

Rules of Engagement

Reviewing self-employment
and employment in the UK

Nigel Keohane

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ABOUT US

The Social Market Foundation (SMF) is a non-partisan think tank. We believe that fair markets, complemented by open public services, increase prosperity and help people to live well. We conduct research and run events looking at a wide range of economic and social policy areas, focusing on economic prosperity, public services and consumer markets. The SMF is resolutely independent, and the range of backgrounds and opinions among our staff, trustees and advisory board reflects this.

EXECUTIVE SUMMARY

The UK's employment and tax rules no-longer work and they increasingly sit at odds with our diverse and flexible labour market. The consequences are severe:

- Many workers miss out on rights and benefits: our research finds that self-employed individuals are half as likely as employees to receive training, less able to build up retirement savings and less likely to take time off sick. At the same time a significant minority of self-employed workers do not enjoy high levels of autonomy at work – and therefore suffer the downsides of fewer protections, rights and benefits but without greater freedom at work.
- The rules result in a poor deal for the taxpayer. The Treasury misses out on over £5bn of foregone revenue through different NICs rates for the self-employed, as well as other potential revenues.
- Uncertainty about employment status drives inefficiency in the market: injecting costs, whilst providing an opportunity for unscrupulous firms to take a risky approach to compliance thus earning a competitive advantage over compliant firms.

There is now cross-party consensus that such problems must be addressed, although there has been little agreement on how. Our proposed new rules make life fairer for the individual and the taxpayer, whilst providing greater certainty and simplicity to businesses. This report envisages a future where no matter how the work is performed there is greater evenness in tax treatment and in associated rights. As far as possible, we should be moving towards one form of employment.

1. Closing the tax gap:

- From 2018, the Government should introduce a 'Hirer's NICs', which would start at 2% per annum and increase each year until parity is achieved with Employer NICs by 2025. This would overcome the anomaly where organisations engaging self-employed workers are exempt from 13.8% rate of Employer NICs.

2. Equalising benefits and protections

- The Government should design a 'Self-employed Benefits Package'. This should provide Statutory Maternity Pay, contributory JSA and sick leave insurance to workers that save into a private pension scheme. This would be a quid pro quo, with a message from the Government: "If you look after yourself, we will help". Low paid workers could be covered without this requirement.
- To help fill the post-Brexit skills gaps, self-employed workers should become eligible for a Training Voucher that can be redeemed if the individual undertakes training. This would match training vouchers provided for apprenticeships.
- Organisations should be required to estimate the average hourly equivalent payment to their workers and estimate the number of workers who are paid below the equivalent of the National Living Wage, and to disclose this information. This transparency would put social pressure on organisations to remunerate their workers fairly. This should apply in the first instance to organisations engaging more than 50 workers.

3. Stronger, clearer rules

- To confront exploitation, the Government should establish a new misclassification rule which would allow individuals to claim that they have been wrongly labelled as self-employed workers where specific conditions are met. These conditions could include working for more than nine months for an organisation and receiving more than three quarters of their income from them.
- The Government should carry out a strategic review of the employment status definition with a view to establishing a new legal definition which is simpler and easier to enforce.

4. More visible policing

- The HMRC should make a virtue of visibility: pursuing more cases of non-compliance, and publicising how many firms and individuals have been pursued successfully and the value of the money recovered.

5. Better evidence and data on self-employment

- With self-employment now comprising 15% of all employment, government departments, regulators and national statisticians must collect and analyse a much deeper evidence base as a starting point for more sustainable policy.

6. Setting an 'Employment Reform Plan'

- To provide certainty and sustainability, the Government should introduce a long-term plan setting out the sequencing of different reform measures.

CHAPTER 1: WHY WE NEED TO REVIEW POLICY

The UK's labour market has changed dramatically in recent decades, growing increasingly at odds with a tax and regulatory system designed around traditional employment forms. Wage regulation protects employees but not the self-employed. Pension auto-enrolment is designed around employers as a route to make employees save. The tax system treats self-employed workers totally differently from those categorised as employees. While the costs of engaging an employee have risen (pension auto-enrolment, the National Living Wage and Apprenticeships Levy), the costs of engaging self-employed workers have stayed the same.

At the same time, the boundary between employee and self-employed has become increasingly ambiguous as new forms of platform work become common and as employment patterns become more diverse. The problems created are threefold:

- Revenues for HMRC are lower than predicted and lower than they should be (because a growing share of workers is self-employed and pay lower tax, because some workers mis-classify, and because some self-employed workers report lower incomes than they actually have).
- Some workers miss out on employment and benefit rights because they are not labelled as 'employees' when they should be. The self-employed more generally need help in managing risks associated with work.
- The uncertainty about employment status allows unscrupulous firms to take a risky approach to compliance thus earning a competitive advantage over compliant firms, and undermining the efficient functioning of the market.

Over the last two decades, the Government has made numerous attempts to address the problem of mis-classification – adjusting the rules for engaging contractors, establishing new rules for determining whether someone should be designated self-employed or employed and changing the tax rates and reliefs for different forms of work. But, intervention has been typified by seeking to stop whatever is the latest malpractice in the

market without addressing the fundamental drivers of the behaviour. The consequence is that the symptoms of market failure simply reappear in a different form in a different part of the market.

What is needed, therefore, is a fundamental review to establish a tax, regulatory and benefit system that fits the purpose of the UK's labour market and that can prove resilient to future change. In particular, our reform framework needs to be right for individuals and businesses, offer a better deal for the UK taxpayer and be easier to enforce.

Self-employment has recently risen up the public and political agenda. In March 2017, the Chancellor sought to take some small and tentative steps to equalising the tax regime. Yet, he was forced to abandon his policy. In recent years, the employment status and rights of workers have been contested in court, but they still remain unclear. In this context, the Taylor Review of 'modern employment practices' is an important initiative. It has the potential to ask some vital questions about tax, regulation and benefits and to set the agenda for reform into the next decade. The review comes alongside major inquiries by the Work and Pensions Select Committee and the Business Select Committee.¹

The issues have received significant attention in the election manifestos of the major parties. The Labour Party emphasised 'mounting evidence that workers are being forced into self-employment by unscrupulous employers to avoid costs and their duties to workers'.² The Conservative Party meanwhile has committed to '[ensuring] that the interests of employees on traditional contracts, the self-employed and those people working in the 'gig' economy are all properly protected' and responding to the Taylor Review recommendations. At the same time, the Party has accepted that the UK's tax system is far too complicated.

This report seeks to contribute to this policy debate and ask:

- How is the UK's labour market changing?
- How what are the differences between employment and self-employment status and what problems do we observe at the divide?
- How should we reform policy?

CHAPTER 2: UNDERSTANDING SELF-EMPLOYMENT IN THE CONTEXT OF THE UK'S CHANGING LABOUR MARKET

GROWTH IN SELF-EMPLOYMENT

Recent decades have witnessed a transformation to the way that people work. Self-employment as a share of all employment has risen from around 10% in the mid-1980s to 15% in the latest figures.³ Looking further back, levels of self-employment were even lower – with the self-employed as a share of the population aged 16-64 rising from 6% in the 1970s to around 11% in 2014.⁴

BOX 1: EXPLAINING EMPLOYMENT AND SELF-EMPLOYMENT

There are different rules for determining employment status for tax and legal purposes. For tax purposes, there are two classifications: employed and self-employed. For legal status, there are three categories: employees, workers and the self-employed. It is notable that someone can be an employed earner (and pay Class 1 NICs and PAYE), thus making them fully eligible for social security benefits, whilst also not being eligible for full employment rights (i.e. being a worker).

There is no statutory definition of self-employment, but it is established rather by case law. It is a bracket that contains workers such as freelancers, sole traders, contractors, sub-contractors and consultants. Workers who provide their services through a Personal Service Company (a limited company) are governed by the IR35 rules in determining their status. The same case law determines whether the person operating through a PSC is a 'deemed' employee.

The graphic below from the Resolution Foundation captures these differences.

Employment rights	Employee	Worker	Self-employed
Protection against unfair dismissal	✓	✗	✗
Maternity/Paternity leave	✓	✗	✗
Sick Pay	✓	✓	✗
Minimum wage	✓	✓	✗
Working Time protections and holiday entitlement	✓	✓	✗
Discrimination protections	✓	✓	✓ / ✗
Health and Safety protections	✓	✓	✓

5

The rate of growth of the self-employed has varied significantly by sector. The proportion of construction sector workers who were self-employed was already high in 2000 at around three in ten, now it is around four in ten. The marked growth in self-employment within the administrative and support services sector – including workers such as cleaners – is rarely noted on.⁶

Figure 1: Increase in self-employment by sector, 2010-2015

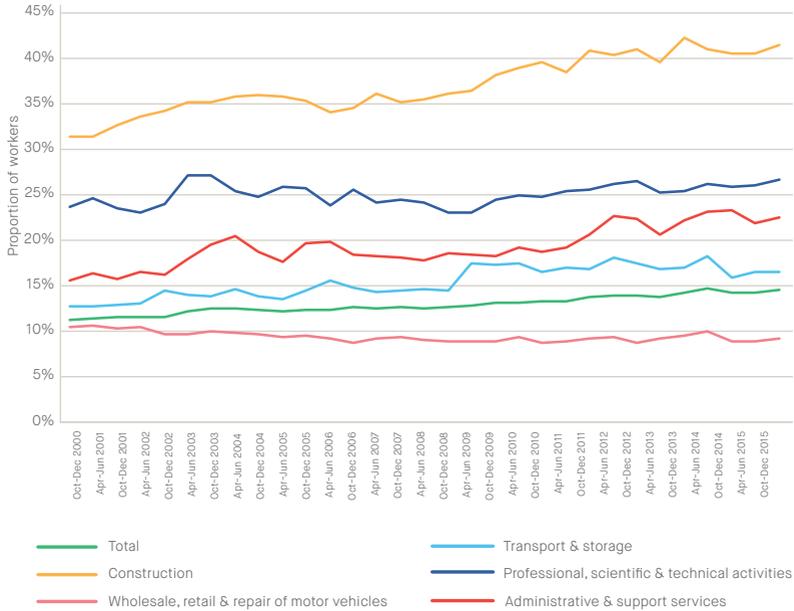
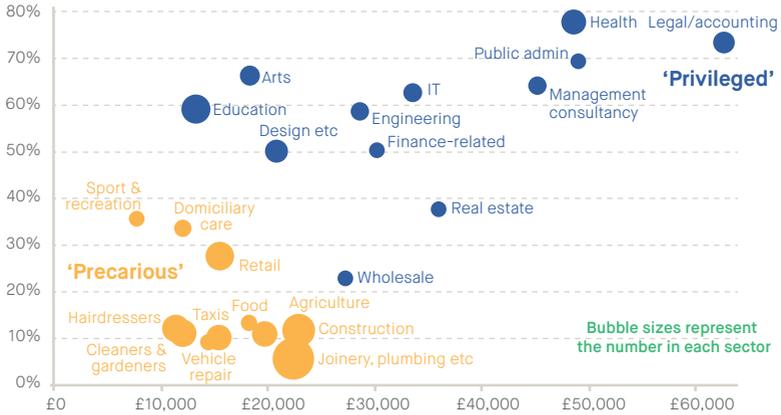


Figure 2 puts some colour around this. As the graph indicates, the self-employed workforce is hugely diverse by sector, qualifications and pay. Moreover, different definitions of self-employment lump together workers with otherwise quite different characteristics including freelancers, contractors, and owner-managers of businesses.

Figure 2: Diversity within the self-employed workforce – annual income versus proportion with degree-level qualifications (Resolution Foundation)



Within the self-employed group, therefore, there is huge heterogeneity. SMF research has shown that the sector includes people who have ambitions to turn their start-up into a million pound company, and people who just want a bit of flexibility and extra cash, perhaps as they near retirement age.⁷ The RSA, meanwhile, has defined six tribes among the self-employed.⁸ Within the wider definition of self-employment, a major distinction is by legal structure. A broad definition of self-employed comprises unincorporated sole traders, in which case the individual is liable for all associated risks and debts, or incorporated in which case the liabilities sit in the company and there is a shareholder structure. These two forms of self-employment contain often quite different workforces. Research by the IFS has shown that the self-employed are more likely to work part-time and much less likely to hold a degree-level qualification than incorporated small company directors, and, indeed, than employees.⁹

Table 1: Characteristics of employees and the self-employed (IFS data)

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

To add to the complexity, many of the self-employed workers are both employed and self-employed. Data from HM Revenue and Customs suggests that more than 5.5 million people report income from self-employment; and that almost 1.8 million of them – close to a third – also report income from employment.¹⁰

COMPLEXITY OF THE EMPLOYEE CATEGORY

Further complexity is added by huge variation within the ‘employed’ workforce. For instance, many people who are classed as employees for tax purposes are not paid directly by the person or firm who uses their labour. They are paid through a payment intermediary or ‘umbrella company’. In this position they may demonstrate some of the characteristics of an employee – for example, paying tax like an employee – while also demonstrating some features associated with the self-employed – for example, working on time-limited projects rather than in a fixed role, or experiencing unplanned gaps between projects.

It is easy to understate the size of these non-traditional forms of work. However, recent research has shown that 24% of the British population have worked as temporary agency worker at some point in their working life, 10% have been contractors and 11% freelancers.¹¹ Work, meanwhile, by the Resolution Foundation has also illustrated the growth of the agency workforce. There are an estimated 865,000 agency workers in the UK, including 340,000 in temporary agency work and 440,000 in permanent

agency work. Meanwhile there has been remarkable growth of workers on zero hours contracts who for tax purpose are treated as employees. ONS figures show that there were 905,000 such workers in Q4 2016 compared to only 108,000 in Q4 2004.¹²

HERE TO STAY?

This diversity is to be welcomed. Research by the Government and the RSA suggests that many self-employed workers report positive rather than negative reasons for becoming self-employed and that many are satisfied with work.¹³ The UK's flexible labour market has been identified as a principal factor in the country's ability to adapt to the last economic downturn and see off the threat of mass unemployment. It is also part of the UK's extremely positive employment story this decade, with record levels of employment.

The growth in self-employment and new forms of work should not be seen as purely a consequence of the economic downturn, filling in low-growth, low-paid jobs and a blip that will (or should) reverse. First, the rise since the financial crash has been driven more by higher paid and higher educated workers than by lower skilled and low paid individuals.¹⁴

Second, the changes observed in the UK are established and long-term. While relatively new gig economy firms have become the focus of public and media attention, the challenges thrown up by the distinction between self-employment and employment are longstanding, and one government study has concluded that rather than focusing on the short-term drivers the growth is better seen as a 'continuation of an existing, pre-downturn trend'.¹⁵ Gig working has been a characteristic of our labour market for a long time, across a wide range of sectors including public administration, education, social care and financial services, as well as the more obvious ones of construction and transport.

Third, we may envisage further change in the future. Higher levels of contracted workers and flexible staff may provide greater flexibility and ability to respond to demand. 'Futures' research by the UKCES reflected the importance of flexible working in the decades ahead.¹⁶ In its most recent

Economic and Fiscal Outlook, the OBR has projected the self-employment share of the workforce to continue rising by 0.1 percentage points a year over the forecast period.¹⁷ Important structural changes have occurred to the economy and are likely to continue having an effect.

- An **ageing workforce** is likely to mean growth in demand for flexible working and for phased retirement.¹⁸ Research from the ONS and the business department analysed people going into and coming out of self-employment. It found that over time there were fewer exits among older workers and concluded that 'recent growth in aggregate self-employment is in part related to workers managing their retirement in a different way to previously'.¹⁹ This is set to continue. Increases to the state pension age and the decline in generous Defined Benefit provision mean older people will have a stronger economic incentive to remain in work; improved health combined with the desire of many to work for non-economic reasons strengthen this case.
- **Emerging social norms among the younger workforce** may also dictate a more flexible, less structured workforce, though this is less certain. Research by the SMF has shown that half of Millennials have an ambition to set up a business of their own.²⁰
- **Technological developments** enable the coordination of self-employed workers more efficiently and may enable greater flexibility for workers by better matching demand for services to supply. Where previously this coordination could occur often only via an employer, this is no-longer the case. Technologies such as the internet may also significantly reduce the costs of entry to market because firms can trade from their home rather than having stores; new production processes such as 3D printing may further reduce the capital intensity in some businesses.²¹
- **Sectoral changes in the UK economy** – away from manufacturing towards services – have lowered barriers to entry (because in a service economy, an individual can contract their services without significant capital outlay). This compounds (and reflects) the effect of technological change.

CHAPTER 3: UNDERSTANDING THE DIFFERENCES BETWEEN THE EMPLOYED AND THE SELF-EMPLOYED

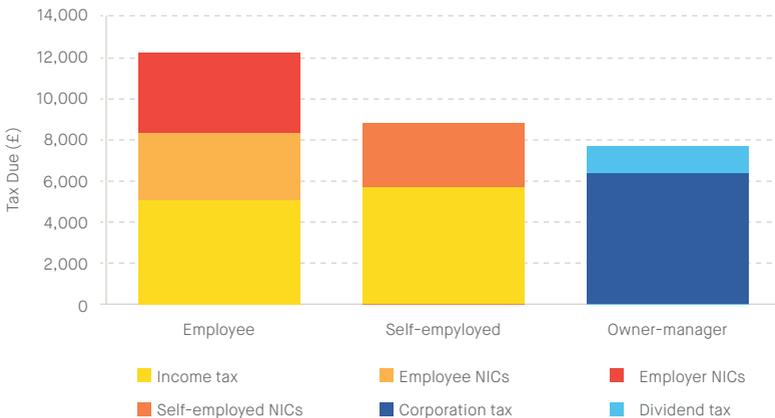
Chapter 2 described an increasingly diverse workforce, and the fact that there is no reason to expect this diversity to reduce in the years ahead. In this section we describe the dilemmas of our current employment divide.

DIFFERENTIAL TREATMENT ACROSS THE EMPLOYMENT DIVIDE

People face very different effective tax rates depending on their employment status

The costs of engaging labour vary significantly depending on the mode by which it is engaged. Recent analysis by the IFS has shown how tax rates differ between employees and the self-employed.

Figure 3: Tax due on total income of £40,000, 2016–17 (IFS)



As can be seen from the graph, there is a marked distinction between the treatment of employees and self-employed. Within the broader self-employed bracket, there is also differential treatment within the self-employed unincorporated (labelled in the graph as ‘self-employed’) and owner managers (incorporated self-employed), although this is more

marginal. Employer National Insurance Contributions account for the most significant discrepancy between employees and the self-employed. As the IFS notes, this may understate the difference in tax treatment as self-employed workers may be able to also claim tax relief on some business expenses (e.g. travel and subsistence) which other workers would not be able to claim. Historically, the differences in tax were reflected in much lower entitlement to social insurance and state benefits, although, as will be discussed below, this is now less stark.

Regulation may exacerbate the tax differences

This tax discrepancy is compounded by regulatory requirements that further increase the costs of engaging people as employees. Over time, the Government has introduced additional social obligations on employers, both entrenching a reliance on traditional modes of employment to fulfil social goals, whilst also exacerbating the differences between self-employment and employment. Three of the most important are:

- The National Living Wage (NLW) which applies to all workers aged over 25 and the National Minimum Wage for those under 25. The NLW is currently set at £7.50 and is set to rise to around £9 per hour by 2020. A large proportion of UK employees will see their wages rise as a result of this change.
- The Apprenticeship Levy applies a 0.5% payroll tax for employers whose wage bills exceed £3m per annum. Employers will receive a voucher which they can spend on apprenticeship training.
- Pension auto-enrolment requires employers to include employees in a workplace pension scheme as a default. Employers must make contributions to enrolled employees. This is currently 1% of salary but it will increase to 3% by 2019.²²

Combined, these add significant direct costs to engaging employees rather than self-employed labour. There are also a range of indirect costs that employers face when engaging employees such as holiday leave, statutory sick pay and redundancy pay. Research with employers suggests that these factors matter when decisions are made as to whether to engage self-employed workers or employees.²³

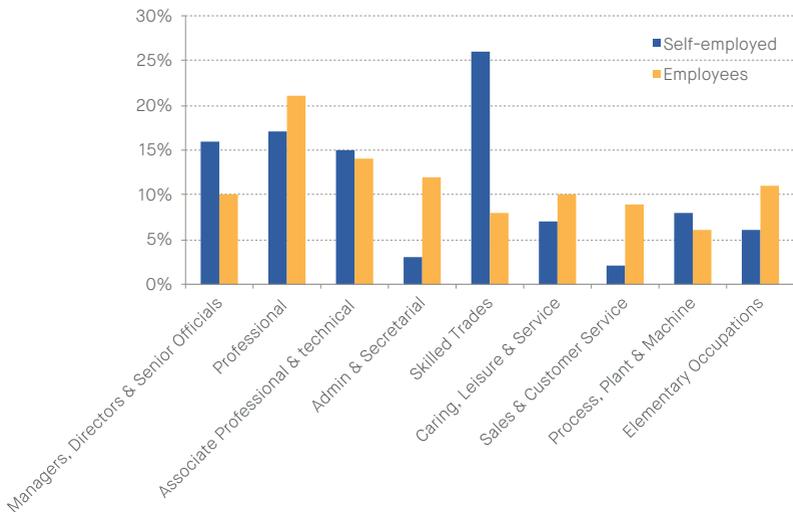
WHY DIFFERENTIAL TREATMENT IS PROBLEMATIC

Lower paid workers with a weak bargaining position may get the worst of both worlds

Variation within the self-employed workforce and the prevalence of low pay

In the first place, the situation is problematic because of the heterogeneity of the self-employed workforce. As described in Chapter 2, the category includes highly-qualified consultants and freelance workers along with self-employed workers who have lower qualifications than the average worker. From an individual’s welfare perspective, the state theoretically may not need to worry if the worker is able to bargain effectively with their contractor to ensure that they are remunerated properly and compensated for lower benefits. Traditional policymaking has assumed that employees need to be protected as the weak party in the employment contract, whilst self-employed workers are equal to their contractor.²⁴ But, looking at pay and occupations suggests the situation is not this simple.

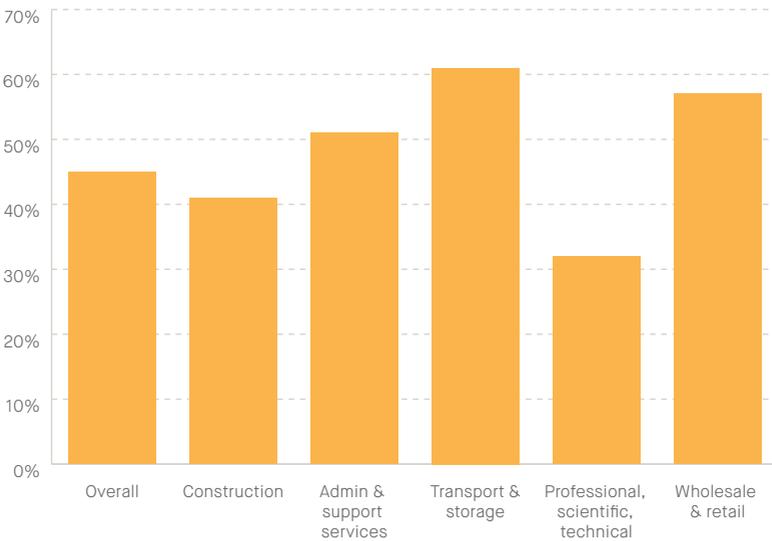
Figure 4: Distribution of employees and the self-employed by occupational grouping (main job) – SMF analysis of Labour Force Survey



As shown in Figure 4, the occupation mix is skewed towards the higher skilled end, compared to employees: 16% of self-employed are managers, directors and senior officials compared to 10% of employees; and 26% are in skilled trades compared to 8% of employees. At the other end of the labour market, 6% are in elementary occupations compared to 11% of employees, whilst 8% of the self-employed workforce is in process plant and machinery compared to 6% for employees.

Occupational breakdowns, however, may mask the extent of the financial pressures facing many self-employed workers. Previous SMF research has shown that around 45% of self-employed workers are paid below the equivalent of the National Living Wage rate per hour.

Figure 5: Proportion of self-employed estimated to be paid below the National Living Wage, 2016 (age 25+ only)



This is particularly alarming given that we would expect firms to pay a higher hourly rate to similarly qualified self-employed workers compared to an employee because the tax they have to pay is lower and the individual receives a lower level of protection. This may be the case for high-skilled

workers who are able to negotiate a good package; it does not appear to be the case for the lower skilled. Some workers may get pressurised into working as self-employed by dishonest firms that are trying to avoid tax or other responsibilities. Others may have few or no alternatives.

Lower levels of protection and benefits for self-employed workers

As noted above, the self-employed enjoy lower levels of social and employment protection than employees. Below we describe some of the vulnerabilities to which they are exposed in comparison to the employed workforce.

The self-employed have different entitlements to social security benefits. The most significant of these was historically the generosity of the state pension they received. This difference no-longer exists because of the introduction of the Single Tier State Pension which makes a more straightforward requirement of 35 qualifying years of National Insurance contributions. However, some important differences remain. The self-employed are not entitled to receive certain benefits, including contribution-based Jobseeker's Allowance. They are also not entitled to receive statutory pay for maternity, paternity, adoption or shared parental leave. Under Universal Credit they will also be treated differently to workers. After the first 12 months of their business, the Minimum Income Floor policy will make a blanket assumption that the worker is earning the equivalent of the minimum wage rate for 37 hours a week.²⁵ This will leave many without benefit income.²⁶

Beyond these specific social insurance and welfare benefits, we should think more broadly about the vulnerabilities to which the self-employed are exposed, and our analysis of the Labour Force (Q2 (April-June) 2016) Survey reveals some of these. First, the self-employed are less likely to receive training: 4% of self-employed workers received training in the 4 weeks before the survey, compared to 8% of employees. When self-employed do receive training, it is less likely to be on the job. In other words, they may be expected to train in their own time. This perhaps fits with our traditional conception of self-employment – training on the job suggests more control by the person paying for work – though it is likely to diminish the time self-

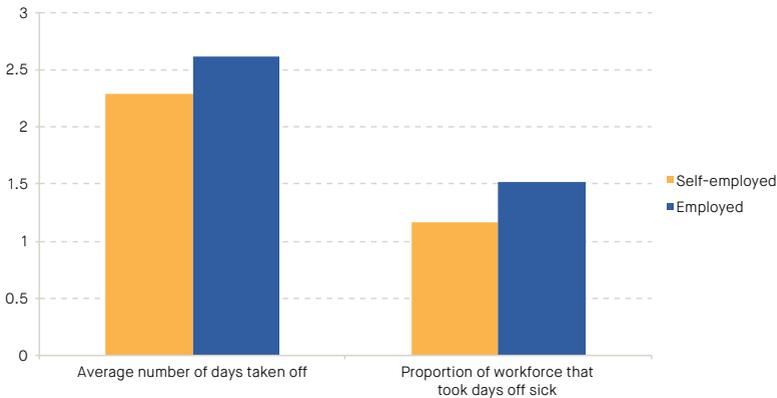
employed have to take on other work. It may also contribute to lower levels of training overall and therefore diminished prospects for progression.²⁷

Table 2: Proportion that received education and training on or off job (last 4 weeks)

	On	Off	Both	% of total
Self-employed	26%	61%	13%	4%
Employees	44%	35%	20%	8%

Our analysis of the LFS also shows that the self-employed are less likely to take days off sick. When they do take days off sick, as can be seen in Figure 6, on average they return to work quicker than employees. The reason for this is likely to be obvious: their sick days are unpaid. Although the self-employed have access to the Employment and Support Allowance this only becomes available after six days and is less generous than statutory sick pay let alone the higher levels of discretionary sick pay offered by many employers.

Figure 6: Average number of days taken off sick and proportion of population taking time off sick in the week of the survey



Finally, the self-employed are less likely to be saving: only 43% of self-employed are saving compared to 54% of employees. Many employees have workplace pension schemes, and, by the end of the decade, all employers will have to auto-enrol their workers into pension saving. Self-employed workers may invest in their business rather than save money into a pension scheme. But, the self-employed on this evidence face the prospects of lower retirement incomes than employees.

Put alongside our analysis of the pay and occupations that many self-employed occupy we may conclude that there are a proportion of workers who are well-remunerated and may receive higher pay to compensate them for any benefits and protections to which they are not entitled (whether as part of the social security system and as a consequence of not having rights to which employees are entitled to receive from their employers). However, there also appear to be many who are paid very low wages – below, note the levels that are the legal minimum for employees – *and* do not receive the benefits that go to employees. The latter group should be a particular focus for policymakers, especially as self-employed workers may be vulnerable to a weak bargaining position because they are not able to operate through collective bargaining (at least in its traditional forms). Moreover, as will be shown below, the complexity of the system itself may exacerbate the vulnerability of workers if they misunderstand what form of work they are undertaking. Our discussions with sector participants – those representing self-employed workers or contractors providing services to them – reinforced the idea that this part of the labour market should be thought of as an hourglass: a group of highly-paid, highly-skilled workers at one end and low-paid, low-skilled workers at the other end.

Potential for individuals and organisations to exploit the system

A second problem is that individuals and organisations may seek to exploit the uncertainty around the boundary between self-employment and employment. This has received significant media attention in recent years, for instance in legal cases involving Uber. Such cases have often focused on the difference in legal status between self-employment and ‘worker’ and whether such workers should be entitled to rights associated with this definition, rather than on the boundary in tax status between employees and self-employed.

There are significant opportunities for arbitrage (achieving a gain without taking any accompanying risk) by registering work as self-employed rather than employed. Not only do organisations pay no ‘Employer NICs’, they do not face costs around sickness pay, paternity and maternity pay. But, policymakers should also be alert to more subtle forms of arbitrage. For instance, thresholds apply to Employer NICs: below £157 weekly wage no employer NICs are paid. There is therefore an incentive for firms to engage two people part-time rather than one person full-time so as to avoid making these payments.²⁸

In fact, as the Low Income Tax Reform Group has pointed out, the business may be able to avoid other costs by employing workers on short hours. Employer contributions to auto-enrolment pension schemes – those on weekly earnings of below £192 do not have to be automatically enrolled – whilst employers may also be able to avoid liability for statutory sick pay.²⁹

It is possible to become too mathematical about this. It is also very difficult to find conclusive evidence of deliberate mis-classification. One source of proof would be a large number of successful legal cases brought against non-compliant firms. However, the complexity of the system, the costs of enforcement and the desire of HMRC to reach agreements with perpetrators limits this. The lack of visible enforcement is not an indication that all is well in the market.

Individuals mis-classifying

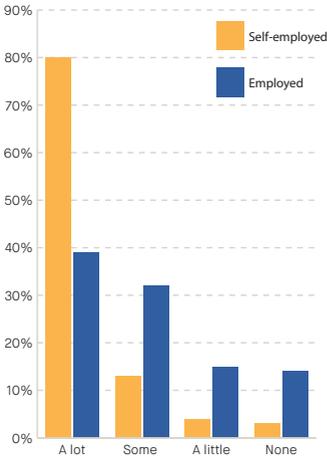
At an individual level, it is possible to identify mis-categorisation among workers. Our analysis of the Understanding Society dataset (Wave 4) sought to establish the extent to which those who identify as self-employed exhibit behaviours that we would typically associate with self-employment. For instance, we would expect such workers to report high levels of autonomy. This is important not least because the tax rules stipulate that, under IR35, workers that work under ‘supervision, direction or control’ should be categorised as employees rather than self-employed, and ‘control’ is frequently cited in case law.

Our analysis reveals that, on average, higher proportions of self-employed workers report autonomy compared to employees. As shown in Figure 7, 80% of self-employed report 'a lot' of autonomy over job tasks compared to 39% of employees. The same pattern is apparent in autonomy over hours: 68% of self-employed have 'a lot' of autonomy over work hours compared to 22% of employees. These are much more substantial differences than we observed, for example, on the number of working hours.

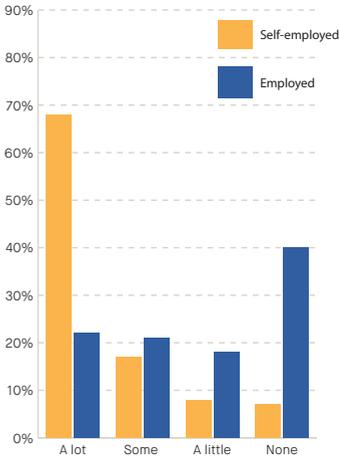
That said, there is nevertheless a significant proportion of self-employed experiencing 'some', 'a little' or no autonomy over either job tasks or work hours. The proportion is 1 in 5 for job tasks; and 1 in 3 for work hours. Some individuals (albeit a small proportion of the whole self-employed workforce) report having no control. The experience of these self-employed workers may be much more akin to that of the employed, suggesting that their employment status may not convey so much useful information about their actual conditions of work; and that the test of employment status may be failing as a way to reflect the underlying nature of the working relationship.

Figure 7: Proportion of workers citing autonomy

Proportion of workers reporting that they have autonomy over job tasks



Proportion of workers reporting that they have autonomy over work hours



These results could be interpreted in multiple ways. They could reflect mis-reporting of work status in the survey – and therefore an exposition of uncertainty (for more on this see below), of deliberate false engagement or of mistakenly registering under the wrong tax status. Alternatively, they could be read as demonstrating that a significant proportion of the self-employed do not enjoy the autonomy associated with self-employment; and yet also fail to enjoy some of the rights and protections that those in employment, with similar levels of autonomy, have access to. Other evidence also suggests mis-reporting occurs whether deliberately or mistakenly by individuals. Research by the Resolution Foundation identified 66,000 workers who were self-employed but who also ‘indicate that they are paid by an agency and do not administer their own tax and/or national insurance.’³⁰

As part of this research we carried out a survey of workers who are very likely to be caught up in the complexity. While the survey was not designed to be nationally representative we felt it was an important experimental technique given the shortage of data on this sector of the market. Specifically, we sent out a survey to workers via the member organisations of Prism – firms that provide payroll and other intermediary services. We received around 1,000 responses to the survey, and around 700 people responded to all the questions in the survey. The largest industry sector in the sample was construction, accounting for close to half of all respondents; followed by transport and storage and information and communication. Respondents were well distributed across the country. The average respondent earned above the national average for workers as a whole; and the self-employed in the sample earned significantly above, with the average being £31,360 after tax.

The first relevant finding was that 27% of respondents said that their employment status changes from one contract to another. This is likely to make planning as well as compliance with tax rules more difficult. When employed these workers will have tax deducted from their pay under PAYE; and then make a tax return on their other work. That is, if their perception that their employment status changes from one contract to another is correct. Second, 60% of the self-employed respondents reported that they currently use an umbrella company and a further 23% have done so in the past.

Those using an umbrella company are in fact employees, so these workers are mistaken about their employment status. It is easy enough to imagine how the confusion arises: these workers are likely to be searching for work themselves; switching between projects and firms during any particular year; and many of them have unplanned gaps when they switch. Hence their experience of the labour market is like that of a self-employed person even though they are treated for tax and other purposes as employed. When such large proportions of workers do not reflect their own correct employment status when asked about it, it is hardly surprising that we find uncertainty and complexity at the divide between employment and self-employment. As noted earlier, these results should be treated with caution: the sample was not designed to be representative of the UK labour market as a whole and intended very much to focus in on a particular segment of workers. But, they do indicate that further research is needed to understand workers who are caught in the grey areas of employment practice.

BOX 2: CASE STUDY: SELF-EMPLOYMENT IN THE CONSTRUCTION SECTOR

There have previously been concerns in the construction sector that engagers have an incentive to categorise workers as self-employed. The sector has been subject for some time to a special scheme (Construction Industry Scheme (CIS)), in which those who engage self-employed sub-contractors deduct a certain amount of money from payment, to be set against the sub-contractors' income tax and national insurance liabilities. The purpose of the scheme has been to ensure greater levels of tax compliance in the sector among the self-employed. Tighter rules in the mid-1990s were credited with removing part of the artificial incentive to set up as self-employed and resulted in a 10% reduction in the proportion of workers in the sector who were categorised as self-employed. Despite this, there are still advantages to engaging workers as self-employed (as described above). In 2009, the Government estimated that somewhere between 200,000 and 400,000 workers treated as self-employed in construction for tax purposes should be treated as employees given the working relationship they have with their engagers.³¹

More recently, concerns switched to the growing use of intermediary companies, paid by businesses for the services of self-employed workers. Intermediary companies have a potentially important role to play in providing specialist payroll and other services and providing a coordinating function. However, HMRC had concerns that, in some cases, the use of intermediary companies was motivated by other factors, and noted the proliferation of off-shore intermediaries.³² One potential advantage of hiring self-employed workers indirectly was that the business that ultimately engaged the worker did not have responsibility for determining the status of the worker. This therefore reduced the “risk to engagers of incorrectly engaging workers on a self-employed basis”.³³ This situation is exacerbated by recent changes to the tax relief on travel and subsistence. This removed the ability of those working through umbrella companies, those supplying personal services and those who are under SDC to receive tax relief.

In 2014, the Government estimated that false self-employment had resulted in 200,000 people in the construction sector and 50,000 others being wrongly categorised as self-employed in on-shore intermediaries.³⁴ UCATT has estimated that the annual lost revenues to HMRC through false self-employment amount to £1.9bn.³⁵

Uncertainty and market behaviour

Market behaviour also suggests that mis-classification has occurred. In an efficient market, engagers would use whichever form of labour best suits their business needs and competences. This may mean engaging self-employed workers directly; it may mean engaging workers through an intermediary company if that company deals with tasks more efficiently than the engager can; it may mean employing employees directly; it may mean using temporary agency staff. None of these are inherently better or worse than the other if the rules are fair and clear and if social obligations are fulfilled properly. However, complexity and uncertainty drive market behaviour.

The behaviour of a minority of non-compliant firms can potentially affect the functioning of the whole market. Small differences can make the difference between winning or losing a contract for instance in sectors such as construction, ICT and public administration. In these settings, firms and workers can win a competitive advantage by taking a risky approach to tax compliance, including by flexing the distinction between employment and self-employment. Firms that are deliberately non-compliant can claim a tax and regulatory advantage; they may also have lower costs of compliance. If those firms and workers are seen to get away with it, then others are faced with the choice of either imitating them or taking the risk of losing out on contracts. Throughout this project we heard examples of where potentially non-compliant practices had spread through an industry because the risk of not adopting these practices, in terms of the likely impact on business performance, was judged to be higher than the risk of adopting them. This applies to the intermediary sector as it does more generally to engagers. For instance, a non-compliant intermediary may be able to enter the market, exploit the system and then liquidate if pursued by HMRC.

Ambiguity also leads to inefficiency in the market in a different way: some employers take a risk-averse approach to compliance therefore adopting a sub-optimal means of engaging workers due to concerns of being on the wrong side of the boundary. Some employers feel that employment status represents a 'disproportionately large risk' from a tax and reputation perspective. Therefore they may act to reduce this risk by: paying all self-employed people by payroll; only engaging with self-employed individuals via their own limited company (because IR35 transfers the liability over to the limited company); or engage with an agency for the provision of workers. Conversely, businesses in the past have required individuals to incorporate as sole traders so that the employer does not have to take the employment status risk.³⁶

Ultimately, compliant firms lose out. Competitiveness in the industry is undermined because firms are competing not on their business strengths in the market but on the level of risk they are ready to take in relation to compliance and interpretation of the law. When firms mis-classify workers, the Treasury and taxpayer lose out.

It remains hard to be precise about the level of deliberate false self-employment rather than simple mistaken self-employment. The OTS concluded in its major review that 'at present, businesses and especially individuals find it difficult, if not impossible, to be certain of an individual's employment status.'³⁷

Uncertainty for workers and firms is likely to increase compliance costs; and therefore the premium for non-compliance. The complexity of the rules also means that enforcement is slow and changes to the rules may simply create new opportunities for non-compliance. In sum, the greater the distinction between tax treatment, the more weight is put on the clarity of the legal definition and the classification between employees and self-employed and on effective enforcement. This problem is not new. A paper published by the IFS at the turn of the century noted that 'There are workers who do not fit either of these two descriptions precisely, but lie somewhere between the two ends of this spectrum. They may be described as occupying a 'grey area' at the borderline of the classification divide.'³⁸

While policymakers have done their best to respond to market reactions and behaviours, too often this has simply sought to block off the latest undesirable practice. In turn each regulation has added more complexity and indeed sometimes perverse incentives of its own. The story is told well through the OTS chart of reforms (see Figure 8). It shows the number of reforms and market behaviours that have adjusted the boundary one way or the other. Neither is this a complete list nor an up-to-date one. Last year we had reforms to tax relief on travel and subsistence which provides a further incentive for individuals to be classified as self-employed.

Figure 8: Market and tax environment movements affecting employment status (OTS chart)

Regulatory changes causing new reporting obligations and/or increased tax liabilities, akin to employment tax consequences	
Changing market practices, in part to reduce reporting obligations and/or reduce tax liabilities, akin to self-employment	

Employment or quasi – employment tax consequences	Self-employment tax consequences	Market/tax environment change
		Construction Industry Scheme withholding requirements
		1988 agency rules placed recruitment companies at risk of PAYE
		Use Personal Service Companies to place the risk with the directors and away from agencies; also to reduce tax (for other drivers see above). Initially the high paid market
		1999 IR35 treats Personal Service Company owner/worker as deemed employee in some circumstances
		Use umbrella companies (leading later to concerns of forced self-employment), also composite companies
		2007 managed service company rules
		Use offshore intermediaries (eg supply teachers hired through Sark)
		Use personal service companies for low paid
		Offshore employment intermediaries rules
		Use of agency contracting structures to assist self-employed categorisation
		Onshore intermediaries rules extend circumstances when PAYE must be applied

The tendency, therefore, has been towards more rather than less complexity. A recent example is the Off-payroll working in the Public Sector policy. Off-payroll rules 'ensure that individuals who work through their own company pay broadly equivalent taxes as employees, where they would be employed if they were taken on directly'.³⁹ Due to concerns about non-compliance the Government's recent reforms moves responsibility for deciding on the application of the rules from an individual worker's PSC to the public sector body, agency or third party paying them. That organisation also becomes responsible for paying associated employment taxes and NICs.⁴⁰ Workers will now have tax subtracted at source as if they were employees for tax purposes. However, the OTS concluded in its response to the consultation that the 'proposals will not, overall, deliver simplification', citing concerns over additional administration, uncertainty about the status test results (which won't be binding) and distortions across the market as the rules will only apply to the public sector and not the private sector.⁴¹ There have been worries that it may reduce individuals' incentive to work in the public sector rather than the private sector. Trade bodies representing freelance workers and contractors have also warned of a risk-averse and blanket approach from public sector bodies towards treating all as employees despite there being many genuinely self-employed workers.⁴²

Uncertainty, tax and enforcement

As the Off-Payroll reforms indicate, the Government is concerned at the contribution that false self-employment makes to the 'tax gap' (the difference between what HMRC should expect to collect in taxes and what it collects in practice). The reforms are intended to raise £185m this year.⁴³ More broadly, the OBR and the Treasury have noted concerns that tax revenues are predicted to be lower than originally thought because of the fact that a larger share of the workforce are self-employed (and therefore paying lower taxes).⁴⁴

Closing the tax gap is not easy. If the differences in status are sufficient to incentivise certain behaviours to reduce tax liabilities or other responsibilities, enforcement plays a fundamental role in ensuring compliant practice. Yet, the more complex and uncertain the rules, the harder and more costly it is to enforce. Research participants noted that enforcement

needed to be more visible so as to discourage others from non-compliance whilst reassuring compliant firms that they could succeed in the market without taking risks on compliance.

Conclusions

This chapter has shown that:

- Depending on their status, workers are entitled to differing benefits and protections.
- The tax treatments of different forms of labour vary significantly. These are exacerbated by social obligations imposed on employers that increase the costs of traditional employment.
- The self-employed display vulnerabilities in a number of related areas, including low savings rates, low use of sick days, low levels of training and lower social security entitlements.
- It appears that there is a group of low paid workers who do not get financially compensated for the absence of benefits – they may have the worst of both worlds.
- Differential tax treatment incentivises non-compliant self-employment. Individuals may practice this. Some engagers and intermediaries may also practice this. This non-compliance undermines competitiveness in the market and can lead to organisations gaining market share simply because they are ready to take a more risky approach to compliance rather than because of any fundamental business advantage.
- Non-compliance is facilitated by the complexities and uncertainties that characterise employment law and practice. These uncertainties make enforcement simultaneously harder and more necessary.
- Revenue for HMRC is much lower than it otherwise would be.

CHAPTER 4: POLICY RESPONSES

Addressing these problems is hugely difficult. The solution cannot be to eliminate self-employment or restrict the scope of firms to engage labour flexibly. Flexibility brings significant benefits. If anything, we should be preparing for a more diverse labour market.

Based on the problems described in Chapter 3, we describe below how we should change the system so that it establishes:

- 1. Equal (or at least much more equal) tax treatment of labour.** This will be fairer and will remove the financial incentive for firms to arbitrage the system and for individuals to misreport. In so doing, this should be designed so as to make the UK's tax base more resilient for the future.
- 2. Equal (or at least much more equal) benefits and protections to workers whatever their classification.** This is the quid pro quo of (1). But, there will remain considerations as to how to deal with and fund non-tax issues such as private pensions and training.
- 3. Greater certainty for individuals and businesses.** This will reduce the opportunities for deliberate non-compliance, whilst reducing the uncertainties and administrative burden for those seeking to comply.
- 4. More visible and active enforcement.** This includes enforcing compliance whilst providing reassurance to compliant firms that the market is functioning effectively.
- 5. Better evidence to allow for better policy decisions in the future.** This will allow future policy to evolve better in step with the contemporary labour market and promote greater scrutiny.
- 6. Setting out an 'Employment Reform Plan'.** This long-term plan would set out all the steps for reform, including changes to tax and law as well as necessary changes to support systems such as to digital tax infrastructure.

THE NEED FOR A FUNDAMENTAL REVIEW AND A LONG-TERM STRATEGY

The consequences of our current situation are severe – for the individual who suffers welfare losses, for the taxpayer who loses money, and for the business who faces compliance costs and risks associated with competitor non-compliance.

Theoretically, we could respond by doing more of what we've done in the past more, just better. That may sound unappealing. It is. Each new regulation adds complexity, thus increasing the inefficiency in the market and often creating a new boundary around which unscrupulous firms can take advantage. Above all we must resist the temptation to plug the latest gap and instead address the underlying drivers of behaviours. In setting a long-term strategy, we should be aware that certain steps cannot yet be taken for political or practical reasons. But, we should at least set the direction of travel to help businesses plan for the future.

More or less

Broadly speaking there are two routes for reform. The first is to develop more categories of workers to better reflect the nuanced position they have in the market currently. This was proposed by some stakeholders in the OTS review of 2015, and we considered it in this project. For instance, an additional status could be created between 'worker' and 'employee'. In tax terms, a third form of employment could be defined in between self-employed and employed. Theoretically, one could envisage this middle form being populated by contractors who take on a succession of contract roles and Limb B workers. This could include establishing a new mode called 'single person limited company'.⁴⁵

Analysis by the OTS found that more than half of the countries looked at had more than two categories of employment, the most common being for freelancers or contractors. Often these were developed to provide fuller rights to workers who would previously have been classified as self-employed.

But, this would be the wrong path for three reasons. First, it would be a misreading of the UK's labour market. If the recent past suggests anything it is the unpredictability and fluidity of the market, based in part on legal and cultural flexibility unique to the UK. The status quo should not be viewed as any more permanent than the position we have moved from in the last ten years. This is especially so, given claims that the rate of technological change and advance robotics will continue apace. We may expect greater diversity of form in the future, and those structures may not look anything like the forms we currently have. It might be noted that one study concluded that the countries that have developed hybrid or additional forms of employment class are the countries that have the highest level of labour regulation laws.⁴⁶

A second argument against a third form of employment is that more definitions would quite likely mean more complexity. If the boundary between the work categories is where the problem occurs, then doubling the number of boundaries seems a strange logic. If in the past we have sought to contain employment forms in two modes, we would be left containing them in three modes. The UK already has three modes in employment law, but the boundaries are no less contested. As noted earlier, complexity is the friend of uncertainty, which is the friend of non-compliance.

Third, it is hard to see how any additional category of employment would not lead to lower revenues for the Exchequer. To be meaningful, the intermediate category would have a tax status that was in-between the employee and the self-employed. If this was the case, individuals would be likely to move (or be moved by their employer) to the intermediate category in greater numbers from the employee category than from the self-employed category. In other words they would move to a lower tax bracket.

An alternative approach would be to make the boundary less important. This could be done by equalising tax treatment, equalising benefit entitlements and providing firmer methods for interpreting the test. This is the argument that we develop through our recommendations.

1. CLOSING THE TAX GAP

The tax treatment of self-employment and employment differs markedly. Even on its own terms, it is illogical – differences in social security entitlements are now much narrower than they were and are dwarfed by the differences in taxation. The HMRC has estimated that in 2016-17 £5.1 billion is forgone through lower self-employed NICs.⁴⁷ The pressure that the tax differential places on the question of employment status is damaging. All other things being equal, levelling the tax treatment would reduce the incentive to mis-classify as self-employed and boost efficiency across the market.

Even over the five-year forecast period, the OBR predicts that the growing proportion of individuals that are self-employed rather than employed will result in reduced ‘overall income tax and NICs receipts by around £1 billion’.⁴⁸ Meanwhile, the HMRC estimated in 2013 that IR35 protected revenues of £550m.⁴⁹

Arguments in favour of equal treatment are not new.⁵⁰ The u-turn by the chancellor following the March 2017 Budget shows that moving to a new regime may be politically challenging in the short-term. However, we have not encountered any sound arguments for why the tax treatment of self-employment and employment ought not to be reformed in the long term. Given that the rights and protections associated with self-employment are in fact lower, then if anything the tax burden on self-employment should be higher, so that the state can provide the benefits which the firm does not. On the whole though, it would be much better simply to have no tax differential between the two employment statuses, allowing workers and firms to choose the status which is the best fit with the nature of the work.

Addressing the anomaly of Employer NICs at 13.8% is the most significant step. Three questions in particular will require detailed examination.

- **Designing the mechanism.** If the politics can be managed, self-employed NICs are easily resolved. The bigger challenge is Employer NICs. Levying these directly on workers, by increasing the individual’s NIC by 13.8%, would be impractical. It would also be undesirable as the visibility of the tax would reduce work incentives. A more feasible

proposition would be a “Hirers’ NICs”, with any organisation engaging labour playing a flat rate of NIC.⁵¹

- **Timing:** If introduced overnight the consequences could be significant including a combination of: firms competing down the prices that they pay contractors (although this would depend significantly on the level of competitiveness of the sector and the pool of labour supply); price rises for consumers and other businesses; and, potentially, unemployment. We recommend that the Government should establish the direction of travel for the taxation of the self-employed after the publication of the Taylor Review. We envisage that the equalisation of tax could take place gradually with taxes being raised by 2% per year starting in 2018. Setting the direction of travel is likely to have a positive effect on the market, discouraging firms from seeking to exploit the tax advantage.
- **Treatment of entrepreneurialism:** An argument is often heard from its representatives that a lower tax rate and more flexibility in terms of how taxes are managed are a necessary reward and incentive for risk-taking among entrepreneurs. However, as the IFS has shown, there are other ways of removing any disincentive for individuals working through incorporated companies to invest in their businesses which are more targeted on the issue in question rather than a blanket lower tax rate for all self-employed people. More broadly, if tax treatment is equalised, policies can be targeted specifically at entrepreneurialism.⁵²

Alongside this reform, the Government should commit to a moratorium on other changes to the employment status and tax treatment of workers on the borderline during the transition period.

Recommendation: *In 2018, the Government should introduce a ‘Hirer’s NICs’, this would start at 2% per annum and increase each year until parity was achieved with Employer NICs.*

2. EQUAL BENEFITS AND PROTECTIONS

In his Budget statement, the Chancellor spoke about his desire to equalise the benefit system so that self-employed workers are not disadvantaged compared to employees. He reiterated this in his letter announcing that the NICs increase would not go ahead.⁵³ While this is an important cause, care should also be taken that we do not undermine the value of employment. Many of the benefits for employees derive directly from employers. For instance, strictly speaking, maternity and paternity pay are statutory employment benefits rather than funded from the National Insurance Fund. However, the aim should be to correct clear anomalies and to address the most significant vulnerabilities of the self-employed. International comparisons suggest that the UK is by no means unique in having lower benefits for the self-employed.⁵⁴

Benefits and insurance

As noted earlier, the most significant discrepancy has been removed with the introduction of a Single Tier Pension. However, anomalies remain within the strict parameters of the social security system. In addressing these, there is a spectrum of policies: private provision; private provision with government incentives or nudges; voluntary social insurance; and, compulsory social insurance. Given the nature of different markets, we propose a mixture of responses.

Maternity and paternity entitlements

Currently, the self-employed have access to Maternity Allowance, which pays £139.58 a week or 90% of your average weekly earnings (whichever is less) for 39 weeks. In contrast, employees get Statutory Maternity Pay which is 90% of average weekly earnings (before tax) for the first 6 weeks, then £140.98 or 90% of average weekly earnings (whichever is lower) for the next 33 weeks. The difference is generosity and it is not clear why this differential exists. Employees can receive statutory Paternity Pay at a weekly rate of £140.98, or 90% of their average weekly earnings (whichever is lower) for two weeks. The self-employed are not eligible.

Maternity and paternity are lifecycle insurance schemes which do not suit voluntary enrolment. Voluntary schemes would be vulnerable to adverse selection with people who already had children or had no intention of having children opting out, thus raising premiums and undermining the collective insurance approach.

Contributory JSA

Self-employed workers are not entitled to Contributory Job Seekers Allowance (JSA) but only to means-tested JSA. For instance, this means that if they have more than £16,000 in savings then they are not entitled to support. International evidence shows that countries operate a range of alternative schemes or opt-ins. Any attempt to include self-employed workers would have to ensure a reasonable qualifying period or waiting period before the benefit could be claimed.⁵⁵

Sickness cover

Employees are entitled to Statutory Sick Pay at £88.45 for 28 weeks (although many individual employers pay more) once they have been sick for 4 days or more. In contrast, the self-employed have entitlement only to Contributory Employment and Support Allowance of £73.10 per week, with first payment made after seven days.

The differences in this sense look modest. However, our analysis of the LFS shows that the self-employed are less likely to take time off sick. Interviews with low paid self-employed workers by the SMF also show the difficulties caused by short-term illnesses and the requirement to carry on working in the absence of cover. The problem therefore is both short-term and long-term cover. There are already a number of insurance schemes and cooperatives which the self-employed can join.⁵⁶ The challenge is increasing participation whilst guarding against adverse selection. Low take-up of non-statutory sick cover is not peculiar to the self-employed: previous research by the SMF has argued that the UKs workforce would benefit from higher levels of cover for long-term illness and disability.

As a starting point, the Government could establish additional voluntary contributions that provide cover for maternity entitlement as well as more generous sick cover from day one (assuming external validation) and contributory JSA. There is already a voluntary contribution rate (Class 3) which exists to allow people to top up their state pension. Bringing these benefits together may help reduce the impact of adverse selection (because the premiums will reflect risks across a range of markets). The Government should look to review take-up of voluntary insurance across the market to evaluate the effectiveness and value for money of this initiative.

Recommendation: *Any increase in tax for engaging self-employed workers should be accompanied by more generous social security benefits and matching the statutory benefits that employers would make to employees. In the absence, of tax reform the Government should create a voluntary Class 3 contribution which would entitle such workers to parental rights, sick leave and Contributory JSA.*

Private pension provision

Saving for a pension is less common among the self-employed than employees. This discrepancy will become more marked as auto-enrolment is fully rolled out across workplaces over the next few years. Auto-enrolment is designed around the employer as the route to nudging people into the habit of saving. It is remarkably successful.

The Conservative Party has committed in its manifesto to make auto-enrolment available to the self-employed. The question is how best to mimic the mechanism. This could be done through the self-assessment tax return, when individuals could be 'nudged' into saving like employees. This could constitute either a soft or hard nudge:

- Self-employed individuals could be warned that the typical worker puts away the equivalent of 8% of their earnings into a private pension. The individual could then be presented with an easy path to invest money into a pension before reconciling their tax, either making a lump sum payment or a direct debit payment into an authorised auto-enrolment scheme.

- Alternatively, a private pension payment could be deducted automatically through the tax calculation, with the individual having to proactively opt out of the payment when completing the process. This is likely to be a more effective policy.

These approaches should be trialled by the Behavioural Insights Team. In either instance, efforts should be made to make the most of the tax relief that contributions enjoy and the loss that would be incurred by not making pension payments.

Some may consider these interventions excessively paternalistic. But, given the diversity of the self-employed workforce, there is no reason why the government should not intervene for the self-employed as with the employed, even while it remains important for the self-employed to have the final say over what to do with their money (they may for instance want to invest in their business).

Recommendation: *As part of the DWP's auto-enrolment review, the Government should opt workers into pension saving.*

Recommendation: *In introducing such reforms, the Government could design a 'Self-employed Benefits Package' (including Statutory Maternity Pay, contributory JSA and sick leave insurance) which was made available to workers who saved into a private pension at a given minimum contribution rate. This would provide an additional incentive and a quid pro quo, with a message from the Government: "If you look after yourself, we will help". The Government could devise an exemption for low paid workers.*

Training

Our evidence shows that the self-employed are much less likely to receive training than employees. There is a danger that this position may worsen, with the increasing focus on employer-led skills and the Apprenticeships Levy leaving little attention for the training and development needs of self-employed workers. Yet, we know that the self-employed workforce comprises occupations of many different types and that many self-employed workers struggle to find opportunities to progress. Other SMF research has shown that training is an intervention that can help lower paid self-employed workers progress their earnings and their businesses.⁵⁷

Recommendation: *The self-employed are in danger of being over-looked as the focus of adult skills switches to apprenticeships. As with small employers, the self-employed should be eligible for a Training Voucher that can be redeemed if the individual undertakes training. The process could be managed through the self-assessment tax form.*

Regulatory protection

National Living Wage

Dispensing with the dual tax regime is likely to lead to more predictable and efficient behaviour. Regulatory differences would still remain. Some of these are inherently problematic to deal with, such as holiday pay and redundancy pay.

However, the Government should consider whether there are means of applying the principle (if not the regulation) of the minimum wage for self-employed workers. As the National Living Wage rises to £9 by the end of the decade, the incentive for firms to engage workers outside of this framework will grow stronger. Past SMF research has shown that a large proportion of self-employed workers are currently paid below the NLW hourly rate. A first move into this territory could be requiring firms to estimate the median hourly pay of their workers and estimate the number of workers paid below the equivalent of the NLW and to disclose this information. This transparency would help maintain social pressure on firms to pay reasonable rates, help potential contractors understand the deal and enable consumers to make choices about which services they use based on fuller information. It would also over time provide a mechanism for accreditation by the Living Wage Foundation (which develops the Living Wage accreditation for employers). We suggest that the Government should engage with business groups and campaigns such as the Living Wage to assess how calculations could be made. Although this would only constitute a small regulatory cost to firms, we believe that it should be limited, at least in the first instance, to organisations engaging more than 50 workers.

Recommendation: Organisations should be required to estimate the average hourly equivalent payment for workers and estimate the number of workers who are paid below the equivalent of the NLW, and to disclose this information. This should apply in the first instance to organisations engaging more than 50 workers. The Low Pay Commission should be asked to oversee and scrutinise this process. Ahead of implementation, the Government should consult with contracting organisations, workers, trade unions and others on how best to devise the rules.

3. GREATER CERTAINTY FOR INDIVIDUALS AND BUSINESSES: RE-THINKING THE BOUNDARY

Our third set of recommendations is targeted primarily at the issue of uncertainty. Many workers do not correctly identify their own employment status; and there is a divergence between what the firms who use their labour may be reporting and what the individuals believe. Uncertainty brings compliance costs to businesses. Ambiguity creates room for non-compliance, which undermines competitiveness in the market. Greater certainty should also, all other things being equal, increase tax revenues for the Exchequer as non-compliance falls and enforcement becomes easier.

We explore three lines of enquiry:

- a) **Changing the test** itself to make it easier to interpret.
- b) Establishing basic **rules of thumb** that protect the interests of vulnerable individuals.
- c) Better use of **tools**.

a) Changing the test

The UK's rules on employment and tax status are confusing. But, then so are the rules of many countries. While no country has rules that eliminate uncertainty, analysis by the OTS highlighted the USA as a jurisdiction where the test functions comparatively well. In the USA, the ABC test has three

criteria for determining status, with the default being employee.⁵⁸ Similar to the UK definition, the distinction is determined by the nature of the work rather than time served or value of contracts, including:

- (A) whether the workers is free from direction and control in the performance of the service *AND*
- (B) the work is outside the usual course of the employer's business OR the work is outside of the employer's place of business *AND*
- (C) The workers is customarily engaged in independently established business of the same nature provided.

While the rules are different from the UK's, the focus on 'control' is common ground. International evidence suggests that the UK will not be able to create a definition which removes uncertainty entirely. However, we recommend that the Government pursue the OTS's recommendation of establishing a legal employment status. This could bring clarity as well as an opportunity to revise the current definitions. Clarifying employment status would also provide an opportunity to reconsider the role of IR35, which in the view of the Treasury's expert advisory body is 'not working' and 'unlikely ever to work practically'.⁵⁹ In doing so, the Government should look in depth at the characteristics of those who are on the boundary of employment and self-employment, including contractors and those working through intermediaries.

Recommendation: *The Government should carry out a strategic review of the employment status definition with a view to establishing a new legal definition which is simpler and easier to enforce.*

b) Rules of thumb

It would be possible to introduce special rules of thumb that help protect the individual or the taxpayer. International practice shows that these rules can apply to: the nature of work engaged, the length of time the worker is engaged, the value of the work, the value of the work as a proportion of the worker's annual earnings and the payment schedule.

For instance, Italy has historically had high levels of self-employment compared to the European average. To manage the divide between self-employment and employment, Italy has adopted much more hard and fast rules on when a worker will be defined as being in employment. Regardless of what the firm may claim, an individual can claim misclassification and demand to be treated an employee if two of the following three conditions are met:⁶⁰

- The relationship by which labour is provided by the worker to the firm lasts for more than eight months during two consecutive years.
- Earnings from the specific relationship are more than 80% of the annual earnings of the worker during two consecutive years.
- The worker has their own permanent desk at the office of the firm.

Such rules can strengthen the bargaining position of the worker where this otherwise may be weak. They could be developed around the proportion of income that the individual derives from a single workplace and the length of time that they have spent working there. This approach does not deal directly with better paid workers who may, like the firm, have an incentive to pursue self-employed classification. However, we believe that this could be a useful first step and that it may develop lessons that can be rolled out to higher paid workers as well.

In designing such a policy, care should be taken to ensure that perverse incentives are not created for firms to game the rules. For instance, a simple time-served threshold might be vulnerable to employers ending contracts or employment just before the deadline and then re-engaging the worker. One option would be a 'Nine Month rule': that where an individual receives 75% of their income (the equivalent of working for nine months with them full time) from one firm and he / she is engaged for more than nine months in two consecutive years that they should be able to claim misclassification.⁶¹

Recommendation: *The Government should look to establish a new rule which would allow individuals to claim mis-classification as self-employed where they meet specific conditions. As a starting point, we propose that 'Nine Month rule' could be consulted on: where an individual receives 75% of their income (the equivalent of working for nine months with them full time) from one firm and they are engaged for more than nine months in two consecutive years.*

c) Better tools

In 2016, the Government committed to improving its Employment Status Indicator following criticism from the OTS.⁶² Currently there is a presumption that if the tool is completed accurately then the HMRC will stand by the result.⁶³ The principal problem remains the fact that ambiguity about interpretation of employment law undermines the usefulness of the indicator as a tool. However, if the definition is tightened up then greater weight could be put on the tool, including making it mandatory for certain categories of workers. For instance, the Government could require that all individuals who earn a given amount from a single client must complete the tool. Such an approach could allow enforcement activity to be better targeted as well as potentially increasing the tax take for the Treasury.

Recommendation: *The Government should consider making the Employment Status Indicator tool compulsory for workers earning more than a set amount from a single client. For the sake of simplicity, the Government could establish this at the income tax allowance threshold of £11,500. The HMRC should consult on the minimum earnings requirement and the mechanism by which it could be made a mandatory requirement.*

4. POLICING THE BOUNDARY

Addressing uncertainty will, in and of itself, make policing easier and more effective as there will be less ambiguity for unscrupulous firms to exploit. We remain convinced however that a greater focus on enforcement and more visible enforcement would also help provide greater confidence to compliant firms as well as discouraging firms from taking excessive risks with compliance. Other work in the sector has also emphasised the importance of exposure and penalties for tax avoidance.⁶⁴ As such, enforcement has a major role to play in pre-empting market failure. HMRC needs to enforce and be seen to enforce.

Recommendation: *The Government should commission a study to assess the straightforward net cash savings achieved for each additional pound spent on enforcement of employment tax status. This should be used to help the Government assess the level of additional resources that can be directed at the issue.*

Recommendation: *HMRC should make a virtue of visibility. While there may be instances where HMRC wishes to settle out of court with non-compliant firms and individuals, it should, nonetheless publicise information on how many firms and individuals have been pursued successfully, how and why the misclassifications occurred and the value of the money recovered, together with any losses. Given the importance of this question for the UK tax base, HMRC should publish this annually and feed it into the OBR's Fiscal Sustainability Report.*

This information would promote better external scrutiny as well as demonstrating to non-compliant firms and compliant firms that effective action is being taken.

The Government should consider setting HMRC a target to bring case(s) forward by the end of 2018, with the scrutiny provided by the Public Accounts Committee.

5. BETTER EVIDENCE FOR POLICYMAKING

Policymakers should become much better informed about the groups of workers who occupy the blurred space between self-employment and employment; and the firms who use their labour. As we have observed, many of these workers do not know themselves which side of the divide they really fall on. And none of the datasets we looked at provided objectively valid ways of making the divide, other than by relying on what workers state as their employment status. When completing its study of IR35, the OTS concluded that the data simply was not there for it to make an informed and complete judgement on the effectiveness of the policy.

We are not aware of any holistic attempt by Government to provide a richer understanding of the groups of workers we are talking about; and the timeline of the Taylor review may make it hard for that body to instigate any major new data collection.

Recommendation: *The Government should request the ONS to carry out an audit of available data on self-employment, including administrative and survey-based information. A study should also be commissioned to assess how the UK's data on self-employment compares with other advanced countries.*

6. SETTING OUT AN ‘EMPLOYMENT REFORM PLAN’

Finally, the Government must consider the sequencing of reforms. This includes helping prepare the market ahead of the introduction of reforms as well as getting the necessary systems in place. We believe that particular attention should be given to:

- **Providing advance warning of tax and regulatory changes:** The market reaction to the Soft Drinks Levy suggests that businesses may adapt their practices in advance of tax reform, in this case with firms seeking to reduce their exposure to the tax by reducing sugar levels ahead of the introduction of the change.⁶⁵ The Government can take advantage of this effect as well as providing greater certainty to businesses on the direction of travel. Two other instances are worth noting. First, in the case of the National Living Wage the Government set a target date for full implementation of the reform five years ahead. In 2016, the Government published a ‘Business tax road map’ which set out the principles for its business tax policy as well as the direction of travel for tax rates.⁶⁶ For instance, it confirmed that corporation tax would fall to 17% by 2020.

This approach should be mirrored for employment and self-employment tax reform, including a ten-year strategy for change: an ‘Employment Reform Plan’.

- **Digital tax system:** Multiple job holders can find themselves administering multiple tax forms. Individuals can also find themselves stuck on the wrong tax band and overpaying or under-paying tax. The Conservative Government’s initiative ‘Making Tax Digital’ (MTD) aims to make the process of paying tax and being compliant easier, more straightforward and more flexible. Reforms such as tax in real time and having a single tax account are needed to fit with the modern nature of work. These reforms are scheduled to be in place by 2020 – but are necessary building blocks for a new tax regime. The MTD policy should also help reduce the tax gap and increase the reliability of revenue from the self-employed.⁶⁷

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