Bringing the self-employed in from the cold

1. Introduction

This note sets out why political attention is turning to the inadequacy of pension coverage for the self-employed and how the issue could be solved in an efficient way.

2. Summary

2.1 The self-employed could be given an incentive to automatically enrol. This could be done by using an increase in Class 4 NICs to provide an "employer contribution"which would be lost (along with tax relief) if the self-employed did not enrol.

2.2 On the supply side, HMRC will soon have the capability to act as the aggregator of demand by the self-employed. It would be able to operate an allocation system for the self-employed – using an carousel arrangement to allocate them to participating providers where the self-employed express no preference. This is necessary as the average income of the self-employed is low and, in addition, absence this aggregation of demand, all of the scale obtained by selling through employers is lost. For this reason serving the bulk of the self-employed is not currently a cost-effective proposition for providers.

3. Who are the self-employed?

3.1 The Federation of Small Businesses (FSB) state that in the past that the majority of self-employed people worked in the construction and building trades and that while this remains the case, the recent growth in self-employment has been primarily in professional occupations including the education, technical information and communication sectors[1].

3.2 The self-employed are growing in numbers and now comprise roughly 15% of the workforce[2].

3.3 A small tail (approximately 2%) of the self-employed earn over £100,000 and a similar-sized tail earn £2000 or under (approximately 1.5%)[3]. When these extremes are deducted, the average wage of the self-employed was just over £18,000 in 2011[4].

3.4 The number of self-employed has been growing rapidly. The ONS estimate that there were 3.8 million people in this category in 2008 and 4.6 million in 2015[5].

4. Extent to which the self-employed have pensions

4.1 A report produced for Citizen's Advice in 2015 found that only 17% of the self-employed were contributing to a pension[6]. Self-employed women had a lower rate of participation than self-employed men – 13% as opposed to 19%[7]. In the mid-1990s, participation of the self-employed in pensions was much higher and was estimated to be as high as 62% by DWP[8].

4.2 Citizen's Advice concluded that the characteristics of the new self-employed and their low participation in pensions "...can put those at the lower end of the of the labour market at a disadvantage... The introduction of auto-enrolment for workplace pensions has improved levels of saving among employees, and an equivalent offer to support saving amongst the self-employed is one option to address this which deserves consideration."[9]

[1] FSB (2016) "Going it alone, moving on ip: supporting self-employment in the UK", p.4

[2] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/500317/self-employed-income.pdf

[3] http://www.taxresearch.org.uk/Documents/SE12013.pdf

[4] Ibid, p.24

[5] https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/articles/trendsinselfemploymentintheuk/2001to2015

[6] https://www.citizensadvice.org.uk/Global/CitizensAdvice/Work%20Publications/Whoaretheselfemployed.pdf, p.3

[7] Other surveys, for example by the FSB find larger minorities of self-employed contributing to pensions. The latter found that 31% of their survey were contributing to a pension (op. cit, p.4), similarly the resolution Foundation

[8] http://www.royallondon.com/about/media/news/2016/april/britains-forgotten-army-the-collapse-in-pension-membership-among-the-self-employed-and-what-to-do-about-it

[9] https://www.citizensadvice.org.uk/about-us/policy/policy-research-topics/work-policy-research-surveys-and-consultation-responses/work-policy-research/who-are-the-self-employed

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5. Political response

5.1 Concern at the growing numbers of self-employed people falling outside of pension saving is one of the reasons for the DWP select committee to open an inquiry into whether the structure of the UK welfare system is supporting the self-employed[10].

5.2 The Pension Minister has also stated on a number of occasions that one focus of the 2017 Review into automatic enrolment should be on whether and how the self-employed should be brought into automatic enrolment.

6. Demand-side obstacles to bringing the self-employed into automatic enrolment

6.1 Lack of incentives for the self-employed

Currently, the incentive on the self-employed to save into a pension is limited to tax relief. For the majority, given the average wage for the self-employed, this will be at the basic rate.

6.2 Fluctuations in income

6.2.1 A concern for the self-employed is that their income is unpredictable and intermittent, making regular set contributions problematic.[12]

6.2.2 The government's self-employment review also indicated a desire on the part of the self-employed to access their pension savings when needed.[13]

7. Supply-side obstacles

7.1 The main supply-side obstacle is that there is no pay roll function with which automatic enrolment workplace pension providers can interact.

7.2 Even if we assumed for the purposes of argument that 6.1. were not the case, single individual workforces eliminate the benefits of scale and would constitute business on which AE providers could not cover their costs. Fluctuations in income would also play havoc with current AE requirements.

8. Political obstacle

8.1 The main political obstacle will be the Treasury objection to spending more money on tax relief.

8.2 A subsidiary objection from the Opposition could be any diversion of any existing national insurance receipts to funding tax relief for the self-employed rather than existing welfare institutions, primarily the NHS.

9. Suggested solutions

9.1 Demand side obstacles

9.1.1 Lack of incentives

It has been suggested that the self-employed could be brought into AE by assessing them as if they were their own employer.

The mechanism proposed is one in which Class 4 NICs are raised from 9% to 12%. The extra 3% would go to into AE as long as the individual made a matching 4% contribution. If they opted not do so, they would be passing an extra 3% of tax to HMRC and forfeiting a 4% matching contribution from the state (the returned 3% of NICs plus tax relief).

[10] https://www.parliament.uk/business/committees/committees-a-z/commons-select/work-and-pensions-committee/news-parliament-2015/self-employment-gig-economy-launch-16-17

[11] https://www.ft.com/content/77f24f6a-ad91-11e6-9cb3-bb8207902122

[12] http://www.fsb.org.uk/docs/default-source/fsb-org-uk/fsb-supporting-self-employment-ukf15f3abb4fa86562a286ff0000dc48fe.pdf?sfvrsn=0

[13] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/529702/ind-16-2-self-employment-review.pdf

9.1.2 Fluctuations in income

9.1.2.1 If, as we describe in section 9.2.3. below, HMRC were to collect the self-employed contributions, then the issue of fluctuations in income could be met by having an annual lump sum contribution (potentially split into instalments) based on the preceding year's accounting profit.

9.1.2.2 It should also be noted that by 2019-20 that the flow of RTI into the HMRC system will mean that the future equivalent of self-assessment would likely be more frequent than once a year, meaning that the lump sum assessments would be more frequent but smaller.

9.1.3 Access to pension savings

While a desire to access savings is understandable. It is undesirable for this to be a feature of a pension system. Systems that attempt to achieve this are likely to mislead people. Accessible pension savings have two features that are destructive of a retirement income: pension providers are obliged to invest savings in low return but liquid investments, and, in a UK context, in aggregate, these savings will be transferred from a younger saving population to an older property owning age-group and not retained in a pension saving vehicle.

9.2 Supply-side obstacles

9.2.1 The supply side obstacles would be met by tasking HMRC to occupy a functional position equivalent to that currently played in automatic enrolment by payroll today.

9.2.2 Workplace pension providers would continue to play the role which they do today as regards the employed. However, economies of scale would be retained by HMRC acting in its functional equivalent of payroll. Efficiency and equality of Pension provider selection could be achieved by a carousel system. Where individuals did not opt out and did not name a preferred provider, HMRC could operate a carousel system, allocating self-employed individuals to providers on this rotational basis.

9.2.3 HMRC operation of the contribution deduction system

9.2.3.1 The self-employed would be picked up through self-assessment or rather the equivalent of self-assessment in the fully digitalised environment (see 9.2.3.4 below).

9.2.3.2 The calculations of contributions should be based upon accounting profit (income may seem sensible however depending upon the self-employed person's business model, it could be misleading and risk a disproportionate amount being required, assuming that it is percentage based). Taxable profit would be much harder for many to calculate and many probably won't even attempt to do so.

9.2.3.3 Income, expenditure and profit (three line accounting for the micro businesses) are often all that is logged officially and is:

- Only visible, officially, once a year (via Self-Assessment = SA 103f), and

- Is the only means that can be used to determine prospective contributions.

- That the most widely adopted means of submitting SA are currently via:

a. HMRC's Online SA portal, inc. SA 103

b. Accountants/bookkeepers own software solutions (provided by the likes of Sage, IRIS, etc.) that let them process SA and interact with HMRC along with other key tasks, such as producing a set of accounts

c. SA Software for self-employed (provided by the likes of TaxCalc, BTC, etc.) that provide a richer experience (than HMRC's online service) – e.g. help and support - for such customers, inc. the filing to HMRC.

9.2.3.4 HMRC have introduced the 'Personal Digital Tax Account' (PDTA) – a portal that presents all the info they know about the individual (including income sources, amounts, etc.), with the aim to enable the individual to validate/challenge these items and the SA path for SA103f should disappear from their SA portal from 2018 and whilst software systems will be able to submit this data, the info should be presented via the PDTA and the customer's task is to confirm/amend such information, for subsequent processing by HMRC.

9.2.3.5 Given the time taken to implement such new regimes, it would be sensible if supply-side access would be into the new PDTAs, or the 'Business Digital Tax Account' (BDTA) – whichever is most appropriate (and have these calculate the pension contributions) along with working with the software industry on how they would feed such info in re. contributions in their various solutions for Accountants, Bookkeepers and Individuals.

9.2.3.6 This should take place once a year (at a reasonable time post year-end, giving accountants/bookkeepers/end-users time to close the previous year, including corrections) and apply the appropriate pension deduction. We are cognisant of the Making Tax Digital initiative and whilst in principle this could facilitate more regular reporting (and so, deductions), we feel that annual is most appropriate as it is through their annual year-end accounting process, that the accounting profit figures can most effectively be produced.

9.2.4 Interaction between the individual, HMRC and the provider

9.2.4.1 The self-assessment form and future equivalent would request information relevant to setting up a pension, for example intended retirement date.

9.2.4.2 In order to minimise the barrier to participation that separate provider information requests could constitute, HMRC (working with FCA and TPR) could require any participating providers to work to a common standard information request which was built into, and so surfaced through the self-assessment process. The HMRC system could also be receiving feeds of information from the systems feeding information to the pension dashboard, which would in many cases allow it to pre-populate much of the information and in reverse, the same pension dashboard infrastructure could also be enhanced to pass the contributions information to the providers.

9.2.4.3 When the individual is completing her self-assessment, they would be given the option to opt out. If they opted out, then they would pay a higher level of NICs.

9.2.4.4 If they stayed in, then they would be offered a choice of providers. If they made no choice, they would be defaulted to the carousel.

9.2.4.5 Whether they made a choice or were given a carousel provider, they would be passed through to the site of a provider.

9.2.4.6 At the provider's site, they would receive disclosure of the provider's terms and conditions and be asked for their agreement as well as any additional information required (standardisation as per 9.2.4.2 would eliminate the need for any additional information).

9.2.4.7 Once agreement was given by the individual, the provider would automatically alert the HMRC that contributions should be deducted and passed across. This communication would also inform HMRC if the individual wished to contribute above the minimum level.

9.2.4.8 If the individual began the journey but did not provide agreement, HMRC would not receive the automatic alert, and the individual would pay a higher rate of NICs. The HMRC system would be capable of detecting this and providing a prompt.

9.2.4.9 It would be critical for the economic feasibility of this system for providers that the body responsible for collecting contributions (i.e. HMRC) was responsible for dealing with any queries regarding the correct collection of contributions.

9.2.4.10 HMRC would make the NICS deduction and pass the values across to the relevant provider (with the remittance data) using existing payment capabilities (e.g. VAT refunds, benefits) – probably on a daily, batch basis for efficiency (and harness the dashboard infrastructure for passing back the remittance data).

9.2.4.11 HMRCs control over collection would facilitate a far more efficient process for the payment of tax relief.

9.2.5 Feasibility of HMRC occupying the functional position

9.2.5.1 For the software interface, this would need a relatively small amendment to the planned APIs from HMRC along with changes to the P/BDTA platform – neither of which would be difficult or costly.

9.2.5.2 For the systems interface, this would need some new development to surface the carousel and make the deductions along with adding APIs to interface with the Pensions Dashboard (which, conceivably, could have its scope extended to incorporate to include some of this systems development) and could harness some of HMRC's existing capabilities, such as its collection of contributions for repayment of Student Loans.

9.3 Political obstacle

9.3.1 The Treasury is spending a minimum of £850 million on the Lifetime ISA, according to its own calculations. This figure is dependent on the unlikely assumption that no employees are diverted from saving from a workplace pension into a Lifetime ISA. This is unlikely given the temptation of early access and the brand strength of the ISA name. (Surveys indicate that take up of the Lifetime ISA will not follow the pattern predicted by the Treasury.) There are a host of reasons why the Lifetime ISA is likely to be an extremely poor product from the perspective of anyone trying to build a pension, which is why the FCA are proposing that it can only be sold with a risk warning .

9.3.2 The cost of bringing the self-employed might be roughly £550 million, if the system went to flat rate tax relief and the lower NICs threshold were retained. If the lower NICs threshold were removed it might be roughly £800 million.

9.3.3 The difference between a LISA for the self-employed and a workplace pension for the self-employed is:

9.3.4 No reliance on inertia, so take up will be lower;

9.3.5 None of the protections on governance or charge-cap and drive to low cost on part of the master trusts;

9.3.6 An ISA market primarily based cash ISAs incapable of generating a retirement income;

9.3.7 Early access will mean a product that does not deliver pensions but instead boosts the housing market (allowing claw-back of tax relief).

More information

For further information on this response, or the work of B&CE and The People's Pension, please contact:

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