

National Insurance and the self-employed

1.1 This fact sheet sets out the current system of income tax, National Insurance contributions (NICs) and contributory benefit entitlement for the self-employed compared to the employed. It details the changes that the government is making to self-employed National Insurance from April 2018.

Background: self-employment in the UK

1.2 The self-employed make a valuable contribution to the UK economy. The number of self-employed working in the UK has increased over recent decades and now accounts for 15.1% of the UK workforce. Self-employment allows individuals to innovate, develop and run their own business; some of the UK's most successful and high profit sectors include large numbers of self-employed individuals. Self-employment can also offer employment opportunities that would not otherwise exist and allow people to pursue more flexible forms of working, whether entering self-employment as a main source of income or as a supplement to employment income. Technological developments have provided opportunities for more people to offer their labour flexibly; the UK is a leading centre for the development and adoption of many new disruptive technologies.

1.3 The self-employed are a diverse population. They work across all major sectors of the economy; the two most common of which are construction and 'professional, scientific and technical activities'. Around a third of the self-employed are in professional, or associate professional and technical occupations, and around a quarter are in skilled trades. The self-employed include sole traders and those working through partnerships. This includes the Limited Liability Partnership structure, which is commonly used in the professional, legal and financial services sectors.

1.4 The tax system supports the self-employed through a high income tax personal allowance, an increasing higher rate threshold (the point at which the higher rate of income tax is paid), and a number of targeted reliefs to encourage investment and entrepreneurship. In addition, the Lifetime ISA, which will be available to under 40s from April 2017, will particularly help the younger self-employed save flexibly for the long term.

Personal tax: current system

1.5 As set out in Table 1.A, the tax and NICs that an individual pays varies according to whether they are employed or self-employed. The self-employed pay the same rates of income tax as employees: 20% at the basic rate; 40% at the higher rate; and 45% at the additional rate. Both employees and the self-employed benefit from the personal allowance, which will increase to £11,500 in April 2017. Since 2010, increases in the personal allowance have been worth £1,005 to a typical basic rate taxpayer, whether employed or self-employed.

1.6 There are some differences in the way that employed and self-employed tax is calculated. For example, expenses not subject to income tax are typically more generous for the self-employed than the employed. In addition, there is a losses regime in place for the self-employed, which allows them to offset losses made in one year against their income tax liability over time.

1.7 The self-employed also pay a lower rate of NICs than employees, at 9% between the lower profits limit (£8,060 in 2016-17) and the upper profits limit (£43,000 in 2016-17) compared to

12% for an employee on earnings between the same thresholds. Currently, the self-employed also pay Class 2 NICs at a flat rate of £2.80 per week (or £145.60 a year) although this is due to be abolished from April 2018.

1.8 In addition, employer NICs adds a 13.8% charge on employees' earnings above £8,112. The employer is liable for paying employer NICs, but the cost of this tends to be passed on to the employee through reduced wages.¹ No such charge is due for those engaged by a business on a self-employed basis.

Table 1.A: Rates of tax and NICs for employed and self-employed (2016-17)

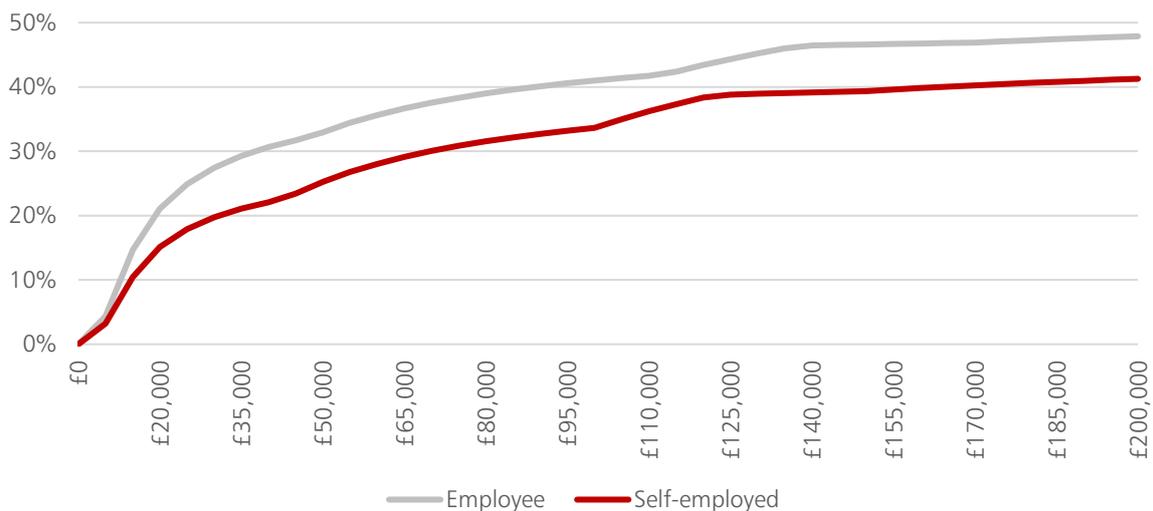
	Employee	Self-employed
Basic rate of income tax	20%	20%
Higher rate of income tax	40%	40%
Additional rate of income tax	45%	45%
Class 4 NICs for self-employed	12%	9%
Class 1 Primary NICs for employed		
Class 4 and Class 1 Primary NICs upper rate (paid above £43,000)	2%	2%
Class 2 NICs (profits above £5,965 until 2018)	-	£2.80pw
Employer NICs (paid by the employer)	13.8%	-

1.9 The tax and NICs paid by an individual differs depending on whether they are employed or self-employed. For example in 2016-17, an individual in employment with a salary of £32,000 will pay £7,073 in tax and employee NICs, whereas a self-employed person earning the same amount will pay £6,500; a difference of £573. In addition, the employed person's employer will have to pay an additional £3,297 in employer NICs, making a total differential of £3,870. This extra employer NICs charge may lower the headline salary offered to the employee.

1.10 Chart 1.A below shows the average effective tax rates (including employee and employer NICs and income tax) for employment versus self-employment at different income levels, before changes announced in Spring Budget 2017.

¹ See: <http://www.bankofengland.co.uk/archive/Documents/historicpubs/qb/2002/qb020402.pdf>

Chart 1.A: Average effective tax rates across the income distribution in 2016-17²



Source: HMT analysis

Entitlements to contributory benefits: current system

1.11 NICs have a specific purpose: receipts from NICs are spent on the NHS and contributory benefits (including the State Pension). A proportion of NICs, around 20%, goes directly to fund the NHS. A fund separate from general taxation called the National Insurance Fund takes in NICs receipts and uses them to fund contributory benefits.

1.12 Individuals in work between the age of 16 and State Pension age pay NICs above a certain earnings or profits threshold; this provides eligibility to certain benefits.

1.13 Historically, the differences in rates of contributions reflected the fact that the self-employed received less support than employees from the state in the form of contributory welfare benefits and statutory payments, particularly the State Pension. But over time this gap has reduced.

1.14 In particular, the government has introduced a new State Pension for people who reach State Pension age on or after 6 April 2016. This is more generous for self-employed people than the previous system and gives the self-employed access to the same State Pension as employees.³ Under the old rules, the most someone who had been self-employed and making Class 2 contributions could be eligible for was the basic State Pension of £119.30 a week (in 2016-17). The self-employed can now build entitlement to the new State Pension, which is worth £155.65 a week in 2016-17. So the self-employed can now receive up to £1,800 a year more in State Pension. Someone aged 65 would currently need a private pension pot of around £50,000 to get an annuity that pays £1,800 a year.

1.15 National Insurance determines eligibility to contributory benefits and state-funded statutory payments such as statutory maternity pay. The differences in eligibility to these benefits between employed and self-employed are now mainly limited to certain parental benefits. Spring Budget 2017 announces that the government will consider whether there is a case for greater parity in parental benefits between the self-employed and the employed.

² The average effective tax rate for an employee is calculated on the basis of total labour costs (income tax plus employee and employer NICs divided by salary plus employer NICs).

³ An individual's existing National Insurance record will be taken into account when their new State Pension is calculated. If they are eligible for more pension under the existing system than the full amount of the new State Pension, they will still get this higher amount when they reach State Pension age.

1.16 The other remaining difference is contribution-based Jobseeker's Allowance (JSA). JSA is designed to support those looking for a job, rather than self-employed individuals who may be temporarily experiencing a shortage of work. In common with other individuals who do not satisfy the conditions of contribution-based JSA, the self-employed may be entitled to appropriate income-related support (dependent on their household income level and savings).

1.17 While the NICs system specifically relates to contributory benefits, there are also differences in employment rights between different groups in the labour market. This includes rights provided by employers to their employees, such as statutory sick pay and holiday pay. The Prime Minister has asked Matthew Taylor, Chief Executive of the Royal Society for the Arts, to lead an independent review into employment practices to consider issues such as these.⁴

Fiscal impact of rising self-employment

1.18 While the difference between self-employed and employed individuals' access to contributory benefits has diminished significantly with the introduction of the new State Pension, the abolition of Class 2 NICs from 2018 means that the difference in NICs paid was due to widen. At the same time, the proportion of the workforce who are self-employed has risen considerably since the late 1970s, with recent growth continuing a steady upwards trend that began in the early 2000s.

1.19 This poses significant fiscal challenges. The foregone NICs from lower rates paid by the self-employed compared with employees is estimated to cost the public finances £5.1 billion in 2016-17.⁵ And the Office for Budget Responsibility have revised their self-employment forecast at Spring Budget 2017 to reflect the changing make-up of the labour market, which reduces projected tax receipts by around £1 billion a year by 2020-21.

Reforms to Class 2 and Class 4 NICs

1.20 Budget 2016 announced that Class 2 NICs would be abolished from April 2018. The rationale for abolishing Class 2 is twofold. First, the government wants to simplify the NICs system for the self-employed, responding to a recommendation from the Office of Tax Simplification.⁶ After this change, self-employed individuals will pay only one class of NICs, rather than two separate amounts calculated via different methods. Secondly, the changes make the system more progressive. Because Class 2 is a fixed cash amount, it is a regressive charge.

1.21 Currently, Class 2 determines entitlement to benefits for the self-employed. From April 2018, Class 4 will become the replacement for determining entitlement to benefits.⁷

1.22 Budget 2017 announces that to reflect the significant improvement in access for the self-employed to the new State Pension, and alongside these changes to Class 2, the rate of Class 4 NICs will be brought closer to the rate of employee NICs. The current self-employed NICs system of a flat rate of £2.80 a week plus 9% of profits at the main rate will be replaced by a single charge of 10% in 2018, which will rise to 11% in 2019.

1.23 In the short term, the combined impact of these changes will be to raise less revenue for the public finances, but by 2019-20 the reforms will increase revenue, as set out in the table below.

⁴ https://beis.dialogue-app.com/matthew-taylor-review/home?sort_order=most_comments

⁵ This represents the NICs that would be paid if the self-employed were subject to Class 1 (employee and employer) NICs. See: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/579720/Dec_16_Main_Reliefs_Final.pdf

⁶ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/199183/05_ots_small_business_interim_report.pdf

⁷ The vast majority of those paying Class 4 will see only minimal changes to the way they access contributory benefits.

Table 1.B: Revenue impact of changes to NICs

	2017-18	2018-19	2019-20	2020-21	2021-22
Class 2 abolition	-	-405	-430	-380	-350
Class 4 increase (announced Spring Budget 17)	-	+325	+645	+595	+495
Net exchequer impact	-	-80	+215	+215	+145

1.24 This package protects those with the lowest profits:

- only someone with annual profits of more than £16,250 in 2019-20 will have to pay more NICs as a result of these changes; and
- in combination with the increases in the income tax personal allowance, only someone with profits of more than £32,900 in 2019-20 could have to pay more in tax and NICs than in 2015-16

Examples of how these changes will affect individuals⁸

1.25 The examples below show how the changes to NICs in combination with the increases to the income tax personal allowance and higher rate threshold will affect how much tax and NICs a self-employed person will pay in 2019-20, compared to the start of the Parliament.

Before these changes (in 2015-16) a self-employed courier with profits of £17,500 would pay income tax of £1380, Class 2 NICs at a total of £146 and Class 4 NICs of £850. In total, he would pay £2,376 in income tax and NICs.

His employed counterpart on a salary of £17,500 would pay £2512. That is £137 more than the self-employed courier, or £1,433 more including employer NICs.

After the changes to income tax and NICs (in 2019-20), the gap in tax and NICs paid between the employed and self-employed will have reduced. The self-employed courier will pay income tax of £1,086, no Class 2 NICs and Class 4 NICs of £981. **Overall, this means a reduction in tax and NICs paid by the self-employed courier of £308 compared to 2015-16.**

Before these changes (in 2015-16) a self-employed taxi driver with profits of £25,000 would pay income tax of £2,880, Class 2 NICs at a total of £146 and Class 4 NICs of £1,525. In total, he would pay £4,550 in income tax and NICs.

His employed counterpart on a salary of £25,000 would pay £4,913. That is £363 more than the self-employed driver, or £2,694 more including employer NICs.

After the changes to income tax and NICs (in 2019-20), the gap in tax and NICs paid between the employed and self-employed will have reduced. The self-employed taxi driver will pay income tax of £2,586, no Class 2 NICs and Class 4 NICs of £1,806. **Overall, this means a reduction in tax and NICs paid by the self-employed taxi driver of £158 compared to 2015-16.**

⁸ HMT analysis. 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.

Before these changes (in 2015-16) a self-employed electrician with profits of £50,000 would pay income tax of £9,403, Class 2 NICs at a total of £146 and Class 4 NICs of £3,241. In total, she would pay £12,790 in income tax and NICs.

Her employed counterpart on a salary of £50,000 would pay £13,674. That's £884 more than the self-employed electrician, or £6,665 more including employer NICs.

After the changes to income tax and NICs (in 2019-20), the gap in tax and NICs paid between the employed and self-employed will have reduced. The self-employed electrician will pay income tax of £8,132, no Class 2 NICs and Class 4 NICs of £4,311. **Overall, this means a reduction in tax and NICs paid by the self-employed electrician of £348 compared to 2015-16.**

Before these changes (in 2015-16) a self-employed lawyer with profits of £150,000 would pay income tax of £53,643, Class 2 NICs at a total of £146 and Class 4 NICs of £5,242. In total, she would pay £59,030 in income tax and NICs.

Her employed counterpart on a salary of £150,000 would pay £59,914. That's £884 more than the self-employed lawyer, or £20,465 including employer NICs.

After the changes to income tax and NICs (in 2019-20), the gap in tax and NICs paid between the employed and self-employed will have reduced. The self-employed lawyer will pay income tax of £52,960, no Class 2 NICs and Class 4 NICs of £6,311. **This means an increase in tax and NICs paid by the self-employed lawyer of £240 compared to 2015-16.**

Impacts of changes in personal tax on different profit levels

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