Comment

# Time for a different approach on employer's NIC?

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**Speed read**

**Aligning the main NIC rate for the self-employed with the employee class 1 NIC rate has much to commend it, provided there is broad equivalence in benefit entitlement. But this still leaves employer's NIC which only applies to employees and which tends to discourage businesses from hiring staff and to depress wages. The c£65bn raised each year means reform is not easy. One approach may be to base employer's NIC on business operating costs rather than employee wages. This would level the playing field across employment and self-employment, address the impact of employer's NIC on jobs and future-proof exchequer revenue against increasing automation.**

In his Spring Budget 2017, the chancellor, Philip Hammond, announced his intention to increase the main rate of class 4 NIC from 9% to 11% by 6 April 2019. Had this proposal gone through, it would have resulted in the near full alignment of the self-employed NIC charge with employee's class 1 NIC. But, in the end, the proposal was dropped amid questions of whether it breached the Conservative Party's 2015 election manifesto.

However, politics aside, from a policy perspective many would argue that the proposal had a lot to commend it.

Historically, self-employed NIC has been set at a lower rate than employee's NIC, as the following example illustrates:

| | Salary | Profit | Income tax & employee's NIC | Employer's NIC | Total income tax & NIC |
|---|---|---|---|---|---|
| Employment | £32,000 | | £7,073 | £3,297 | £10,370 |
| Self-employment | | £32,000 | £6,500 | £0 | £6,500 |
| Difference | | | £573 | £3,297 | £3,870 |

*Based on 2016/17 rates, and taken from the HM Treasury factsheet 'National insurance and the self-employed', published at Spring Budget 2017.*

The example also addresses employer's NICs and I refer to this aspect below.

The original rationale for a lower self-employed NIC rate was that the self-employed enjoyed less support via social security benefits, particularly as regards the state pension. However, in recent years benefit entitlement has been largely aligned (with further alignment on parental benefits planned). And this, of course, is the justification for aligning the lower NIC main rate for the self-employed with the employee NIC rate. Indeed, the reality is that considerable sums of money are at stake.

HM Treasury estimates that the cost to the public purse of reduced NIC rates for the self-employed is c£5bn per annum, and that this is set to increase as self-employment continues to rise faster than employment.

So this proposal may well re-emerge as part of the Autumn Budget, particularly if it chimes with any comments on tax and NIC that Matthew Taylor includes in his report on modern employment practices (see bit.ly/2gEV1Fm). But even then, this would still leave one key anomaly between the NIC position for the employed and self-employed, namely employer's NICs.

Employer's NIC is paid by employers on earnings paid to employees but is not paid by businesses on amounts paid to the self-employed. And, as it is not linked to any contributory benefits, it is, in essence, a payroll tax or, as some would say, a tax on jobs.

It is currently charged at 13.8% on earnings over £157 per week and generates c£65bn annually (see OTS March 2016 report on closer alignment of income tax and NIC, at bit.ly/2fQZMez). As the example above shows, for an annual salary or profit of £32,000 the additional cost of employer's NIC to the employer, relative to engaging on a self-employed basis, is £3,297 (at 2016/17 rates). That's a fairly substantive difference.

And, as HM Treasury acknowledges (see factsheet at bit.ly/2sQdPa5), the effect of this additional cost is to depress employee wages. As they put it, 'the employer is liable for paying employer NIC, but the cost of this tends to be passed on to the employee through reduced wages'. And if the cost of employer's NIC is not passed on through

reduced employee wages then there is, nevertheless, downward pressure on the hiring of new employees – and/or attempts to avoid paying employer's NIC. Certainly, as regards avoidance over the years we have seen schemes involving gilts, gold bullion, diamonds, fine wine, trade debts, platinum sponge … you name it!

To address the negative effect of employer's NIC on jobs, successive governments have introduced (limited) carve-outs. These include the 0% rate which applies to those under 21, and apprentices under 25, on earnings up to the upper secondary threshold, and the employment allowance which was introduced in April 2014 to help businesses to grow by cutting the cost of employment. And you may recall the 'NIC holiday scheme' which ran between 2010 and 2013 and was designed to 'encourage the creation of private sector jobs in regions reliant on public sector employment by reducing the cost to new businesses of employing staff' (see press release at bit.ly/2rXIMpP).

The base for employer's NIC should be expanded so that it is calculated with reference to the operating costs of a business as a whole, as opposed to being limited purely to employee costs

However, for those outside the scope of these carve-outs, the most obvious way to negate the cost of employer's NIC is to engage labour on a self-employed basis (provided this is possible and desirable). And the numbers appear to confirm that this is happening as the growth in self-employment continues to outstrip that of employment. Indeed, HM Treasury's projection is that the changing make-up of the labour market will reduce projected receipts by around £1bn a year by 2020/21 (see HMT factsheet *National insurance and the self-employed*, published at Spring Budget 2017).

Of course this coincides with significant changes in the way people are working, whereby the very distinction between employment and self-employment is increasingly being called into question. This is particularly true in the so-called 'gig economy', where people are working in combination with technology platforms and the providers of those platforms (think Uber, Deliveroo, Pimlico Plumbers, etc.) and this problem is only going to get more acute. Forming a view on the tax and NIC status position is not easy!

But there is another looming problem as well. With automation and robots coming to the fore (coupled with offshoring) there will, in any event, be fewer and fewer people to sustain the Exchequer's tax and NIC yield in the first place. Employer's NIC may be driving *self*-employment trends at the moment, but it could also end up driving *un*employment trends in the future, as it will surely act as an added incentive for business to opt out of human labour entirely. And, if that happens, where will the £65bn that employer's NIC raises today come from in five or ten years' time?

### So what can be done to address this problem?

One approach would be to introduce a statutory definition of employment and self-employment for tax and NIC purposes – a bit like the statutory residence test – and then to police it vigorously and clamp down on any non-compliance. However, I am not convinced this approach will work. Both because I think preserving the boundary will only encourage people to try and find a way around it, and because it would be very challenging to find a straightforward, practical means to legislate a tax demarcation between employment and self-employment. And, in any event, I think this ducks the underlying issue that employer's NIC is a tax on jobs and unhelpful as such – particularly at a time of increasing automation. So I have come to the conclusion that it's time for a different approach. And that the answer may lie in decoupling employer's NIC altogether from the employee/employer relationship and taking a very much broader view on what is, in essence, a levy on but one component of business cost, i.e. employed labour.

In this vein, a different approach would be to reformulate employer's NIC so that it applied to all labour, i.e. employed and self-employed. But whilst this would level the playing field, it does not address the underlying, corrosive impact of employer's NIC on jobs. So I am not keen on this either. Rather, I think that the base for employer's NIC should be expanded so that it is calculated with reference to the operating costs of a business as a whole, as opposed to being limited purely to employee costs. It is then immaterial whether a business engages employees or the self-employed, offshores or automates. Albeit that with a much expanded base the rate of employer's NIC should then fall significantly. Accordingly, reference to 'employer's NIC' would become a misnomer; better would be to call it something like 'business social contributions' or 'BSCs', i.e. contributions to the public coffers paid by businesses on the *total* resources they consume in their day-to-day operations.

It is true there would be winners and losers, and no doubt the losers would shout the louder. But BSCs could be designed to smooth out a number of these rough edges. For example, would small businesses which don't have any employees, and so don't pay any employer's NIC at the moment, pay BSCs? Well not if a lower threshold applied to ensure that only larger, more established businesses were within scope – a similar approach to the way that the employment allowance works at the moment. As noted, calibration of the rate of BSCs would be needed so that they raise no more or less than the £65bn currently raised by employer's NIC. And transitional rules could apply so that BSCs are phased in over time, as employer's NIC are phased out. These and many other issues would need careful consideration and wide consultation.

But de-coupling employer's NIC so it is no longer linked to payroll would mean no tax incentive for businesses to prefer self-employment over employees. It would also complement the chancellor's thoughts on aligning NIC for the self-employed and employed, and remove some of the downward pressure on jobs and pay levels which currently favour automation. That said, it is inevitable that over time the shape of the workforce will change and an advantage of BSCs would be to future-proof exchequer revenue in that it would no longer be dependent on whether business engages labour or automates. And last, but by no means least, the cat and mouse game played around avoidance of employer's NIC would finally come to an end.

I believe that the time is ripe for an open and considered debate about employer's NIC, and I hope that a potential move to BSCs, or something similar, will form a part of that debate. ■

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