THE LIKELY IMPACT OF THE TAX SYSTEM ON SELF-EMPLOYMENT IN THE BRITISH CONSTRUCTION INDUSTRY

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This paper examines the development of self-employment in the British construction industry over recent decades, and relates trends in self-employment to changes in the tax regime. The paper traces the rise of the self-employed construction worker during the 1980s and early 1990s in the face of very favourable tax and National Insurance legislation. The preferences of both employers and workers for self-employment status are critically examined. During the late 1990s the tax authorities began a clampdown on bogus self-employment which has resulted in a very significant switch back into direct employment. Further tax changes are in prospect and these are likely to lead to further reductions in the numbers in self-employment. The paper analyses the most recent changes and probes the likely consequences for the industry, in areas such as training and labour turnover.

Keywords: direct-employment, labour market, self-employment, tax system.

INTRODUCTION

The construction industry is a sector where it is comparatively easy to set up in self-employment, and the industry has always had a significant proportion of its workforce in self-employment since the earliest times (Winch 1998). Accordingly, the British construction industry has come to form a high dependence on the supply of skills arising from the external self-employed market. Self-employment has grown considerably over the past three decades. This trend has been attributed to a very favourable tax regime benefiting the self-employed and to the widespread use of subcontracting services. However, in the second half of the 1990s, the Inland Revenue and the Contributions Agency embarked on a programme of reform of the tax arrangements for the self-employed in the construction industry. These measures have changed the financial climate for both construction workers and employers, and have led to marked shifts in the pattern of construction self-employment. The steady increase in the percentage of the construction workforce in self-employment has been thrown into reverse and direct-employment is beginning to grow again after many years of decline.

This paper examines the trends in construction self-employment from 1970 to the present. It analyses the financial factors, especially the taxation regime, behind the increasing popularity of self-employment as a preferred method of working. The paper details the acceleration in self-employment during the 1980s and explains why it was favoured, not only by the workers, but also by the construction employers. The paper then goes on to describe the new tax regime and it assesses the likely impact on...
the future structure of the construction labour market. Finally, the management implications of the changes to labour market for construction employers are evaluated.

HISTORICAL DEVELOPMENTS IN SELF-EMPLOYMENT IN THE BRITISH CONSTRUCTION INDUSTRY

In post-war Britain self-employment in construction, has increased appreciably. Prior to 1980, a number of factors contributed to a steady growth in construction self-employment. In the mid-1960s, the introduction of redundancy payments legislation and a Selective Employment Tax prompted a move to higher levels of self-employment. By the time the Phelps Brown Report (1968) was commissioned to examine the condition of labour and sub-contracting in the British construction industry’s work force, there were already significant numbers of workers in self-employment. The report itself extolled the advantages of the self-employed, arguing that such workers produced higher productivity and thereby yielded better employment conditions for both employers and employees. Whilst there are many factors influencing the rise growth of self-employment within the UK construction sector (Winch 1998), this paper focuses on the role of the tax regime as the prime causal factor in this regard.

The new Conservative government of 1970, although abandoning a plan for compulsory registration of the self-employed, laid the basis for a taxation regime, which encouraged further growth in self-employment within the sector (Harvey 1995). The 1971 Finance Act introduced a new form of taxation collection in the construction industry, namely the 714 Certificate Scheme. Under this scheme, self-employed workers and sub-contracting companies could, subject to certain easily satisfied conditions, receive a certificate which would ensure that no income tax would be deducted at point of payment. Instead, an annual assessment tax was paid on profits agreed after the deduction of a generous level of expenses. If an operative claiming self-employed status did not qualify for a 714 Certificate, they came under the SC60 scheme. Under this scheme, income tax at the base rate was deducted from any payment for labour and a final appraisal of tax owing or refundable was made at the end of the tax year. This tax regime, which was unique to the construction sector, was introduced to try to collect more income tax and National Insurance contributions than had proved possible under the original Pay As You Earn (PAYE) arrangements. Workers in construction, who chose to regard themselves as self-employed, were allowed to do so by both the Inland Revenue and the Contributions Agency, regardless of their actual employment circumstances.

In the years immediately following the 1971 Finance Act, the transition from direct to self-employment was relatively gradual. The recession of the mid-1970s limited opportunities for the self-employed and the small sub-contractor. Trade unions resisted the trend towards self-employment by establishing a clause in the National Working Rule Agreement for the NJCBI. This suggested removal of contractors from the register of firms who tendered for public sector work, if they employed labour only sub-contractors. At this time, the public sector client generated a larger proportion of total construction work than is the case today.

The advent of another Conservative government after 1979 triggered a strong resurgence in construction self-employment. Figure 1 show how over the decade 1981-1990 self-employment in construction grew markedly, whereas self-employment in other sectors increased only very slowly. Throughout the 1980s, self-employment
Self-employed taxation

was encouraged as evidence of entrepreneurial behaviour and little concern was shown over the true status of many construction workers who rushed into self-employment. Figure 2 also shows self-employment in construction increasing significantly during the 1980s.

The 1980 Finance Act eased the conditions for qualification as a 714 Certificate (or 715 Voucher) holder, by removing the requirement for the self-employed contractor to possess a substantial minimum level of employer and public liability insurance. At the same time, the 1980 Planning and Land Act introduced a new measure of competition into tendering for public sector contracts let by local authorities. In this way, this important market was progressively opened up to labour-only sub-contractors and self-employed operatives, as the share of the work given to Direct Labour Organizations was significantly reduced. The 1982 Employment Act outlawed contracts which specifically stipulated the use of unionized labour and so, the clause in the Working Rule Agreement that had been introduced in the 1970s to restrict the role of labour only sub-contracting in public sector work was effectively defeated. All of these measures effectively provided a platform for new growth of self-employment in the 1980s.

Figure 1: trends in self-employment % self-employed in workforce (Source: LFS Historical Trends, 1998)

Figure 2: construction employment: by type of employment (Source: LFS Historical Trends, 1998)
It is unlikely that without the boom in construction demand, which occurred in the second half of the 1980s, that self-employment would have accelerated in the way it did. The rapid expansion in speculative house building and commercial buildings in the period 1985-1989 led to a strong growth in demand for construction skills, and skill shortages became quite common in key trades (Briscoe 1990). Many contractors, unable to meet their labour demand from within the ranks of their own direct employees, turned to the external labour market. Both day-rates and piecework rates were rapidly bid up in the face of this strong demand, and many construction operatives now saw the opportunity to increase their earnings by switching into self-employment. In fact, it was not until the recession of the early 1990s that the growth of self-employment within the industry showed any signs of decline. Figure 2 shows that the numbers in self-employment reduced through this period, although as Figure 1 shows, construction self-employment as a percentage of the work force remained more or less constant throughout the recession years. This was because direct-employment was increasingly difficult to find. When demand began to increase after 1993, so the numbers in self-employment resumed their upward trend.

**REASONS FOR THE HISTORICAL RELIANCE ON SELF-EMPLOYMENT WITHIN THE BRITISH CONSTRUCTION INDUSTRY**

The key reason for contractors preferring a predominantly self-employed work force, is the financial savings that can be made over direct-employment. Evans and Lewis (1989) estimated the overall savings from all sources at between 20 and 30 percent of the total wage bill. Savings for employers using a labour-only work force include the national insurance contribution on the employees gross wage payment (a saving of around 12 % on the wage bill); the administrative costs of making PAYE deductions from the employee; payments for sickness or holidays; higher overtime rates and bonus payments (Druker and White 1996). Contractors who rely on labour-only sub-contracting and the hiring of self-employed operatives also avoid the potential costs of training their direct employees. Such costs have been shown by Hogarth *et al.* (1996; 1998) to be highly significant in training new entrants to National Vocational Qualification Levels 2 and 3 in craft and technician skills. Failure to train avoids these costs and leaves the training responsibilities to other construction firms and organizations.

The benefits of self-employment for contractors are not restricted to the direct financial gains that can be made over direct-employment. A key advantage concerns the flexibility which a self-employed work force conveys (Druker and Macallan 1996). In markets characterized by fluctuating workloads, there are clear financial advantages in using self-employed operatives for each contract. The self-employed work force have no protection from redundancy or unfair dismissal, and the contractor’s responsibilities for such workers is strictly limited in law. Only rarely will self-employed operatives be members of a trade union and generally their working conditions will be outside the scope of any collective agreement. In addition, the European Union Working Time Directive, introduced into Britain in 1998, has reinforced the benefits of using a labour-only work force. This directive imposed new requirements in respect of monitoring the length of the working week and ensuring that the direct work force receive their statutory entitlement to paid holidays. Employers seeking to minimize their obligations are drawn towards self-employment as a preferred way of meeting their labour requirements.
The economic evidence as to whether self-employment provides higher financial rewards than direct-employment has recently been reviewed by Bryson and White (1998). It is difficult to make simple comparisons on average earnings between the two types of employment as it is rarely possible to compare like with like. Variations about the average are particularly significant for all self-employed workers, with some individuals receiving very low incomes. Self-employed earnings also vary across the economic cycle. Thus, Bryson and White concluded that there appears to be little real difference in earnings between self and direct-employment. However, despite there being no clear overall economic case for self-employment, workers in the construction industry have often shown a preference for this form of employment (see Winch 1998). This is because historically the self-employed operative has gained financially through evasion of taxes and National Insurance contributions.

Construction workers in possession of 714 Certificates had the opportunity to make significant financial gains from adopting self-employed status, as opposed to direct-employment with its associated system of PAYE taxation. In the first instance, the self-employed worker is responsible for providing information to the Inland Revenue on annual earnings from all sources. It is highly unlikely that all operatives make full income disclosures. Some of the work done by the self-employed is paid for by cash-in-hand and these earnings may well not be fully declared for tax purposes. It is impossible to estimate with any accuracy the amounts lost to the Inland Revenue through such practices, but, many self-employed workers retain a higher proportion of their gross earnings than would be the case if tax was deducted at source. For those operatives on the SC60 scheme this opportunity for financial gain is not theoretically available.

Perhaps a more important source of income gain, however, is the current expense allowances which the self-employed are able to claim against gross earnings, thereby reducing the amount of earned income on which tax becomes payable. Allowances can be claimed in respect of tools and clothing, travel, reasonable entertainment in pursuit of business and domestic costs. Additionally, many self-employed claim for the cost of a spouse or partner’s notional services in carrying out secretarial work for the business. Of course, the ability of the self-employed to fully realize all these potential benefits may well hinge on the efficiency of accountants and the maintenance of accurate paperwork in support of such claims. Whilst the well-organized 714 Certificate holder is likely to take full advantage of the potential savings to be made from the available allowances, the less-favoured SC60 worker is much less likely to claim the allowance (see Harvey 1995). Furthermore, it should be noted that practices of making false declarations of gross income and fraudulent claims for expense allowances are well known to the Inland Revenue (see Golzen 1997), and the resulting penalties are particularly severe.

Prior to the introduction of the new system of self-assessment in taxation in April 1997, taxes arising from self-employment were paid with a significant time delay. Such a system aided the cash flow for the self-employed business and enabled interest to be earned on the balances owing to the Inland Revenue, between the receipt of income and the actual payment of the tax due. The self-employed worker does not usually pay Class 1 National Insurance contributions, but pays a Class 2 contracted-out contribution instead. In the tax year 1997/8 the difference for an operative on £20,000 per annum is a saving of about £1,400 over the year. When added to advantages of the higher pay rates that the self-employed can command in times of high construction demand, there can be seen to be many factors encouraging operatives to opt for self-employment.
THE CHANGING POSITION OF THE INLAND REVENUE AND THE CONTRIBUTIONS AGENCY IN THE 1990S

During the 1990s, there was an increasing tendency for the Inland Revenue to challenge all tax payers’ claims to be assessed as self-employed (Schedule D), and to attempt to bring them within the PAYE system used for employees. By the mid-1990s, it was apparent that the Inland Revenue and the Contributions Agency were being deprived of large amounts of revenue through bogus self-employment in construction. Harvey (1995) estimated the combined revenue loss to the Exchequer to be between £1.2 and £1.8 billion each year. Such a calculation does not include any losses from VAT fraud associated with self-employment. Birkbeck (1995) cites an Amalgamated Engineering and Electrical Union estimate of almost £1.3 billion annual loss on National Insurance contributions alone.

In 1994, the Inland Revenue issued a draft guidance note warning construction employers that a 714 tax-exemption certificate did not make the holder self-employed (Inland Revenue 1994). Employers were warned that where they issued instructions to “self-employed” workers on how to perform specific tasks, this could make such workers classifiable as employees. The 1995 Financial Bill outlined plans to introduce a minimum turnover threshold for 714 Certificate eligibility, so as to ensure that only substantial businesses would be eligible for gross payments under contract. Increasingly, it became clear that the tax authorities were intent on reversing the trend into self-employment. At the beginning of the 1997 financial year the Inland Revenue and the Contributions Agency launched their “clampdown” on self-employment in construction (Ridout 1997). This did not involve any new legislation, but it was an attempt to close existing loopholes and compel firms to take workers onto their direct payrolls, where hitherto they had been enjoying self-employed status.

The changing position of the Inland Revenue and the Contributions Agency obliged construction employers to review the position of their self-employed workers. Knutt (1997) identified six options available to the employers: decide that 714/SC60 workers are genuinely self-employed under Inland Revenue conditions; rearrange contractual relationships with 714/SC60 workers to meet Inland Revenue conditions for self-employment; acknowledge that 714/SC60 workers are in reality direct employees and take them onto PAYE; negotiate with recognized labour agencies to transfer 714/SC60 workers onto their books; create a company labour agency specifically to employ 714/SC60 workers who can then be hired out to the company; or assist groups of self-employed workers to form themselves into a limited company. Initially the labour supply agency options were seen to be very attractive (Ridout 1997). However, the Inland Revenue closed this exemption loophole very quickly, by insisting that such agencies treat their employed workers as direct employees rather than self-employed operatives. The limited company option is unattractive, given the legal obligations which it would entail. Thus, the basic decision for the employer is whether to try to meet Inland Revenue criteria for self-employment and specify the contractual relationship in writing, or to take the workers on to the payroll as direct employees.

Throughout 1997 and 1998 the construction press ran articles and commentaries painting a very grim picture of the demise of self-employment in construction. The clampdown was described as especially difficult for smaller companies and specialist sub-contractors. It was assumed that these firms would be the prime target for Inland Revenue compliance checks (Knutt 1997). Larger companies, who are more...
orientated to management contracting, were felt to be little effected by the clampdown. It was widely supposed that construction costs would be significantly increased, as many self-employed workers were moved into direct-employment and company payroll costs would rise. Statistics derived from the Labour Force Survey (LFS) data indicate that the clampdown has effectively reversed the upward trend into self-employment. Figure 1, for example, clearly shows self-employment falling sharply after 1996. Likewise, Figure 2 shows direct employees in construction increasing significantly after 1996, as self-employed workers switch status. However, despite these trends, the impact of the clampdown has not been uniform across the industry. Whilst some employers have felt the pressure to expand direct-employment, others have continued to operate bogus self-employment and cash-in-hand working (Knutt and Glackin 1998). Advertisements continue to appear in both the national and construction press for “self-employed” work, which in reality must be regarded as direct-employment according to Inland Revenue definitions. There have been relatively few prosecutions of contractors by the Inland Revenue and compliance investigations are far from widespread. It is not proving easy to implement the clampdown effectively.

There is little hard evidence to date that construction costs have increased much as a result of the clampdown and certainly nothing like the 20 percent increase in labour costs which were originally claimed. Wage cost and tender price indices do not show any unusual upward movement in the period after 1996. Some smaller subcontractors, who complied with the clampdown and switched their workers into direct-employment, have claimed that their costs have increased as a result, but such costs have not been passed on into higher tender prices to main contractors. Many employers remain very reluctant to take workers onto PAYE. Knutt and Glackin (1998) reported that seminars have even been developed to show employers legal loopholes for avoiding direct-employment. It will take a much longer period of time to get widespread compliance with the new regime.

Under the New Construction Industry Scheme (CIS), current 714 Certificates become invalid and the conditions for obtaining new tax certificates to enable sub-contractors to receive gross payments become much more stringent (Inland Revenue 1998). In order to qualify for the new tax exempt certificate (CIS6), an individual self-employed worker must demonstrate an annual net turnover of over £30,000, operate a business which maintains proper accounts from recognized premises and have an up-to-date tax record for the preceding three years. A comparable set of rules apply for a partnership or company obtaining the new tax certificate (CIS5 for companies). Failure to obtain the relevant tax certificate means self-employed workers will be forced onto the SC60 scheme, where basic rate taxes and National Insurance are deducted at source from any payments. The CIS brings with it new responsibilities for employing contractors. Broadly, these involve checking the validity of any presented certificates and recording any payments made on appropriate Inland Revenue vouchers. The contractor is charged to determine whether the worker is really self-employed or an employee. It is anticipated that many “self-employed” workers currently in possession of 714 Certificates will not be able to qualify for the new CIS6 Certificates. Likewise, some partnerships and smaller limited companies may not meet the corporate threshold for the CIS5 Certificate (Bridge 1998). The Inland Revenue sees the new system as an important step in recovering more tax and National Insurance from the half a million or so construction workers who remain holders of 714 Certificates.
DISCUSSION: THE LIKELY IMPACT OF THE NEW LEGISLATION

The impact of both the 1997 clampdown and the 1999 CIS will be to reduce the number of self-employed workers in the construction industry (Briscoe 1999). Whilst larger employers may view the tax reforms as significant improvements in the labour market, many others, including smaller companies and self-employed workers, are decidedly unenthusiastic about the new arrangements. As Winch (1998) has argued, it will prove very difficult for construction to revert back to direct-employment on a much larger scale. Yet the trend back is clearly established and the consequences of this turnaround need to be faced. Even those who predict that the shift away from self-employment will yield improvements to the industry acknowledged that this will be at a price (Green 1998).

Perhaps the biggest gain lies in the potential to improve the quality of the construction work actually carried out. Many clients are concerned about the quality of the work done, see, for instance Egan (1998). Where more of the production work is executed by the company’s direct-labour force, theoretically, there is much better control over quality. When the work package is distributed amongst a number of different subcontractors, many of them small firms, staffed by self-employed operatives, control over quality can become difficult to achieve. Certainly, construction clients often comment adversely on a production system that relies so heavily on external self-employed skills. Closely associated with quality is the issue of labour productivity. Construction is a sector often regarded as having relatively low labour productivity, which manifests itself through project and budget over-runs. Traditionally, self-employed workers have often produced relatively high output per hour as a result of time-related systems of payment, although such gains have frequently been dissipated through high material wastage and poor work co-ordination. Accordingly, there exists considerable potential for raising productivity by greater use of direct labour, and an increased investment in plant and machinery. Smaller firms, with only a few self-employed workers, are not usually financially able to make this kind of investment.

Self-employment is commonly associated with low levels of training (Rainbird and Clarke 1988). Where more workers switch into direct-employment it is expected that the incentive for employers to train (including safety training) will increase. Clarke and Wall (1998) stress how casualization associated with self-employment, especially the SC60 system, has led to de-skilling in the UK construction industry. A return to direct-employment will not guarantee a higher level of training, but if it provides a more long-term employment structure, this is expected to produce increased levels of investment in human resources. This investment may also realize benefits in industrial relations, increases in union membership, with direct employees being more likely to join trade unions (Langford et al. 1995), and lower levels of labour turnover. Construction currently suffers relatively high labour turnover, but the shift into more direct-employment should place greater emphasis on continuous working and staff loyalty. The ability to develop teams of workers and hold the team together over several contracts should also be much enhanced. Such changes will require companies to develop their human resources management much more fully. At present, this function is not at all well developed in many construction companies, often because the direct staff is small, or restricted to professional/managerial employees.
Employers are concerned that their labour costs will increase as a result of taking more workers onto the payroll. Certainly, these are higher on-costs with direct employees than with self-employed workers. The key to controlling these cost increases lies with securing higher productivity, possibly through increased training and investment in new technology. There is a challenge for company management to produce higher levels of productive efficiency with the direct work force. This will involve the company looking at ways of securing the same kind of flexible working from its employees, which it traditionally obtains from the self-employed workers.

CONCLUSIONS

The self-employed worker is an important part of the construction labour market in the UK. In the period 1970-1995, self-employment increased significantly to the point where, on many projects, it became the dominant form of labour input. This rise in self-employment was driven by a tax system, which was highly favourable both to the worker and to the company seeking self-employed services. In recent years, however, changes in the tax and National Insurance regime have led to a downturn in the numbers in self-employment. Such changes pose challenges to construction companies in the form of larger numbers of direct employees seeking continuous employment. The impact on self-employed workers of having to switch to the SC60 scheme could be very strong, with those unwilling to switch into direct-employment, perhaps, being forced to attempt to move to the black economy and work for cash-in-hand. The option of forming a small construction company would not appear to be viable under the new stricter tax regime.

The full impact of the taxation changes has yet to work out on the construction labour market. Indeed, the clampdown is still being assimilated by many companies in the industry and the New Construction Industry (Tax) Scheme is only now being introduced. Further research will be needed to establish the longer-term effect of the recent tax changes on the propensity to self-employment and to evaluate how construction companies are adapting to using more direct labour, rather than sub-contracting out to predominantly self-employed workers.

REFERENCES


Briscoe, Dainty and Millett


