Ending the self-employment tax break

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May 2013

CENTREFORUM

Summary

Self-employment is currently taxed at a lower rate than employment. The self-employment equivalent of employee National Insurance (NICs) has a main rate of 9% rather than 12% and there is no equivalent of the 13.8% employer charge levied on wages. Both of these are little more than extra income taxes.

The introduction of the single tier pension will end the only significant difference in benefit eligibility between the self-employed and employees. Aside from a small disparity in Jobseeker's Allowance, there is no compelling reason for the self-employed to pay any less into the system. The large tax differential leaves the door open to tax avoidance and benefits the richest most.

The tax break is worth £1.6bn at present and we estimate this will rise to £2.3bn following the anticipated pension reform. To ensure parity, and account for complications caused by employer NICs, the ideal solution would be to levy an equivalent of employer NICs on self-employment income, followed by standard income tax and employee NICs on the remainder. Alternatively, any increases in the current 'Class 4' rates, up to a main rate of 20.2% and an additional rate of 9%, would be at least broadly fair.

'Class 2' NICs should be scrapped. This poll tax of £141 per year for most self-employed workers is a regressive and unnecessary complication, and raises almost no revenue. Given that the self-employed already get a tax break, the fairest way to fund this would be to raise the main Class 4 rate from 9% to 10.5%.

Ending the £2.3bn self-employment tax break would be a fair way to reduce the deficit. However, we model using this revenue to increase the NICs thresholds for all. Even spread across the entire population, this would leave employees £110 per year better off. By scrapping Class 2 and increasing the point at which NICs are payable, the poorer 50% of self-employed workers would also be winners or unaffected, despite the increase in rates.

The broader picture

Over 4.2 million people in the UK are self-employed in their main job.[1] This number has increased substantially during the recession, rising by 10% between 2008 and 2012 while the number of employees has fallen.

There is some debate as to whether this increase is a good thing. Ministers can claim that the number of businesses has increased: 72% of the UK's private sector businesses are in fact self-employed sole traders or partnerships with no employees.[2] Self-employment has also helped to keep unemployment figures down, accounting for 40% of new jobs created since early 2010.[3] For some, the move to self-employment is positive and liberating. On the other hand, it has

1 A further 0.3 million are self-employed as a second job www.ons.gov.uk/ons/dcp171776_298533.pdf

2 62.7% sole proprietorships and 9.3% partnerships. A further 2% are companies with a sole employee as director. www.gov.uk/government/uploads/system/uploads/attachment_data/file/80247/bpe-2012-stats-release-4.pdf

3 www.tuc.org.uk/economy/tuc-21841-f0.cfm

been claimed that, "For most people, becoming self-employed is a bad idea"[4], representing underemployment, higher debts,[5] and a decrease in security.

As a corollary, self-employment covers a huge range of sectors, lifestyles and incomes. The median self-employment income is lower than that for employees, and has been decreasing for some time.[6] But at the other end of the scale, the self-employed are over-represented amongst those on the highest incomes. The self-employed make up 7.5% of basic and higher rate taxpayers, but over 19% of additional rate payers – those with incomes above £150,000.[7]

What is clear is that the tax system does not treat self-employment income the same as income from employment. This paper argues that self-employment income is treated too generously, even after accounting for (ever-diminishing) differences in benefit entitlement. Ending unjustified tax breaks should be near the top of the list of ways to reduce the deficit. This is especially true if doing so also makes the tax system simpler and more rational, and removes opportunities for tax avoidance. Reforming self-employment taxation meets these ideals.

Current tax differences

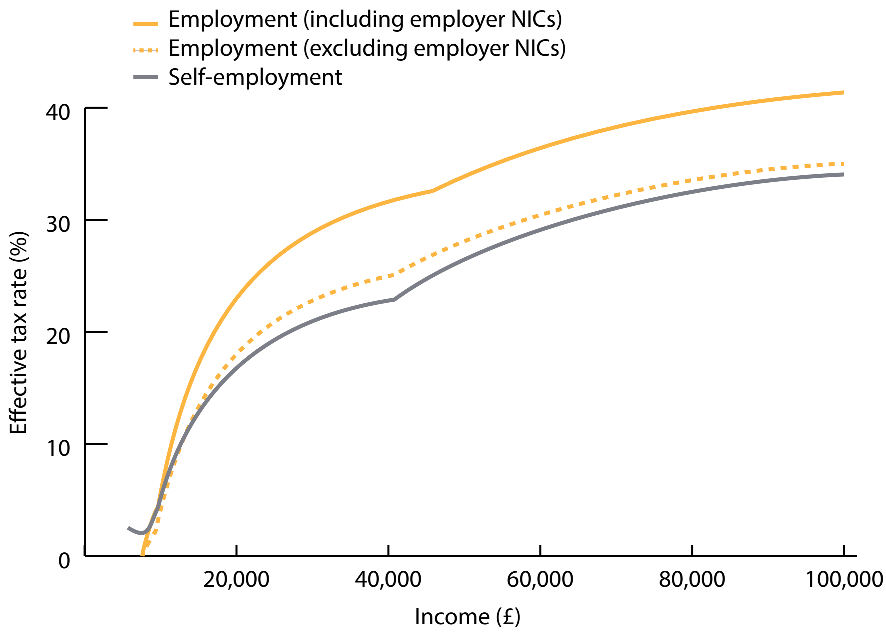
Alongside income tax, the UK's labyrinthine tax system has four main types of National Insurance, with two applying to wages and two to self-employment income.[8] Table 1 shows the rates set for 2013/14,[9] and the income thresholds at which the main and additional rates begin (note that some rates decrease at higher incomes).[10]

Though a broad discussion of the nature of National Insurance Contributions (NICs) lies outside the scope of this paper, it is taken as read that employer NICs is largely equivalent to a tax on

Table 1 - National Insurance Rates and thresholds (2013/14)

	Starting threshold	Main rate	Additional rate (above ~£41,500)
Class 1 primary ('employee')	£7,769 (£149/week)	12%	2%
Class 1 secondary ('employer')	£7,717 (£148/week)	13.8%	
Class 2 (self-employed)	£5,725	£2.70/week	
Class 4 (self-employed)	£7,755	9%	2%

Figure 1 - Effective tax rates for employed and self-employed workers (2013/14)



employees - both leading to a reduction in take-home pay (as supported by the literature).[11] This paper will refer to the value of someone's labour: how much their services are worth to another party.[12] The labour value of a self-employed individual is simply their pre-tax income (profits). But an employee's value to their employer and customers is their wages plus the employer NICs on these. This distinction between pre-tax labour value and headline income is an inevitable confusion caused by employer NICs, and is key to understanding the differences between employment and self-employment taxation. Any fair comparison must look at the total tax paid, including employer NICs.

4 David Blanchflower CBE www.newstatesman.com/blogs/david-blanchflower/2011/03/public-sector-workers-business & see flipchartfairytales.wordpress.com

5 www.independent.co.uk/news/business/news/small-business-owners-owe-over-30000-on-average-7627648.html

6 www.newstatesman.com/economics/economics/2012/08/perhaps-iain-duncan-smith-will-accuse-me-peeing-data

7 www.hmrc.gov.uk/statistics/personal-incomes/tables3-1_3-10.pdf Figure 2.9 +Table 3.4

8 Alongside Class 1A (for benefits-in-kind), Class 1B (for PAYE settlement agreements) and Class 3 (for voluntary contributions).

9 The additional NICs rate should not be confused with the additional rate of income tax, which kicks in at £150,000.

10 Those over pension age are excluded from National Insurance, aside from employer contributions.

11 www.bankofengland.co.uk/publications/Documents/quarterlybulletin/qb020402.pdf

12 This might also be considered to be someone's 'pre-payroll-tax income'. There is a need for a better, standard term for this concept.

Table 2 - Examples of tax differences

	Worker's gross pay	Employer NICs	Total cost to company	Income tax and non-employer NICs	Disposable income after NICs and IT
Employee	£20,000	£1,700	**£21,700**	£3,580	**£16,420**
Self-employed	£20,000	£0	**£20,000**	£3,360	**£16,640**
Employee	£60,000	£7,220	**£67,220**	£18,240	**£41,760**
Self-employed	£60,000	£0	**£60,000**	£17,230	**£42,770**

Figure 1 shows the effective tax rates for employed and self-employed workers on a range of incomes, caused by the marginal rates in Table 1.[13] An effective tax rate of 10% for someone with a labour value of £10,000, for example, means they have paid £1,000 in tax and their disposable income is £9,000.

If we ignore employer NICs, the gap between the self-employed and employees does not appear overwhelming. That said, every one percentage point difference in effective tax rate at £40,000 makes an employee £400 worse off than their self-employed equivalent, for example. But, again, we must account for employer NICs – just as HMRC do when assessing this tax break. Comparing like-for-like labour value, we see a very substantial gap, with many employees facing a 10 percentage point higher effective tax rate than an equivalent self-employed worker. An employee doing £30,000 worth of work is taxed at around 30% while the same self-employment income would be taxed at 20%. A self-employed person would need to earn around £70,000 to pay the same tax rate as an employee on £30,000 (though not the same amount of tax). The self-employment tax break benefits those on the highest incomes most: at the lowest incomes the self-employed are taxed more heavily than employees (as discussed later), while someone on £100,000 gains over £7,500 compared to an equivalent employee.

Such a large tax difference inevitably distorts choices of employment status, and is open to abuse. While employment status is determined by working conditions, rather than by ticking a particular box, these conditions may be chosen with an end in mind. Self-employment involves a number of pros and cons for both worker and company, but tax undoubtedly influences these decisions. As Paul Johnson, Director of the Institute for Fiscal Studies (IFS), told MPs, "The current way of treating the self-employed for National Insurance is a huge open invitation to tax avoidance, because it is so much lower than you pay as an employee. Therefore, there is a very large incentive to be self-employed or to claim you are self-employed."[14] For illustration, Table 2 compares the tax aspects of a company's choice to hire either an employee or a self-employed contractor.[15]

In these two examples, the tax bias towards self-employment is clear. Compared to hiring an employee, the employer pays less and yet the worker also takes home more money. In practice, the employer may need to pay more to a self-employed individual than an employee, to account for differences in worker rights and company benefits, but the tax system should seek to provide a level playing field before these considerations, rather than counteract them by subsidising self-employment. The tax difference is an added incentive – in addition to immigration rules and pre-tax savings – for unscrupulous employers to bend or break the law by taking people on as self-employed workers but imposing working conditions identical to those for employees.[16] It has potentially played a role in the recent flow from employment to self-employment, with the attendant loss of rights and government tax revenues.

The differences in tax treatment additionally put more pressure on defining the employment - self-employment boundary. As the Office of Tax Simplification says, this "has always been difficult and confused", and resorting to case law "is time consuming", "costly" and "uncertain".[17] Providing an exploitable tax differential leads to additional complex rules to try to prevent abuse, such as the much-loathed IR35 legislation for personal service companies (the incentive towards incorporation and dividend payments is briefly discussed later).

13 When including employer NICs, 'income' - on the X axis - refers to labour value.

14 Oral evidence to Work and Pensions Committee, Single-tier State Pension report, www.publications.parliament.uk/pa/cm201213/cmselect/cmworpen/1000/130227.htm

15 Using 2013/14 taxes. Rounded to nearest £10.

16 See The Mirror's 'Gizza Proper Job' campaign, "calling for more rights for "self-employed" people who are treated as staff" blogs.mirror.co.uk/investigations/2012/01/restaurants-could-hire-british.html & TUC www.tuc.org.uk/workplace/tuc-18234-f0.cfm

17 www.hm-treasury.gov.uk/d/ots_small_business_interim_report.pdf

Removing the difference in rates "could take a good deal of the pressure out of the employment and self-employment boundary".

The next sections rebut some possible justifications for the tax break, and look at just how much it costs the Exchequer and employee taxpayers.

Potential justifications

While there will be those who oppose any tax increase (even to fund better-justified tax cuts elsewhere), the fundamental tax disparity between employment and self-employment incomes is hard to defend. The self-employed have slightly reduced benefit eligibility, but the value of these differences accounts for very little of the tax disparity. Coming reform of the state pension will almost entirely close the remaining gap. While self-employment can be a tough and entrepreneurial activity, it is not plausible to argue it is worth such huge universal subsidy compared to employment.

Differences in benefits

Aside from the state pension, which is discussed separately below, we must look at a number of smaller benefits. The self-employed are eligible for maternity allowance (in lieu of statutory maternity pay), bereavement allowance and other benefits in the same way as employees. The only differences are in Statutory Sick Pay and Jobseeker's Allowance.[18]

However, it is employers who pay Statutory Sick Pay[19] (£86.70 per week if ill) so it is not the case here that employees pay NICs in order to get something out when needed. Statutory Sick Pay is therefore not a reason for the self-employed to pay less tax. It is more similar to rights such as holiday pay and parental leave. We may well expect employers to pay employees less in order to fund these benefits, but they are not a reason for the state to tax employees more heavily than the self-employed.

HMRC has confirmed that estimates of benefit differences "[take] account mainly of Jobseekers Allowance" (JSA).[20] Self-employment contributions do not generally build eligibility for contribution-based JSA. But even here, the maximum amount is the same under both contribution-based and non-contribution-based JSA (£71.70 per week); the only difference being that contributory JSA is not means-tested.[21] If this is the only meaningful benefit difference (aside from the additional state pension, discussed below), it would – as the IFS has suggested[22] – be worth attempting to extend contribution-based Jobseeker's Allowance to the self-employed, rather than trying to account for the difference through the tax system.

So it does not seem, qualitatively, that benefit differences can justify the lower tax rates for self-employment over employment. A simple test of this would be to offer the same deal to employees: considerably lower taxes in return for having any future JSA means-tested. Few would turn down such an offer, given the sums involved.

HMRC have also shown this quantitatively, acknowledging a substantial tax break for the self-employed – quantified in the next section – that is "not attributable to reduced benefit eligibility". As a large tax difference remains after accounting for benefit eligibility, these differences cannot be an argument against closing the gap.

In fact, "the estimate of benefits to which the self-employed are not entitled is a relatively small part of the calculation".[23] The main difference stems from exclusion from the additional state pension, a difference that is soon to end.

The Additional State Pension

Like employees, the self-employed build up eligibility for the full basic state pension. The differences lie in the Additional State Pension (ASP).

ASP is based on earnings, with those on higher incomes – and therefore paying more National Insurance – later receiving an extra amount on top of their basic state pension. Unlike employees, the self-employed do not build up eligibility to ASP. In this respect, they are equivalent to 'contracted-out' employees who pay reduced rates of NICs but will not receive ASP. This accounts for some of the current tax difference between employees and the self-employed, though a very substantial tax break remains even after accounting for this and the other benefit differences above.

18 www.hm-treasury.gov.uk/d/ots_small_business_interim_report.pdf
19 Employers with a very high incidence of sickness absence can recover a fraction of SSP, though this is being abolished.
20 Author's FOI request.
21 www.gov.uk/jobseekers-allowance/what-youll-get
22 IFS, 'Tax by Design', p463, "Any difference [in taxation] should reflect only the actuarial value of differences in entitlements to state social security benefits, and these entitlement differences should be limited to benefits where it would be administratively difficult to extend full coverage to the self-employed."
23 Author's FOI request.

However, as part of the proposed, more generous, 'Single Tier Pension' – applying to those reaching pension age after April 2016 – the government is intending to scrap the Additional State Pension and the ability to contract out. This is a welcome simplification, but has consequences for the self-employment tax break. As the pensions minister Steve Webb said, "The single tier will also mean that, for the first time in around 40 years, self-employed people will be treated the same as employees for the purposes of state pension entitlement."[24] The self-employed will be particular winners from this package of changes and – according to the IFS – "the case for the self-employed paying a lower rate of NI than employees would then be weakened".[25]

As shown in the next chapter, the self-employment tax break is already substantial. With the end of the Additional State Pension, it will grow larger still. The issue cannot be avoided any longer and it is right that the self-employed, as big winners from these changes, begin to pay more in.

Special treatment

A more nebulous defence of lower taxes for the self-employed may be that their entrepreneurship represents a social good and so deserves a subsidy not available to those working for others. Aside from belittling employees' worth, this is not a robust argument. One particularly perverse suggestion is that because self-employed people might hire employees, the income of the self-employed should be taxed at a lower rate than paying an employee. Additionally, there exist plenty of targeted tax reliefs for those developing their businesses. It is implausible that a chancellor with billions to spend on boosting innovation would be best off subsidising all self-employment rather than investing in science and research, infrastructure, human capital, or targeted reliefs and lending.[26] Nor is it clear why – if the state pension reform is not accompanied by a self-employment tax increase – the effective subsidy should now be substantially increased.

On the other hand, self-employment is less secure and protected than employment, aside from any small differences in state benefit eligibility. Some may argue that self-employment therefore 'deserves' more favourable tax treatment – if customers are not willing to recompense them for their troubles. However, if we are concerned about the rights of the self-employed, and the recent shift of people from employment to self-employment, preferencing self-employment in the tax system is not the way to respond. The state provides a social safety net, support for low incomes and a progressive tax system: it should not deliberately subsidise self-employment based on its insecurity.

Similarly, we have said that the median self-employment income is lower than that of employees (though the former are over-represented at the top of the scale). Because the self-employed on average earn less, it is tempting to argue that they deserve more generous tax treatment. But this is a fallacy that confuses the group with the individuals in it.[27] The median self-employment income should indeed be taxed less than the (higher) median wage, but this does not mean that someone on a self-employment income of £20,000 should be taxed at a lower rate than an employee with a labour value of £20,000 – both are equally poor or well-off before tax. And it certainly does not suggest that we must give a tax break to someone on a self-employment income of £500,000. As demonstrated later, the reforms suggested in this paper are distinctly progressive.

The self-employed as a group are also less likely to live outside London, or to be young, or female: 70% of the self-employed are male compared to 51% of employees.[28] For those concerned over economic inequalities along these lines, the case for not favouring the self-employed becomes even stronger.

The tax system should perhaps make amends for the extra paperwork and record keeping forced upon the self-employed, but this hardly accounts for the size of the tax break, and the better solution would be to simplify the system as proposed in this paper. Such small differences might also be countered by pointing to the tax deductibility of home expenses such as council tax.

The strongest defence of preferring self-employment in the tax system is that small company taxation is even more favourably treated. At present, there is

24 www.publications.parliament.uk/pa/cm201213/cmhansrd/cm130319/wmstext/130319m0001.htm
25 www.ifs.org.uk/publications/6547
26 The £2.3bn tax break quantified in this paper compares to the science and research budget of £4.6bn.

27 As so often also happens when discussing pensioners. See T Leunig with A Corlett, 'Tax Justice', CentreForum, 2012.
28 www.ons.gov.uk/ons/dcp171776_298533.pdf ibid

a strong incentive for a small business owner to become a limited company and pay themselves largely in dividends, rather than through self-employment income or wages.[29] An increase in self-employment National Insurance would at present increase this incentive (as well as the incentive for tax evasion) – though not everyone can or does opt for the most tax-efficient structure.[30] Dividend and capital gains taxes are in need of complementary reform, but further discussion of this is not a topic for this paper (see the IFS's 'Tax by Design' for coherent proposals). Rationalising self-employment tax is nonetheless an essential part of building a fair, non-distortionary tax system. This paper is concerned with the much lower self-employment tax rates compared to employees, and just what this tax break costs.

Ending the tax break

HMRC puts a value on "reduced contributions for self-employed not attributable to reduced benefit eligibility" of £1.7bn in 2011-12 and £1.6bn in 2012-13.[31] This takes into account the small differences in JSA and similar eligibility, as well as the more substantial additional state pension difference (by comparing the self-employed to contracted-out employees).

There is no official figure yet for how this figure will grow when the pension difference is removed and contracting out is no longer possible. However, we estimate that the reform will add at least £700 million to the value of the self-employment tax break, giving a total of around £2.3bn.[32]

The Office of Tax Simplification recommended that the government "[examine] current differences in NICs between employees and self-employed and [recommend] potential, costed, methods to align the rates" in order to deliver simplification benefits. Below we explore what an alignment of rates might look like.

29 The IFS give an example of an employee, a self-employed worker and small company - all with same value of output of £400pw: The employee gets net £290.30, self-employed £319.30, and small company £339.10. Tax by Design, Table 19.1, p457

30 And legislation such as IR35 is designed to tackle particularly abusive use of these tax differences.

31 www.hmrc.gov.uk/statistics/expenditures/table1-5.pdf The figure was £1.95bn in 2008 (CPS) – clearly it is falling.

32 Estimated using HMRC Ready Reckoner figure for increasing the main Class 4 rate, and separately by using 'Income of individuals with self-employment sources', HMRC, www.hmrc.gov.uk/statistics/income-by-year/table3-10.xls

Table 3 - Marginal tax rates (%)

	Between NICs thresholds and Personal Allowance	Basic (main) rate	Higher rate	Top rate
Tax on wages	22.7	40.2	49	53.4
Tax on wages - 'contracted out'	18.5	37.1	49	53.4
Self-employment tax[2]	9	29	42	47
Self-employment marginal tax increase to close full gap	+13.7	+11.2	+7	+6.4

Alignment

Table 3 shows how the NICs and income tax rates combine to give total marginal tax rates.[33] These are the rates at which an additional pound of income is taxed, rather than the effective tax rates someone on a particular income has paid in total. Employer NICs are included, as they must be to give a fair comparison, and tax is taken as a percentage of labour value. For example, if an employer wishes to pay a basic rate employee an extra £1, 20p is paid in income tax, 12p in employee NICs and 13.8p in employer NICs. The total tax paid is therefore 45.8p but we must divide this by the full cost to the employer, £1.138, which gives the full marginal tax rate of 40.25%.

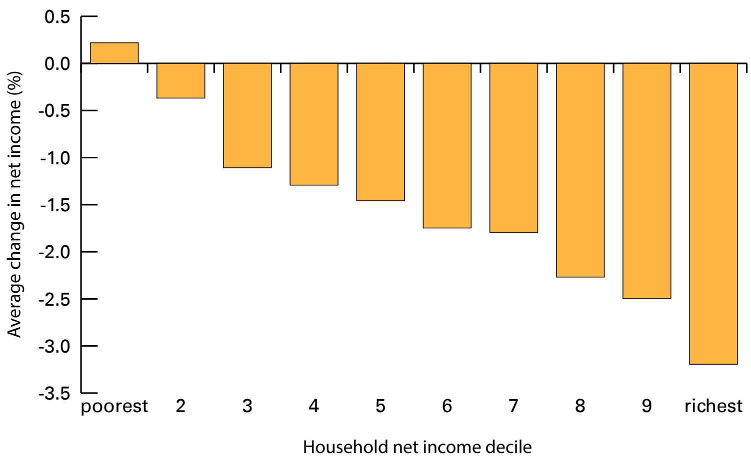
As a first approximation, these marginal rates give another good indication of the size of the self-employment tax break.

With the abolition of contracting out, these marginal rates could be broadly aligned by increasing the basic self-employment Class 4 rate from 9% to 20.2% (up 11.2), and the higher rate from 2% to 9% (up 7). This would give a reasonably fair outcome, with most self-employed workers paying around the same tax as equivalent employees.

However, this would treat some self-employed workers slightly too harshly (as well as top rate payers facing a marginal rate 0.6% too high). The problem is caused by employer National Insurance. Essentially, for employees, one tax is deducted – employer NICs –

33 Ignoring Class 2, as discussed later. Once above the threshold, Class 2 has a marginal rate of zero, but represents an extra 2% effective rate for someone on £7k and 0.3% for someone on £47k.

Figure 2 - Distributional impact of ending the self-employment tax break (only households with self-employment income)



and then tax is paid as a proportion of the remainder. Self-employment income is taxed in the much simpler manner of levying income tax and NICs on full labour value (i.e. profit). This is not a problem when we aggregate income tax and national insurance rates as in Table 3, but means – assuming these taxes are not merged – it is not possible simply to charge 13.8% employer NICs on the self-employed concurrently with income tax and other NICs.

The barrier to alignment is that this also affects the thresholds at which the various tax rates begin. For the self-employed, income tax kicks in at a labour value of £9,440 – the personal allowance. But, in terms of labour value, for employees it begins at around £9,700, as some employer NICs have already been deducted. The difference is significantly larger for higher thresholds, with higher rates kicking in earlier for the self-employed.[34] This explains why increasing the Class 4 rates by 11.2 and 6.4 percentage points, as suggested by Table 3, hits some self-employed workers (those just above thresholds) slightly too hard – and would not give precisely the effective tax rates shown in Figure 1.

To align the tax treatment in this way, we would therefore need to change both the rates (as described) and almost all the thresholds affecting the self-employed. This would likely be too great a complication to consider and would drive apart rather than integrate the operation of self-employment and employment taxes.

34 The most disruptive being the withdrawal of the personal allowance at £100,000.

But there is a more practicable solution, assuming no large shake-up of NICs for employees. To treat self-employment and employment income equally, an equivalent of employer (Class 1 secondary) NICs could be levied on the former. Employer NICs represents a 12.1% tax on labour value (13.8% of headline income) so this would be the rate used.[35] Income tax (e.g. 20%) and employee NICs (i.e. 12%) would then be levied on the remainder using the standard thresholds and rates. The tax process for self-employment income would thus be exactly equivalent to that for employees. While it may seem perverse or overly complex to tax the self-employed in two stages like this, and to ask them to pay 'employer' NICs for themselves, this seems the fairest and easiest method of complete alignment. If the government wished only partially to narrow the gap, increasing the Class 4 rates presents a simpler route.

Effect of alignment

Using an equivalent of employer NICs results in precise alignment of the effective employee and self-employment tax rates shown in Figure 1. Someone with a self-employment income of £100,000 would pay 12.1% secondary Class 1 NICs on their income above the £7,717 threshold, then the standard income tax and primary Class 1 NICs treatment – with their respective allowances – on the remaining £88,830. This results in a total tax bill of £41,510, compared to the £33,730 they currently pay – a significant £7,780 difference. Readers may well think that this is too much tax, but it is the amount employees pay, and shows just how much those with very high self-employment incomes benefit from this tax break.

Using a model of the tax system based on the Family Resources Survey, we can see which part of the income spectrum would be hardest hit. Dividing UK households into 10 deciles from poorest to richest, we can see in Figure 2 that alignment would be very progressive, with the poorest households actually gaining on average (as alignment would also mean scrapping Class 2, discussed later) and the richest hit hardest. This is before considering what might be done with the net revenue raised and who might benefit from that.

35 There may be other ways to present this, such as dividing above-threshold income by (1 + 0.138), and then taking 13.8% of that new figure. This would remove the need for a separately listed rate, but may be harder to understand.

In this analysis we have ignored the small benefit differences that might remain even after the abolition of the additional state pension. As argued, these account for only a small difference in justified tax rates. We have also said that it would be preferable to remove these differences, primarily through extending contribution-based Jobseeker's Allowance to the self-employed than try to account for it using the tax system. We have also not discussed the £141 Class 2 tax that most self-employed people must pay, as we argue later that it should be scrapped. For the lowest self-employment incomes, this would offset the increase in rates. The £350m cost of this abolition is accounted for in the £2.3bn tax break figure.

Staggered and targeted introduction

As ever, sudden tax increases come with their own costs and in this case the changes would be large and currently unplanned for. This tax break should be ended, but there is certainly a case for doing so gradually and for giving significant notice, particularly at a time when many businesses are struggling. Another alternative would be to target changes – in the short term, at least – on those with the highest self-employment incomes, who would be best placed to absorb a tax increase.

Increasing the 'additional' Class 4 rate from its current 2% would affect only those with self-employment incomes above £41,450 (on top of any other income). It could be increased to 9% to match the basic rate and, as shown in Table 3, this would align the higher employee and self-employment marg-inal tax rates. The unaffected basic rate tax break would outweigh the threshold and benefit differences discussed, and – for all but a handful of extreme cases – the fact that additional rate payers would face a slightly higher rate than employees. Increasing the rate by 6.4 percentage points rather than 7 would ensure that not even the richest self-employed worker was worse off than an equivalent employee. Those earning below roughly £100,000 would still receive a very substantial tax break. Each one point increase in the additional Class 4 rate would raise £100m.[36] These increases would be entirely justified, and come almost entirely from a subset of the richest 10% of households in the UK. Targeting only higher rate payers would leave a large unjustified tax break and raise significantly less money than full parity with employees, but any increase in Class 4 rates would be welcome.

Aggregation across multiple jobs

The Treasury is planning to consult on further aligning National Insurance with the income tax system.[37] Two key elements of this are to make NICs annual, rather than weekly and aggregated across jobs, rather than on a per job basis. These are fair and sensible moves. It is right that someone earning £10,000 in one job and £10,000 in another pays as much in NICs as someone earning £20,000 through a single job.

These rough proposals should be extended to include self-employment income. Rather than have separate NICs 'allowances' for employment income and for self-employment income, a single allowance would be used across all sources of labour income (unless a small disregard would be administratively worthwhile). If an equivalent of employer NICs were also levied on the self-employed, proposals for a single allowance across employers should similarly be extended to this self-employment income too. These steps may raise significant revenue.

Abolishing Class 2 National Insurance

Class 2 National Insurance is a flat tax of £2.70 per week – £141 per year – levied on all those with a self-employed income over £5,725 (see Table 1).[38] It is this contribution – rather than Class 4 – that currently counts towards state pension and other benefit eligibility. It raises a mere £350m per year:[39] less than a third of one per cent of National Insurance revenue.[40]

This is a poll tax that hits the poorest hardest. It represents an extra 2% effective tax rate for someone on £7,000, but only 0.3% for someone on £47,000. It therefore explains the strange 'tick' visible in Figure 1, and expanded in Figure 3 opposite: at low incomes the self-employment tax system is regressive. Despite the tax break described in this paper for those on higher incomes, below around £8,600 the self-employed have a higher effective tax rate than employees.

36 HMRC Ready Reckoner www.hmrc.gov.uk/statistics/expenditures/table1-6.pdf

37 This was first announced in Budget 2011, but is yet to happen. www.hm-treasury.gov.uk/tax_income_nics_integration.htm

38 2013-14 figures

39 Calculated from HMRC's Ready Reckoner www.hmrc.gov.uk/statistics/expenditures/table1-6.pdf

40 £107bn in 2013-14. Budget 2013, OBR forecast.

Figure 3 - Effective tax rates for self-employed and employed workers at low incomes

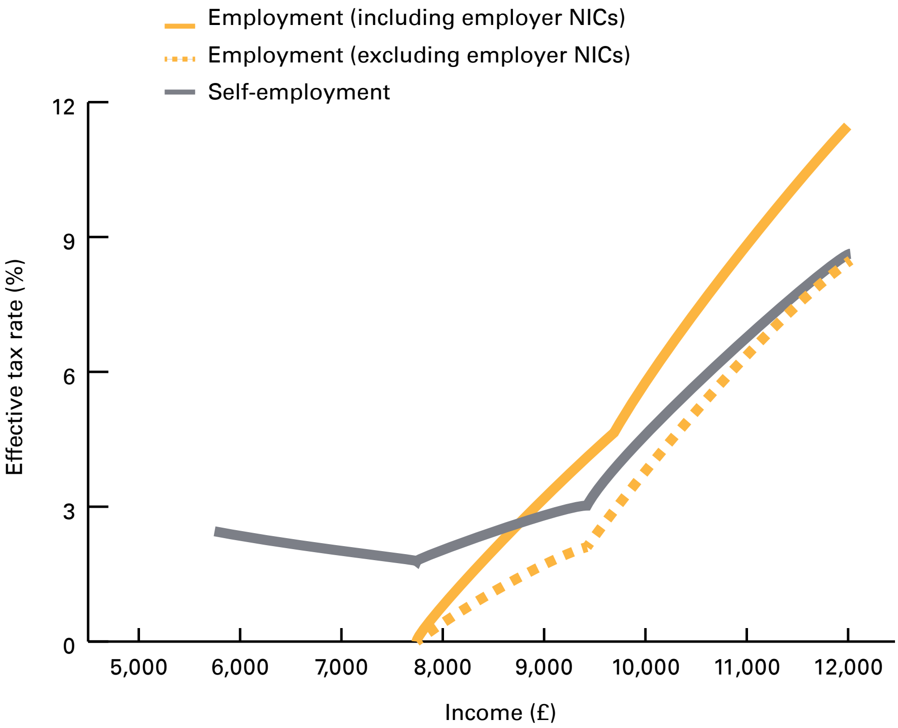
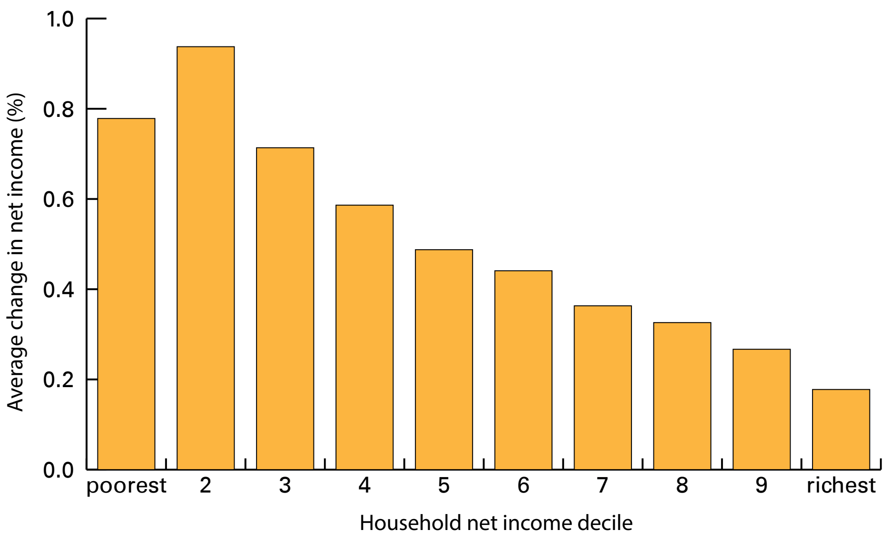


Figure 4 - Distributional impact of scrapping Class 2 National Insurance (only households with self-employment income)



£141 may not sound like much, but it nonetheless means around 300,000 people with very low self-employment incomes paying more tax than we expect from equally poor employees.[41]

The Class 2 charge goes from £0 at £5,724 to £141 at £5,725. This is not a good tax. While it is not a particularly large 'cliff edge', there is a clear incentive for workers around the threshold to artificially limit their actual or reported self-employment income.

41 Author's calculations, using FRS data.

As well as being a regressive financial burden to those on low incomes, it is also a tax complication and administrative burden. It clutters the tax system and makes National Insurance even less understandable to the uninitiated. What's more, it is dealt with and paid separately from the main self-employment self-assessment process. If a taxpayer is expecting to earn below the Class 2 threshold, they need to apply for a Small Earnings Exception certificate; or apply through a separate process to defer Class 2 payment until their total income for the tax year is known.[42] Some may be paying Class 2 unnecessarily.

Following advice from the Office of Tax Simplification, the government is planning to "consult on options to simplify the administrative process for the self-employed by using self-assessment to collect Class 2 NICs alongside income tax and Class 4 NICs."[43] But it should go further. Why bother with a £350m tax complication at all, when it does nothing that another tax could not do? The Centre for Policy Studies says, "In fact, Class 2 NICs are of such a small amount that, as confirmed by notes to the National Insurance Fund Account, no action is in practice taken to enforce payment if they are not paid. It is stated that the cost to the authorities of doing this would not be justified."[44] The cost to HMRC of administering the tax will nonetheless absorb some of the revenue raised.

The tax should be scrapped. The only other change that would certainly need to be made is to ensure that HMRC use the Class 4 self-assessment system to determine whether a year's income contributes to benefit eligibility.[45] For employees, contributions are deemed to have been paid if income is above roughly £5,700 – the same as the Class 2 threshold – even though no NICs are due at that level. The same could and should be done for the self-employed. For those who make voluntary Class 2 payments to maintain their contribution history, alternative provision could be made (should the 'Class 3' system used by the non self-employed be unacceptable).

42 This paper will not explore the special Class 2 rates for share fishermen and volunteer development workers!
43 www.hm-treasury.gov.uk/tax_income_nics.htm
44 Abolish NICs: Towards a more honest, fairer and simpler system, David Martin, Centre for Policy Studies, 2010
45 The OTS also recommended this: "The link between payment of Class 2 NICs and entitlement to benefits needs to be addressed which could be by having a presumption that Class 2 NICs will be paid by those eligible, or that eligibility comes from Class 4 NICs."

Amongst households with any self-employment income, the poorest would see the greatest benefit from scrapping Class 2 NICs, as shown in Figure 4. Individuals at the Class 2 threshold would see the biggest impact, with a 2.5% income increase.

In the absence of broader changes, scrapping this poll tax, at a cost of £350m, should be funded by increasing the main Class 4 rate from 9% to 10.5%, raising £345m.[46] Given the fiscal circumstances, and that self-employment income is taxed too lightly already, it is right that it should be funded in this way.[47] At the very least, if Class 2 were scrapped, the rate should be increased to around 9.4%, which would target the tax cut at those below the higher rate threshold – without anyone being worse off – and reduce the cost to £260m or less. The revenue-neutral rate of 10.5% would still be lower than that paid by employees. Pairing the abolition of Class 2 with an increase in the Class 4 rate is also the method suggested by the TaxPayers' Alliance.[48] Figure 3 (overleaf) shows just how progressive this tax simplification would be, with the richest 30% of these households on average giving up some of their tax break to fund a tax cut for those on lower self-employment incomes.

There is no good reason not to scrap this unnecessary and regressive tax.[49]

Increasing the Class 2 threshold

A limited alternative would be to simply increase the Class 2 threshold (provided the means of calculating benefit eligibility is altered, as above). This would be a cheap and cheerful change: moving to £10,000 in 2014-15 – the level of the income tax personal allowance – would cost around £60m.[50]

Unlike increases in the income tax personal allowance, only those below the new threshold would gain, with those above unaffected. It would simply put the £141 back in the pockets of around 0.5 to 1 million workers with low self-employment incomes.[51]

Figure 5 - Revenue-neutral package – scrapping Class 2 NICs and increasing Class 4 rate (only households with self-employment income)

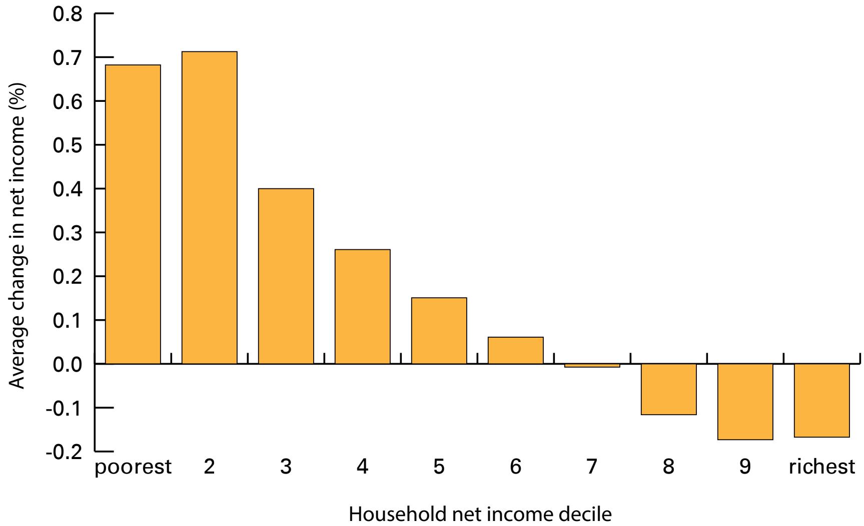
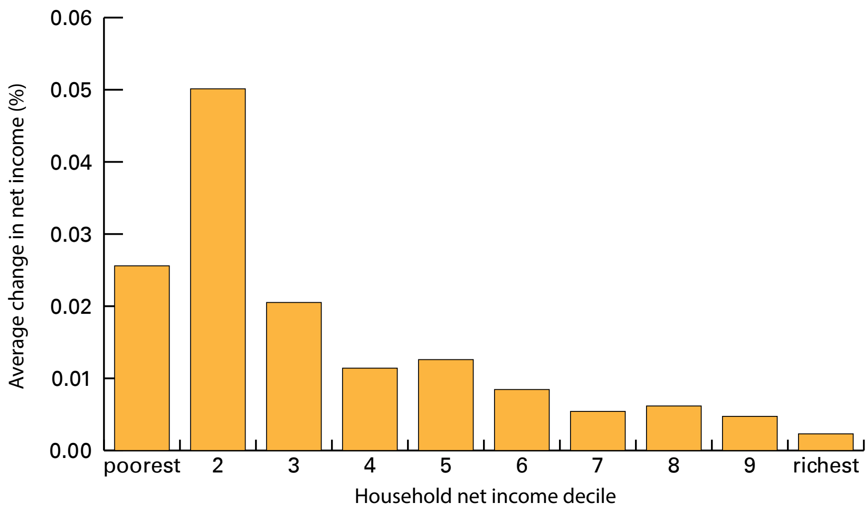


Figure 6 - Distributional impact of increasing the Class 2 NICs threshold to £10,000 (2014-15, all households)

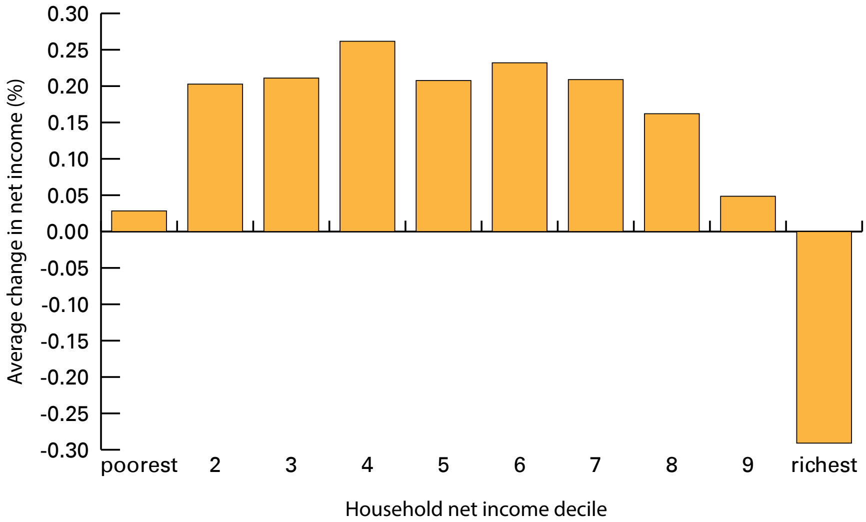


This tax cut, with its concomitant administrative change regarding benefit eligibility, would make it easier to later scrap Class 2 entirely. It also does not appear that a cliff-edge threshold at £10,000 would have any greater incentive effect than it does at £5,500: indeed, there are more people with self-employment incomes around the latter.[52]

Figure 6 shows the distributional effects of aligning the Class 2 threshold with the income tax personal allowance. The poorest 30% of households are the clear winners. It is rare to see such a progressive direct tax cut (even before considering how it could be paid for). But this small tax cut may not justify the effort and small disruption required.

46 Both figures calculated from the HMRC Ready Reckoner www.hmrc.gov.uk/statistics/expenditures/table1-6.pdf
47 An increase in the additional rate from 2 to 5.5% would also cover the cost, but is a less comparable replacement.
48 Though they recommended an increase only to 10%, giving a net loss in revenue. R Meakin 'How to abolish National Insurance' and 'Tax 2020', 2012.
49 A conclusion reinforced in the author's discussions with various parties.
50 Author's tax model using Family Resources Survey.
51 Family Resources Survey and ONS (Income of individuals with self employment sources, 2010-11).
52 Author's research using Family Resources Survey.

Figure 7 - Revenue-neutral package – aligning treatment of employment and self-employment, and increasing NICs thresholds (all households)



It would be far better to scrap the tax entirely.

While changes to Class 2 could easily be funded by increasing the Class 4 rate, ending the disparity between employment and self-employment entirely would raise a large surplus. We now turn to how that might be used.

Overall impact and what to do with the money

It has been suggested that tax increases are likely after the 2015 election.[53] The IFS currently predict that cutting non-ringfenced departments by a further 10.5% after 2015 would still require £4bn in tax increases or welfare cuts, assuming deficit reduction plans were kept unchanged. The government is also on course to ultimately overshoot its preferred ratio of spending cuts to tax increases, reaching 85:15 by 2017-18, after the planned 80:20 by 2015-16.[54]

If taxes are to be increased, the opportunity should be taken to do so in ways that also make the tax system more rational and equitable, not less. The measures suggested in this paper would end an unjustified tax break, abolish at least one kind of tax, remove a distortion to employment status choices, and raise money in a fair and progressive manner.

Beyond deficit reduction, political parties and government departments would not struggle to think of ways of using £2.3bn. But we might also want to use this revenue to reduce taxes elsewhere, and we can model this to help show how employees are currently getting a raw deal.

We model increasing the self-employment rates and using the £2.3bn raised to increase the National Insurance thresholds – the points at which people begin to pay direct tax (note that benefit eligibility is determined by a separate threshold and would be unaffected). Crucially, this would also benefit poorer self-employed workers.

Having already accounted for scrapping Class 2 NICs, £2.3bn could fund an increase in the point at which employees, employers and the self-employed begin paying NICs to almost £8,200 – £400 more than the existing levels given in Table 1. Employees would each be £110 better off per year if the self-employed paid their fair share.[55]

Accounting for all of these tax changes, self-employment incomes below £11,250 would also be taxed less than at present. For comparison, the median income for those whose main employment status is 'self-employed' was £11,050 in 2010-11.[56] So not only would employees be better off, but the bottom 50% of the self-employed would be too.[57] It is the richer 50% of self-employed workers who would bear the burden, with those on the highest incomes hit hardest. As Figure 7 shows, only the richest 10% of households would be worse off as a group following this combination of justified tax increases and equitable tax cuts.

53 www.guardian.co.uk/uk/2013/mar/21/budget-2013-ifs-9bn-tax-rises-election; 'Green Budget', IFS, 2013, p163.

54 www.telegraph.co.uk/finance/budget/9727257/IFS-7bn-in-new-taxes-to-plug-Britains-budget-black-hole.html

55 Except for those who already pay no NICs. In this particular model, we assume the employer tax cut is passed on to employees (as it would be in the long-term at least). Using this money to instead increase the employee threshold further would give similar results. We also treat the employer tax cut as going direct to employees' net income, as any extra tax payable on the original tax cut would in turn be used to increase the employee thresholds.

56 ONS, 'Changes in real earnings in the UK and London, 2002-2012', Feb 2013.

57 To ensure that even more of the self-employed benefit, despite any rate increases, an alternative would be to use some of the revenue to align the starting point for self-employment NICs with the income tax personal allowance (£10,000 in 2014-15). This would be a further simplification and ensure those on up to £15-16,000 were better off; but would mean a continuing disparity with employees.

Conclusions & recommendations

The self-employed receive a large tax break in comparison to employees, and those with the highest incomes benefit the most. There is no robust justification for this disparity. Even accounting for current differences in benefit eligibility, the tax break costs the Exchequer £1.6bn each year. The introduction of the Single Tier Pension will reduce most of the remaining benefit gap between employees and the self-employed, and increase the value of the tax break to £2.3bn or more. Addressing this unequal tax treatment would be a fair way to raise money in a time of austerity. In the process, the tax system can be made simpler and the scope and drivers of tax avoidance reduced.

This paper therefore recommends a number of steps:

- **Scrap Class 2 National Insurance**, a poll tax of £141 per year for anyone with a self-employment income over £5,725, regardless of any other changes. The fairest way to cover the £350m cost would be to increase the self-employment 'Class 4' rate from 9% to 10.5%. A limited alternative to scrapping Class 2 would be to increase its threshold. In both cases, benefit eligibility would be determined using the Class 4 system.
- **End the multi-billion pound tax break by increasing self-employment NICs rates.** To do this perfectly fairly, 12.1% NICs above the employer threshold would be charged as an equivalent and offshoot of employer NICs. Net of this, income tax and Class 1 primary NICs would be levied, just as for employees. Class 4 NICs as a separate set of rates and thresholds would end. Alternatively, increasing the Class 4 rates up to a main rate of 20.2% and an additional rate of 9% would be broadly fair, with smaller increases entirely justified. These tax increases might be introduced gradually, and targeted at higher incomes if desirable.
- **Extend contribution-based Job-seeker's Allowance eligibility to the self-employed if possible.**
- **Extend proposals to aggregate NICs across jobs to include self-employment**, raising further revenue. Someone with both self-employment and wage income should pay the same as someone with the same total income from one source.

Ending the tax break would be a fair way to reduce the deficit, but we also model using the money to increase the NICs thresholds for all (with Class 2 scrapped). Employees would get a £110 tax cut , and the poorer 50% of the self-employed would be better off or unaffected.

While this paper concentrates on self-employment NICs, two broader points should be noted. The failure to merge employee and employer NICs with income tax causes significant complexity and misunderstanding and so helps shelter this and other tax breaks. Secondly, the taxation of dividends and capital gains also has significant implications for the self-employed and requires reform.

About the author

Adam Corlett is an economics researcher at CentreForum. He is co-author of 'The path to IPO: funding SME jobs and growth' and 'Tax justice: whatever your age'.

Acknowledgements

The author is extremely grateful to Iain McCluskey at PwC, the Institute for Fiscal Studies, and former and current CentreForum staff for their assistance. The views expressed and any errors are the author's alone.

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