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BEING YOUR OWN BOSS:

SHOULD THE GOVERNMENT CARE?

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Summary

- Self-employed workers have lost out badly during the pandemic. Their numbers have so far fallen more sharply than the numbers of employees. There is evidence that government assistance has been poorly targeted: over half of the self-employed have received no help.
- The Chancellor has hinted that, in return for the assistance the government has granted, the self-employed may be taxed more heavily in the future.
- The tax authorities have long been concerned that the self-employed do not pay enough income tax and, particularly, national insurance contributions. Already the conditions under which self-employment status is recognised have been considerably tightened. The Chancellor's hints tie in with this.
- On the other hand, trade unions and others have argued that the self-employed are a disadvantaged group which misses out on many welfare benefits and employment rights. Some self-employment by freelancers may be encouraged by big employers as a way of avoiding costly employment mandates.
- These two approaches suggest a 'pincer movement' towards giving the self-employed greater entitlements but at the cost of paying more to the Exchequer and tighter regulation.
- The self-employed are an extremely heterogeneous group. The danger is that new 'one size fits all' legislation will have unintended consequences such as deterring many people from entering self-employment who would gain from doing so, and driving more activities into the informal economy.
- There are no very strong public policy grounds for subsidising self-employment status, but there are no grounds for deterring it either. In the current climate, given the importance of getting people back into work, it could be unwise to penalise the self-employed unnecessarily.
- Changes to the status of self-employed workers could take place in the context of a long-overdue merger between national insurance and income tax. This could deal with wider anomalies and enable the public to see more clearly just how much the government takes from their pay. The end of the pandemic, and the huge changes it will have permanently made to the economy, may be a timely moment to consider such radical reform.

Introduction

Millions of UK citizens work on their own account, rather than for an employer. Motives differ, but the majority have chosen to do so because they value their independence, a different lifestyle or are able to make a better living in this way.

Politicians have long taken an interest in the self-employed. Some have seen them as the vanguard of an entrepreneurial and innovative economy, or as sturdy individualists battling against an ever-more powerful state. They have accordingly advocated government assistance and privileges for the self-employed.

Others, however, have seen self-employment as a tax dodge, and the self-employed as avoiding obligations to their fellow citizens. In this view, reforms should increase the income tax and national insurance (NI) contributions paid by the self-employed.

Still others have seen many of the self-employed as victims: they point to poorly paid and insecure work, often undertaken because disadvantaged groups such as the disabled, some ethnic minorities and the housebound are unable to access full-time paid employment in the mainstream economy. In some cases, workers may have effectively been coerced into freelance status by unscrupulous employers trying to avoid costly employment mandates. Accordingly, it is argued that the situation of the self-employed should be improved by new rights and benefits.

The Covid-19 pandemic has crystallised some of these concerns. This paper sets out the main issues.

Self-employment and the pandemic

Before the pandemic, there were around 5 million self-employed people in the UK, 15 per cent of all those in work. Their numbers had been growing steadily for the last decade, although their composition had been changing.[1]

Since the early part of this year, however, the number of active self-employed has fallen sharply. Between January-March and July-September they fell by over 400,000 – a far larger proportionate fall than that in employee jobs. In April, three-quarters of self-employed workers reported less work than usual (Blundell and Machin 2020). According to the Resolution Foundation, for most of the period between March and October more than half of all self-employed workers were earning less than before the crisis; in April, three in ten received no pay at all (Brewer et al. 2020).

Since then, government support has been available through the Self-Employment Income Support Scheme (SEISS), through suspending the Minimum Income Floor for self-employed Universal Credit claimants, and through access to government-backed loans. However, these schemes were rushed out and there is evidence they were initially poorly targeted. The Resolution Foundation claims that, bizarrely, one in six recipients of the first tranche of SEISS grants had not suffered a fall in earnings. The rules have been tightened for payments that will be made in the revised New Year scheme, but payment has been made more generous, in line with the Coronavirus Job Retention Scheme (CJRS) for employees.

On the other hand, the Institute for Fiscal Studies estimates that 38 per cent of those with any self-employment and 18 per cent of those for whom self-employment counts for more than half their income have been ineligible for government support (Waters 2020). To be eligible for SEISS grants you must have submitted a 2018-19 tax return (thus excluding around 5 per cent of the self-employed who are recent entrants to the status), have more than half of your income from self-employment, and have profits less than £50,000 in the relevant tax year. Of the 3.4 million apparently eligible only 2.3 million seem to have claimed the September payment (HMRC 2020).

The Chancellor of the Exchequer has suggested that, as a quid pro quo for this assistance, he will 'review' the tax status of self-employed workers, which presumably means requiring them to pay higher taxes and/or national insurance contributions.[2]

This may be galling to the majority of self-employed people who have not benefited from the SEISS; they can also point out that there is as yet no suggestion that individuals or companies benefiting from the CJRS or the many other forms of emergency support will similarly be subject to higher taxation for that reason alone. Of course, we may all have to pay higher taxes in the future, but that's a different matter from singling out the self-employed.

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1 For example, with more 'solo' self-employed and fewer self-employed with employees (see Boeri et al. 2020).

2 'Tax pain ahead for self-employed after state bailout', Telegraph, 26 March (https://www.telegraph.co.uk/business/2020/03/26/tax-pain-ahead-self-employed-state-bailout).

A pincer movement against self-employment

Mr Sunak's suggestion ties in with a longstanding Treasury and HMRC suspicion of self-employment. The self-employed pay lower national insurance contributions than those in employment, while both national insurance and income tax are charged on 'profits', earnings after the deduction of allowable expenses. And the self-employed inevitably have greater opportunities than the employed for under-reporting income and over-stating expenses.

In his 2017 budget, Philip Hammond proposed to reduce these advantages by a phased introduction of higher rates of national insurance contribution for the self-employed. He was, however, forced into a U-turn by a backbench revolt. But rules have nevertheless been considerably tightened in recent years. The circumstances in which an individual can use an intermediary company to provide services to another business, while receiving a dividend rather than a salary,[3] and thus avoiding national insurance contributions, have been greatly restricted under IR35.[4] In 2017 public sector authorities were obliged to ascertain a contractor's status for tax purposes, and this obligation has been extended to the private sector from April 2021 (it was to be April 2020 but the requirement was postponed because of the Covid-19 crisis). In addition, HMRC is pushing costly real-time reporting on many self-employed people with the Making Tax Digital scheme. The government has also launched a consultation on alleged VAT losses in the 'sharing economy' which encompasses some new forms of self-employment.

At the same time as the self-employed are seen as privileged by the tax system, they are paradoxically also seen as disadvantaged in lacking entitlement to some welfare benefits. Recently they have also been seen as victims of large businesses which have outsourced work to freelancers and gig economy workers to cut costs by avoiding employer's national insurance contributions and mandates such as paid holidays, parental leave, sickness payments and pension contributions. The rise of app-based employment by firms such as Uber and Deliveroo has also led to legal cases querying whether those using these apps are 'really' self-employed or simply a new type of employee for which the app owners are evading responsibility.

So, we have a pincer movement between the tax authorities seeing tax-dodgers everywhere and those who want to protect 'exploited' workers and give them greater access to benefits.

Among the latter is Interim Director of Labour Market Enforcement, Matthew Taylor. His Review of Modern Working Practices, undertaken for Theresa May's administration, called for higher national insurance payments by the self-employed, to give them wider access to state welfare benefits (Taylor 2017).

Taylor also advocated a new status of 'dependent contractor', enforcing obligations on businesses which contract work out. While the cost of these obligations seems to fall on the employer, economic theory and experience suggest that they will eventually be passed on to workers in terms of lower pay and/or employment opportunities (Krueger and Reinhardt 1994).

3 In principle a rational and legitimate way of smoothing fluctuations in income, although critics charge that the tax system makes this more attractive than it would be otherwise.

4 IR35 is the short name for tax rules applying if you work for a client through an intermediary. See: https://www.gov.uk/guidance/understanding-off-payroll-working-ir35

One size does not fit all for the self-employed

A problem with these approaches, contributing both to the limited effectiveness of government support in the pandemic and the difficulty of making changes to the tax and national insurance position of the self-employed, is the heterogeneity of those who work for themselves,[5] and their motives for doing so.

The majority are men: they account for two-thirds of all self-employed, a much larger proportion than they represent (marginally over 50 per cent) amongst employees. But whereas 81 per cent of male self-employed are full-time, this is true of only 46 per cent of females. Where self-employed women have dependent children, 61 per cent are part-time.

A quarter of male self-employed work in the construction industry (where concern about tax status has historically focused), while the largest single group of women work in health and social work (where there has not been nearly so much concern). There are 292,000 self-employed male road transport drivers compared with just 22,000 females. On the other hand, there are 132,000 self-employed female hairdressers, but only 17,000 males.

The self-employed are typically older than employees: only 4 per cent are aged 16-24, compared with 13 per cent of employees in the same age group, while 10 per cent are 65 or older as against only 3 per cent of employees. And while most self-employed workers operate either alone or with a partner, around 750,000 of them employ other people in their business. The different sections of this disparate population have fared differently in the pandemic.

The motives of individuals taking up self-employment differ considerably.[6] Some value independence and flexibility above simple monetary rewards. Some are genuine entrepreneurs, ambitious to start their own business, which they hope to see grow. Others see self-employment as a way of continuing in a profession after retirement from a salaried position. There are others who simply hope for flexibility to combine working from home with looking after children or elderly relatives. Some are continuing a longstanding family business. For actors, musicians and stage technicians where permanent employee status is next to impossible, self-employment has always been a way of life.

But there are also those – albeit, the data suggest, a smallish minority – who accept self-employment because they cannot obtain employee jobs (some ethnic minority workers may be in this position[7]) or because an employer has asked them to move to self-employment status.

Finally, it is instructive to distinguish between self-employment as a status and as an activity. Many statistical sources, such as the Labour Force Survey, classify people as

5 See ONS (2020), plus related data file. The data refer to January-December 2019.

6 See, for example, Dawson et al. (2009) and BIS (2016).

7 See Clark (2015). But note that only two large groups – those of Pakistani and Bangladeshi heritage – have higher self-employment rates than whites. Some other sizeable groups – Indian, Black/African/Caribbean/Black British – have rates well below whites. It is also worth noting that some ethnic minority employment has a much more positive dimension, with successful self-employed people able to exploit a comparative advantage in catering for specific needs of minority communities, for example in food and clothing, and even in extending the appeal of ethnic products to the wider community.

self-employed on their own attribution. Generally, someone describes themself as self-employed if the bulk of their earnings comes from self-employment. Yet many who are employed in a regular employee job, and earn most of their income from this job, may nevertheless also have significant income from self-employment and would be affected by legislative change. Conversely, people who are normally self-employed – such as 'resting' actors - may temporarily take on employee jobs. In the lockdown, significant numbers of people normally running their own cleaning or hairdressing business seem to have taken temporary jobs in supermarkets to make ends meet. Many will have received little or no government support in lieu of self-employment income.

The point to emphasise is that, in considering changes in future policy towards the self-employed, it is worthwhile bearing in mind their heterogeneity. Pressure groups such as trade unions tend to focus on some groups of the self-employed rather than on others, while the tax authorities impose restrictive rules which may make sense in relation to some types of self-employment, but can be a heavy burden on other types of people. Raising their costs of doing business may possibly deter them from some types of work completely - meaning that the total amount of extra revenue raised is less than expected, while customer choice is restricted.

Freelancers, contractors and gig workers: should their status be changed?

The self-employed pay income tax on their profits (which means income net of allowable expenses), and they pay lower national insurance contributions, also on their profits. There is no equivalent of employer's national insurance contribution. Moreover, most self-employed people fall below the VAT threshold, so do not pay VAT on services they provide (whereas large companies would have to do so). In addition, between 10 and 15 per cent of the self-employed are paid through their own companies, which means that they can pay themselves dividends which are taxed less than regular pay. [8]

These advantages have the downside that the self-employed don't have access to some benefits and rights which employed workers possess. For example, they are not entitled to statutory sickness pay, maternity pay, contribution-based jobseeker's allowance or employer contributions to pensions. They have no right to minimum wages or redundancy payments. They also face the - less measurable but, for many, highly significant - disadvantage that they must regularly seek out and maintain links with clients and customers, rather than have assignments handed to them by an employer with all the risk and insecurity that this entails.

Particular attention has focused on the tax and benefits status of freelancers, contractors and the newer category of 'gig' workers.[9]

There is an implicit bargain here between the self-employed and the government. Self-employed people have some financial advantages over the employed, in exchange for which they take more responsibility for their own future. The terms of the deal may have to change from time to time.

8 Many people new to self-employment are also helped by various grants, loans and subsidies under business support schemes. Those transitioning from long-term unemployment to self-employment may also be given guidance, mentoring and financial support through the New Enterprise Allowance.

9 Gig work involves flexible, temporary assignments. It has always existed, but has been considerably boosted by the possibility of connecting with clients or customers through an online platform.

One view is that the balance of power has shifted towards big business and away from the self-employed, and that the government should intervene. The TUC, for instance, 'is worried that the growth in self-employment is … driven in part by sham forms of self-employment, which are used by some employers to reduce their tax liability, avoid the minimum wage and deny workers their rights' (Klair 2019).

This view is probably widely held on the left, but it is difficult to see that increased self-employment has mainly been driven by big firms attempting to cut costs. The recent expansion in self-employment has come in expanding areas such as business and IT services at the high end, and new app-linked services at the less-skilled end, rather than in areas where employee jobs have been lost. As the CIPD puts it (Beatson 2018):

> There is no convincing evidence of the increase [in self-employment] being driven by employers exploiting their position, forcing 'bogus' self-employment on the people working for them. Indeed, if there has been any change in the numbers of 'bogus' self-employed, this could just as easily have been the result of changes in tax law or its enforcement and of individual preference.

Nevertheless, it is worth thinking in more detail about the distinction between freelancers and contractors. Freelancers are a long-established presence in some creative industries, notably journalism, design, editing and proofing, and are increasingly found in newer fields such as web design. Freelancers frequently work for multiple clients at the same time. They are often paid for a completed piece of work rather than at an hourly rate, and tend to work in their own home or studio.

Payment of tax by self-assessment each year probably remains the appropriate method for sole trader freelancers, as is payment of Class 2 and Class 4 national insurance. Freelancers who operate through a limited company pay Class 1 national insurance and PAYE tax on salaries, plus tax on dividends via annual self-assessment.

By contrast, contractors typically work on fixed-term contracts for clients, often arranged through an agency. They are often professionals with particular skills such as IT and engineering, and are likely to work at a client's site. They usually work through their own limited companies or an 'umbrella' company.

To the extent that these statuses are blurred at the margin, with some 'freelancers' being inappropriately employed on what amounts to contractor status, there may be a case for looking again at this - particularly as both types of work may grow in importance in the aftermath of the lockdowns, with organisations seeking to minimise the risks of taking people on as direct employees.

However, it could be a mistake to generalise from this to all types of self-employment and to make a case for higher national insurance contributions all round, with concomitant greater rights and access to benefits. For many self-employed, paying lower NI contributions is an acceptable offset to greater risk and self-reliance rather than complete dependence on employers and the state. Higher contributions (or less favourable income tax arrangements) would alter the balance of risks and could deter some people from entering self-employment.

Do the self-employed generally need more assistance from the state? A basic safety net for the self-employed is already provided by universal credit. To the extent that there is a latent demand for further security for some freelancers and other self-employed workers, it is not clear that the state should make blanket provision, particularly at a time when there are so many demands on the public purse.

It is a well-established proposition in economic analysis that the costs of employment mandates of various kinds are not ultimately paid for by the employer. To the extent that they cannot be passed on to the consumer, they will fall on the employee. If freelancers are given greater job security or other benefits, this is costly and will reduce the amount the employer can afford to pay the employee. As employers could already make an offer of more entitlements but lower pay to freelancers, this suggests that they would not get many takers and that these rights are not as highly valued as pay at the margin.

This issue has been foregrounded by the development of apps. It may be that app workers would benefit from being treated as employees. However, the company's business model might not work if costly new rights – and the expensive organisational structure necessary to support them- were instituted and yet app workers were to be paid at the same rate as before. The provision of such rights would rather necessitate a larger chunk of payment for the service going to the app company, and a fall in the share going to the worker.

Uber already provides some basic insurance to its drivers but it is unlikely that most Uber drivers, or similar providers of app-based services, would wish to take a significant pay cut to finance a full range of benefits (Berger et al. 2019). A high proportion of gig workers are part-time, doing this work as an occasional addition to other jobs and they value the flexibility which allows them to take work as and when they wish, rather than being tied to the type of formal employment contract which an employing organisation would impose.

If there is an unsatisfied demand for greater support for some freelancers or gig workers, one answer might be to extend the system of voluntary (Class 3) contributions, thus allowing the self-employed to access a fuller range of benefits for an enhanced NI payment. However, there are dangers of adverse selection- where only the biggest risks take on the extra payments, meaning that the voluntary contributions would have to be higher than if they were compulsory – in such an arrangement.

There is the potential for voluntary action to come to a private insurance arrangement, possibly via a trade union, rather than impose an employment mandate which could well reduce opportunities for many people who prefer this sort of flexible arrangement.

This is an area where trade unions could seek to recreate 'friendly society' arrangements. A useful model might be the Dutch broodfond schemes, where voluntary collectives of 20 to 50 freelancers make monthly payments into a fund which they can draw upon in times of sickness (Oostveen 2019). The small scale of these enterprises, where participants largely know each other, reduces administrative costs and the risk of fraud.

Should the government encourage self-employment?

A more fundamental issue is to consider how far, if at all, the government should encourage self-employment. The best-argued case for reducing the tax and national insurance advantages enjoyed by the self-employed, and moving towards neutrality between different forms of employment, has come from the Institute for Fiscal Studies.

IFS authors are sceptical of many of the claims made on behalf of the self-employed, such as the romantic view that they are buccaneering entrepreneur types whose innovatory ideas spark economic growth (Adam et al. 2017). On average, they point out, self-employed workers display lower productivity than employees. Few of them go on to build growing businesses; most do not wish to. Their work may be often be routine (running corner stores, small cafes or hairdressing salons) and display little innovation or genuine entrepreneurial flair.

Tax and National Insurance concessions which encourage people to switch into low-productivity sectors artificially subsidise these sectors and contribute to low growth prospects for the economy. Rather than subsidise all self-employment, the IFS authors argue, resources might be better employed incentivising genuinely innovative growth businesses.[10]

Furthermore, the IFS points out, the bargain that offers lower national insurance contributions in return for lower benefit entitlements is too generous. In 2016-17 the self-employed were only paying 37 per cent of the NICs that would be paid if they were employed. Differential benefit entitlements might have justified some difference in rates, but not on this scale.[11]

However, the IFS position perhaps understates the benefits of having an alternative lifestyle to that provided by mainstream employment, which may be of particular importance to some groups such as families with dependent children or elderly parents, and people whose disabilities preclude regular mainstream employment. It may also overestimate the gains to the Exchequer of higher taxes and national insurance contributions if this leads to withdrawal from the workforce of significant numbers of the self-employed (for instance those over or close to state pension age), or increased under-reporting of income as efforts switch to the informal economy.

Those advocating government neutrality between self-employment and employee status should be aware that it is difficult, perhaps impossible, to design an actuarially 'fair' system of income tax and national insurance for the self-employed which makes the benefits of self-employment and employee status equal at the margin.[12]

For one thing, the taxable 'profits' of self-employment may often involve both labour income and a return on the capital employed in the business. Discrete streams of the two income sources are taxed differently almost everywhere. In practice it is impossible to distinguish between them in self-employment income.

For another, the national insurance system involves employer contributions as well as contributions by individuals. Although some have suggested that those who use freelancers should pay these contributions, this only really works if the freelancer has one client; the idea of spreading the contribution over several clients becomes impossibly complex. And the idea doesn't work at all for most self-employed workers.

10 That of course assumes governments can distinguish likely winners, and the past record does not create confidence. Few of the myriad business support schemes instituted in recent decades have ever been properly evaluated, as the National Audit Office has noted (https://www.nao.org.uk/press-release/governments-support-to-business/).

11 Particularly since there are often means-tested benefits which may substitute for contribution-based entitlements.

12 Boeri et al. (2020: 86-92) point out many of these difficulties.

The national insurance system doesn't fit the self-employed well. But this is unsurprising, as self-employment contributions were a late addition to a system which was put together (designed is too strong a word) for different purposes in a very different world. When the system began before World War I, it was an add-on to private systems of friendly society benefits. Greatly enhanced and modified following the Beveridge Report at the end of World War II, it remains focused on the majority of workers who have an employment contract, meaning that there are all kinds of anomalies such as special arrangements for share fishermen and landlords renting out their own property.

More generally, 'national insurance' is a misnomer. There is no insurance fund and benefits are paid out of current revenue. Employee national insurance is in effect an unnecessarily complicated and confusing form of income tax which is not properly aligned and thus can produce discontinuities and high effective marginal tax rates. Employer national insurance is a payroll tax, undesirable if we want to increase employment (and anyway tending to reduce employee wages). There is a strong case for a complete merger between national insurance and income tax, which would enable significant administrative savings and also make it much more obvious to the public what share of pay, and pay increases, they are making over to the government.

Many Chancellors of the Exchequer have seriously considered this (see Peacock and Peden 2014) and the Office of Tax Simplification recommended it in 2011. But politicians balk at the rise in income tax which would be necessary and the fact that, though some people would gain from the reform, others would lose and make a fuss.

So, while there is certainly a case for altering the national insurance contributions of the self-employed, rather than tinker with the existing set-up it could make sense to undertake more fundamental changes. Perhaps the end of the pandemic, and the huge changes it will have permanently made to our economy, may be a timely moment to consider such radical reform.

Conclusion

Self-employment is an important form of employment which contributed disproportionately to the growth in total employment in the decade following the last recession. For many people it represents a rewarding career and contributes to a balanced lifestyle with a degree of independence from the state and an increasingly conformist corporate structure.

It has, however, benefited from tax and national insurance status which may have artificially made self-employment seemingly more financially attractive than employee work at the margin for some groups. However, fiscal incentives have probably had only a minor effect on the growth of self-employment. Working on one's own account remains a risky and demanding career choice, as the pandemic has shown. The UK government's response to the pandemic – lockdown of major parts of the economy for extended periods – has hit the self-employed particularly hard.

Despite this, emergence from the recession is likely to involve a recovery and indeed expansion in some forms of self-employment. On the one hand, large firms are going to be unwilling to take on new permanent employees in an uncertain business environment, and may make greater use of freelancers and gig workers. On the other, in a situation of rising unemployment, many who would otherwise have preferred an employee job may be motivated to try their hand at self-employment. They may be encouraged to do so by an increased awareness, honed by months of lockdown, that remote working and online delivery of services offer a range of new possibilities for working on one's own account.

While there are indeed arguments for realignment of the borders between employee status and self-employment, any proposed changes would benefit from being carefully thought through, with due attention paid to the heterogeneity of the self-employed. There could be pitfalls if they are imposed to meet a short-term political or financial imperative and there is a case for subsuming them in a wider reform and simplification of our complex tax system.

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