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Rethinking legal taxonomies for the gig economy

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Abstract: Both tax law and employment law incentivize engagers of labour to structure their workforce as a crowd of self-employed micro-entrepreneurs. Recent technological change and the rise of the gig economy have made it easier for agents to respond to these incentives, contributing to an increase in self-employment. In this article, we review the evidence on the rise of the gig economy in the UK and lay out a set of key principles to guide the reform of tax and employment law to better enable policy to meet its underlying objectives.

Keywords: gig economy, employment law, tax law, self-employed, employee, incorporation
JEL classification: K31, K34, H25, H25, J21, J88

I. Introduction

Recent labour market changes, from an increase in the number of individuals running their own business to the fragmentation of traditional employment relationships into short-term, intermittent work for multiple engagers ('gigs'), have brought a host of challenges for regulators. The law struggles, not least because long-established taxonomies used in tax and employment law are coming under increasing pressure. Legal regulation in these areas divides the labour market into a number of predetermined categories, to which benefits and obligations (rights and duties) are then attached. The tests determining into which category an individual falls are unclear and too easily manipulated. In particular, there is a real lack of clarity as to how categories in employment and tax law should map on to each other.

In one sense, there is little new about these challenges: classification has been the holy grail of legal labour market regulation since the inception of employment law. With technology increasingly facilitating easy shifts between legal forms in response to skewed incentives, however, the underlying questions have become more salient than ever.

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In order to put forward a framework for a more coherent approach, this article is structured as follows. Section II explores recent labour market labour trends using evidence from the Labour Force Survey (LFS), providing key evidence of changes in rates of self-employment and incorporation, as well as exploring why these changes may have occurred (section III). We then turn to the policy incentives underpinning the different regulatory regimes of tax and employment law as a starting point for reform principles. Section IV considers these competing objectives with a view to distilling a set of principles to guide reform. Section V, finally, applies these norms to the UK context, suggesting how reform should be oriented towards a reshaping of legal taxonomies in line with each regulatory system's underlying goals.[1] Section VI concludes.

II. The UK situation

The UK employment rate hit a record high at 74.6 per cent in the final quarter of 2016. However, focusing on total employment masks important changes in how labour is organized. The term employment is being used here in a broad economist's sense. There are three main ways in which individuals can supply their labour to the market: (*a*) as an employee of a company, (*b*) as an independent (self-employed) contractor, or (*c*) through an incorporated business (owner-manager of a personal service company).[2] Forty per cent of employment growth in the wider sense since 2008 is attributable to increases in self-employment and companies with a single owner-manager. This has led to increasing pressure on public finances due to differences in tax treatment across these categories, as well as a rise in the number of individuals who seem to fall outside the scope of traditional employment law.

(i) Recent labour market trends

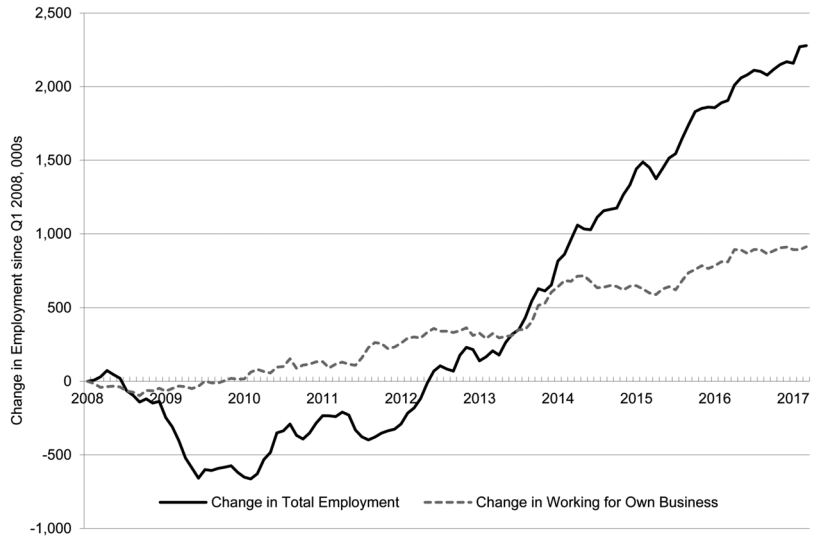
The majority of the UK workforce, 84.3 per cent, is employed directly by firms.[3] However, a growing number of individuals are self-employed or working for a company they own themselves. Figure 1 gives the cumulative change in the size of the workforce since the first quarter of 2008. Until mid-2014, the vast majority of employment growth came through increases in self-employment and those working for their own incorporated businesses. Stronger growth in direct employment since 2014 means that 40 per cent of the growth in total employment between Q1 2008 and Q3 2016 can be attributed to rises in categories (*b*) and (*c*) above.

[1] While the work for this paper was undertaken, the Taylor Review (Taylor, 2017) reported. The Government's response was published after this article was completed and is being consulted upon as we go to press. The authors will engage in that process in separate analysis. This article deals with many of the points that are raised for discussion. We reference specific Taylor proposals where relevant to our discussion.

[2] As we discuss in due course, employment law also distinguishes between different groups of employees and workers.

[3] Office for National Statistics, Table EMP01 SA, June 2017.

Figure 1: Change in total employment and working for own business[4] Since Q1 2008



Source: Authors' calculations from Quarterly Labour Force Survey.

Self-employment

Self-employment (supplying one's labour as a sole trader, i.e. through an unincorporated business—(*b*) above) is at its highest level in the last 40 years, with one in seven workers (~4.8m) declaring this as their main form of economic activity.[5] The rise of the so-called 'gig economy' is one salient aspect of this shift. This term is increasingly used to refer to individuals performing small tasks as independent contractors through digital platforms. Popular operators in the sector include Uber, Deliveroo, and TaskRabbit (Prassl and Risak, 2016).

Incorporation

Individuals might also choose to supply their labour through an incorporated business, increasing their options over the form in which to take their returns; labour income may be converted into dividends, other distributions, or capital gains. Fourteen per cent of 'employment' growth since 2008 has come through increases in company owner-managers, which corresponds to a doubling of the company owner-manager population since 2008 (Adam *et al.*, 2017). The Office for Budget Responsibility (OBR) predicts that the total company population will grow by 60 per cent between 2014/15 and 2020/21, fuelled by growth in sole-director companies (OBR, 2016).

It has been suggested by the OBR that part of this growth might be attributable to the lifting of constraints on small company formation, such as the abolition of the legal requirement for companies to have at least two directors in the Companies Act

[4] This term refers to the self-employed and company owner-managers.

[5] Given the way that LFS statistics are collected, note that it is not always clear whether these figures include or exclude incorporated owner-managers.

2006. Single-director companies effectively accounted for all growth in the total number of incorporations since 2007. The LFS suggests that employment among sole directors of their own limited businesses increased by ~25 per cent between 2014 and 2015 (OBR, 2016). That said, while official statistics typically focus on the growth of single director companies, personal service companies may have more than one director, and many existed in this form prior to 2006.[6]

Multiple legal forms

Figure 1 categorizes individuals by their main employment status. However, one should note that some evidence points to a rise in the number of individuals *combining* employment with self-employment; the number of individuals declaring employment and/or pension income in addition to self-employment income has increased at a faster rate than the numbers in self-employment overall.[7] Surveys of online gig workers suggest that the majority engaging in these forms of work are doing so to top up their employment income, which would also point to a rise in individuals supplying their labour through multiple legal forms (Berg, 2016).

Rise in part-time work

Alongside the changes in legal form, there has been a rise in part-time working, especially among those working for their own businesses. Between 2007/8 and the final quarter of 2016/17, the proportion of the workforce working part-time increased slightly from 26.1 to 28.7 per cent. However, this growth has been faster among those working for their own business; see Table 1.[8] Within the employed and self-employed, the growth of low-hours work has been more pronounced at the bottom end of the labour market, especially for men (Belfield *et al.*, 2017).

Table 1: Part-time work by legal form, Q4 2007/8 and Q4 2016/17, %

	2007/8	2016/17	Difference
All	26.1	28.7	2.6
Employees	26.0	28.1	2.1
Own business	27.1	31.9	4.8

Source: Quarterly Labour Force Survey.

[6] Note that it was not especially difficult prior to 2006 to find a second, nominal, director. Thus, we believe that the ability to set up a company with one director only is a very minor practical change and very unlikely to account for much of the growth. The proportion of companies relative to other legal forms of business has been rising since before 2006 (Crawford and Freedman, 2010).

[7] The number reporting income from self-employment rose from 4.17m in 1999/00 to 5.50m in 2012/13, an increase of 32 per cent. The numbers reporting both self-employment and employment income rose by 49 per cent in the same period. See Office of Tax Simplification Report on Employment Status, Table 1.B.

[8] Adam *et al.* (2017) also provide a breakdown separately for the self-employed (from 25.3 to 31.2 per cent) and company owner-managers (11.8 to 17.5 per cent).

III. Why have these changes occurred?

There are good economic reasons for workers to be organized as employees of larger firms rather than as small businesses. It is usually more efficient for individuals to come together and form a large company rather than to exist as many small businesses with contractual relationships between them. There might exist economies of scale and scope; for example, larger firms can exploit technical economies of scale, negotiate cheaper prices with suppliers through bulk-buying, and might be better able to bear risk through diversification of product range and investments. 'Transactional failures' arising from matching frictions, difficulty of providing appropriate incentives, and incomplete contracting also produce incentives for 'the substitution of internal organisation for market exchange' (Williamson, 1971). Why then does the market increasingly appear to favour individuals working for their own small businesses?

Some have argued that technological change has reduced economies of scale and alleviated transactional failures, reducing costs to self-employment and making it easier for firms and workers to choose their legal form to better align with their preferences, to minimize their tax burden, and for employers to limit their exposure to employment law (Sundararajan, 2016). Online gig-economy applications ('apps') facilitate the efficient matching of engagers and labour suppliers. The provision of rating systems and the constant stream of data on individual performance that is provided by platforms are said to have created new mechanisms for control and provision of incentives beyond those found in traditional contracts of employment.

These developments have made it easier for firms and individuals to respond to longstanding pathologies in the UK tax system. As is discussed in more detail in the next section, there exist significant tax differentials across legal forms. Currently, the self-employed pay £3 billion a year in National Insurance Contributions (NICs). If they were subject to the same treatment as employees, they would have paid £8 billion a year (Adam *et al.*, 2017). The self-employed also fall beyond the scope of employment law. Thus, minimum wage, working time, and dismissal legislation and (arguably) employment discrimination law does not apply to this group (Prassl, 2017). Organizing one's workforce as a 'crowd of micro-entrepreneurs' thus reduces indirect costs to employers of acting in accordance with labour regulations (Prassl, 2018).

The ageing workforce and increasing labour force participation of women are also listed as factors driving a greater preference for self-employment. Such groups are often thought to have a 'preference for flexibility'. Tatomir (2015) estimates that half of the rise in self-employment between 2004 and 2014 can be explained by changes in the age composition of the labour force alone. Hurst and Pugsley (2011) find that over 50 per cent of US small business owners report starting the business due to non-pecuniary benefits such as 'wanting flexibility over schedule' or 'to be one's own boss'. Adams and Berg (2017) find that a preference to work from home and for flexibility are routinely listed as a 'very important' motivation for engaging in online gig economy work.

Macroeconomic weakness might also have contributed to an increase in the number of individuals working for their own business. There is a large literature on self-employment as arising from a lack of opportunities in the formal labour market rather than as a reflection of entrepreneurial nous. In the United States, Evans and

Leighton (1989) find that most one-person retail businesses are those who did not succeed as salaried workers. Schoar (2010) distinguishes between 'subsistence' and 'transformational' entrepreneurs, arguing that there is little connection between the two groups. In a developing country context, Banerjee and Duflo (2011, p. 226) argue that: 'The enterprises of the poor often seem more of a way to buy a job when a more conventional employment opportunity is not available than a reflection of a particular entrepreneurial urge.' In the UK, the rise in those working for their own business has been linked to a fall in the exit rate from self-employment (ONS, 2014), consistent with a reduction in opportunities to work as an employee with the onset of the financial crisis, and the self-employed (rather than owner-managers) are on average less educated than the workforce as whole.

(i) Policy incentives

Under the current tax and employment law systems, similar economic activity can be classified into different legal forms, creating powerful financial and regulatory incentives to adopt one legal form over another. Insofar as engagers seeking to avoid regulatory responsibilities and cost are concerned, both labour law and taxation offer a series of incentives to treat those supplying services to the engager's business as self-employed contractors. The tax system provides further incentives for the person supplying the services to incorporate. A person providing services will usually be better off within the protective scope of labour law. However, at the same time, she might be able to increase her contemporaneous take-home pay by being treated as self-employed or as providing services through a company. Figure 2 gives the key categories relevant for our analysis.

Employment law

Employment law does not cover those it defines as self-employed.[9] For those within the scope of employment law, a distinction is made between a core group of 'employees' and the more peripheral 'worker' category.[10] Both workers and employees have access to a basic set of rights including, notably, an entitlement to be paid the minimum wage. Employees are covered by a further set of protections including statutory sick pay, maternity and paternity pay, unfair dismissal protection, and redundancy payments.

Tax

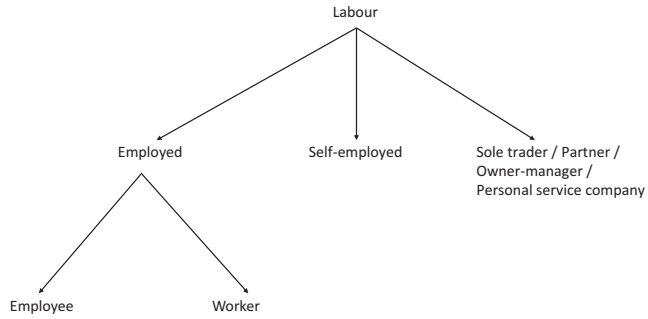
The tax system currently distinguishes between employees, the self-employed, and incorporated businesses owned by one or two director/shareholders and with no employees. There is no general classification of 'worker' as intermediate between employees and the self-employed in tax law.[11] Thus, for example, the fact that drivers in the on-going Uber

[9] As explained below, this may be a narrower group than those defined as self-employed for other purposes (e.g. tax).

[10] The Taylor Review recommended changing the term 'worker' to that of 'dependent contractor' to make the scope of the term more explicit (Taylor, 2017). It is unclear that this would be the result of the change.

[11] The term 'worker' is used in tax legislation but not in the same way as in employment legislation. For example, it is found in relation to special provisions for agency workers (as defined within the legislation) and in the personal services intermediaries legislation know as 'IR 35'. However, the meaning with regards to IR 35 is not the same as in employment law.

Figure 2: Key UK labour market categories



litigation were held to be workers in the context of employment law does not necessarily determine the question of whether they are employed for tax purposes. There would need to be a separate determination on the facts to decide whether Uber drivers should be taxed as employees under the PAYE (pay as you earn) system, placing a responsibility on Uber as an employer to collect tax, or as self-employed, with tax collection organized under the self-assessment scheme.

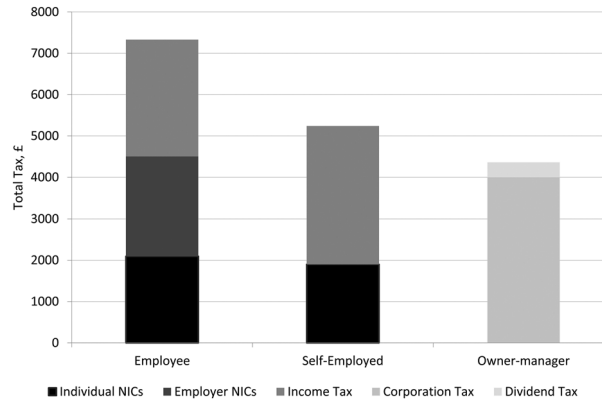
Further, it is important to note that, in theory at least, the case law to be applied in deciding employment status for tax purposes is the same as the case law on employment status in employment law. However, in practice, factors that may weigh heavily in an employment case can appear less significant in a tax case, so-called 'mutuality of obligation', in particular. As employment law cases rest so heavily on a case-specific analysis of the facts, such differences are possible in practice without full recognition in the books (Freedman, 2001).[12]

Figure 3 gives the difference in total tax paid on the average UK salary by legal form. It demonstrates the extent to which employment is tax-disadvantaged in the UK: labour income earned as an employee is taxed more heavily than self-employment income, profits, and dividends. Under certain assumptions, employees, together with their employers, pay almost 70 per cent more tax on that amount than a (well-advised) company owner-manager, and 35 per cent more than an equivalent self-employed individual. This creates significant incentives to organize activity other than through employment contracts. Given these differences in tax rates, the trend towards working as a self-employed contractor or through a personal service company is having a negative impact on overall tax revenues. The OBR estimates that the increasing trend towards incorporation will further reduce total receipts by £3.5 billion in 2021/22 (OBR, 2016).[13]

[12] A further complication is that 'personal service providers' who operate through a partnership or, more frequently, a company, may be subject to the intermediaries' anti-avoidance legislation (IR 35). The net effect of this legislation is that these personal service providers are taxed as though they were employed directly by the client company contracting with them. These personal service providers still own a company but their tax benefits are negated and, at the same time, they do not get the employment law benefits of being employees or workers. The tests applied to determine whether they are caught by IR 35 are based on the employment law tests (modified by the tax context as explained above), but the result is only to change their tax treatment and not to treat them as employees of the primary engager for all purposes. For a more detailed technical explanation see Fairpo and Salter (2017, paras 8.31–8.39)

[13] See 'The effect of incorporations on tax receipts' (OBR 2016, p. 121).

Figure 3: Total tax paid on UK average salary, by legal form



Source: Taylor, 2017.

These differences in total tax burden arise from a number of sources. There are differences in the income tax rules for the employed and self-employed, largely necessitated by the difference between receipt of a salary and payment of tax on profits.[14] The big substantive differences in amounts payable arise from variation in NICs, as discussed below. There are also sales tax differences, and with corporation tax payable at a lower rate than the higher rates of income tax, income may be sheltered by passing it through a company.

These tax differentials have existed for some time and, indeed, they have been worse at points in the past (Crawford and Freedman, 2010). Recent reforms have attempted to reduce the gap between these figures, notably by increasing dividend taxation. While these reforms had some impact, the benefits of incorporation will be increased in the coming years as corporation tax rates reduce down to 17 per cent and capital gains tax remains lower than income tax. Further, it is sometimes possible to divide payments from owner managed companies between family members, using their tax allowances. Hence, recent reforms have not been effective at closing the gap.

Dealing with the differences in treatment for NICs between different types of legal arrangements for the provision of labour is a complex issue.[15] The UK welfare system was conceived of as a system of social insurance. Beveridge's vision was for individuals to fund the welfare state through NICs, and in return to receive support when either unable to work or retired (House of Commons Work and Pensions Select Committee, 2017). Historically, lower NICs were justified by the fact that the self-employed received less support from the welfare state than employees, notably with regards to the state pension.

[14] However, note that some of these differences could be reduced.

[15] The ill-fated attempt in 2017 by Philip Hammond, Chancellor of the Exchequer, to increase the NICs of the self-employed by a very small amount, failed because the ground had not been laid properly and the change was not presented as part of a larger package to align the position of the self-employed. The proposed change would have reduced the gap between the employed and the self-employed slightly but would have done nothing to align the position of those who incorporated their own firms (Miller, 2017).

However, the link between contributions and benefits has been broken for some time and recent policy changes have taken that delinking further. In part, this is due to increases in NICs on a progressive basis that are clearly a form of taxation rather than benefits related. Successive governments have pledged to keep income tax rates low and have thus seen NICs as a way of raising revenue without breaching manifesto promises. Employers' National Insurance contributions have also been raised. This is essentially a payroll tax avoided in its entirety by those engaging self-employed contractors (although, in theory at least, part of that saving might have to be passed on to the contractor).

The other change has been the erosion of earnings-related state benefits and, most importantly, recent changes to state pension entitlement that have resulted in the self-employed having access to most of the same benefits as employees, thus undermining the historic justification for differential tax rates. The remaining differences in entitlements between the employed and the self-employed have a relatively low cost. In 2016, HM Treasury estimated that the effective NICs annual subsidy to the self-employed relative to the employed would exceed the value of their reduced benefit entitlement by £5.1 billion.[16] While the 2018 figures have been revised downwards to £3.95 billion in 2016/17and forecast to be £4.1 billion in 2017/18, the point remains.[17]

A further tax issue is that VAT is payable on services provided by a business over a certain turnover threshold. The UK has a high VAT threshold relative to other jurisdictions. This further increases the tax incentive for vertical disintegration of business activity. An extreme example would be an Uber driver who earns well under the sales tax threshold in gross receipts and so charges no VAT. However, if the chargeable service of transportation was held to be being provided by Uber for tax purposes, VAT would be payable, thus putting up the cost of the service to the consumer who could not generally reclaim the VAT paid.[18]

IV. Principles for reform

We here consider principles that should guide the reform of tax and employment law. Policy should be designed to meet its objectives at the lowest social cost. In the UK

[16] Estimated costs of principal tax reliefs in December 2016 given at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/579720/Dec_16_Main_Reliefs_Final.pdf. This figure includes the NICs paid by employers for their employees, but assumes a corresponding reduction in earnings to hold staff costs broadly constant, and also takes account of the resulting reduction in income tax.

[17] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/675345/Dec_17_Main_Reliefs_Final.pdf. The figure has been revised downwards for previous years also. HM Treasury responded to author inquiries on this by stating that 'Total self-employment income from taxpayers has reduced slightly (£78.6 billion to £78.2 billion) due to a fall in the number of self-employed taxpayers (3.4m to 3.3m—average profits have increased however). This reduction, combined with the change in OBR determinants, affects the amount of tax and NICs paid when the self-employed are simulated as being employees, the process by which the published figure is generated.' (e-mail to authors dated 1 February 2018)

[18] The VAT threshold in the UK is currently being reviewed by the Office of Tax Simplification (OTS, 2017). The argument that Uber is not providing transportation services could also be challenged but at present HMRC takes the view that it would not win such a case (House of Commons Public Accounts Committee, 2017, qs. 88–92).

context, labour market tax and regulation are not currently designed efficiently to meet any coherent set of objectives. As technology continues to lower the cost of organizing one's workforce as a group of self-employed contractors, engagers and suppliers of labour will increasingly be able to respond to distortions in incentives arising from the current regulatory environment.

(i) Objectives

While often (and rightly) raised alongside each other in recent debates (Taylor, 2017), tax law and employment law pursue fundamentally different policy objectives.

The key objective of the tax system is to raise the revenue necessary for sustainable funding of public services and redistribution at minimum social cost (IFS, 2011). From a tax point of view, the only reason to treat different groups supplying labour in different ways is because of practical limitations or structural differences that have other consequences.[19]

The objectives of employment law are somewhat harder to discern, but seek to reflect the relationship between the supplier of labour and the engager in a way that is not fundamentally necessary for taxation purposes. Historically, labour law has been understood as a corrective mechanism for inequality of bargaining power in the labour market (Wedderburn, 1986), with more recent theories adding concerns of fundamental rights protection and correcting market failure (Deakin and Wilkinson, 2005). Inefficiencies resulting from monopsony power, arising from inelastic labour supply to the firm, for example, can be 'alleviated' by imposing minimum wages. Legislation providing for unfair dismissal protection, and worker consultation in case of collective redundancy or transfers of undertakings, can be understood as mechanisms to correct for underinvestment in firm-specific human capital in the face of imperfect commitment (Davies, 2015).

Redistribution towards workers is a further objective of employment law. Certain aspects of labour law require employers to provide something of value to employees, such as a safer workplace or particular workplace amenities. Such rules produce a downward shift in both the labour demand *and* labour supply curves by the value of the mandated benefits (Summers, 1989).

There is a further, overarching policy goal which should drive both tax and employment law in addition to these domain-specific objectives: equal treatment. *Horizontal equity* is the principle of treating equals, equally. Individuals who are identical in every way except their legal form should not face radically divergent tax incentives or employment protections. Most certainly, incentives to escape employment protection should not be exacerbated by the incentive to reduce tax liabilities.

The social cost of each regulatory system is determined by the extent to which firm, worker, and consumer choices are distorted. Labour taxes and wage regulation alter wage rates and prices, and thus distort choices at the margin. In response to the parameters of labour and corporate taxation, workers will choose whether or not to work

[19] NICs (although now in practice essentially a tax) serve a further purpose, in theory at least, of providing an entitlement test for some benefits. This does complicate the picture from a tax collection perspective, but as explained above, this is less important in practice than it was previously.

extra hours—and in which legal form to cast their services. At first glance, employment law raises the cost of hiring workers, even though it might move the labour market close to a social optimum. When these costs are not offset by any surplus on the table or, with mandated benefits, a willingness to accept lower wage rates, then overall employment and output might fall. Further, when employment protections differ among workers, incentives to hire particular types of workers will be distorted to favour those without access to costly rights.

Deadweight losses also arise from avoidance activity. Time and resources devoted to minimizing one's tax burden or exposure to employment law could instead be directed towards more socially useful ends. The administrative costs of running the regulatory system must also be considered. Complex systems often invite avoidance through the creation of artificial schemes to exploit the legislation. This can add further to administrative costs as the authorities constantly try to catch up with the avoidance activities of firms and taxpayers (Oei and Ring, 2016).

(ii) Principles

What, then, might be some of the core principles to guide reform of tax and employment law policy?[20] As described above, both tax and employment law work by defining a set of categories (e.g. employee, worker, independent contractor) and attaching tax obligations and employment rights to them. In considering reform, therefore, there are three key questions to consider:

(i) What is the objective to be served in each case and does this require differences in treatment between different groups?
(ii) If so, what should the categories be and on what criteria should classification be based?
(iii) What tax burden and employment protective rights should be associated with each category?

Note that any commonalities in principles for the design of tax and employment law do not imply that similar reforms, let alone a complete alignment of tax and employment law tests, are required in practice given the many differences in underlying objectives between the two systems. Indeed, too tight an alignment might create additional incentives for distortion of behaviour. It would be better if taxation did not reinforce already existing incentives to escape from employment regulation.

Neutrality is a central principle of any efficient tax and regulatory system. A neutral system treats similar activities similarly and in so doing does not create incentives for individuals to distort their behaviour to move from high to low taxed/regulated activities.

There are important and pervasive non-neutralities in the current regulatory environment. As seen in Figure 3, the same productive activity attracts significantly different tax rates depending on whether an individual supplied their labour as an employee,

[20] See IFS (2011) for further details on optimal tax design.

through self-employment, or as a company owner-manager. The same underlying work relationship can also attract different levels of employment protection. At any one moment, there might be very little difference in the work done by a zero-hours contract worker, a worker supplied by a temporary work agency, a self-employed contractor, and an individual in a direct contractual relationship with the employer. However, in practice, the permanent employee in a direct contractual relationship will often have access to a much greater range of rights than the zero-hours contract, agency worker, and self-employed contractor. In the case of higher earners with a good bargaining position, the tax benefits to both parties of not having an employment relationship might cancel out the disadvantages for the service provider. In other words, the rewards might be shared. However, where monopsony power is greater and workers have less bargaining power, an individual might lose out both on the protection of employment law and the benefits of any tax savings.

The need simultaneously to consider the boundaries between all categories in the labour market creates further complexity. For example, in the tax system one must be aware that boundaries exist even beyond the traditional binary divide (i.e. the employee–self-employment boundary), notably in the form of a self-employment–incorporation boundary. By reducing the tax advantage of self-employment relative to employment, one may increase the rate of tax-motivated incorporation.

The principle of neutrality points to the likely futility of introducing new categories to deal with emerging forms of work. If these categories are close substitutes, this raises the likelihood of agents distorting their behaviour to fall into the cost-minimizing category. Rather than creating new classifications, it would be preferable to align the tax payable by each group as far as possible,[21] such that boundaries mattered less or, if possible, not at all, for tax purposes. This suggests removal of differences between the employed and self-employed in relation to NICs as far as possible. Where incorporation is concerned, there is an argument for combined rates of corporate and shareholder taxation to be at a similar level to labour income taxation for this reason. In employment law, by raising the level of protections afforded to workers relative to employees, one might increase engagers' incentives to classify suppliers of labour as self-employed. As a further consideration, our regulatory systems should be as simple as possible to meet their objectives (but no simpler!). Simple, transparent regulation is often considered to be correlated with minimization of regulatory loopholes and thus the potential for avoidance. Simple systems are also, *ceteris paribus*, less costly to run. Systems in a constant state of flux, on the other hand, are more costly to administer and might distort economic activity. Uncertainty over tax rates and future employment law obligations might reduce the propensity of firms to take on new workers and distort incentives to invest in one's own business or a particular employment relationship. Neither tax nor employment law in the UK is simple. The boundaries between different labour law categories are fiendishly difficult to determine and employment status is a subject of continual litigation.

[21] Including NICs.

V. Appropriate categories

How might we reform the current UK system better to meet the objectives of tax and employment law? There are two key questions to address given the UK policy backdrop:

(i) Do we require alignment of tax and employment law status tests?
(ii) How might we reform existing regulatory categories?
- Do we need more or fewer categories?
- On what criteria are these categories to be defined?

It is important to note at the outset that, conceptually, these questions have long been asked in the academic literature. The quickening pace of labour market changes, however, takes many practical challenges to their logical extremes.

(i) Tax and employment law alignment

It is often argued that the criteria determining tax and employment status should be harmonized to reduce compliance and administrative costs. The Taylor Review, for example, recommends that '"self-employed" should mean the same for both employment rights and tax purposes' (Taylor, 2017, p. 38). In theory, alignment could lead to a much more simple system: businesses and individual taxpayers would only be required to consider and determine categorization once for all purposes. In principle, therefore, there are reasons to favour such a reform and, for the most part the case law governing classification is currently the same for both systems when it comes to the criteria for determining employment. (However, in practice some of the factors carry greater weight in employment law than in tax law, and vice versa (Freedman, 2001).)[22]

Yet, as discussed above, there is currently no general concept of 'worker' in tax law, an issue that must be addressed if alignment of regimes is the goal. There is an argument for classifying all those who are 'workers' for employment law purposes as employees for tax purposes. Since the issues that arise concerning the different rights of employees and workers are not relevant to taxation, there would be no problem in taking this approach, other than the practical problems of collecting tax under the cumulative PAYE system where there are multiple employer/engagers. Cumulative PAYE seeks to extract exactly the correct amount of tax payable in the year so that no reconciliation and no tax return is needed at the year end for the majority of individual taxpayers. This is highly unusual as compared with other jurisdictions and might need to be a casualty of any reforms, since it was designed for an era of different work patterns. This is a problem that could potentially be managed by better use of technology. HMRC's digitalization programme holds out some promise, with its personal tax accounts and collection of third-party information. Development of this technology has been deferred as a result of lack of resources and other difficulties that have been

[22] For example, mutuality of obligation, which may be important for employment law rights because the length of the relationship may be significant, could be much less important for tax purposes, where all that matters is the relationship on the day in question, as described in paragraph 0543 of HMRC's *Employment Status Manual* (HMRC, 2017). See also the discussion of mutuality in an employment law context below.

encountered with the computer systems, but it is a long-term goal that needs to be pursued to deal with this issue.

In other cases, the problem of efficient tax collection could be dealt with using the special rules for taxation developed for work agencies (Fairpo and Salter, 2017). If workers are engaged via a platform (e.g. in the case of organizations such as Uber), it would be relatively easy to make this PAYE work for them regardless of whether they were employees for employment law purposes. These ideas fit into the suggestion in the Taylor Review that workers and the casual self-employed could be provided with a government cashless platform (Taylor, 2017). However, this is less likely to be operable in the case of those working for private households and small businesses and it is not compatible with the cumulative aspects of PAYE.

These practical issues can be seen to suggest a rather different solution from complete alignment. Indeed, we caution that there are real reasons to be wary of the apparently obvious answer that there should be harmonization between tax and employment categorization. The most difficult aspect of treating all workers as employees for tax purposes would centre on NICs; alignment might result in employers of 'workers' being required by statute to pay employer NICs (with a consequent significant impact on costs). By adding financial incentives on to the distinction between worker status and self-employment, one might further disincentivize the existence of employment relationships. The proposal in the Taylor Review that 'dependent contractors' (a confusing proposal to rename the existing worker status) should be treated like employees for tax and National Insurance purposes would thus be unlikely to reduce litigation and uncertainty, instead shifting the arena for litigation from the distinction between the employed and self-employed to the worker/self-employed distinction.

Thus alignment of treatment, rather than alignment of categories, together with the use of technology, could be used to deal with the tax issues around employment status, leaving employment law categories to be determined according to the needs and objectives of that regulatory system. The alternative approach, of working towards alignment of tax and employment law using existing, and perhaps new, categories, seems likely only to create new boundaries and an incentive to structure relationships so as to move out of employment law, not only because this removes regulation but also because it reduces tax costs. Designing a system where the tax incentive reinforces the incentive to escape regulation seems less than ideal.

For these reasons, we are suspicious of too tight an alignment between tax and employment law categorization in the labour market. Instead, we argue that each system should be reformed better to allow it to meet its respective policy objectives at lowest social cost.

(ii) Employment classification

Historically, employment law was defined by a binary classification scheme: an individual worked either under a contract of service, and was within the scope of employment law, or under a contract for services, in which she was self-employed and thus beyond the scope of employment protective rights.

It was only from the late 1990s onwards that a distinction between 'employees' and 'workers', both of whom were within the scope of employment law but with workers

having access to a narrower set of rights, became increasingly salient. The test for employee status was left to the common law,[23] drawing on concepts such as control and 'mutuality of obligation' (viz the obligation to offer work and to accept such offers on a long-term basis), whereas worker status is defined in statute as

> an individual who has entered into or works under (or, where the employment has ceased, worked under) (*a*) a contract of employment, or (*b*) any other contract, whether express or implied and (if express) whether oral or in writing, whereby the individual undertakes to do or perform personally any work or services for another party to the contract whose status is not by virtue of the contract that of a client or customer of any profession or business carried on by the individual. (Employment Rights Act 1996)

However, some recent case law has also attempted to rely on mutuality to distinguish between workers and the self-employed (Prassl, 2017). Mutuality of obligation is a fundamentally problematic test in a world of intermittent work: those employed on casual, zero-hours, or other on-call arrangements will almost by definition lack mutuality in the traditional sense. For intermittent workers, as the courts have noted, mutuality quickly becomes 'the rock on which [workers claims] founder'.[24]

The key questions for employment law are thus whether a bipartite or tripartite scheme is optimal, and how mutuality of obligation should be used in the definition of these various classifications.

First, the extent to which the distinction between employees and workers is still relevant in practice has become increasingly questionable. The worker category has become more and more centrally relevant, as the key rights available to employees alone (including notice periods, unfair dismissal protection, and statutory redundancy pay) are increasingly linked to qualification thresholds. The majority of employment rights today (including minimum wage, working time, and whistleblowing and discrimination protection), apply 'from day one' and extend to all workers. In this case, the distinction simply creates confusion and administrative burdens.

Second, even if a third category is still desirable, it is unclear how the distinction between workers and employees aligns with the redistributive and market failure objectives of labour law. One could argue that employment on an intermittent ('gig by gig') basis potentially indicates a degree of independence and thus relatively elastic labour supply to the firm ('flexibility' as independence). In this case, monopsony power is decreased and some market failure concerns alleviated. However, for those accepting casual employment because of a lack of alternative options, rather than due to a preference for flexibility, the opposite might be true ('flexibility' as insecurity). Further, if certain protections are considered 'rights', this distinction is almost certainly problematic. Given the vast heterogeneity of modern labour markets, it is likely that there will be at least some workers at either end of the independence–insecurity spectrum, with many scattered at various points along the distribution.

[23] Common law is a precedent-based system.

[24] *Carmichael v National Power Plc* [1999] WLR 2042 (HL).

Finally, the use of mutuality seems particularly problematic in the current context. It is arguable that the need for employment law's intervention in the labour market is strongest where workers in weak bargaining positions are exposed to insecure, intermittent work: mutuality of obligations as a legal test, however, achieves the precise opposite, guaranteeing rights for those in stable, long-term employment relationships while denying them to those in intermittent work. Furthermore, mutuality is a complex and easily mutable term. Its use creates incentives for employers to structure working relationships in an intermittent fashion to avoid employment classification, undermining incentives for investment in firm-specific human capital, potentially undermining productivity growth. Controlling for observables, individuals employed on zero-hours contracts are 20 per cent less likely to have been offered training and are more likely to have to pay for it themselves when they do (Adams and Prassl, 2017).

(iii) Tax classification

As discussed above, as a first approximation one can consider the current tax system as operating according to a tripartite classification system, distinguishing between the employed, (unincorporated) self-employed, and incorporated firms.

One key classificatory question concerns whether there is any need for a distinction between the self-employed and employees at all as far as labour earnings are considered. In line with the principle of neutrality, a well-designed tax system will seek to tax those playing similar economic roles in a similar way unless there is a good reason to do otherwise (Crawford and Freedman, 2010).

There is some debate about whether an employee and a self-employed person are playing similar economic roles, because a self-employed person is often seen as taking greater risks. However, it is not clear that this is true in practice. The risks taken by zero-hours contract workers and the self-employed might, for example, be similar: indeed, the zero-hours contract workers' daily routine may even be riskier. Further, not all self-employed persons nor incorporated businesses necessarily take significant risks on a day-to-day basis—some will have a very well established relationship with one engager. Moreover, in theory at least, the market will adjust the pricing, so that the self-employed will charge more for their services than employees, to reflect the fact that they are not entitled to certain benefits such as holiday pay (which are not related to the tax system). However, the lower the bargaining power that those providing their labour have, the less likely they are to share the tax benefits of a contractor arrangement, so that they may lose out on the employment law protection for no increase in pay. It can thus be seen that the tax system is too crude a tool to reflect varying risks in a sensible way.

Nor does the role of NICs justify the distinction between employees and the self-employed. As discussed earlier, the link between contributions and entitlements is now effectively broken within the social security system; the self-employed have similar access to state benefits as employees.[25] Yet, aligning NICs for all (that is employees,

[25] However, note that not all individuals are entitled to contribution-based job-seeker's allowance or statutory maternity/paternity/adoption/shared parental pay. This may be significant for an individual, and is being examined by the government, but in terms of costs, by far the most significant difference was in pensions in the past, and on this there is now no difference (Adam *et al.*, 2017). Hence the rising number in government figures for the cost of reduced contributions for the self-employed.

workers, and self-employed) is desirable but difficult to achieve because of the perception, however mistaken, that the payments are contributory.

Moreover, employer's NICs are significant in size and would be very difficult to subsume into ordinary taxation. Deciding which workers are covered by employers' NICs will always require difficult worker classifications while the amounts involved are significant. However, it is not clear that these distinctions need to be made. Seeing employers' NICs as a payroll tax highlights that it could be subsumed into corporation tax or, alternatively, into a sales tax, some other levy, or a VAT. The former would collect the tax only from profitable and incorporated businesses and would add to the existing inefficiencies of a corporation tax. An increase in VAT would give the appearance, at least, of being regressive and the UK VAT is already comparatively high, making this route politically very difficult. The alternative is to merge both individual and employers' NICs into income tax, but this would involve a politically unacceptable increase to income tax. Merger of personal income tax and NICs has been suggested as a long-term goal by Crawford and Freedman (2010) and the Office for Tax Simplification (OTS, 2016*a*) among others, but the political path has to be prepared and change may need to be gradual.[26]

Incorporation enables a person providing personal services to convert labour income into income on capital. With corporation tax rates at a lower rate than the higher rates of income tax, this allows income to be sheltered. Note that this can only become more of a problem with planned further reductions of corporation tax. This behaviour would be possible even if employees and the self-employed were treated in the same way for taxation on labour earnings. Indeed, the incentive to incorporate might increase unless changes were made to deal with the ability of individuals to convert labour into capital income at the same time. Attempts have been made to deal with this by increasing dividend tax. In addition, anti-avoidance provisions around company liquidations have been increased to deal with the problem of conversion of labour income into capital gains, but there are still very substantial benefits to be had by retaining profits in a company and then selling it on or in some circumstances liquidating it, paying only capital gains tax, probably at a very low rate due to the over-generous provision of entrepreneur's relief.

It might appear that one answer to tax-motivated incorporation would be to make incorporation more difficult or less attractive, or to provide a different regime for taxing small corporations from that applicable to large corporations. However, it would be very difficult to limit access to incorporation, given the association between incorporation and entrepreneurship in the psyche of politicians and business organizations. Limited liability is seen as an important tool for the encouragement of business creation (Freedman, 1994). Most recent government policy has been directed towards making incorporation easier and cheaper, and it is unlikely that would be reversed, even if it should be. Creating a completely different regime for taxing small businesses creates potential barriers to growth and further boundary and definitional issues.

Another route would be to make incorporation less attractive by offering alternative legal forms. To this end the Office for Tax Simplification proposed the creation of an additional tax status of Sole Enterprise with Protected Assets (SEPA) to protect the

[26] We note in particular the issues around those currently receiving NICs-free income, especially pensioners.

main residence of the business owner without incorporation (OTS, 2016*c*).[27] It argued that this would be attractive to those who did not want the difficulties of incorporating.[28] Yet, SEPA seems unlikely to hold very great appeal while incorporation is so cheap and easy and creates tax advantages. Rather, the creation of another legal form seems to unnecessarily complicate the tax system, moving us further from the ideal of a simple and neutral framework.

The proposals for taxation of corporations made by Crawford and Freedman (2010) are designed to counteract the conversion of labour income into income on capital. This proposal, based on the Nordic Dual Income tax, would provide for an allowance for corporate equity at the corporation tax level and a rate of return allowance at the personal income level. By this means, normal returns on capital would not be taxed, but returns above that level would be taxed at both the corporation tax rate and a personal income tax rate which could combine to be equivalent to the tax on labour. The result would be that owner-managers who were using their company purely to provide personal services would be taxed at the same rate as those providing services without using a company. Companies used as a mechanism for investment would be taxed at a lower rate because of the exemption of the normal return on income. Variants of this system are used in some Scandinavian countries, although not without difficulty, valuing the investment in the company being a major issue. One of the major advantages of this system would be that it would not be necessary to define a class of companies to which it applied: it would be self regulating in that sense.

VI. Conclusion

The issue of employment status is complex and unsatisfactory in both employment law and tax law. Currently, both incentivize engagers to structure their affairs such that they are not employers of workers or employees. Thus, taxation reinforces the employment law incentive to organize one's workforce as a 'crowd of micro-entrepreneurs' and results in loss of employment protection for individuals as well as a loss of revenue for the government (Prassl, 2018). While tax savings may in theory be shared with those providing their labour, for the lowest paid with low bargaining power (who might gain most from employee status), this sharing of savings is much less likely.

An initial reaction might be to argue for alignment of tax and employment law in order to clarify the situation. We doubt whether this should be the primary objective. Rather, we propose that the aim should be to find solutions for employment law and tax that suit the separate objectives of those systems. We suggest that reducing the number of categories in both areas should be the ideal. This might result in a measure of alignment, but the driver would be simplification, not alignment.

[27] The OTS has also investigated a look-through regime for small companies, but have rejected this option recently and, unless made mandatory, it would not be a great help and would, in fact, increase tax planning opportunities (OTS, 2016*c*).

[28] There are some traps to incorporating for the unwary and some tax issues around incorporation. Not least, accounts must be made up in a certain way and filed at Companies House and cash accounting cannot be used. There can be a double charge on the extraction of capital from a company.

Boundary lines are always hard to draw and bright line tests would primarily delight those who wish to plan around them as they provide a clear guide as to how that is to be done. The creation of new categories such as 'dependent workers' or 'SEPA' would simply exacerbate an already complex system and should be rejected. There will always need to be a line drawn between the self-employed and employees. For employment law purposes, on which side of this line a person falls will mark a considerable difference in the obligations of the engager. This sharp difference is not so necessary for tax purposes and for that reason it may not be the critical classification for tax purposes.

For taxation purposes, the aim should be to reduce the differences between the tax payable by those providing labour in different capacities, so that the boundary becomes much less important. If it is practical to collect tax at source, for example, it should not matter for tax purposes whether the taxpayer is employed or self-employed for employment law purposes. The sole driver should be the most efficient way to collect the tax due. If taxation could be detached from employment law in this way, tax would cease to exacerbate the incentives to find ways not to treat people as employees for employment law purposes. Thus, for tax law purposes, we propose as much alignment as possible of the amount of tax (including NICs) due. We would apply this reasoning also to incorporated businesses. There are many political difficulties in the path of this reform, but it should provide a direction of travel.

For employment law purposes we continue to wonder about the viability of a third category in addition to the employed and self-employed. The current distinction between workers and employees simply creates confusion and administrative burdens, and it is unclear how this separation aligns with the redistributive and market failure objectives of labour law. An extension of a basic floor of rights to all working individuals, regardless of legal status, on the other hand, might be a much more promising avenue. Furthermore, the use of mutuality of obligation seems particularly problematic in the current context and requires urgent attention.

The on-going structural shifts in the UK's labour market will only continue to make these challenges ever more salient. The political backlash faced by the Chancellor of the Exchequer following even the most modest of proposals to realign national insurance contributions for the self-employed in the spring of 2017 serves as a stark reminder of the practical difficulties involved—not least because they came in isolation, rather than bundled with the earlier alignment of benefits. While we have advocated against identical approaches in substance, then, in order to be successful in the long term, any proposed reform will have to look at employment and tax law issues in the round, rather than seeing them as isolated policy issues.

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