. HMRC estimates that the revenue forgone by applying lower NICs rates to the self-employed exceeded the value of their reduced pension entitlements by £3.2 billion (or £800 per self-employed person) in 2015–16, increasing to £5.1 billion (£1,240 per self-employed person) in 2016–17.³⁴ To put that into context, total self-employed NICs revenue in 2016–17 is expected to be £3.0 billion.³⁵ Before allowing for the reduced benefit entitlements that remain, they are paying only 37% of the NICs that would be paid if they were employed. Differential benefit entitlements that remain may justify some difference in tax rates, but not on anything like this scale.

³³ 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.

³⁴ See HMRC, 'Estimated costs of principal tax reliefs', December 2016, <https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs>. Based on the number of self-employed individuals in 2016 Q3 (see Figure 7.1).

³⁵ Source: Appendix 4 of Government Actuary's Department, *Report by the Government Actuary on: the Draft Social Security Benefits Up-Rating Order 2016; and the Draft Social Security (Contributions) (Limits and Thresholds Amendments and National Insurance Funds Payments) Regulations 2016*, 2016, <https://www.gov.uk/government/publications/report-to-parliament-on-the-2016-re-rating-and-up-rating-orders>.

Employment rights

Employment law bestows employees (and ‘workers’ to a lesser degree) with a set of rights that self-employed people do not have (see Box 7.1 earlier). However, unlike higher state benefit entitlements, these employment rights are not a benefit given by the government to employees, but a benefit that the government requires employers to give to their employees. In so far as these rights make employment more attractive to the employee (relative to self-employment), they also make employment less attractive to the employer (relative to getting the work done by a self-employed contractor). So it is not clear that the existence of these rights biases the economy overall towards more employment and less self-employment. The government is not favouring employment over self-employment overall in a way that might justify an offsetting tax differential; it is merely redistributing between the two parties *within* an employment relationship. Indeed, in a well-functioning labour market, we would expect an employee’s greater employment rights to be offset by lower earnings, making them (on average) no more likely to choose employment over self-employment than they would in the absence of these rights.³⁶

Compliance burdens

It is sometimes argued that differences in tax rates between different legal forms are justified by a difference in the burden of tax (or regulatory) compliance that the government imposes on them. For example, company owner-managers must fill out corporation tax and income tax returns, deal with capital gains tax and dividend tax, file company accounts, and so on.

Unlike employment rights, this is a government-imposed difference in the *total* burden associated with a particular legal form, not just a transfer of burdens from one party to another *within* one legal form. In that respect, differential compliance costs have something in common with differential state benefits entitlements, discussed above. In addition, however, compliance costs add to total resource costs in the economy – they are not simply a transfer of resources between different people like state benefits are. That is important. If people shift between legal forms because of higher benefit entitlements, their gain in higher benefit entitlements is mirrored by a corresponding loss to the exchequer; there is no net gain to society from such a shift. There is therefore a case for using tax rates to offset the difference in entitlements and avoid the inefficiency of people choosing their legal status to gain preferential treatment rather than for underlying commercial reasons.

In contrast, if people shift between legal forms as a result of compliance costs, their gain in reduced compliance burdens is not offset by a loss to the government. Ideally, of course, there would be no such difference in burdens on different legal forms (and there are many features of the system that are designed to mitigate burdensome obligations on small businesses, including a VAT registration threshold and less onerous accounting requirements). But, if such differences do exist, it is then more efficient for the economy to have less of the burdensome form, just like a sector of the economy facing high costs of any other kind should be smaller. The government should not push the economy back towards having as much of the costly activity as it would if the cost were not there. The same argument applies not just to differences in tax compliance costs, but also more

³⁶ While this wage adjustment might offset the difference in rights on average, note that it might still be the case that workers who value these protections unusually highly, and firms that find them unusually cheap to provide, will tend to favour employment relationships rather than self-employment, and vice versa.

widely to differences in regulatory burdens and employment rights that raise the net burden on a legal form.

Should lower tax rates be used to increase 'entrepreneurship'?³⁷

Employees, the self-employed and company owner-managers often differ in many ways, including in how much risk they take and whether they conduct investment, for example. The first question is whether any such differences merit preferential treatment in principle. Even where they do, we must also ask whether differential tax rates are the best-targeted way to provide it, and whether the benefits outweigh the costs of differentiation described above.

One fundamental difference is that, unlike employees' wages, the income of the self-employed and owner-managers often represents a return to capital invested as well as labour. While it is inevitable that real-world tax systems discourage work to some extent, economic theory suggests that they should not additionally discourage investment. Taxing earnings or expenditure discourages work by reducing the amount of goods and services that working enables someone to buy. Investing (or keeping) money in a business defers consumption from today until tomorrow, and there is little reason to tax future consumption more heavily than today's consumption: it further distorts behaviour and is an inefficient way to raise revenue.³⁸ Wanting to avoid discouraging investment while taxing labour income provides a *prima facie* case for applying reduced tax rates to the self-employed and company owner-managers, whose income is a mixture of returns to capital and labour. Crucially, however, we can avoid discouraging investment in a better-targeted way than by applying reduced tax rates on income, by instead adjusting the tax *base* to give an allowance for the money that has been invested in the business. We return to this in Section 7.5. Given this superior alternative, investment in the business does not provide a good argument for lower tax rates for the self-employed or company owner-managers.

Investment aside, preferential rates of tax are often defended as essential to reward difficult and risky entrepreneurial activity. But it is important to recognise that the difficulty and risk associated with entrepreneurship do not in themselves justify favourable tax treatment. If the market does not provide sufficiently high rewards for such activities, they should not be undertaken: it is not a justification for special tax breaks. What is needed (though not necessarily sufficient) to justify preferential tax treatment is a reason why the market will lead to too few 'entrepreneurs' when the tax system is neutral between legal forms. That is, preferential tax treatment may be justified if markets fail to provide the appropriate incentives for entrepreneurship.

In some cases, the tax system itself distorts the market rewards to different choices. Risk-taking is an example of this. A higher tax rate *per se* does not necessarily discourage risk-taking. If the government taxes high returns, but also fully offsets losses at the same rate, it is sharing in both upside and downside risk. This should not make risky investments any

³⁷ For a fuller discussion of these arguments, see C. Crawford and J. Freedman, 'Small business taxation', in S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba (eds), *Dimensions of Tax Design: The Mirrlees Review*, Oxford University Press for IFS, Oxford, 2010, <https://www.ifs.org.uk/publications/7184>.

³⁸ For a fuller discussion of this argument, and caveats, see chapter 13 of J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba, *Tax by Design: The Mirrlees Review*, Oxford University Press for IFS, Oxford, 2011, <https://www.ifs.org.uk/publications/5353>.

less attractive relative to safe ones.³⁹ Yet in practice, tax policy does discourage risk-taking. That is mainly because tax policy does not treat the upside and downside symmetrically. Marginal tax rates that are higher at high incomes, for example, mean that above-average returns are taxed more than below-average returns are cushioned. And the tax system does not currently match taxation of profits with symmetrically generous rebates for losses: losses can only be set against other income (there are no cash refunds), with significant restrictions (which differ between companies and the self-employed) on what income they can be used to offset. Losses carried forward to set against future income get no compensation for the delay and there is a risk that the losses can never be used. Being taxed on positive returns but not symmetrically cushioned from negative returns does discourage risk-taking. It is not clear that the government should actively encourage risk-taking, and in any case lower tax rates for certain legal forms are not an effective way to do so. But nor should it actively discourage risk-taking. A sensible focus would be on reducing the disincentives currently created by asymmetric taxation, and in particular reforming the treatment of losses. We return to this in Section 7.5.

Even where the tax system does not distort behaviour, market failures can arise in relation to entrepreneurship. 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. Such market failures create a case for government intervention. But blanket reductions in tax rates for all the self-employed and company owner-managers are poorly targeted at such problems. It is better to determine which specific activities justify different tax treatment and design a policy targeted at those activities.⁴⁰ It may be difficult to find precisely targeted measures that will encourage the kind of socially beneficial ‘entrepreneurship’ that is hard to define but nevertheless real. Yet most small businesses are not particularly innovative and 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.

7.5 How should tax policy be changed?

The preceding sections discussed the problems caused by taxing employees, the self-employed and company owner-managers in different ways. The tax system should not favour one legal form over another without good reason for doing so. It is difficult to make a compelling case for the differences in headline tax rates that we currently have.

³⁹ In effect, the government is providing a form of insurance for the investor, cushioning both the possible upside and the possible downside. Individuals may in fact respond by taking bigger (pre-tax) risks, leaving the after-tax risk and returns they face similar to what they would have been without the tax. The government itself, however, is now making a risky investment in the business, with a boost to tax revenue if the risk pays off but a corresponding downside if it does not.

⁴⁰ Examples of more-targeted (though not always well-designed) policies include R&D tax credits that aim to increase innovation and loan guarantees, enhanced investment allowances and venture capital schemes that aim to increase access to finance for small firms.

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. This is evidenced by the fact that incentives to switch between legal forms depend on the bases and rates of income tax (including the treatment of dividends), NICs, corporation tax and capital gains tax. 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 businesses, 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. As such, the tax treatment of legal forms should always be seen in the context of the whole tax system.

The comprehensive Mirrlees Review of the UK tax system undertaken for IFS proposes a design for the whole tax system that aligns the taxation of legal forms as just one part of a broader plan.⁴¹ Essentially, it argues that the same overall rate schedule should apply to income from all sources, but with full allowances (at both the personal and corporate tax levels) given for amounts saved and invested to avoid discouraging those activities.

Minimising (or removing) the tax differences across boundaries (e.g. between employees and those running their own business) is the best way to deal with the problems that arise because of boundaries. Many of the concerns highlighted in Section 7.3 – such as labour income being characterised as capital income – would be dealt with directly through alignment of tax rates.

It is tempting to deal with boundary problems by trying to write and police rules that determine what should fall on each side of the boundary (such as 'IR35'⁴²) to prevent people exploiting the tax differentials. It is also tempting to try to solve a narrow problem without affecting the rest of the tax system by introducing different tax regimes for (say) a subset of small businesses. But these approaches are the policy equivalent of 'whack-a-mole': one particular problem is fixed, but at the expense of another one popping up elsewhere in the system. If definitions around the boundaries are adjusted, the new definitions will quickly come under pressure. A special regime for 'small businesses' would add another boundary to the tax system (between small and large businesses) that would create problems of its own and not reflect any underlying principle. 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.

Sometimes the government does even worse than this by increasing the distinctions between legal forms. For example, faced with a boundary between (higher-taxed) labour income and (lower-taxed) returns to capital across the tax system as a whole, in 2008 the government introduced entrepreneurs' relief for owner-managed businesses, exacerbating the problem at precisely the point where it is most acute.

A different approach is needed.

⁴¹ J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba, *Tax by Design: The Mirrlees Review*, Oxford University Press for IFS, Oxford, 2011, <https://www.ifs.org.uk/publications/5353>; see especially chapter 19. All documents related to the Mirrlees Review are available at <https://www.ifs.org.uk/publications/mirrleesreview/>.

⁴² IR35 rules try to prevent individuals disguising their employment by operating as an independent contractor (see <https://www.gov.uk/guidance/ir35-find-out-if-it-applies>).

Long-run goal: align the tax treatment of income across legal forms

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 and 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 (set with reference to multinationals). Aligning the treatment of these income sources would also mean reversing the recent trend towards having large separate allowances in each tax, something that now 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.

The income of the self-employed and company owner-managers generally reflects a mix of rewards for labour and capital. Aligning the treatment of total income would almost certainly lead to higher tax rates on income from self-employment and companies and thus to higher rates on the returns to capital. On its own, therefore, simply aligning tax rates across legal forms would create undesirable disincentives to save and invest. Higher tax rates on profits, dividends and capital gains can make otherwise viable investments unviable. This is undesirable and results in a perceived tension between keeping capital tax rates low so as not to discourage saving and investment, and raising them towards personal income tax rates so as to minimise tax avoidance and avoid distorting choices (as discussed above). The attempts to manage this trade-off have arguably been at the heart of capital tax policy, and especially gains tax reform, for decades (see Box 7.5). However, this trade-off is not as inescapable as it might seem.

In a nutshell, the solution is to tax the returns to capital and labour at the same rate at the margin (thereby removing distortions over how to take income) but to design the tax base so as to avoid disincentives to save and invest. The latter 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:⁴³

- Cash saved or invested can simply be deductible 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 in limited cases where 100% first-year allowances are available (as in the case of the annual investment allowance).

⁴³ These approaches and their properties – including other advantages not discussed here – are explained in J. Mirrlees et al., *Tax by Design: The Mirrlees Review*, Oxford University Press for IFS, Oxford, 2011, <https://www.ifs.org.uk/publications/5353>. 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.

- A deduction could be given each year for an assumed (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 taxable income generated exactly offset 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 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 approach helps to resolve a conundrum that policymakers around the world have struggled with for decades: the tension between preventing tax avoidance on the one hand and minimising disincentives to save and invest on the other. Eager to encourage saving and investment, policymakers have sought to reduce tax rates on capital income; but wary of opening the door to widespread conversion of labour income into capital income, they have also sought to keep tax rates as closely aligned as possible. The result has usually been an awkward compromise, with capital income taxed at reduced rates (and often different forms of capital income taxed at different rates), leaving some disincentive effects and some scope for avoidance. Taxing capital income in full *while giving a full deduction for capital costs* addresses both problems.

As discussed in the previous section, the hurdle for departing from alignment should be high, with measures targeted as precisely as possible on the specific problem to be addressed and assessed against this benchmark. All too often, preferential treatments are bolted onto a flawed existing system with too little regard for how they will interact with policies already in place or what they mean for the system as a whole.

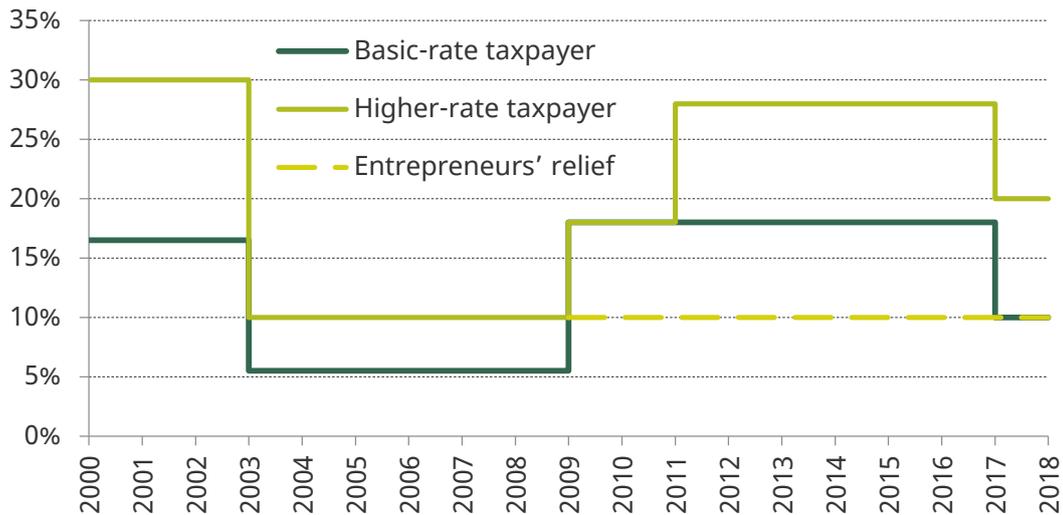
Steps towards the long run

The solution proposed above would require major changes. Ideally, the government would set out a vision for the tax system and a path that moved us towards the end goal. In the short run, it would not necessarily be wise to pick one of the reforms highlighted above and introduce it independently of a wider set of reforms. Changing any subset of taxes in isolation can lead to problems elsewhere. For example, it would be possible to align the treatment of employees and the self-employed by increasing the rate of NICs on the self-employed. But this would also increase the incentive for a self-employed individual to incorporate and take their income in the form of dividends or capital gains. Similarly, aligning the tax on capital gains with marginal income tax rates without any changes to the tax base would reduce the incentive to recharacterise labour income as capital income, but come at the expense of discouraging saving and investment. Policies that deal with only a subset of problems in isolation therefore require careful consideration of any possible costs and benefits.

Box 7.5. The capital gains tax roller coaster

Since its introduction, capital gains tax has been increased and cut, often in different ways for different types of assets or taxpayers, as successive Chancellors battle with the trade-offs between higher and lower capital tax rates described in the main text. This is a potted history of the main changes.^a Figure 7.9 shows the result for one type of asset.

Figure 7.9. Capital gains tax rates for a business asset held for two years, 2000–01 to 2018–19



Note: Years refer to the start of financial years (e.g. 2000 refers to financial year 2000–01).

Source: IFS Fiscal Facts, https://www.ifs.org.uk/tools_and_resources/fiscal_facts/.

Capital gains tax was introduced in 1965 at a flat rate of 30%. Geoffrey Howe introduced indexation allowances in 1982, ensuring that only gains in excess of inflation were taxed. In 1988, Nigel Lawson aligned capital gains tax rates with individuals' marginal income tax rates. In 1998, Gordon Brown scrapped indexation allowances and introduced taper relief, which reduced capital gains tax by more the longer an asset was held and was more generous for 'business' than 'non-business' assets. Taper relief was subsequently made more generous, but then being scrapped by Alistair Darling in 2008. Mr Darling went back to a single flat rate, set at 18%, but quickly (following a backlash from business lobby groups) introduced entrepreneurs' relief, which applied a 10% rate to the first £1 million (since increased to £10 million) of lifetime gains for some business assets (see Section 7.3). George Osborne raised the rate to 28% for higher-rate taxpayers in 2010, but then cut it (for most assets) to 20% for higher-rate taxpayers and 10% for basic-rate taxpayers in 2016.

It would be better to get off this roller coaster – the main text discusses how to do this – than continue the ride that successive Chancellors are taking us on.

^a See S. Adam, 'Capital gains tax', in R. Chote, C. Emmerson, D. Miles and J. Shaw (eds), *The IFS Green Budget: January 2008*, <http://www.ifs.org.uk/budgets/gb2008/08chap10.pdf>.

One approach to moving towards the long run (without overhauling the tax system overnight) is to look for reforms that improve the structure of the tax system and accompany these with changes to rates (or other parts of the system) that offset any new distortions created. Here we provide four potential examples of this approach:

- Section 7.4 explained that the tax system can discourage risk-taking by not providing full loss offsets. Increasing the generosity of loss offsets would reduce this disincentive. There may be good reasons for the government to be wary of giving out tax refunds in cash whenever losses are made, not least concerns about potential tax evasion. But there are various less radical ways in which the generosity of loss offsets could be increased, including allowing losses to be set more easily against profits from other activities, extending the period over which losses can be carried back or allowing losses to be carried forward with an interest markup to compensate for the delay before they can be utilised.⁴⁴ However, (absent a wider set of reforms) more generous treatment of losses would increase the incentive to move out of employment and into self-employment or company owner-management, thereby increasing the distortion between legal forms that we would like to reduce. It would also have a revenue cost for the exchequer. One could make a judgement that the benefits outweigh the costs. Another option would be to increase tax rates on business profits, so that there was no change in the average tax burden on businesses or the average incentive to set up a business. Such a package, which would be broadly revenue neutral, could reduce the disincentive to take risks and reduce the incentive to take income as business profits, while leaving the average tax burden on businesses and the average incentive to set up a business unchanged.
- A similar argument could be made with respect to investment costs. The current system discourages investment by not allowing the full cost to be deducted from tax. A short-run option that increased investment incentives for the self-employed and company owner-managers (and for small companies more generally) would be to extend the annual investment allowance to assets other than plant and machinery. This could be accompanied by higher marginal rates on the returns to investment. This would increase incentives to invest (at least for assets that received more generous treatment) while leaving average incentives over legal forms broadly unchanged.
- The government could consider abolishing entrepreneurs' relief. Unlike the two preceding examples, this would reduce the incentives to move from employment to self-employment or company owner-management. It would also: (i) substantially reduce the incentive for individuals to retain profits in a company (or through business assets) when, absent the tax, they would prefer to spend the money sooner or invest it elsewhere; (ii) reduce the unfairness caused by discriminating against individuals who cannot convert the returns to their labour into capital gains; and (iii) simplify the system by no longer requiring a distinction between qualifying and non-qualifying assets or records of disposals in order to enforce the lifetime limit. The cost of doing this reform in isolation is that it would increase tax on investment returns and thereby reduce investment incentives in some cases. Entrepreneurs' relief always lacked a clear rationale (there is little

⁴⁴ For the same reason, losses should also have an interest rate adjustment when carried back.

evidence that reduced rates of capital gains tax are well targeted at alleviating any concerns around business start-ups, for example). There is an argument that the benefits of scrapping the relief outweigh the cost. However, the cost of increasing the tax on the return to investment could also be ameliorated by using the revenues raised to reduce the burden of capital gains tax on all assets. For example, one attractive option would be to allow capital gains to be inflation adjusted before being taxed (such that only real gains were taxed), as was the case before 1998. An alternative would be to give more deductions for asset purchase costs via an RRA as described above. Such a package would improve the structure of the system and remove various distortions, while reducing the impact of scrapping entrepreneurs' relief on investment.

- Another option is to move to a single allowance for all income sources. Currently, there are separate tax-free allowances for different income sources, which favours people who are able to diversify their income sources and time their income carefully. Those (particularly company owner-managers) who can take advantage of all of the separate nil-rate bands for interest, dividends and capital gains, as well as their income tax personal allowance, can receive around £28,000 a year free of tax, compared with the £11,000 available to those who can only use their ordinary personal allowance. Moving to a single allowance to set against income from all sources (perhaps retaining much smaller *de minimis* allowances for individual income sources for administrative reasons) would reduce incentives to be self-employed or a company owner-manager. The revenue raised could be used to make the main allowance larger or reduce taxes elsewhere in the system.

The spirit of these packages is to find a practical way to improve parts of the tax system in the short run, while offsetting any distortions that can arise elsewhere in the system as a result. Two broad points should be noted. First, such an approach does have distributional consequences (there would be winners and losers). Second, such packages do not completely avoid increasing distortions in some areas. As long as investment costs remain in the tax base (such that marginal investments attract tax), any increase in rates can discourage some investment. Packages of reforms can be designed so that the benefits of a reform are sufficiently high to outweigh the costs. But any short-run moves towards the full alignment outlined above will necessarily involve trade-offs that must be managed.

7.6 Conclusion

The overall shape of the labour market has not changed radically, yet. For example, 85% of the workforce are still employees. But in recent years we have seen notable trends, including substantial growth in the number of individuals working for themselves either through self-employment or as company owner-managers. We cannot know to what extent these changes are linked specifically to the 'gig economy' rather than to broader changes in the labour market; we simply lack sufficiently detailed data. It has become slightly more common to see individuals working for their own business (rather than as an employee) as a second job and this fits with some commonly-cited examples of the gig economy (such as individuals driving taxis or delivering fast food to supplement their main income). Although looking at the industries in which individuals are working and how these are changing suggests that the recent trends are much broader than those captured by the fashionable 'gig economy' label.

It is possible that the labour market will continue to change as more individuals take advantage of the benefits of working for their own business or find that they have reduced employment opportunities. The possibilities afforded by digital platforms may lead to further growth in the gig economy. In all cases, there will be ongoing concerns about the potential costs of more precarious and less secure income streams. Now is a good time to consider the employment rights and benefits of different groups.

However, the policy issue that we discuss in this chapter was important before the rise of the gig economy, is important today, and will be important regardless of how the labour market evolves. The tax system provides preferential treatment to the self-employed and company owner-managers (conversely, it provides a penalty to employees). It does so in ways that cannot be rationalised by either reduced entitlement to social security benefits (there are relatively few differences across legal forms) or differences in employment rights or compliance burdens. It is also very hard to make the case that across-the-board lower rates are well targeted at activities where there is a clear rationale for providing a tax incentive. The different tax treatment of individuals according to their legal form is unfair and creates myriad problems, including avoidance opportunities that require complex legislation and suck in the talents of civil servants and accountants.

The government should set out a plan to align the overall tax rate schedules facing employees, the self-employed and company owner-managers, so that a marginal pound of income is taxed in the same way regardless of how it is earned, while at the same time providing full allowances for money invested in a business so that investment is not discouraged. This is preferable to living with the distortions provided by the current system, or patching it up in ways that simply move boundaries in the tax system or reduce one distortion at the expense of another.

Any major reform creates winners and losers. If done in a revenue-neutral way, the winners from this reform would include employees and those whose business income mainly reflected the money they had put into the business in the past. The losers would include those self-employed individuals and company owner-managers whose income (above the amount invested) was subjected to higher rates. There would need to be careful thought as to how the transition to a better system should be done. But it is right that in the long run there should be some losers. Currently, a large group of taxpayers are receiving substantial benefits at the expense of others, and creating a level playing field entails making some individuals worse off. To retain the current system is to allow the clear inequities it delivers to persist. The growth in self-employment and company owner-management (including in response to tax differences) means that the longer we wait to level the playing field, the more losers there will be. The losers would no doubt be more vociferous than the winners. This should not prevent us from fixing the tax system.