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National Insurance contributions (NICs) and the self-employed

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Contents:

Contents

Summary

National Insurance contributions – NICs, for short – are paid by employees, employers and the self-employed. NI receipts are used to fund contributory benefits: the state pension, contributions-based jobseeker's allowance, contributory employment and support allowance, maternity allowance, and bereavement benefits. In turn entitlement to contributory benefits is based on someone's National Insurance payment record. Receipts from NICs go into the National Insurance Fund, which operates on a 'pay as you go' basis: broadly speaking, this year's contributions pay for this year's benefits, though a fixed proportion of NI receipts go to the National Health Service rather than into the Fund.[1]

NICs raised an estimated £132.5bn in 2017/18. This compares with estimated Exchequer receipts from income tax of £180.7bn, and £125.3bn from VAT.[2]

NICs are charged on income from employment and self-employed only, not income from other sources – such as savings, pensions or benefits. Someone is liable to pay NICs if they are aged 16 or over and under state pension age, though employers' liability to pay NICs on earnings paid to employees is unaffected by employees reaching state pension age.

Employees pay income tax and primary Class 1 NICs on their earnings, deducted at source by their employer under PAYE. Their employer will be liable to pay secondary Class 1 NICs on the employee's earnings. By contrast, self-employed persons providing their services to clients will receive any payments gross of tax, and be responsible for paying income tax and NICs on their annual profits. Individuals who are self-employed are liable to pay both Class 2 NICs, a weekly flat-rate charge, and Class 4 NICs, based on a percentage of their annual profits. There is a significant financial advantage to individuals working as self-employed rather than as employees. The rate of NICs that the self-employed pay is lower than the rate paid by employees (9% vs 12%), and the self-employed face no equivalent to employer NICs (charged at 13.8%). Employers also have incentives to engage self-employed workers, rather than take on employees: the absence of employer NICs on the payments they make, and the absence of employment rights which employees have.

Over the last decade there has been a significant growth in the numbers of self-employed persons, as well as the numbers of individuals providing their services through a limited liability company that they run as a company owner-manager. While these two groups are often considered together, there are important differences in their treatment by tax and legal systems. In the case of incorporated companies, the profits the company makes are liable to corporation tax, while its employees will be liable for income tax and NICs on their earnings. Company owner-managers may choose to pay themselves dividends to realise a further tax saving as dividend income is subject to income tax but not NICs.

The Institute for Fiscal Studies has published some analysis to illustrate the tax drivers to self-employment and incorporation.[3] For a person generating £40,000 of income per year, the total tax liability, taking into account both employer and employee NICs as well as the individual's income tax, would be £12,146 if that person worked as an employee. The tax liability would be £8,713 if this income was earned through self-employment, and £7,358 someone provided their services through a company, and paid themselves dividends rather than wages. The IFS note that the figures will understate the potential tax

[1] For more background on the National Insurance system see, *National Insurance contributions: an introduction*, Commons Briefing paper CBP4517, 9 June 2017.
[2] OBR, *Economic & Fiscal Outlook*, Cm 9713, October 2018 p104 (Table 4.6)
[3] *Tax, legal form and the gig economy*, Institute for Fiscal Studies, February 2017; and, Helen Miller, "Tax in a changing world of work", *Tax Journal*, 21 April 2017. These estimates are for 2017/18.

advantages. The self-employed will have more scope to deduct work-related expenses from their income, and both self-employed persons and company owner-managers will have greater opportunities to (legally) avoid or (illegally) evade tax. In its *Economic & Fiscal Fiscal Outlook* in November 2016, the Office for Budget Responsibility looked at the impact that the current trend in incorporations could have on public finances if it continued, concluding that, "relative to a counterfactual that incorporations increased in line with employment, this takes around £3½ billion off total receipts in 2021/22."[4]

Historically the self-employed have reduced entitlement to some contributory benefits. In paying Class 2 NICs, they could accrue rights to the basic state pension but not the state second pension, and were not entitled to claim contributory-based jobseeker's allowance.[5] Payment of Class 4 NICs has not triggered any benefit entitlement. In April 2016 the new single-tier pension was introduced, replacing the basic state pension and state second pension for those now reaching state pension age, and it applies equally to employees and the self-employed.[6] Previously employees had the option to 'contract out' of the state second pension and pay a reduced rate of NICs on their earnings. As part of this reform, employees are now all liable to pay the same rate of Class 1 NICs on their earnings.

Although there has been a significant difference in access to contributory benefits between employees and the self-employed, overall the self-employed have paid relatively less into the NI Fund, given what they have been entitled to receive. In the past the size of this subsidy has been put at around £3 billion a year; taking into account the reforms to the state pension, HMRC have estimated that the revenue foregone by applying lower NICs rates to the self-employed exceeded the value of their reduced pension entitlements by £4.1 billion in 2017/18.[7] By comparison projected receipts from Class 2 and Class 4 NICs for 2017/18 is £3.4 billion.[8]

In his Spring 2015 Budget the then Chancellor George Osborne announced that "to support 5 million people who are self-employed and to make their tax affairs simpler, we will, in the next Parliament, abolish entirely Class 2 National Insurance contributions for the self-employed."[9] In December 2015 the Government launched a consultation on the design of new contributory tests, so that the self-employed would continue to have access to contributory benefits when Class 2 NICs were abolished. In the Autumn Statement in November 2016 the Government confirmed it would proceed with its plans to abolish Class 2 NICs, with effect from April 2018.[10]

In the Spring 2017 Budget the Chancellor Philip Hammond confirmed that Class 2 NICs would be abolished from April 2018, and announced a two-stage increase in the rate of Class 4 NICs, from 9% to 10% in April 2018, and to 11% in April 2019. The Chancellor argued that it was fair to reduce the differential between the rates of NICs paid by employees and by the self-employed, following the introduction of the new state

4 OBR, *Economic and Fiscal Outlook, Cm 9346*, November 2016 pp121-3 (Box 4.1)
5 It is worth adding that unlike employees, the self-employed are not entitled to statutory maternity/paternity/adoption/shared parental pay.
6 There are transitional arrangements to deal with past contribution records. For details see, *The new 'single-tier' State Pension*, Commons Briefing paper CBP6525, 30 August 2016.
7 HMRC, *Estimated costs of principal tax reliefs*, January 2018. HMRC note this "represents the difference between Class 2 and 4 NICs paid by the self-employed on their profits and an estimate of the Class 1 NICs that would be paid at contracted out rates on an equivalent amount of employee earnings. The Class 1 estimate includes employer contributions due but assumes a corresponding reduction in earnings to hold staff costs broadly constant, and also takes account of the resulting reduction in income tax" (fn 49).
8 Government Actuary's Department, *Report to Parliament on the 2018 re-rating and up-rating orders*, January 2018 pp31-2 (Appendix D)
9 HC Deb 18 March 2015 c777; *Budget 2015*, HC1093, March 2015 para 2.74
10 *Autumn Statement*, Cm 9362, November 2016 para 4.8; HMRC, *Abolition of Class 2 National Insurance contributions: tax information & impact note*, December 2016

pension.[11] However, a few days later Mr Hammond reversed this decision to increase the rates of Class 4 NICs, on the grounds that it would have breached the 'tax lock' pledge made in the Conservative Party's 2015 General Election manifesto not to increase the headline rates of income tax, VAT or NICs.[12] In his statement to the House, the Chancellor said that the Government would go ahead with the abolition of Class 2 NICs, as it was "an outdated and regressive tax, and it remains right that it should go."[13]

In November 2017 the Government stated that it would defer the abolition of Class 2 NICs until April 2019, a one year delay to "allow time to engage with interested parties and Parliamentarians with concerns relating to the abolition of Class 2 NICs on self-employed individuals with low profits."[14] There was relatively little comment on this delay, although the Low Incomes Tax Reform Group welcomed the announcement, "because of our concerns that the abolition of Class 2 was being rushed through without adequate further consultation, together with a lack of publicity and guidance for the people affected."[15] However, on 6 September 2018 Treasury Minister Robert Jenrick announced that the Government would **not** proceed with the abolition of Class 2 NICs "during this Parliament … given the negative impacts it could have on some of the lowest earning in our society."[16]

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11 HC Deb 8 March 2017 cc813-4. Taken together it was estimated these reforms would cost £80m in 2018/19, and then raise £215m in 2019/20: *Spring Budget 2017*, HC1025, March 2017 (Table 2.1 – item 15; Table 2.2 – item am).

12 HM Treasury, *Letter from the Chancellor to the Chair of the Treasury Select Committee*, 15 March 2017

13 HC Deb 15 March 2017 cc420-1

14 Update on the National Insurance Contributions Bill: Written Statement HCWS220, 2 November 2017; *Autumn Budget 2017*, HC587, November 2017 para 3.10. These changes were estimated to cost £125m in 2018/19, rising to £645m in 2019/20: *op.cit.* Table 2.1 – item 66.

15 LITRG press notice, *NICs announcement good news for self-employed on low incomes*, 2 November 2017. Prior to this the charity had published some advice for individuals in this position, following the Chancellor's statement : *Self-employed NIC reform – a trap for the lowest paid*, 20 March 2017.

16 National Insurance Contributions: Written statement HCWS944, 6 September 2018. Maintaining Class 2 NICs, while deferring certain other minor planned changes to NICs is estimated to raise £180m in 2019/20, rising to £395m in 2020/21: *Budget 2018*, HC 1629, October 2018 (Table 2.1 – item 75).

1. Current structure of NICs

Employees are liable to pay primary Class 1 National Insurance contributions (NICs) on their earnings if they exceed the lower earnings limit (LEL).

The LEL is set at £116 per week for 2018/19. A zero rate of NICs is charged on earnings between the LEL and the primary threshold (PT), set at £162 per week. A notional primary Class 1 NIC is deemed to have been paid in respect of earnings between LEL and PT to protect benefit entitlement. Earnings above the PT are charged NICs at a rate of 12%, subject to a cap at the upper earnings limit (UEL), set at £892 per week. Earnings *above* the UEL are charged NICs at a rate of 2%.

Prior to 6 April 2016 employees were charged a reduced rate of NICs if they had contracted out of the state second pension (S2P). These arrangements have ended with the introduction of the new 'single-tier' state pension, and the closure of the additional state pension.

Employers pay secondary Class 1 NICs on employee earnings at a rate of 13.8% on earnings above the secondary threshold (ST). The ST is set at £162 a week for 2018/19. Employers also pay Class 1A or 1B on employees' expenses or benefits at a rate of 13.8%.

In the 2013 Autumn Statement the Government announced that from April 2015 it would abolish employer NICs on earnings for employees under 21, on earnings up to the higher rate threshold. From this date a zero rate has applied to earnings on this category of employee up to the 'upper secondary threshold' (UST), set in line with the UEL.

In December 2014 the Government announced that it would abolish employer NICs up to the UEL for apprentices aged under 25, with effect from April 2016. Consequently a zero rate also applies to earnings on this second category of employees up to a new 'apprentice upper secondary threshold' (AUST), which is also aligned with the UEL. The UST and AUST are set at £892 per week for 2018/19.

Self-employed people pay a weekly flat rate Class 2 NIC (set at £2.95). They may apply for exemption from paying class 2 contributions if their annual profits are less than the level of the 'small profits threshold' (SPT), set at £6,205. In addition they may be liable to pay a separate Class 4 profits related contribution. Class 4 NICs are charged at a rate of 9% on profits between a lower annual profits limit (£8,424) and an annual upper profits limit (£46,350 – all figures for 2018/19). Profits above the upper limit are charged NICs at a rate of 2%.

Further to these categories, individuals may be entitled to make voluntary Class 3 contributions to ensure that they qualify for basic retirement pension and bereavement benefits. Class 3 NICs are charged at a weekly flat rate, set at £14.65 for 2018/19.[17]

[17] HM Treasury, Autumn Budget 2017: overview of tax legislation & rates – rates and allowances, November 2017

NICs receipts: estimates for 2017/18 and 2018/19

Great Britain, £ million		2017-18		2018-19	
National Insurance Fund					
Class 1[1]	Primary	40,628		41,741	
	Secondary	58,923		60,306	
	Total		99,551		102,047
Classes 1A and 1B			1,268		1,323
Class 2			415		430
Class 3			12		13
Class 4			2,085		2,110
Total National Insurance Fund contributions[2,3]			**103,332**		**105,922**
National Health Service					
Class 1	Primary	9,476		9,722	
	Secondary	13,741		14,098	
	Total		23,217		23,819
Classes 1A and 1B			203		211
Class 2			76		79
Class 3			2		2
Class 4			818		825
Total National Health Service contributions[3]			**24,316**		**24,937**

Great Britain, £ million		2017-18		2018-19	
All contributions					
Class 1[1]	Primary	50,104		51,463	
	Secondary	72,664		74,403	
	Total		122,768		125,866
Classes 1A and 1B			1,471		1,534
Class 2			491		508
Class 3			14		16
Class 4			2,903		2,935
Total contributions[3]			**127,648**		**130,859**

Notes:

[1] All figures are gross of recoveries by employers of Statutory Maternity Pay, Statutory Paternity Pay including Additional Statutory Paternity Pay, Statutory Adoption Pay, and, for births due after April 2015, Statutory Shared Parental Pay.

[2] These figures appear in Table 5.1 in the main report.

[3] Figures may not sum to totals shown due to rounding.

Source: Government Actuary's Department, *Report to Parliament on the 2018 re-rating and up-rating orders*, January 2018 pp31-2 (Appendix D)

2. The OTS' 2015 report on employment status

In July 2014 the Office for Tax Simplification launched a review of 'employment status' – the ways employment and self-employment are categorised for tax, as well as for employment law.[18] As it noted at the time, "the boundary between employment and self-employment has not kept pace with changing work patterns, especially in recent years" and "there are significant tax and NIC differences between employed and self-employed status" and "these potential tax and NIC benefits and risks drive business behaviour, exemplified by many of the personal service companies that are in use (though many are simply sensible vehicles for the taxpayer's operations)."[19]

The OTS's final report was published in March 2015, just prior to the Spring Budget. The report argued that the traditional approach to categorising the workforce had failed to take account of the large increase in the numbers of people working as freelancers:

> The tax system is still in many ways stuck in an out-of-date mindset: of categorising workers as either employees, firmly on the payroll, or self-employed, with the traditional jobbing plumber in mind. This made sense in the 1950s and 1960s but the huge growth in freelancing as a way of life (and work) doesn't fit readily into this traditional model. That growth stems from the IT industry, but has spread far beyond it, facilitated by the internet and (nowadays) 'apps'. Some people may be forced into this form of working but more choose it and value the flexibility it brings. All of this leads some to suggest that the tax system needs to recognise a 'third way' of working.[20]

Although the main focus of the report was on employment status, one of its conclusions was that any effective long-term solution would require substantive reform of National Insurance:

> If progress is to be made in 'solving' employment status as an issue, it is difficult to see how this can really be made without tackling NICs: the differences between NICs and income tax and, of course, the differing NICs rates.
>
> The OTS has recommended the integration of income tax and NICs in the past in a number of our reports[21] and we do so again in [this report] … There is a strong case for evening up NICs (and consequent benefits entitlement) between employment and self-employment (ignoring employers' NICs at this stage). But employers' NICs is the real 'elephant in the room'. It is not an easy thing to tackle, given the money it raises, but it is key to 'solving' the employment status issue.[22]

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18 For an overview of the issue see, *Employment status*, Commons Briefing paper CBP8045, 28 March 2018.
19 Letters between Exchequer Secretary and OTS: employment status and tax penalties reviews, July 2014
20 *Employment Status report*, March 2015 pp1-2
21 For example, OTS, *Small business tax review*, March 2011
22 *Employment Status report*, March 2015 pp9-10

The report gives a short history to the development of NICs for the self-employed:

> Historically, the self-employed were included in the 'welfare state' for the first time in 1942, see the Beveridge Report. The National Insurance Act 1946 introduced three classes of contributor, class 1, 2 and 3, to make up the funds required:
>
> - for paying such benefits as are payable out of the National Insurance Fund, and not out of other public money
> - for the making of payments towards the cost of the National Health Service
>
> Class 1 is earnings related, payable by employed earners (primary contributions) and employers (secondary contributions).[23] Class 2 is a flat rate charge, payable by self-employed earners and Class 3 payable voluntarily with a view to providing or enhancing entitlement to benefits. The different classes confer different levels of benefits.
>
> In 1975, class 2 had increased to 90% of the combined cost of the flat-rate class 1 contracted out contribution, but it had fallen to 40% of the combined total of flat-rate and graduated contributions for a contracted out employee on average earnings. However, benefit entitlement is restricted compared to class 1 …
>
> Raising the flat-rate contribution of class 2 to a sufficient level would have caused hardship on those of the self-employed whose income was low. So, in the Social Security Act 1973, an additional contribution of 5% of relevant earnings from the self-employed with earnings above a certain level (profit based) was introduced. The contribution was collected through Schedule D tax assessments and paid in bulk to the National Insurance Fund and called class 4. In 1975, class 4 was raised to 8%. The class 2 rate was also raised by 22.9%.
>
> In 1977, The Federation of Small Business (FSB) undertook litigation against the Government on the basis that the class 4 contributions had no mathematical or actuarial base, did not provide the right to benefits (since class 2 does that) and therefore should be repealed. Although the FSB lost their case, in 1978 the rate was reduced to 5%, in line with reductions in other rates. However, it has subsequently increased to 9% (up to the upper profits limit, equivalent to the upper earnings limit, 2% thereafter).[24]

The report suggested that "it would seem logical to harmonise both the contributions and the benefits between employed and self-employed", although there were several obstacles to "this obvious simplification":

> The amounts paid are similar (class 1 vs classes 2 + 4) for most workers, with the same 2% rate applying to income above the upper threshold. This would result in increases in NICs bills for the self-employed. It is estimated by HMRC that the current benefit to the self-employed compared to employees is of the order of

[23] It is worth noting that employer's contributions have been a feature of NICs from their introduction by Lloyd George in 1911. The principle seems to be simply that the employer and employee should jointly fund the benefits to the employee

[24] *Employment Status report*, March 2015 pp99-100

£2.6bn; to put this into context, the total NICs revenues from the self-employed is currently about this amount.[25]

The compensation would have to be that benefits entitlements are similarly harmonised … The reduction and numbers of benefits relying on the contributory principle leave only four that remain available to employees which are not available to the self-employed:

- contributory based job seekers allowance
- statutory maternity/paternity/adoption pay
- statutory sick pay
- state second pension, state graduated pension, state earnings related pension (SERPS).

Of these, the state pension is of course by far the largest in terms of cost. However, the proposal for a flat rate state pension payable from April 2016 further reduces the link to paying NICs. This would clearly be a major policy issue and as such we acknowledge that it is outside the OTS's scope, but we have to point out that the way the work force is changing does argue strongly for comparable arrangements for all workers, not least to make it easier to move between the two main states (or carry out both types of work at the same time).

There are other issues in the way of this obvious simplification

- weekly/monthly vs. annual payment basis: to properly harmonise would require NICs to move to an annual cumulative payment basis, in line with PAYE, as the OTS has recommended in the past (we return to this issue below in the argument for general change to NICs)
- cost: we have not been able, given the time available, to consider the costs of such a move. In the past it has been suggested that there would be a significant net cost to the Exchequer (i.e. a benefit to the self-employed) because of increased state pension entitlement. With the move to flat rate pension the figures will alter and our instinct is that the costs involved are reasonably balanced. But the costs to both the self-employed as a whole and to HMRC and the Exchequer would need to be considered carefully.

There is also the overall issue that if this increases the tax burden on the self-employed it would discourage investment and/or simply increase the drive to work through service companies or umbrellas.[26]

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25 As noted above, HMRC estimates this benefit to be of the order of £4.1bn for 2017/18 (*Estimated costs of principal tax reliefs*, January 2018).

26 *Employment Status report*, March 2015 pp104-5

3. Abolishing Class 2 NICs

In the March Budget a few days after publication of this review, the Government simply welcomed the OTS' report, and stated that it would "respond to the recommendations made in the next Parliament."[27] However, in his Budget speech the then Chancellor George Osborne announced that as part of a wider reform to provide digital tax accounts for taxpayers, "to support 5 million people who are self-employed and to make their tax affairs simpler, we will, in the next Parliament, abolish entirely Class 2 National Insurance contributions for the self-employed."[28] The Budget report gave further details:

> Budget 2015 announces that the government will transform the tax system over the next Parliament by introducing digital tax accounts, removing the need for annual tax returns. By the end of the next Parliament over 50 million individuals and small businesses will be able to see and manage their tax affairs online.
>
> 'Making Tax Easier' sets out what this will mean for taxpayers. As a first step, the Government will:
>
> - publish a roadmap later this year setting out the policy and administrative changes needed to implement this reform
> - introduce digital tax accounts for all 5 million small businesses and the first 10 million individuals by early 2016
> - abolish Class 2 NICs in the next Parliament and consult on reforming Class 4 NICs to include a contributory benefit test.[29]

In December 2015 the Government launched a consultation on the design of new contributory tests, so that the self-employed would continue to have access to contributory benefits when Class 2 NICs were abolished. In the Autumn Statement in November 2016 the Government confirmed it would proceed with its plans to abolish Class 2 NICs, with effect from April 2018.[30]

Further details were published the following month.[31] From April 2018 the self-employed would gain access to contributory benefits based on a profits test in Class 4 NICs. A new zero-rate band would be introduced into Class 4 NICs on profits between the Small Profits Limit (replacing the Class 2 Small Profits Threshold) and the Lower Profits Limit:

> In April 2018, Class 4 will be reformed to confer entitlement to the new State Pension and other contributory benefits.

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27 *Budget 2015*, HC1093, March 2015 para 2.189. For a summary of its recommendations and the Government's response, see: *Letter from the Financial Secretary to the Treasury to OTS on Autumn Statement 2015*, November 2015

28 HC Deb 18 March 2015 c777

29 *Budget 2015*, HC1093, March 2015 para 1.108-9. For more details see, *Making Tax Digital*, Commons Briefing paper CBP7949, 28 February 2018; HMRC, *Overview of Making Tax Digital*, October 2018.

30 *Autumn Statement*, Cm 9362, November 2016 para 4.8

31 HM Revenue & Customs, *Abolition of Class 2 National Insurance contributions: tax information & impact note*, December 2016

- The contribution conditions attached to the new State Pension and other contributory benefits will be changed to enable Class 4 NICs to count towards benefit entitlement.
- A new zero-rate band of Class 4 NICs will apply on annual profits between a threshold to be known as the Small Profits Limit (SPL) and the Lower Profits Limit (LPL, the point beyond which Class 4 NICs become payable).
- This means that self-employed individuals with annual profits at or over the SPL will be able to gain qualifying years (QYs) for benefit entitlement.
- The SPL will be aligned with the annual equivalent of the Lower Earnings Limit (LEL) in Class 1 employee NICs.

The existing and proposed systems are shown in Figures 2.A and 2.B.

Figure 2.A: The existing Class 2 and 4 NICs structure

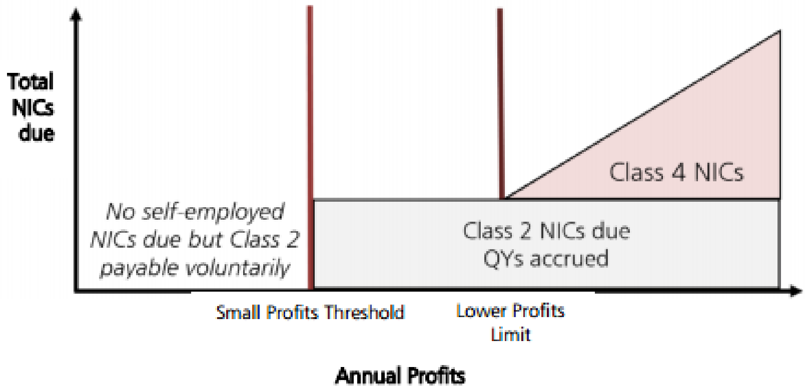
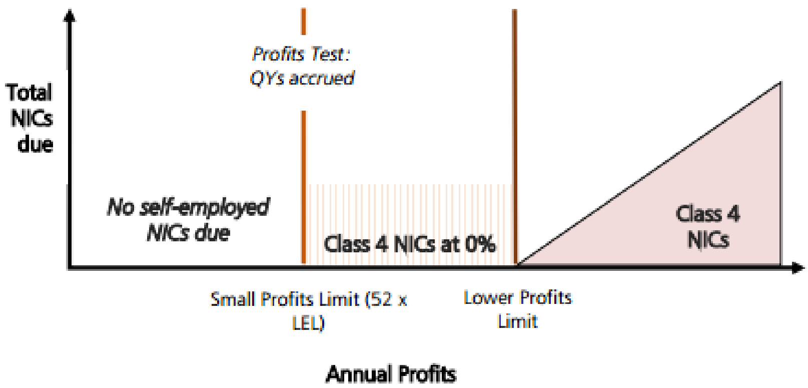


Figure 2.B: The proposed Class 4 NICs structure



(QY = Qualifying Year towards the State Pension)

This reform means that self-employed individuals will gain access to benefits if their profits are over the SPL, even though Class 4 NICs are only paid on profits over the LPL. This is consistent with the rules in place for employees, who are treated as having paid Class 1 NICs with earnings between the LEL and the Primary Threshold in an earnings period. By aligning the way in which employees and the self-employed gain access to benefits based on their earnings or profits, this reform also makes the NICs system simpler and more equitable for all.[32]

32 *Abolishing Class 2 and reforming Class 4 National Insurance contributions: response to the consultation*, December 2016 pp7-8

Individuals whose profits fell below the Small Profits Limit would be able to protect their entitlement to the State Pension by taking up the option of paying Class 3 NICs. As noted above, employees whose earnings are too low to be liable for NICs may protect their benefit entitlement by paying Class 3 NICs, though at present the rate of Class 3 is considerably higher than the rate of Class 2.

Many respondents to the Government's consultation paper raised concerns that people who were paying Class 2 NICs voluntarily would have to pay considerably more in tax if they wish to protect their entitlement to the State Pension. In its response the Government argued that relatively few individuals in this position would have to pay Class 3 NICs …

> The government wants to ensure that self-employed individuals who have profits below the SPL can continue to gain access to the new State Pension. There is already protection in the NICs system for these individuals to do this:
>
> - government analysis suggests that in 2018-19, around 77%[33] of all self-employed individuals expected to have profits below the SPL will see their State Pension record protected by NI contributions from employment alongside self-employment, by NI credits or will already have a full State Pension record[34]
> - the remainder will be still be able to pay Class 3 voluntary NICs to gain access to the new State Pension for those years in which their profits were below the SPL. Class 3 NICs can usually be paid for up to six years after the year in which an individual did not achieve a qualifying year. Individuals are able to check their National Insurance record on their Personal Tax Account (via GOV.UK) before deciding whether to pay Class 3 voluntary NICs[35]
> - an individual needs 35 years of NICs and/or NI credits to qualify for the full rate of the new State Pension. NICs are currently payable by those aged between 16 and State Pension age, which means that an individual could have up to 15 years of gaps in their National Insurance record without their State Pension award being affected
> - the median duration of self-employment is between six and ten years (Department for Work and Pensions analysis). This means that those with profits below the SPL are unlikely to rely solely on their profits for their entire working lives
>
> Analysis suggests that those expected to pay Class 3 NICs in any one year following the abolition of Class 2 would represent only 5% of those with profits below the SPL in 2018-19, and around 2% of all self-employed individuals who may have self-employment profits.[36]

33 This is based on HMRC forecasts. This figure also includes those who have already achieved the maximum number of qualifying years towards the State Pension.

34 NI credits are available to individuals in certain circumstances and help to protect their future entitlement to contributory benefits. More information is available here: https://www.gov.uk/national-insurance-credits/overview.

35 More information is available on how to check your National Insurance record is available here: https://www.gov.uk/check-national-insurance-record

36 This is based on HMRC forecasts showing that there will be over 5 million self-employed individuals who may be liable to NICs in 2018-19.

… and that the introduction of the new State Pension would mean that the self-employed will be able to gain a greater amount of pension than they had in the past:

Box 2.A: The self-employed and the new State Pension

The new State Pension allows self-employed individuals to gain a greater amount of State Pension than they were able to in the past. Under the old system, Class 2 NICs counted towards the basic State Pension (a maximum of £119.30 a week in 2016-17, for 30 years of contributions). However, Class 2 NICs did not count for the earnings-related additional State Pension. This meant that in general, each qualifying year based on Class 2 NICs in the 'old' system would only have been worth £3.98 of State Pension per week every year.

Under the new State Pension, all contribution years after 6 April 2016 will add a year of new State Pension in the same way for all classes of NICs and credits. That is 1/35 of the full amount for each post-2016 year. The full new State Pension is £155.65 a week in 2016-17, for 35 years of contributions.

Therefore, a qualifying year gained under the new system, including those by self-employed individuals, is worth £4.45 of State Pension per week. As a result, it will be possible for self-employed individuals to gain a much higher State Pension (with 35 years of any NI contributions) under the new State Pension system, than they could in the previous system (with 30 years of Class 2 NICs).[37]

At this time the Government published a draft National Insurance Contributions Bill with provisions to make these changes. **The draft Bill also included two other provisions to amend the NICs treatment of termination awards and sporting testimonial payments**, following changes in tax law.

In the case of termination payments, in a 2014 report on the tax treatment of employee benefits and expenses the Office for Tax Simplification recommended certain reforms to the tax regime for termination payments, as "this is an area which gives rise to confusion because many people believe that the first £30,000 of any 'payoff' will be tax-free" and "many employers are unclear about which parts of a termination package qualify for the exemption."[38]

After a consultation exercise, the 2016 Budget stated that "from April 2018, the Government will tighten the scope of the exemption to prevent manipulation and align the rules so employer NICs contributions are due on those payments above £30,000 that are already subject to income tax" though "the first £30,000 of a termination payment will remain exempt from income tax and the full payment will be outside the scope of employee NICs."[39] Provision for these tax changes was made by s5 of the *Finance (No.2) Act 2017*.[40] Following the initial delay

37 *Abolishing Class 2 and reforming Class 4 National Insurance contributions: response to the consultation*, December 2016 pp 9-10
38 *Review of employee benefits and expenses: final report*, July 2014 p7
39 *Budget 2016*, HC 901, March 2016 para 1.145-6
40 For more details see, *Taxation of termination payments*, Commons Briefing paper CBP8084, 8 May 2018.

to the introduction of the Bill,[41] and then the Government's announcement in September 2018 that it would not to scrap Class 2 NICs, it is now planned to extend employer NICs on termination payments above £30,000 with effect from 6 April 2020.[42]

In the case of sporting testimonial payments, following a consultation exercise, provision was included in the *Finance Act 2016* to clarify the tax treatment of income from sporting testimonials.[43] A one-off exemption of £100,000 applies to income received from events held during a single testimonial or testimonial year. As with the NICs change affecting termination payments, the Government has confirmed that, with the delays to the Bill, employer Class 1A NICs on sporting testimonial payments above £100,000 will now take effect from 6 April 2020. One unintended consequence of the changes made earlier is that employers could have been liable for the Class 1A NICs charge when an independent sporting testimonial committee organised a testimonial match for a sportsperson, rather than the testimonial committee. As the draft Bill was to have dealt with this issue, secondary legislation has been laid to prevent this.[44]

41 Written Statement HCWS220, 2 November 2017
42 *Budget 2018*, HC1629, October 2018 para 3.12
43 HMRC, Income Tax: update to treatment of income from sporting testimonials – tax information & impact note, November 2017. Provision to this effect was made by s12 of FA2016.
44 SI 2017/307 & SI 2018/120

4. Increasing the rate of Class 4 NICs

4.1 Budget 2017

On 8 March 2017 the Chancellor presented his Spring Budget, and as part of this, announced two reforms to personal taxation: the main rate of Class 4 NICs, paid by the self-employed, would increase from 9% to 10% from April 2018, and from 10% to 11% from April 2019; and, the dividend allowance – the annual amount of dividend income that individuals may receive tax free – would be reduced from £5,000 to £2,000 from April 2018.[45]

In his Budget speech Mr Hammond set out the case for increasing the rate of Class 4 NICs, noting the "dramatic increase in the number of people working as self-employed or through their own companies" while arguing that "people should have choices about how they work, but those choices should not be driven primarily by differences in tax treatment." Mr Hammond acknowledged that, historically, the lower rate of NICs paid by the self-employed reflected their limited access to social security benefits, but suggested the size of this disparity was no longer justified:

> An employee earning £32,000 will incur, between him and his employer, £6,170 of national insurance contributions. A self-employed person earning the equivalent amount will pay just £2,300—significantly less than half as much. Historically, the differences in NICs between those in employment and the self-employed reflected differences in state pension entitlement and contributory welfare benefits, but with the introduction of the new state pension last year, these differences have been very substantially reduced …
>
> The most significant remaining area of difference is in relation to parental benefits, and I can announce today that we will consult in the summer on options to address the disparities in this area…
>
> Such dramatically different treatment of two people earning essentially the same undermines the fairness of the tax system. Employed and self-employed alike use our public services in the same way, but they are not paying for them in the same way. The lower national insurance paid by the self-employed is forecast to cost our public finances over £5 billion this year alone. This is not fair to the 85% of workers who are employees.[46]

Mr Hammond noted that the size of this disparity would increase with the abolition of Class 2 NICs, and announced that in the light of this, the rate of Class 4 NICs would be increased to 11% by April 2019:

> The abolition of class 2 NICs for self-employed people … due to take effect in 2018 would further increase the gap between employment and self-employment. To be able to support our public services in this Budget, and to improve the fairness of the

45 For more details on the Budget as a whole see, *Spring Budget 2017: a summary*, Commons Briefing paper CBP7919, 17 March 2017.
46 HC Deb 8 March 2017 cc813-4

> tax system, I will act to reduce the gap to better reflect the current differences in state benefits.
>
> I have considered the possibility of simply reversing the decision to abolish class 2 contributions, but the class 2 NIC is regressive and outdated—it is absolutely right that it should go—so, instead, from April 2018, when the class 2 NIC is abolished, the main rate of class 4 NICs for the self-employed will increase by 1% to 10%, with a further 1% increase in April 2019.
>
> The combination of the abolition of class 2 and the class 4 increases I have announced today raises a net £145 million a year for our public services by 2021-22. That is an average of around 60p a week per self-employed person in this country. Since class 2 contributions are payable at a flat rate while class 4 is chargeable as a proportion of profits, all self-employed people earning less than £16,250 will still see a reduction in their total NICs bill.[47]

Further to the Chancellor's comments, the Budget report underlined that the Government would "consider whether there is a case for greater parity in parental benefits between the employed and self-employed", alongside the review of employment practices being undertaken by Matthew Taylor.[48] In October 2016 the Prime Minister appointed Mr Taylor (Chief Executive of the Royal Society of the Arts) to lead a review "to consider how employment practices need to change in order to keep pace with modern business models."[49]

In his speech the Chancellor noted that Mr Taylor's final report was expected in summer 2017, though "he is clear that differences in tax treatment are a key driver behind the trends we are observing—a conclusion shared by the Institute for Fiscal Studies and the Resolution Foundation."[50] Subsequently the Prime Minister was asked about this aspect of the Budget at the EC Council meeting on 9 March when she confirmed that the legislation to implement these reforms would be introduced in the autumn:

> We've been very clear, the government was very clear that when the tax lock legislation was passed that it related to the class 1 national insurance contributions. Now of course it's class 1 that covers 85% of workers. The legislation was clear that it was honouring the 2015 manifesto and no amendments or concerns were raised at the time.
>
> …The change to national insurance will require legislation of its own, it won't be part of the Finance Bill, that's always what happens with national insurance changes and those elements of the package will be brought forward by the autumn, as I say making lower paid self employed workers better off and we will publish a paper which will explain the full effects of the changes to class 2 and class 4, along with some changes we plan to make on rights and protections for self employed workers including on issues like pension rights and parental rights and maternity pay.[51]

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47 HC Deb 8 March 2017 c814
48 *Spring Budget 2017*, HC 1025, March 2017 para 3.5
49 Details on the Review are on Gov.uk.
50 HC Deb 8 March 2017 c813. Mr Taylor's final report, which appeared in July 2017, is discussed below.
51 No.10 Downing Street, *PM statement at European Council Meeting*, 9 March 2017. See also, "Theresa May delays vote on self-employment tax rise", *Financial Times*, 10 March 2017

The rise in the rate of Class 4 NICs was forecast to raise £325m in 2018/19, rising to £645m in 2019/20,[52] while the abolition of Class 2 NICs was forecast to cost £405m in 2018/19, rising to £430m in 2019/20.[53] The Budget report observed that, taken together, individuals would only pay more in NICs if their annual profits exceed £16,250 in 2019/20.[54]

The Treasury published a number of examples of how these reforms would affect individuals on different profit levels, taking into account the projected increases in both the personal allowance and the higher rate threshold; an extract is reproduced below:[55]

1.26 Chart 1.B shows the difference in tax and NICs paid at different profit levels between the start of the Parliament (2015-16) and when the changes to self-employed NICs take full effect in April 2019. Those on £17,500, £25,000 and £50,000 will gain overall, whereas the individual on £150,000 will not.

Chart 1.B: Cash gain for self-employed person in 2019-20 compared to the same profit level in 2015-16

Source: HMT analysis

Note : Rates and thresholds are based on OBR projections for 2018-19 onwards. The government has committed to increase the income tax personal allowance to £12,500 and higher rate threshold to £50,000 by the end of the Parliament. All case studies apply to England, Scotland and Northern Ireland only, as the main rates and thresholds are devolved to Scotland.

4.2 Initial reactions

There were a variety of reactions to the Government's proposed reforms.

In the first day of the Budget debates after the Budget speech, the Leader of the Opposition, Jeremy Corbyn noted, "we have long argued

52 *Spring Budget 2017*, HC 1025, March 2017 p 26 (Table 2.1 – item 15). Receipts were forecast to fall in later years: £595m in 2020/21, and £495m in 2021/22.
53 *Spring Budget 2017*, HC 1025, March 2017 p 29 (Table 2.2 – item am). The cost of this measure is forecast to fall in later years: £380m in 2020/21, and £350m in 2021/22.
54 *Spring Budget 2017*, HC 1025, March 2017 para 3.5. see also, HM Treasury, *NI and the self-employed factsheet*, March 2017 para 1.23-4
55 HM Treasury, *NI and the self-employed factsheet*, March 2017 p6

for a clampdown on bogus self-employment, but today the Chancellor seems to have put the burden on self-employed workers instead. There has to be a something-for-something deal, so I hope the Chancellor will bring forward extra social security in return."[56] Andrew Tyrie, Chair of the Treasury Committee, noted the Chancellor's "strong argument for matching what people get out of NICs on the receipt side to the contribution side", though on the question of whether the rise in Class 4 contravened the tax lock he added, "I will no doubt have a further discussion [with the Chancellor] when he comes before the Treasury Committee."[57]

Jonathan Edwards observed, "self-employed people do not have equal access to in-work benefits such as holiday pay, sick pay, auto-enrolment and parental leave. How, then, can it be right to put up the tax on self-employed people?"[58] Similarly Chris Leslie argued, "the self-employed do not have the same security [as employees], which is why we have had the discrepancy in the levels of taxation historically."[59] By contrast Charlie Elphike said, "It is also important to have a level playing field for workers, be they employed or self-employed … we have legislated to place a lock on class 1 national insurance contributions, VAT and income tax, but I think that class 4 contributions—as part of creating a more level playing field—are a different matter. For me, it is about fairness and pragmatism."[60]

Much of the comment in the press focused on the Government apparently breaking its manifesto commitment regarding the 'tax lock'.[61] An editorial in the *Daily Telegraph* argued, "since the country will rely more than ever upon its entrepreneurs and risk-takers it seemed at odds with that aim to increase tax on the self-employed, not least when such a move was specifically ruled out in the manifesto on which the Tories won the 2015 election."[62] By contrast the *Guardian* took the view that "Mr Hammond's contradiction of a promise in the 2015 Tory manifesto" was "courageous", a sensible response to the "rapid, tax-incentivised growth of self-employment", and, "as the Resolution Foundation pointed out, a progressive move partly because many highly paid professionals work as partners in firms and are treated as self-employed."[63]

The *Times* expressed the view that, "it is reasonable … for the Treasury to focus on those who have been gaming the system to pay less tax as "self-employed" than people doing similar work as employees. However, the self-employed also include millions of small business

56 HC Deb 8 March 2017 c825
57 HC Deb 8 March 2017 c829
58 HC Deb 8 March 2017 c847
59 HC Deb 8 March 2017 c852
60 HC Deb 8 March 2017 c847
61 "Hammond defends Budget rise in national insurance for self-employed", *Financial Times*, 9 March 2017. See also, "Spring Budget 2017 tax rise: What's the fuss about?", *BBC News*, 9 March 2017
62 "Leader: We still await a Budget for Brexit", *Daily Telegraph*, 9 March 2017. On similar lines see, "The Treasury and the self-employed", *Adam Smith Institute blog*, 10 March 2017.
63 "Editorial: The Guardian view on the spring budget: not enough", *Guardian*, 9 March 2017

owners who are the foundation of an entrepreneurial culture that any Conservative government should be careful to incentivise, not penalise."[64] The *Financial Times* observed that the rise in NICs would be "especially contentious", and "all the more difficult because Mr Hammond is breaching a Conservative manifesto pledge", although "politics aside, his decision is the right one … If the government can find ways to put self-employed people on a more equal footing on parental leave and other benefits, there may even be a case to go further."[65]

Writing in the paper columnist Martin Wolf noted "the logic of equalisation is persuasive although [the Chancellor's] backbenchers might well object," while his colleague Janan Ganesh argued the rate rise "jars with the Conservative commitment to entrepreneurship. It is provocative in a country in which a large share of voters work for themselves, and hard to reconcile with promises made in the party's 2015 election manifesto."[66]

In an opinion piece the next day Judith Freedman, Pinset Masons professor of tax law at Oxford University, argued that critics of the NICs increase "may have fallen for three myths about changing working practices and around self-employment that risk undermining the reform process."

> First is the myth that it is desirable to encourage self-employment indiscriminately through the tax system. The "self-employed" … [vary considerably in circumstance and income, and] untargeted, general tax reliefs cannot be calibrated to reflect all these situations … The second myth is that tax and employment law changes are somehow necessitated by the recent rise of the so-called gig economy. Yet the structural problems have been with us for many years …
>
> The third myth is that tax and employment law operate on a unified basis … Traditionally, tax classification has followed employment status. This is no longer necessarily the case: while tax law has stuck with a binary system (you are either self-employed or employed), employment law has developed a third, intermediary category (confusingly called "the worker"), which gives entitlement to basic protection including minimum wage and discrimination law.

Professor Friedman concluded "there is a real danger that if these myths are not debunked, the fundamental reform that is needed will become impossible politically."[67]

The Chartered Institute of Taxation (CIOT) argued that the decision was 'understandable' but left wider questions about tax reform unaddressed:

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64 "Leader: Calculated risk", *Times*, 9 March 2017
65 "Editorial: Hammond has done what he can to prepare Britain's defences for Brexit", *Financial Times*, 9 March 2017. See also, "Self-employed give thumbs down to Hammond", *Financial Times*, 10 March 2017
66 "Budget 2017: An act of well-judged caution in risky times" & "Hammond risks a jab at the self-employed in the Budget of 2017", *Financial Times*, 9 March 2017
67 "Three myths about tax and the self-employed", *Financial Times*, 10 March 2017

> If the Government truly intend to level the playing field the big factor is employer's national insurance contributions. That is the 'elephant in the room' which went unmentioned by the Chancellor today. And at 13.8% this is a material cost for employers at a time when there is widespread concern about the impact on jobs of automation, offshoring and general economic uncertainty.[68]

In a second press notice the CIOT also raised concerns about the cut in the dividend allowance: "Clearly the 2015 reform of dividend taxation did not achieve its intended objective. We believe the key lesson is that there should be consultation in advance of such major changes, to ensure that the public understand the reasons for them, and that with the benefit of a proper debate, the Government are able to get the reforms right."[69]

There was also a division of opinion among business groups. Carolyn Fairbairn, director-general of the CBI Director-General said, "We understand the decision to introduce a simpler tax system by reducing the difference between employee and self-employed National Insurance Contributions, but it must continue to incentivise entrepreneurship."[70] By contrast, Mike Cherry, national chairman of the Federation of Small Businesses was strongly critical:

> The genuinely self-employed are fundamentally different to employees – they are the risk takers that spearhead growth and productivity in our economy. … this measure is a tax grab on middle income self-employed people, who are just about managing. … Millions of self-employed will now face this tax hike, including plumbers, hairdressers, designers, musicians and many others in all our local communities.[71]

Finally the Resolution Foundation and the Institute for Fiscal Studies, which had both published recent work on the trends in self-employment and incorporation and the tax drivers underpinning these trends, commented on the impact of these reforms in their post-Budget analysis.

In the former case the Foundation described the abolition of Class 2 and the rise in Class 4 rates as a "sensible and modest tax change":

> The greatest losers [from this reform] would be anyone earning above £47,000 – who would pay a little over £600 more tax each year. Given the way it's been reported, it might be worth repeating: most of the self-employed, and all of those on low earnings, will be better off at the end of this decade as result of these NI changes. If it's a tax hike it's not a very good one.[72]

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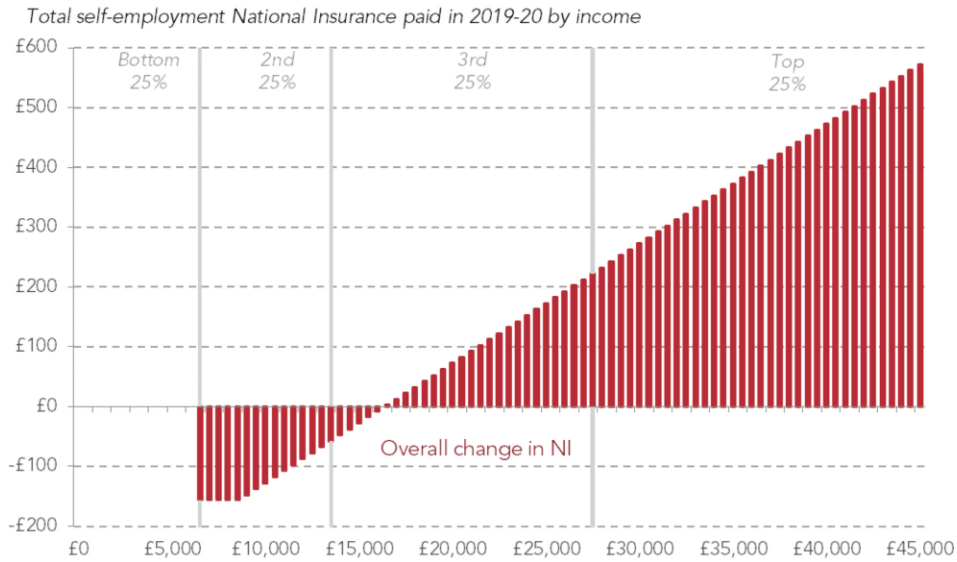
[68] CIOT press notice, *Budget 2017 – self-employed tax: time to open up the debate*, 8 March 2017

[69] CIOT press notice, *Changes to dividend tax allowance will not stop tax-motivated incorporation*, 8 March 2017

[70] CBI press notice, *Our full reaction to the Budget*, 8 March 2017

[71] FSB press notice, *Budget relief on rates but a tax grab on the self employed*, 8 March 2017

[72] "A small and sensible National Insurance rise for the self-employed is not the real strivers tax", *Resolution Foundation blog*, 10 March 2017. For their earlier work see, *A tough gig? The nature of self-employment in 21st Century Britain and policy implications*, February 2017



In a separate blog post the director of the Foundation, Torsten Bell, argued that because, in his view, the amounts raised by this reform were "so tiny" that "it's worth reflecting on why the Chancellor is acting":

> It can't be just to raise revenue, because there are hundreds of easier ways to do that like scrapping expensive and unwise corporation tax cuts between now and 2020 that would raise £5bn. So the Chancellor's action is not about the revenue raised but the incentives changed. He and many others rightly recognise that fast growing self-employment combined with a much lower tax take for each person that is self-employed is posing an ever growing risk to our public finances. Or to put it another way, to everyone else's tax bill and public services.[73]

As part of its Green Budget in February 2017 the Institute for Fiscal Studies published some detailed analysis of the trends in work patterns over the previous decade, and the tax advantages to working as self-employed or as company owner-managers.[74] It estimated that the differential NI treatment for the self-employed amounted to £1,240 per self-employed person per year:

> In principle, lower access to social security benefits may justify some tax reduction, but in practice, the differences in benefit entitlements are small.

Further to that, "company owner-managers get the most generous tax deal":

> Company owner-managers can pay themselves in (more lightly taxed) dividends, and possibly capital gains, rather than just wages. Along with the self-employed, they also have more opportunities to avoid or evade taxes.
>
> **The massive tax advantages that come with working for your own business are not new and not justified.** The tax system has long encouraged people to work for their own

73 "Reforming tax for the self-employed should be welcomed by progressives and fiscal hawks alike", *Resolution Foundation blog*, 9 March 2017

74 "Chapter 7: Tax, legal form and the gig economy", in Green Budget 2017, Institute for Fiscal Studies, February 2017

> business rather than be an employee. Lower tax rates are not justified by differences in employment rights or compliance burdens and are not well targeted at encouraging entrepreneurship.
>
> **Differing taxes based on how people work (their legal form) are unfair and inefficient.** Similar individuals can face very different tax burdens. This is unfair and creates economic inefficiency. Some people set up a business when, absent tax, they would be an employee. Much time and effort goes into policing the boundaries between legal forms.
>
> **The tax system should be reformed to align taxation of income across legal forms while not discouraging capital investment.** Saving and investment should be deductible from the tax base. Each extra pound of income earned should then be taxed at the same overall rates for employees, the self-employed and company owner-managers. This would simultaneously deal with many problems that plague the tax system.[75]

In his presentation on the 2017 Budget, the director of the IFS, Paul Johnson, identified the reforms to NICs, and the cut in the dividend allowance as, the "only two tax changes of any substance" that had been announced by the Chancellor:

> The former is a modest but welcome change designed to shore up the tax base and create a slightly less unequal playing field between the self-employed and employees. The latter reflected the concern that if you increase tax on the self-employed you increase their incentive to incorporate. It undoes most of a change introduced less than a year ago.[76]

Mr Johnson went on to argue that the reforms were "baby steps in the right direction", but was strongly critical that the Government had made its 'tax lock' commitment in the first place:

> The 2% increase in NICs for the self-employed closes a small fraction of the gap between employees and the self-employed …The tax advantage to being self-employed will still run into the thousands of pounds. The really big difference in treatment is the fact that employers pay 13.8% NI on anything they pay to their employees and nothing on anything they pay to self-employed contractors.
>
> A tax system which charges thousands of pounds more in tax for employees doing the same job as someone else needs reform. It distorts decisions, creates complexity and is unfair ...
>
> You'll note that the Chancellor at the same time announced that the £5,000 tax free dividend allowance, introduced less than a year ago, would be cut to £2,000 ... It happened because he worries that by increasing tax on the self-employed he increases the incentive to incorporate. He is right to worry. Rates of incorporation have been rising and they are sensitive to the tax treatment. All in all these feel like baby steps in the right direction. But they are sticking plasters not the fundamental look at the tax base as well as tax rates that is required …

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[75] Stuart Adam, Helen Miller and Thomas Pope, *Tax, legal form and the gig economy*, IFS Report, 2 February 2017

[76] *Spring Budget 2017: IFS Director Paul Johnson's opening remarks*, 9 March 2017 p1

> Part of the problem of course is that the increase in class 4 NICs does look like a breaking of the manifesto commitment not to raise NI. Just as the last Labour government broke its manifesto pledge not to raise the basic or top rates of income tax when it increased the top rate to 50%. As we said at the time these were silly pledges. To commit yourself to not raising the three main taxes – income tax, NI and VAT – ties your hands to an absurd extent. No party should repeat these sorts of promises.[77]

In addition to Mr Johnson's comments, Helen Miller, associate director of the IFS, gave a presentation on business taxes, which discussed both of these changes, and provided some distributional analysis of the NICs reforms.[78]

4.3 Decision to reverse proposed rate rise

On 15 March the Chancellor announced that the Government would *not* proceed with the proposed increase in Class 4 NICs, first in a letter to the Chair of the Treasury Select Committee,[79] and later that day in a statement to the House – part of which is reproduced below:

> The measures I announced in the Budget sought to reflect more fairly the differences in entitlement in the contributions made by the self-employed. The Government continue to believe that addressing this unfairness is the right approach. However, since the Budget, parliamentary colleagues and others have questioned whether the proposed increase in class 4 contributions is compatible with the tax lock commitments made in our 2015 manifesto.
>
> Ahead of last year's autumn statement, the Prime Minister and I decided that however difficult the fiscal challenges we face, the tax lock and spending ring fence commitments we have made for this Parliament should be honoured in full ... As far as national insurance contributions are concerned, the locks were legislated for in the National Insurance Contributions (Rate Ceilings) Act 2015. When the Bill was introduced, it was made clear by Ministers that the lock would apply only to class 1 contributions … However, it is clear from discussions with colleagues over the last few days that this legislative test of the manifesto commitment does not meet a wider understanding of the spirit of that commitment.
>
> It is very important both to me and to my right hon. Friend the Prime Minister that we comply with not just the letter but the spirit of the commitments that were made. Therefore … I have decided not to proceed with the class 4 NICs measures set out in the Budget. There will be no increases in NIC rates in this Parliament. For the avoidance of doubt, and as I set out in the Budget, we will go ahead with the abolition of class 2 national insurance contributions from April 2018. Class 2 is an outdated and regressive tax, and it remains right that it should go. I will set

77 *Spring Budget 2017: IFS Director Paul Johnson's opening remarks*, 9 March 2017 pp4-5. An editorial in the *Financial Times* the following day made a similar point: "Leader: Stand your ground on the tax rise, Chancellor", 10 March 2017.
78 *Spring Budget 2017: Business Taxes presentation*, 9 March 2017 (see slide 7).
79 HM Treasury, *Letter from the Chancellor to the Chair of the Treasury Select Committee*, 15 March 2017

> out in the autumn Budget further measures to fund, in full, today's decision.
>
> I undertook in the Budget speech to consult over the summer on options to address the principal outstanding area of difference in benefit entitlement between the employed and the self-employed: parental benefits. We will go ahead with that review, but we now intend to widen the exercise to look at the other areas of difference in treatment, alongside the Government's consideration of the forthcoming report by Matthew Taylor … on the implications for employment rights of different ways of working in a rapidly changing economy. Once we have completed these pieces of work, the Government will set out how we intend to take forward and fund reforms in this area.[80]

In response Shadow Chancellor John McDonnell argued that the proposed increase in NICs rates was "a £2 billion tax hike for many low and middle earners, and a clear-cut and cynical breaking of a manifesto promise":

> The £2 billion that would have been raised was to go some way to tackling the social care crisis. We need to know where these desperately needed funds will come from now. We need guarantees from the Chancellor that no working people will be hit, either now or in the autumn statement, with stealth or other tax rises, and that there will be no further cuts to public services to pay for this blunder.[81]

Andrew Tyrie, Chair of the Treasury Committee, said the announcement was "doubly welcome" as it "bolsters trust in the Government's other commitments, and removes the perception of a cigarette paper between No. 10 and No. 11", but went on to ask whether the Chancellor agreed that "a differential should, none the less, remain in the long run to reflect the additional risk taken by the self-employed when they are doing their job?" In response Mr Hammond said, "

> In the Budget speech last week, I made very clear that we were seeking to close the gap a little. We were not seeking to equalise the contributions treatment of the employed and self-employed, as there are very good reasons why there may well need to be a gap. That is why we will look at this in the round—contributions, entitlements and the way the whole package works for the self-employed. Let us come back to this once we have completed the review, have the Matthew Taylor work and can look at the problem in the round.[82]

Speaking for the SNP Stewart Hosie welcomed the decision, "not least because about 140,000 Scottish self-employed people would have been affected by it", and other Members who spoke on this occasion were also supportive of this change.[83]

There were a variety of reactions in the press.[84] The *Daily Telegraph* described the decision as "an abject humiliation for Philip Hammond, the Chancellor of the Exchequer, and an acute embarrassment for the

80 HC Deb 15 March 2017 cc420-1
81 HC Deb 15 March 2017 c421
82 HC Deb 15 March 2017 c423
83 HC Deb 15 March 2017 c423
84 "Tory U-turn as Philip Hammond scraps tax rise on self-employed" & "Self-employed relieved but wary after Hammond's Budget U-turn", *Financial Times*, 15 March 2017

Government as a whole."[85] The *Times* suggested that "a relatively minor budgetary issue has been allowance to take a life of its own because of political misjudgement and poor communication between the two most important members of government."[86] The *Guardian* argued "increases in NICs were not … a blow to so-called risk-takers. They were in fact a challenge to those, often very well-off, who avoid their fair share because it can be tax advantageous."[87] An editorial in the *Financial Times* took the view that "the UK government's climb-down on national insurance puts politics over good policy":

> This newspaper has argued that Mr Hammond's mistake was not raising contributions, but rather failing to include the change in a wider package of reforms for self-employment — something that the government is now considering. Mrs May has announced there will be no further changes to NICs until after the next general election, due in 2020.
>
> A serious problem has in effect been put on indefinite hold. The danger now is that the Taylor Review into self-employment due this summer will suffer the same fate.[88]

Among stakeholder groups and commentators, the FSB strongly endorsed the Chancellor's decision,[89] while the Chartered Institute of Taxation suggested "the Government's U-turn over the National Insurance increase for the self-employed shows what can happen when Chancellors pull 'rabbits' out of the hat on Budget day without consulting or preparing the ground in advance."[90]

Torsten Bell, director of the Resolution Foundation, argued that "the Chancellor's U-turn on his Budget plan to raise National Insurance for the self-employed is a very unusual one, combining as it does a very firm defence of the need for the policy with the decision to scrap it":

> That we have ended up in that place reflects the undeniable fact that the politics of the increase in self-employed National Insurance contributions (NICs) has been a disaster, while the policy rational remains absolutely undeniable. To put it another way, whatever the rights and wrongs of breaking the spirit of Manifesto commitments – be it tax rises, migration targets or membership of the single market – the substance of the Chancellor's U-turn on (NICs) means the government has missed an opportunity to correct a big structural flaw in our tax system.[91]

In a letter to the *Times* IFS director Paul Johnson expressed the view that "some long-term planning and strategy would not go amiss":

> We should learn some lessons. First, it is a mistake to commit in a manifesto to not raising the three most important taxes — that

85 "Editorial: Philip Hammond's embarrassing U-turn points to bigger issues in government", *Daily Telegraph*, 16 March 2017
86 "Leader: No way to govern", *Times*, 16 March 2017
87 "Editorial: The Guardian view on the budget U-turn: a climbdown that shows where power lies", *Guardian*, 16 March 2017
88 "Editorial: Philip Hammond has made the wrong U-turn for the wrong reasons", *Financial Times*, 16 March 2017
89 FSB press notice, *NIC's U-turn is a great victory for FSB's self-employed members*, 15 March 2017
90 CIOT press notice, *National Insurance U-turn shows why Budget 'rabbits' are a bad idea*, 15 March 2017
91 "U-turn if you don't want to", *Resolution Foundation blog*, 15 March 2017

> ties the Chancellor's hands to an absurd degree. Second, some long-term planning and strategy would not go amiss.
>
> The self-employed have been handed two big bonuses in recent years: access to a much-enhanced state pension and the abolition of class 2 national insurance contributions. Announcing an increase in the class 4 rate at the same time, rather than as an apparent afterthought, might have made more sense.
>
> And finally, we need a more sensible debate about tax and spend. If we really can't raise taxes, then even more (and even deeper) public spending cuts are the only alternative.[92]

[92] "Letters: Hammond's U-turn over national insurance", *Times*, 16 March 2017

5. Recent developments

In July 2017 the Office for Budget Responsibility looked at the impact of the Exchequer from the growth in the numbers of self-employed and owner-manager or single director companies, discussing the different tax treatment of these three kinds of worker, in the light of the Chancellor's decision to abandon the proposed increases to the rates of Class 4 NICs; an extract is reproduced below:[93]

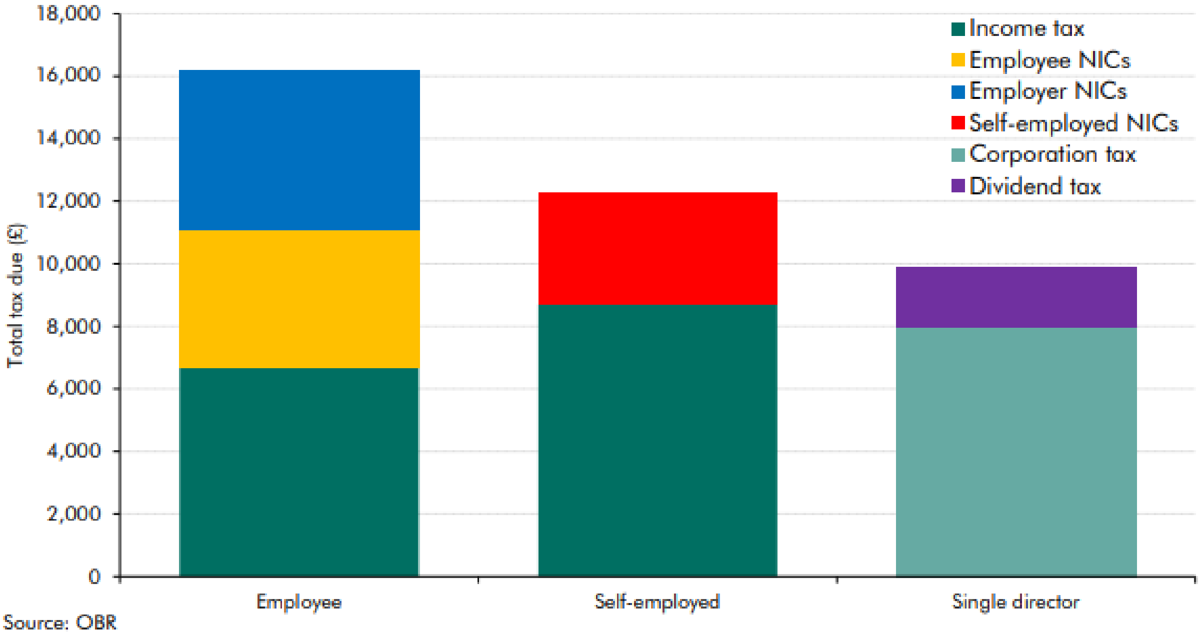
> Employees make up the vast majority of the UK workforce and are characterised by working under an employment contract and having a variety of legal rights such as statutory sick, maternity, paternity and redundancy pay. Their employer must pay Class 1 employer NICs of 13.8 per cent on their wages above the relevant threshold. Their net earnings (excluding employer NICs) are liable to income tax as well as Class 1 employee NICs. Both are collected through the PAYE system.
>
> Self-employed individuals run their own businesses, reporting the profits as income and having more flexibility to deduct business expenses. They pay income tax at the same rates as employees, but are only liable for Class 4 NICs. These are paid at a lower rate than employee Class 1: 9 versus 12 per cent on income below the higher rate income tax threshold. The Class 4 NICs rate increases in Spring Budget 2017 would have reduced this differential, but were abandoned soon after. The self-employed pay tax and NICs liabilities via self-assessment returns due nine months after the end of the financial year.
>
> Working as a director and employee of a very small limited liability company has been possible for many years, but became much easier when the 2006 Companies Act abolished the need for a company to contain at least two individuals (a director and a distinct company secretary). A single director of a company, or a company with a small number of closely linked directors, can run their business very similarly to the self-employed, but also enjoy the benefits of limited liability status.
>
> Company directors can minimise their tax burden by paying themselves (as the sole 'employee') a wage up to the primary threshold at which employee and employer NICs become liable. As this threshold is below the personal allowance, it also incurs no income tax. This wage can then be deducted from the company's gross profits, the remainder of which are liable to corporation tax (currently 19 per cent, but set to fall to 17 per cent in April 2020).
>
> Post corporation tax profits can then be withdrawn as dividend income for the sole shareholder (the director), which is liable for tax at lower rates than other types of income and attracts its own tax-free allowance (currently £5,000, but set to fall to £2,000 in April 2018). Directors can also benefit by retaining profits within the company, paying the lower entrepreneurs' relief rate of capital gains tax (of 10 per cent) upon selling it.
>
> The result of this varying tax treatment is that three people doing very similar work can face very different tax liabilities depending on their form of employment. Imagine a contract being offered for a piece of work (e.g. building a website) offering £50,000 as

93 OBR, *Fiscal Risks Report*, July 2017 pp110-2

compensation in 2017-18, with this being the only source of income during the year for the individual concerned.

Chart 5.12 shows how much of that £50,000 would be paid in tax depending on whether it was carried out by an employee of a medium-sized company, a self-employed individual or a single-director company.

Chart 5.12: Tax due on £50,000 of income in 2017-18



Source: OBR

The employee faces the largest tax burden, paying 32.3 per cent of the £50,000 income in tax or NICs. That compares with 24.5 per cent for the self-employed individual and 19.7 per cent for the sole director of his or her own company.[94]

The biggest difference comes from employer NICs for employees. Despite this being paid by the employer, we include it in the individual's tax burden because it directly reduces the amount available for the employee's wage. Single-director companies benefit mainly from the lower rates of corporation tax and dividend tax.

At this time Matthew Taylor completed his inquiry on employment practices, commissioned the previous October by the Prime Minister. The report made a series of recommendations covering a variety of issues in relation to the 'gig economy',[95] and as part of this, argued that "a self-employed person doing the same work as an employed person can pay a different amount of tax or National Insurance despite receiving similar contributory benefit entitlements in return", a situation

94 These calculations assume the individual has only one source of income. The deduction of employer NICs means that less of an employee's total compensation is made up of their wage, thereby paying less income tax but more NICs than the self-employed. Company directors are assumed to withdraw profits in the most tax efficient way, paying themselves a salary up to the primary threshold for NICs, and taking the rest as dividends, all in the same year.

95 Department for Business, Energy & Industrial Strategy press notice, *Government employment practices reviewer outlines "7 principles for good quality work for all"*, 11 July 2017

which was "not justified, or sustainable, nor is it conducive to the goal of a good work economy":

> The difference in NICs partly reflects the evolution of the contributory benefit system in the UK. Following the introduction of the National Insurance Act 1946 anyone in work was required to buy a National Insurance stamp. For an employee this was the equivalent of 25p a week; their employer also paid 21p. The self-employed paid 31p. This lower overall rate paid by the self-employed compared to that paid by an employee and their employer combined meant that they did not have the same benefits from the government.
>
> The self-employed no longer pay any of the employer NICs contribution and their own rate is now lower than the employee rate: an employee pays NICs on their earnings at a rate of 12%, and their employer pays 13.8% on top of this. Their self-employed counterpart pays 9% with no equivalent of the employer charge. The self-employed also currently pay a weekly charge of £2.85. This means that … the effective tax rates of a self-employed person are significantly below that of those in employment …
>
> Whereas the rates of National Insurance paid by employed and self-employed have moved further apart in the last 50 years, the benefit entitlement has moved closer together. Last year, approximately £100bn was paid out in benefits funded by NICs. Around 94% of contributory benefit spending was on the State Pension – but since April 2016 the self-employed and employed have built up exactly the same State Pension entitlement.
>
> There are some differences in benefit entitlement but these are now relatively small – for example, the self-employed cannot access contribution-based Job Seeker's Allowance and do not receive the same parental benefits.[96]

The report noted the argument that had been made that the higher NI rates paid by employees reflected the benefits they received from employment rights[97] – an argument that it took issue with:

> The rights that an employee gets are paid for by their employer: they form part of their overall remuneration. A self-employed person can set their own prices and keep all of their profits; from this they can choose how much to take home and how much to put into a pension or set aside for holiday pay. However, part of an employee's salary usually has to be received in the form of a pension and holiday pay.
>
> An employed person's total remuneration is therefore rarely their headline salary: an employer paying someone a headline salary of £25,000 could actually pay that person at least £30,000[98] once other parts of their salary – such as mandatory holiday pay and pension contributions – are taken into account. This is partly to reflect the mutual relationship between an employee and employer: an employee has certain rights and benefits but also

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96 *Good work: the Taylor Review of Modern Working Practices*, July 2017 p68, p70. In a report on the gig economy published in May, the Work & Pensions Committee also recommended the equalisation of NICs (*Self-employment and the gig economy*, 1 May 2017, HC 847 of 2016-17 para 10).

97 For example, APPG for Responsible Tax, *Building a fairer system: tax and the UK's gig economy*, June 2018

98 Self-Employment Review: An independent report by Julie Deane OBE, 2016

> obligations to turn up to work and to carry out tasks as directed by their employer.
>
> A genuine self-employed person is their own employer; they work on their own terms and provide themselves with their own pension and holiday pay. The costs associated with providing these benefits will usually be recovered through the amount that they charge. This means that for a business engaging labour, the cost of labour (whether employed or self-employed) should be neutral: they will have to meet an employed person's costs (including wages, holiday pay and pension contributions) directly and a self-employed person's costs by paying a higher fee for their services.[99]

Notably when BEIS Minister Margot James made a statement to the House on the publication of the review, she stated the Government would not revisit the question of reforming Class 4 NICs:

> **Rachel Reeves (Leeds West) (Lab) :** Matthew Taylor said today that he wants employers to pay national insurance for people with whom they have a controlling and supervisory relationship. Do the Government plan to implement that aspect of the Taylor review, and can the Minister reassure workers that the Government do not plan to U-turn on their U-turn and increase national insurance for the genuinely self-employed?
>
> **Margot James :** I can assure the hon. Lady that … Parliament has spoken on the issue of national insurance class 4 contributions. That matter is now settled, and will not be revisited. I agree with her that we should pay close attention to ensure that people who are genuinely contracted to provide an ongoing service are given the protections that workers enjoy, and are not falsely labelled as self-employed. [100]

Initially the Government anticipated giving a formal response to the Taylor review by the end of the year, but in the event this was published on 7 February 2018.

As part of this the Government launched a consultation on employment status, while ruling out any reforms to the level of NICs paid by the self-employed:

> The review … recommended that the principles underlying the proposed National Insurance (NI) reforms in the 2017 Spring Budget were correct. The level of NI contributions paid by employees and self-employed people should be moved closer to parity, at the same time as being taken to address those remaining areas of entitlement – parental leave in particular – where self-employed people lose out …
>
> While we agree with the review that the small differences in contributory benefit entitlement no longer justify the scale of difference in the rates of NI contributions paid in respect of employees and the self-employed, we are clear that we have no plans to revisit this issue. The government also agrees with the principle of equalising benefits for the self-employed, but as the review says, it is right to only consider making changes to this

99 *op.cit.* pp70-1. See also, Helen Miller, *Lack of employment rights doesn't justify lower taxes for the self-employed*, Institute for Fiscal Studies, 19 June 2018 & "Tipping the balance", *Taxation*, 11 October 2018. For a contrary view see, "Fair tax for all", *Taxation*, 22 November 2018.

100 HC Deb 11 July 2017 cc162-3. See also, PQ901, 28 June 2017

> area once we have carefully considered this in the wider context of tax, benefits and rights over the longer term.[101]

On 17 December 2018 the Secretary of State Greg Clark announced a series of reforms to amend workers' rights, following its response to the Tayor review;[102] as part of this Mr Clark confirmed that the Government would "bring forward detailed proposals" to align the frameworks for defining employment status for employment and for tax – but no further details have been published to date.[103]

Turning back to Class 2 NICs, on 6 September 2018 Treasury Minister Robert Jenrick announced that the Government would **not** proceed with the abolition of Class 2 NICs from April 2019, as previously announced:

> National Insurance Contributions
>
> The Government is announcing today that it will not proceed with the abolition of Class 2 National Insurance contributions (NICs) during this parliament.
>
> This change was originally intended to simplify the tax system for the self-employed. We delayed the implementation of this policy in November to consider concerns relating to the impact on self-employed individuals with low profits. We have since engaged with interested parties to explore the issue, and further options for addressing any unintended consequences.
>
> A significant number of self-employed individuals on the lowest profits would have seen the voluntary payment they make to maintain access to the State Pension rise substantially. Having listened to those likely to be affected by this change we have concluded that it would not be right to proceed during this parliament, given the negative impacts it could have on some of the lowest earning in our society.
>
> Furthermore, it has become clear that, to the extent that the Government could address these concerns, the options identified introduce greater complexity to the tax system, undermining the original objective of the policy.
>
> The Government remains committed to simplifying the tax system for the self-employed, and will keep this issue under review in the context of the wider tax system and the sustainability of the public finances.
>
> The Government still intends to legislate for reforms to the NICs treatment of termination payments and income from sporting testimonials, which were set out in the draft NICs Bill published on 5 December 2016. These are important changes to ensure the NICs treatment is consistent with the treatment of income tax in previous Finance Acts. We will set out further details in due course.[104]

101 HMG, Good work: a response to the Taylor Review on Modern Working Practices, February 2018 pp64-5. See also comments made by the BEIS Minister Andrew Griffiths when he made a statement to the House: HC Deb 7 February 2018 c1501.

102 HC Deb 17 December 2018 c572-4; see also, Department for Business, Energy & Industrial Strategy press notice, *Largest upgrade in a generation to workplace rights - getting work right for British workers and businesses*, 17 December 2018

103 See also, HM Government, *Good Work Plan*, December 2018 pp25-9

104 National Insurance Contributions: Written statement HCWS944, 6 September 2018

The Government's decision was confirmed in the 2018 Budget report, presented in October:

> **3.12 National Insurance Contributions Bill** – As previously announced in September, the government will not abolish Class 2 NICs during this Parliament, given the potential impacts on some of the lowest earning in society. There are two remaining measures in the draft NICs Bill published on 5 December 2016: reforms to the NICs treatment of termination payments and income from sporting testimonials. The government still intends to legislate for these reforms, which will take effect from April 2020.[105]

Maintaining Class 2 NICs, while deferring these other planned changes to NICs, is estimated to raise £180m in 2019/20, rising to £395m in 2020/21.[106]

[105] *Budget 2018*, HC 1629, October 2018 p42
[106] *op.cit.* Table 2.1 – item 75

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