

A UCATT Report

# The Evasion Economy

False Self-employment in the UK Construction Industry



Mark Harvey  
and Felix Behling

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## **FALSE SELF-EMPLOYMENT IN THE UK CONSTRUCTION INDUSTRY**

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## Executive summary

- ❖ Self-employment is defined as false when the engaged worker would be deemed directly employed by normal legal tests. False self-employment is adopted as a device to reduce the tax liabilities and employer responsibilities' of the engager and/or engaged. The false self-employed are not in business on their own account, come under the control and supervision of their engagers, are paid wages rather than work for a client under contract, and in most cases, continue to work for the same engager of their labour on successive construction projects, and for long periods of time. It contrasts with genuine self-employment, where work is undertaken for clients by individuals in business on their own account, assuming risk and being rewarded by the price of the contracts and the profits gained thereby. The UK construction industry has been characterised by high levels of false self-employment over several decades, and recently that level has been rising again.
- ❖ The level of registered self-employed is uniquely high in the UK construction industry, and can only be attributed to the presence of false self-employment on a massive scale. Self-employment is between two and three times higher than any other advanced building industry, including the famously flexible US labour market. Even within the UK, the construction industry is a freak case in terms of the level of registered self-employment. After a short period of decline, the evidence now is that **false self-employment is once more on the increase**. On the basis of statistical and empirical evidence, the report concludes that between 375,000 and 433,000 workers are currently falsely self-employed. As a round figure, we estimate **mass false self-employment currently standing at 400,000**. This leaves a figure of genuinely self-employed at between 270,000 and 325,000, a high level by any international standards. These assessments are based on official statistics, and given the hidden nature of informal economies, are undoubtedly conservative. (Chapter 2)
- ❖ With false self-employment, employers pay no National Insurance, and their workers pay a lower rate of National Insurance and less tax, making workers cheaper to employ. In conditions of competition, employers are often faced with little choice but to engage workers illegally on the basis of false self-employment. All construction trades unions, and a significant proportion of construction employers associations, including the Construction Confederation, have long campaigned for a level playing field in order to eradicate the scourge of false self-employment from the industry. (Chapter 3)
- ❖ The fiscal losses arising from false self-employment are on a massive scale. Although by nature precise figures for this evasion economy are impossible to calculate, the loss can reliably and conservatively be estimated as being between £1.4 billion and £1.9 billion per year, **or a best-estimate round figure of £1.7 billion per year**. By far the largest

proportion of this loss is accounted for by the non-payment of National Insurance by employers. If this loss could be eradicated in the way proposed by this report, the recovered revenue would be enough to build, maintain and run many new hospitals or schools. (Chapter 3)

- ❖ Government figures of between 100,000 and 200,000 false self-employed, and a fiscal loss of £340 million are gross underestimates, and reveal little understanding of the construction industry. As surprising is the fact that the Treasury Minister, Stephen Timms, dismissed even these figures as being of little concern to the government, stating that it was a ‘matter for the industry’ and not ‘for Government to regulate how companies are organised.’ This is an unusual government attitude with respect to tax evasion, to seriously underestimate its extent and then to ignore it anyway. (Chapter 3)
- ❖ Much of the recent rise in false self-employment can be attributed to the influx of migrant labour from the new member and accession states in Europe. Employers have taken advantage of the vulnerability of migrant workers, and exacerbated their insecurity by engaging them as false self-employed. Government regulations for migration make it easier to migrate as self-employed, and this has played into the evasion economy characteristic of much of the industry. Building workers from Bulgaria and Rumania have little choice but to come as self-employed if they enter the UK to work in the construction industry. (Chapter 2)
- ❖ The report analyses the reasons for this gross irregularity in the UK construction industry. Confusion in the law, and obstacles to prosecuting the principal responsible agents for engaging the false self-employed are noted. But the distinctiveness of the construction industry lies in a unique and distorting taxation regime, where workers have their tax deducted at source by their employers, whilst still being registered as self-employed. The taxation system thereby provides substantial incentives for tax evasion by engaging workers on a basis that does not require their employers to pay National Insurance. (Chapter 4)
- ❖ Treasury Ministers John Healey and Jane Kennedy have accepted that there have been no effective tests or limits applied by Her Majesty’s Revenue and Customs in issuing self-employed tax status to 2.4 million individuals between 1999 and 2006, and that 1.9 million self-employment identity cards were in circulation in 2007, when the total official self-employed workforce was less than 700,000. In effect, they are admitting that self-employment in the construction industry is out of control. (Chapter 4)
- ❖ False self-employment in the UK construction industry is the most visible and tangible symptom of a much deeper malaise. False self-employment reflects a failure to invest in the employment relation, and especially a

failure to build the necessary skills from within the UK, to support and maintain a technologically innovative and modernising industry. The skills gap has been widely evident ever since the decline in employment-based apprenticeships, and underlies much of the demand for migrant labour. Mass false self-employment is shown to directly contribute the low levels of training, leading to the UK having less than half the level of construction skills to be found in Germany, France, The Netherlands or Denmark. There is now **an annual deficit of over 20,000 apprenticeships and trainees**, with cumulative effects from previous decades. In order to close the historic skills gap, the need has been identified for between three and four times the annual deficit to be trained over the next decade. (Chapter 5)

- ❖ For employees, false-self employment deprives them from employment rights to which they are entitled by law, often with difficulty obtaining holiday pay, and excluded from sick or unemployment benefits. Already reliant on their own provision for pensions, many construction workers end their working lives dependent on means-tested state benefits as a consequence of insecure and irregular employment. This is the hidden cost of false self-employment, and will increase markedly with the implementation of the second state pension, from which they will be excluded, and to which their employers will not contribute. Last, but not least, the construction industry remains one of the most hazardous industries This cannot be only attributed to the physical nature and environment of their work, but more significantly to the failure of their employers to assume their normal responsibilities by investing in a trained workforce. (Chapter 5)
  
- ❖ The diagnosis of the causes of the tax evasion economy leads to a quite straightforward set of proposals for the remedy. The report recommends that a robust business test for self-employed tax status becomes the primary one that is valid for the industry. This brings the construction industry into line with all other sectors in the UK. We recommend that the form of self-employment where tax is deducted by the engager of labour is abolished. We propose a single category of self-employed in the industry. This not only simplifies the taxation system, but also makes it more transparent, and consistent with the accepted legal criteria regarding employment status. This proposal brings the construction industry back into line with all other sectors of the economy.(Chapter 6).

# Chapter 1

## The Evasion Economy

For nearly three decades now, the UK construction industry has been under the sway of a shadow evasion economy,<sup>1</sup> to such an extent that it has almost become accepted as ‘normal’. In simple terms, this aberrant ‘normality’ is characterised by the presence of false self-employment on a mass scale, on the one hand, and extensive tax evasion whereby employers pay no National Insurance, and the falsely self-employed, pay lower rates of National Insurance and tax in conditions of heightened insecurity and exploitation. In this report, the nature of false self-employment and its consequences will be analysed in some depth. The extent of the evasion and the fiscal black hole will be examined, and evidence is presented that it amounts to a staggering £1.4 billion to £1.9 billion per year lost to the taxpayer. And that is just the tip of the iceberg in relation to the shift of costs from employers to the state.

We will explain the more technical legal and taxation definitions of false self-employment later in the report. But there is a fairly straightforward and common sense way of understanding it. In substantiating the case for ‘the evasion economy’, we need to distinguish between genuine and false, even illegal, self-employment. The construction industry is characterised by relatively high levels of genuine self-employment compared with other industries. The genuinely self-employed are, as the term suggests, their own bosses: they decide when, how and for whom they work. They set a price for their work, and they work for a client that purchases their labour

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<sup>1</sup> The term ‘evasion economy’ is used here to mean an illegal and hidden economy, as opposed to a criminal economy, such as occurs with drug or people trafficking, or the mafia economy in Italy. There is no suggestion that illegal false self-employment is a result of criminal activity by any of those implicated in the practice. Tax evasion is distinguished from tax avoidance, where the latter involves all legitimate means for reducing the tax liability of the person or organisation.

services. The self-employed set the price they expect to be paid for the job, and depending on the competition, the client either agrees, or seeks an alternative. These genuinely self-employed may gain respect and trust from their clients, and work on successive contracts over several years. But they also can easily switch from client to client, depending on their work load, and their opportunities for increasing their rate of return. They are described as 'making a profit' rather than earning a wage. If a job is undertaken at a price, including possibly both labour and materials, the gain made by the self-employed exceeds the costs incurred in undertaking the contract. The price is set at the self-employed's own risk.

This characterisation of genuine self-employment describes well the situation for many thousands of jobbing carpenters, plumbers and electricians with which the general houseowner is familiar. It also clearly embraces those situations where small-scale building work is undertaken for private clients. In the construction industry today, even on large construction sites, there are also many occasions when genuinely self-employed workers are contracted to undertake all kinds of specialist jobs. This contributes to the renowned 'flexibility' of the labour market – large contractors are not obliged to keep such specialist trades permanently on their books, but can hire them in, when and where they are needed.

This then describes, in common sense terms, what it means to be genuinely self-employed: people literally employ themselves, they are in business on their own account. They are their own boss. Clearly, their clients have none of the responsibilities of a normal employer when purchasing the services from a self-employed person. You would not expect them to pay holiday pay, for example. Nor would you expect the client to deal with any of the tax affairs of the self-employed person. And it is quite right that they do not have to pay any National Insurance on

top of the price they pay for the job. Because the genuine self-employed do not work for wages in the normal sense, but by contract price, they also pay tax in different ways and, taking the rough with the smooth, are taxed on their annual profits. They are entitled to allowances with respect to running their own businesses – secretarial help, costs of running an office, and so on.

What then is ‘false’ self-employment? Again, in common sense terms, if you walk on to a large construction site, with hundreds of workers, working often in teams, you would not expect them all to be their own boss – the result would not be flexibility but chaos. Yet, as we will show, it is an extraordinary fact that many large construction sites have 100% self-employment, and many others well over 50%. This is strange. Then, the next thing you would find is that most of these ‘self-employed’ are paid wages, say £60, £80, £100 or more a shift of 10 hours a day. These workers do not set their own wages or ‘price’ for their labour – indeed, they may easily be recruited by employers’ advertisements stating their rates of pay. In this sense, to use the term ‘profit’ makes no sense, because there is no difference between the price they are paid and the costs they incur, any more than there is for a normal employee. They take no financial risks, because they do not set their own price. Moreover, they are entirely under the control of their engager, who tells them what to do, when to do it, and indeed they are often in large teams or gangs working under the identical terms and conditions, gangs of bricklayers, plasterers, labourers, scaffolders, carpenters, dryliners, concrete workers, and so on. To think of each of these as independent self-employed persons, every single one their own boss, is a blatant absurdity.

The engagers of the false self-employed are not clients in any normal sense, but employers. Over the last few decades, the large construction companies became ‘hollowed out’, no longer directly employing labour themselves, but managing

subcontractors under contract. The new and dominant type of firm employing labour became the labour-only subcontractor. They do not pay any National Insurance, often pay no separate holiday pay, and are not responsible for sick pay or any other similar expenses. They are simply getting labour on the cheap, treating their workforce as employees, but paying them as self-employed. Moreover, astonishingly, instead of the self-employed paying their own taxes in the way that the genuinely self-employed do, their engager deducts their tax and National Insurance out of their wages. In any normal world of work, you could find no surer sign that the worker is not their own boss, if their engager handles their tax matters for them.

The phrase 'bad money drives out the good' is a commonplace in economics. This is what has happened in the UK construction industry. Faced with the choice of whether to employ workers on a proper basis, as an employee with normal employment rights, or to hire a cut-price phoney employee, the false self-employed, employers have little choice in a competitive world. So false self-employment has driven out proper direct employment in the construction industry. We will later show how and when this has happened, but it can be conservatively shown that there are between 375,000 and 433, 000 false self-employed in the construction industry in the UK today.

The startling fact is that the UK construction industry currently has more self-employed than directly employed manual workers, over 50% of the total workforce of 1,345,000. No other country has more than 25%, not even the USA. In the rest of Europe, including many of the less highly regulated labour markets, the figure never exceeds 20%. Although these statistics are indeed powerful evidence that something is seriously awry, the common sense test is by far the strongest. On an organised building site where there are several hundred workers, working in a hierarchical,

coordinated, and controlled way, it is absurd to think that they could all be independent businessmen and women. It is pretty strange to think that even half could be. It begins to make sense only when you get closer to the numbers found in other countries. It is clear that the UK construction industry is in the grips of an evasion economy. We are used to thinking that illegal economies only happen in other countries – Italy, for example. It could not happen here, not on this scale, it might be assumed. The alarming fact is that this situation has now come to be treated as accepted normality, by successive governments, and by the Inland Revenue who seem to have vested interested in preserving this evasion economy. In the report, we will seek to explain how this ‘normalisation’ of the evasion economy has come about.

The level of self-employment has gone in ups and downs over the years (for reasons looked at in greater detail in Chapter 2). Recently, it has again been increasing quite rapidly. And for two identifiable reasons. First, it has become easier for a worker to self-declare as self-employed. Indeed you can do it on-line. Second, most of the steep increase can be attributed to an influx of migrant labour from the new accession states of Europe, including Poland, Bulgaria and Rumania. Of course, migration can be of genuine as well as false self-employed, and given the nature of the evasion economy, it is not possible to give any precise figures on the respective proportions. There are also many genuine directly employed migrant labours.

But two things have conspired to funnel migrant construction workers into self-employment. Firstly, the immigration rules make it much easier to enter as self-employed than as a registered worker, especially from Bulgaria and Rumania. Secondly, the lack of policing of the evasion economy presents no obstacles to entering into false self-employment. Vulnerable and exploitable workers are only too easily taken advantage of by engaging them on the cheap within the category of the

false self-employed, already endemic in the industry. As self-employed, they do not have the protection they are entitled to as employees, and coupled with their migrant status, that makes them yet more vulnerable. They cannot be held responsible for entering the industry as false self-employed, when in effect there is very little opportunity to do otherwise. They are made into false self-employed by the system that categorises them as such, only after they have entered the UK. It is important to emphasise that migrant construction workers are not responsible themselves from falsely declaring themselves to be self-employed. That is how they are engaged by their employers.

Although the evasion economy is at the heart of bad false self-employment driving out good employment practices, the consequences and impact of the phenomenon are much wider. The UK construction industry is renowned for its lower levels of productivity compared with many countries of continental Europe, where false self-employment is almost non-existent. The artificial competition triggered by tax evasion has led to a race to the bottom, where there is a minimum investment in the employment relation. There is minimum commitment between employer and employed.

For the false self-employed this means deprivation of normal employment rights. Although, as a consequence of European legislation, even the false self-employed have acquired the right to holiday pay in principle, in practice they are in a weak position to ensure their rights. Many thousands do not have normal paid holidays. More seriously still, there is effectively no security of employment. The myth of being your own boss masks a reality of hire and fire by the employers of the false self-employed. Over the course of a working lifetime, this leads to irregular periods of employment, characterised by many interruptions. When the current

construction boom ends as a consequence of the credit crunch, the false self-employed will be the first to go. They are the most easily dispensable, with no costs of redundancy.

Falling outside any working time directives, the false self-employed also work long hours, the ten hour shift is common, a five and a half or six day week also. Again, these false self-employers are no masters of their own hours or time: they work to the conditions required of their real employers. Time off for bad weather, for sickness, for care of sick children, for visits to doctors, are at their own expense. They take all the down sides of self-employment, and none of the upsides of employment. Together with the overall lack of employment rights, it is amongst the false self-employed that you find the most vulnerable and exploited.

The corruption of the construction economy by false self-employment has a profound impact on training and skills. The fact that over half the work force are now self-employed has drastically restricted the opportunities for workplace apprenticeships. Only with employment do employers invest in skills and training. Breaking the employment tie means breaking the commitment to skills training, and continuous skills upgrading. The responsibility and investment for training is shifted onto the self-employed, through college-based learning, and for off-site training. The consequences are plain for all to see in the vicious circle of a skills gap within the UK workforce, leading to demand for migrant labour which expands false self-employment, which then reduces further the scope and opportunity of home-based training, thus exacerbating the original skills gap we started with. In a sense, both the employers and the false self-employed are trapped in this circle: so long as the evasion economy is in place, employers cannot afford to escape it, any more than the false self-employed have an opportunity to do so. That is why, along with the

construction trades unions, the Construction Confederation has supported attempts to get this systemic failure corrected.

The presence of a widespread ‘evasion economy’ at the heart of one of the UK’s major industrial sectors does present something of a mystery. If the Treasury has around £2 billion per year to gain, if the employers want to invest in skills and productivity and regain efficient management of construction sites, if trades unions have long campaigned over the injustices of the exploited and vulnerable in the netherworld of false self-employment, why has the ‘evasion economy’ not only lasted so long, but become more entrenched? The report, after diagnosing the root of the problem, will propose some fairly straightforward, indeed, simplifying reforms that would bring the construction industry back in line with the rest of the economy. If the solutions are simple in principle, further explanations are needed to account for the resistance to reasonable reform to eliminate the aberration. There are certainly some entrenched interests: the housebuilding construction companies were instrumental in initiating the growth of false self-employment, and have in large remained its most bunkered-in defenders. Inland Revenue, as the engineer of the instruments that enable the evasion, have consistently buried their heads in their own bureaucratic routines, and defended what they see as a tool effective in recovering at least some revenue. The Labour Government, since 1997, has run scared of grasping the nettle, frightened of short-term risks of labour-price escalation, unprepared to take on entrenched interests, and unwilling to take a principled long-term stand on the need for systemic reform to remove an injustice and increase productivity and innovation in the industry. The government has allowed its objective to reduce over-regulation to be confused with attempts to eliminate irregularities.

But now is the time to put the construction industry on a legal and proper footing. Once more the evasion economy is on the rise, and the cost to the taxpayer is escalating. The need to address the causes of the skills gap and overdependence on importing skilled labour has become more and more pressing. The insecurity and lack of employment rights for the false self-employed, has been compounded with the vulnerability and exploitation of migrant workers sucked into the shadows of this evasion economy.

Following this scene-setting chapter, the report will provide the detailed evidence.

Chapter Two will first demonstrate the scale of false self-employment in the construction industry in the United Kingdom. It will show how unique the United Kingdom is in comparison with other countries, and it will show also how the construction industry is such an aberration even within the United Kingdom. The chapter will demonstrate the ups and downs of false self-employment, and the recent rise, fuelled by migrant labour.

Chapter Three will draw out the consequences for the losses to the tax payer, and provide estimates of the extent of the fiscal black hole. It will explain how the losses are made, and show that the employers are source of the major losses.

Chapter Four will provide explanation and analysis of how the evasion economy has taken such a hold in the industry, firstly by looking at the law on employment status, and secondly, by analysing the systemic origins of the problem in a taxation regime unique to the construction industry. The analysis will be brought up to date with a discussion of recent fine-tunings of the regime that has facilitated the upsurge of false self-employment.

Chapter Five will draw out the consequence of false self-employment for the ‘victims’: exploitation, vulnerability and the lack of employment rights; the effect on pension provision and exclusion from the second state pension; and the devastating impact on training and the development of skills.

Chapter Six will conclude the report by proposing a set of reforms to simplify the existing tax regime, and bring the construction industry back into line with the rest of the economy. It will spell out the rationale for reform and the benefits to be derived from it, and attempt to counter the most obvious obstacles thrown up by those with entrenched interests in the evasion economy.

## Chapter Two

### The epidemic of false self-employment

In this chapter, we identify the scale and peculiarity of mass illegal and false self-employment in the UK construction industry.<sup>2</sup> In subsequent chapters, the legal and taxation classification of workers is analysed in order to show how, in formal terms, an individual can be deemed to be falsely or genuinely self-employed. Part of the problem that legal and taxation authorities have is that they ask the question of genuine or false employment status to be proven case by individual case. They fail to approach the systemic nature of the evasion economy, and to recognise that there is an argument to be made from the scale of the phenomenon of self-employment in this country's construction industry. Put simply, if there are so many self-employed, not all of them can be genuine. Moreover, above a certain level, you can be fairly sure of a range numbers that are falsely and illegally self-employed. When the number goes above one quarter of the workforce, there begins to be suspicion of deviance from genuine self-employment, and the more it goes above that level, the more suspicion turns to certainty. As explained in the previous chapter, the starting point is the reality

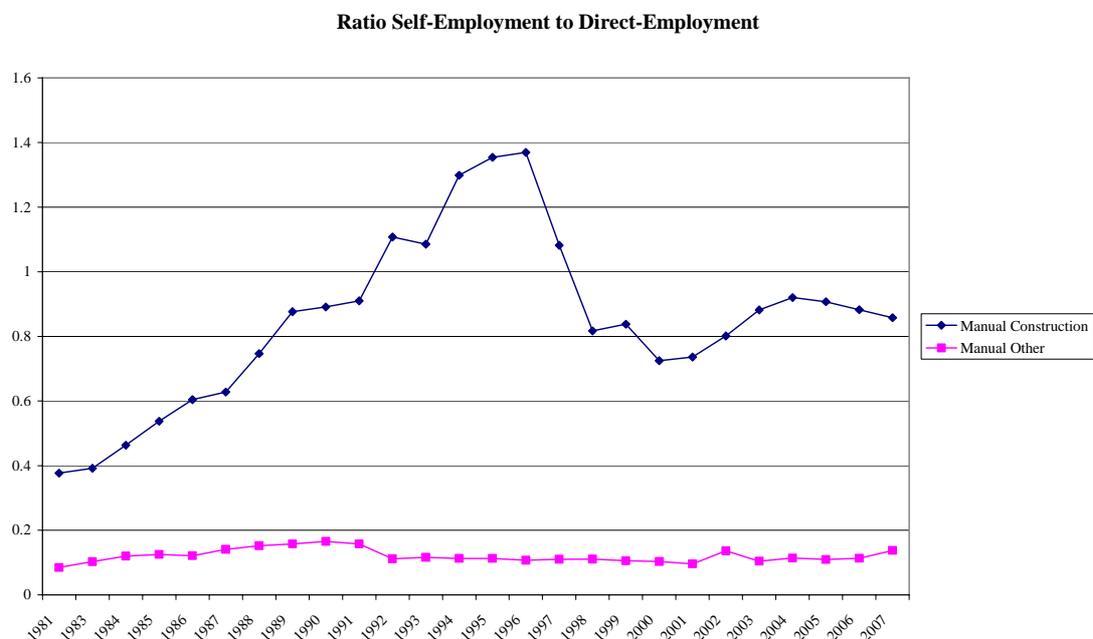
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<sup>2</sup> In this chapter there are two sources for the statistics, the Labour Force Survey and the Housing and Construction Statistics produced by the Department for Business Enterprise and Regulatory Reform (previously the Department of Trade and Industry). There is a discrepancy between the two sets of statistics, and, following previous publications (Harvey, 1995, 2001) the BERR statistics have been used when dealing with the construction industry alone, as they have greater accuracy for dealing with manual occupations. The LFS provides the only source for making comparisons either with other UK data, or with European data, and this database has been used when this is the case.

on the ground. On any given construction site, it is quite absurd to think of the engagement and use of labour as being anything other than employment above a certain percentage. Not everyone can be their own boss.

## The uniqueness of the UK construction industry

How do we know that there is false self-employment on a mass scale in the UK construction industry? Let us first look at just how exceptional the UK construction industry is within the United Kingdom context.



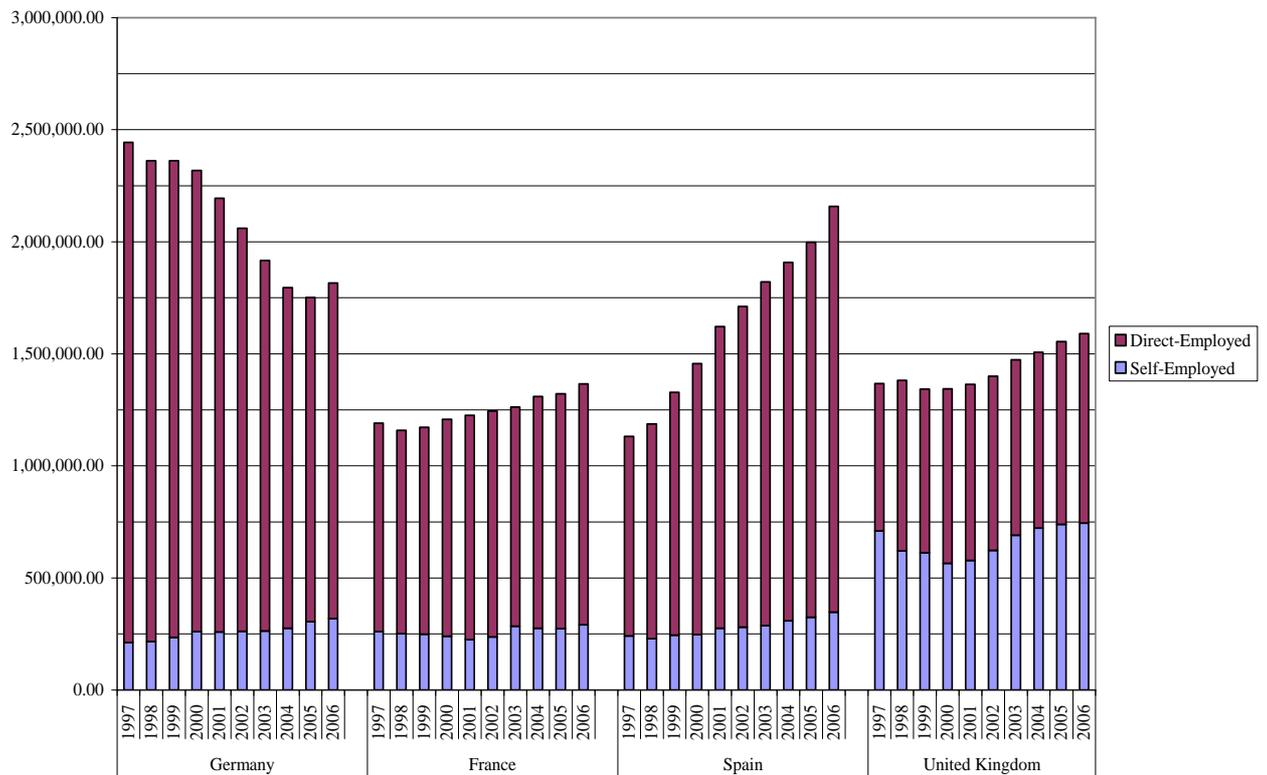
**Figure 2.1.** Ratio of self-employed to employed in construction manual workers versus other manual trades, 1981-2007. *Source Labour Force Survey, 2007. HMSO.*

Historically, there had always been a high level of illegal self-employment in the UK construction industry, even before Thatcher came into power in 1979 (Austrin, 1980; Birch, 1993; Harvey, 1995). Known as ‘the lump’, the system involved cash-in-hand payments, the phenomenon was largely untracked, and reliable statistics hard to obtain. Nonetheless, according to official figures by 1981, the construction industry already had more than double the proportion of self-employed

to employed, at roughly three employed manual workers to every two self-employed (Figure 2.1). This compared to roughly 10 directly employed to 1 self-employed in other manual occupations. Deregulation by the Thatcher government changed the whole scale of the phenomenon, to levels that have made the construction industry a massive aberration. Peaking in 1996 when nearly two thirds of the manual construction force were self-employed (1.4 self-employed to 1 employee), the proportion has fallen but remained at extraordinarily high levels compared with any other industry in the country. It should be remembered that comparisons include transport where significant numbers of self-employed taxi, lorry and bus drivers are included; or catering, distribution and hotels, where likewise there are substantial numbers of small service providers, in cleaning, small shops, food preparation and other such occupations. Even in comparison with these sectors, where there are at a maximum 15% of self-employed, the construction industry is a massive anomaly. So even with the general move towards outsourcing and flexible labour, the contrast between these sectors and the construction industry has grown rather than diminished. Current levels in construction have recently again exceeded 50% of the total manual workforce, more than one self-employed person to every one employed person.

Exceptional within the UK, the construction industry also contrasts with all other comparable and not-so-comparable construction industries in other countries (Philips and Bosch, 2002). For the UK there is just more than one self-employed construction worker for every one directly employed. For the EU overall, there are on average four directly employed workers to every one self-employed (European Labour Force Survey, 2007). If we compare the UK with France, Germany and Spain over the last decade, France has remained more or less stable at 20%; Spain has declined from just over 20% to 18%, and Germany alone has shown an increase from

just under 10% to 18%. So whether comparing with Southern or Northern Europe, and during a period where substantial labour market reforms have taken place, nothing comparable exists in the construction industries of these countries. An argument is often made that there is something special about the construction industry, by nature of the production process – there are distinctive discontinuities in contracts and labour process, in time and place. This, it has been argued, ‘explains’ why self-employment is so much more pronounced. These figures simply demonstrate that this argument has no legs to stand on. Even if there may be slightly higher levels of self-employment in other countries’ construction industries compared with other sectors, there is nothing intrinsic to the construction industrial process that can explain the contrast between UK and other European countries’ patterns of self-employment.



**Figure 2. 2** European construction industries and employment status. *Source: European Labour Force Survey, 2007.*

Developing this argument further, the contrasting fates of European construction industries quite clearly demonstrate that demand for labour supply, the boom and bust nature of an industry sensitive to changes in economic climate, does not account for the expansion of self-employment. As figure Figure 2.2 shows, Spain and France, both enjoyed an expansion, Spain an explosive one. Yet, in contrast to the UK, expansion was accompanied almost entirely by the growth in direct employment in Spain, as was the case, at a lower level, for France. Germany, experiencing a recession in construction, shows the decline to be greatest in direct employment, whereas self-employment increased slightly. So it is not the case there that the 'more flexible' labour was more easily dispensable in times of recession.

Comparisons with the USA are not straightforward, as their industry is quite sharply divided between industry covered by collective bargaining and the non-union sector (Philips, 2002). Nonetheless, even in the highly deregulated labour markets of the USA (Peck, 2002, Peck and Theodore, 2001), the level of self-employed does not exceed 25% (US Bureau of Labour Statistics, Employment and Earnings, 2008).

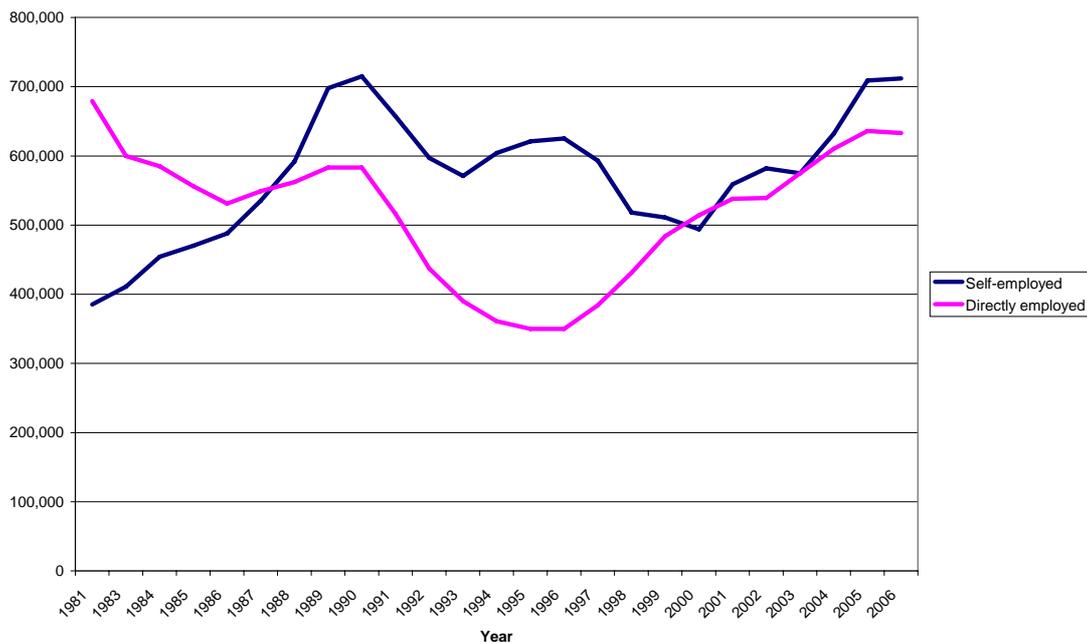
The conclusion to be drawn from these comparisons between construction and other sectors within the UK, and between the UK's and other countries' construction industries, is that there is something distinctly deviant occurring within the UK construction industry. It is freakish. The evidence serves to counter arguments of two kinds. Firstly, there is not a general characteristic of UK labour markets, its case law approach to labour markets, or any policy measures to stimulate enterprise and small business, that can account for the peculiarity of UK construction. Secondly, there is not a characteristic intrinsic to the construction industry that makes it a special case, because otherwise similar effects would be discernible in other countries. Rather the

UK construction industry stands out in its peculiarity both between industries in the UK, and between UK construction industries and other countries construction industries.

### **The ups and downs of self-employment in the UK construction industry**

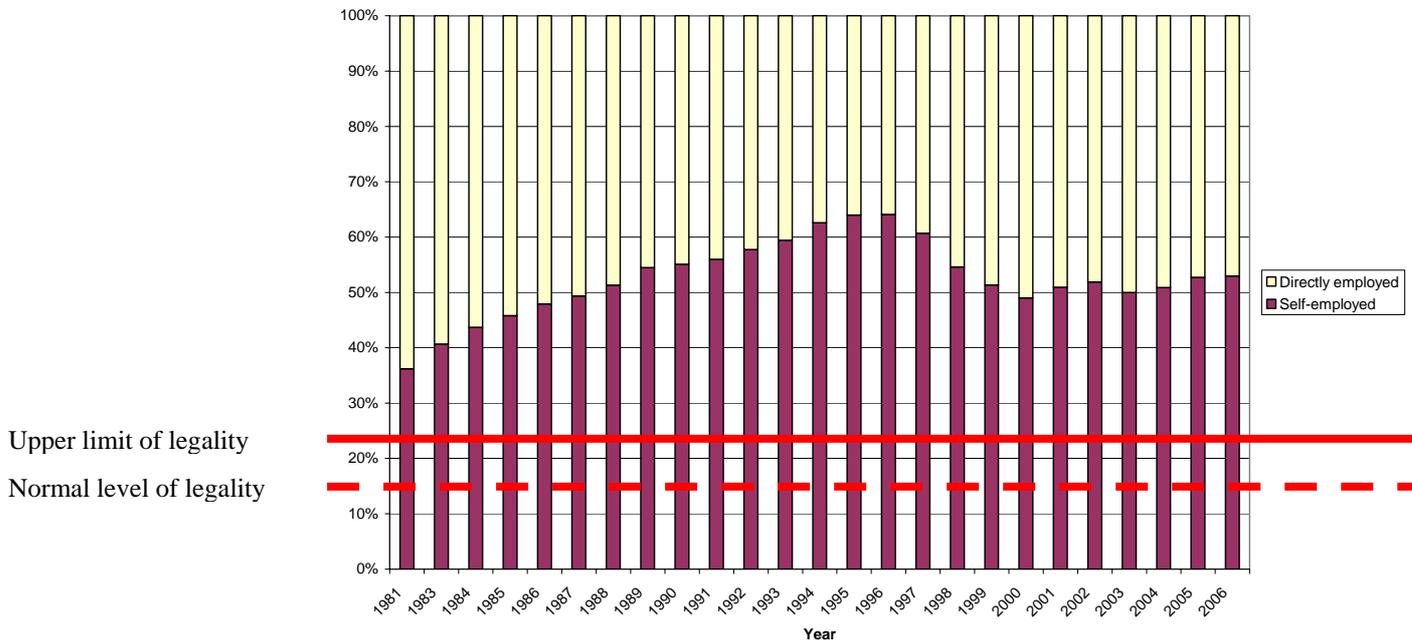
Turning our attention to the emergence of mass and excessive self-employment in the UK construction industry, certain broad patterns can be noted. Following a sharp measure of deregulation by the Thatcher government, to be discussed later, there were more than ten years of sharp increase in the level of self-employment. During this period, the overall level of employment remained relatively stable, so we can talk of a direct switch from direct to self-employment during this period. A sharp downturn of the construction industries in the early 1990s, saw a decline of the numbers in both employment statuses, but accentuated more for the directly employed. Following an industry recovery, self-employment picked up again, until 1995. Then, a campaign by UCATT and other trades unions resulted in minor changes in the regulatory framework, and a half-hearted attempt to tighten up on false self-employment. This period was the only one that has witnessed a switch back from self-employment to employment of roughly 200,000 construction workers. But, following a relaxation of regulation, and the cessation of all serious attempts to enforce the law, the rate of self-employment has begun to climb again. In the long boom in construction work, self-employment rose more rapidly than direct employment, so once more exceeding 50% of the total work force. Figure 2.3 below shows the rise and fall in directly employed and self-employed since 1981 in absolute

numbers. Figure 2.4 tracks the same changes, but this time in terms of the relative percentage of self-employed to employed.



**Figure 2. 3.** The ups and downs of direct and self-employment in UK construction, 1981 -2006.  
*Source: Housing and Construction Statistics, BERR, 2007.*

So, if we turn now to look at the same data in terms of proportions between employed and self-employed, we can isolate the trends from the cyclical effects of growth and contraction of the industry. The pattern becomes clearer. There was a steady increase in self-employment at the expense of direct employment until the regulatory tweak in 1996, and then, after a brief period of reversal, from 2000 the trend has once more been one of an increasing proportion of self-employed, reaching the rarified and legally unrealistic heights of over 50% by 2005.



**Figure 2.4.** The proportion of directly employed to self-employed in the UK construction industry, 1981-2006. *Source: Housing and Construction Statistics, BERR, 2007.*

If we take our country comparisons as our baseline, and also use common sense and business logic to guide us, it is possible to make some reasonably robust judgements concerning the scale of false and illegal self-employment in the UK construction industry. We have seen that no other country exceeds 25% of their workforce as self-employed – and that assumes of course that all of these are all legal. That percentage can be taken as an upper limit of legality. Everything above that line can be thought of as being, in all probability, illegal self-employment. If the numbers had only just exceeded that line, then it would be arguable that there was no systemic or significant problem. But Figure 2.4 above shows just what the scale of the evasion economy has grown to be, and how endemic it has become since the 1980s.

Before providing judgements as to exactly how this might translate into numbers of false self-employed, there is some additional evidence that provides some

useful indicators. A survey by UCATT officials of sites to which they had access – and that means union recognition by the lead contractor – was undertaken in January 2008, across all regions including Scotland. This cannot claim to be a scientifically rigorous exercise. It might be thought that the union would seek to present a worst case scenario. Against that, as anyone who has undertaken research into illegal or informal economies will know, there is certainly a counter-balance to any possible bias in the fact that union officials would certainly be excluded from situations of extreme illegality, but also simply from those sites where employers were resistant to exposure of their employment practices. There are next to no sites in the sample from the major housebuilding construction companies, the champions of illegal self-employment. The sample is relatively small – 154 sites across the country. Yet with these precautions and health warnings in mind, the results of the survey still contain a powerful message, and are presented in Table 2.1 below.

| <b>Percentage self-employed</b> | 0-14% | 15-24% | 25-49% | 50-74% | 75-100% |
|---------------------------------|-------|--------|--------|--------|---------|
| Number of sites                 | 34    | 2      | 28     | 34     | 56      |

**Table 2.1.** The proportion of self-employed on 154 construction sites, January 2008. *UCATT survey.*

The first point to emphasise is that more than a third of sites seem to comply with most normal definitions of self-employment. They include some large sites with over 200 workers, and many of these are public procurement sites where compliance with employment regulations is written into the contract. There is a perfectly legal and bona fide section in the industry. But then there is a gap with just a couple of sites with intermediate levels of self-employment before the number of sites with between

25% and 49% show a marked increase. By far the most frequent category, however, is of sites of over 75% self-employment, and indeed nearly 20% of sites had 100% self-employment. This is the hard core of the evasion economy – the phenomenon of mass false self-employment that defies all logic and sense, with every single worker on a large construction site putatively their own boss, running a profit and loss account. But, not to pick out these extremes, the case of one very large site in the London South East region, with 1500 manual construction workers of which 900 are self-employed, 350 of these migrant, is perhaps the most striking evidence of the evasion economy. It is not as if it is hidden – everyone knows what is going on. The sheer scale of the illegality and the tolerance of it by employers and taxation authorities alike is a demonstration of how entrenched and normalised tax evasion and deprivation of employment rights have become. If one accepts the upper limit of legality in Figure 2.4 above, three quarters of all the sites in this survey have self-employment above 25% and are affected to a lesser or greater degree by this corruption.

This contemporary evidence reinforces the earlier report, *Undermining Construction*, and previous research (Harvey, 1995, 2001, 2002). Some of the key points can be usefully summarised here. The ‘normalisation’ of the evasion economy was recognised by many. The Construction Confederation representing 5,000 construction companies and 75% of the total construction turnover in the UK, was advocating reform. Liz Bridge, Secretary of the Joint Taxation Committee reviewing reform proposals stated quite clearly that

‘A substantial proportion of the construction workforce is mis-categorised as self-employed and should be employed.’ Interview, 19.7.2001.

At a meeting of the Joint Taxation Committee in June 2001, it was noted in the minutes that the Inland Revenue had become

‘discouraged from any vigorous attempt to enforce the law’.

*Undermining Construction* contained a number of reports from contractors working in the industry many of them expressing the frustration of the uneven playing field and the competitive pressures to go illegal – particularly when there was little risk of penalty for doing so. One contractor, Keith Walton, was quoted as saying:

‘Our firm is being stifled because we are working within the law whilst our competitors are not.’  
*Interview, 04.06.2001*

Since 2001, and following the publication of *Undermining Construction*, there was yet a further attempt to revisit reform. The Inland Revenue established a working party on the Employment Status of Workers in the Construction Industry in April 2004, which met for over a year. There was much consensus across the industry and a positive position was taken to grasp the scale of the issue.

‘The Joint Taxation Committee asked that we consider whether it is possible to redefine certain construction workers as employees for tax purposes, so that they are subject to both income tax through PAYE and Class 1 National Insurance Contributions.’

In effect, that would have reduced the percentage of self-employed below the normal limits, and restrict the status of self-employment to those genuinely in business on their own account. It was recognised that large numbers of genuinely self-employed would be required to transfer to a well-defined and tested status. The bulk of the false self-employed would be transferred to employee status.

However, once the opposition to reform from the housebuilders had been mobilised, the government and Inland Revenue appeared to lose the will to pursue the matter. The outcome of the process will be discussed in detail later, but in effect the

rules for genuine self-employment were made tighter, and the rules for false self-employed were made more lax. The consequence is there for all to see. The major change since 2004 has been the steady increase in the proportion of self-employed, especially the false self-employed category, manifest in the statistics cited above.

Having reviewed the evidence of the scale of the evasion economy, we are now in a position to estimate the numbers of construction workers who are falsely and illegally self-employed.

| <b>Self-employment as % of total manual workforce</b> | <b>Number of false-self employed</b> |
|---|--------------------------------------|
| At 15% self-employment                                | 510,250                              |
| At 20% self-employment                                | 433,000                              |
| At 25% self-employment                                | 375,750                              |
| At 30% self-employment                                | 268,150                              |

**Table 2.2** The scale of false self-employment in the UK construction industry.

At the beginning of this chapter, we argued that false self-employment needed to be viewed as a systemic issue, resulting from the entrenchment of the evasion economy. This is a departure from the rather narrow and legalistic approaches that require proof of status for each and every individual. As a consequence, only a range of figures, rather than exact numbers can be advanced. They allow estimates ranging from the plausible at the top and bottom of the range to the highly probable. We also need to apply common sense and understanding of the construction production process. On this basis, we can be confident that the number of false self-employed in UK construction stands between 375,750 and 433,000. The lower figure would be close to the historic starting point of the explosion of the evasion economy. However, it was well known, and the subject of government reports, that even then there was a

considerable number of illegal and false self-employment. The 20% figure would place the UK construction industry above levels of any European construction industry, whilst the 25% figure would shift this country towards the US economic model. A best guess figure, therefore, and to keep it simple, a round figure of 400,000 illegal self-employed can be taken to be robust.

## **Migration and false self-employment**

We have already seen that migrant construction labour has entered into the situation as they found it, and become part of the core of the evasion economy of false self-employment. On many sites where there is over 75% self-employment, migrants constitute an important proportion of this illegal workforce. But at this point, we need to make something quite clear. The UK evasion economy is what makes migrants illegal, not migrants behaving illegally on their own account. And we have strong evidence. First we will compare and contrast what happens when migrants enter the UK construction industry with their counterparts in other European countries. Then, we demonstrate the effects of the expansion of migrant labour on the growth of false self-employment in the UK. The regulations on migration specific to the UK are analysed, and seen to contribute directly to the expansion of self-employment. What makes this self-employment false and illegal only arises when they enter into engagement on UK construction sites under the specific regime operating here. In later chapter, we comment on the effect this has on reinforcing the skills gap that has arisen as a direct consequence of the dominance of false self-employment. High levels of false self-employment will be shown to be one of the major factors behind the absence of apprenticeships, producing a skills gap. Rather than addressing the systemic failure in reproducing skills in the economy, the UK imports skills through

migrant labour to plug the skills gap. Again, it is hardly possible to blame migration as the cause of the skills gap – it is only the effect.

There has been a long history of European construction industries employing migrant labour. Indeed, for a long time, at the height of the construction boom in Germany, that country was renowned for importing the disease of false self-employment through its use of migrant UK labour. Indeed, it is worth emphasising from the outset that the scale of migrant labour in the UK is relatively modest when compared with other European countries. In 2006 there were about 200,000 non-national construction workers in both Germany and France, 500,000 in Spain, and only 100,000 non-nationals in the UK. The boom in Spain's construction industry relied heavily on migrant labour. However, a view of current patterns of migration in the United Kingdom, Germany, France and Spain demonstrates quite clearly that only the United Kingdom combines migrant labour with self-employment to any significant extent. Indeed, all migrant labour shows higher ratios of self-employed to employed when coming into the UK than for the national workforce as a whole, where the ratio is approximately 1 self employed to 1 directly employed. The most extreme deviation in this direction occurs with migrant labour coming from the new accession countries, the EU 27, where there are 11 self-employed construction workers for every 1 directly employed. But the numbers coming from Bulgaria and Rumania are relatively low compared with those coming from the 10 new accession states. Consequently, overall, the level of self-employed amongst migrants to UK construction is 20% higher than would be expected from the national workforce, during the period 1996 to 2007.

The pattern elsewhere is exactly the reverse. In almost all cases, migrant labour tends to be more likely to be directly employed than self-employed relative to

the national workforce as a whole. In Germany and France, migrants from the EU 27 are 100% directly employed, and from the EU 15 the ratio is also shifted in favour of direct employment, although less markedly. Perhaps the most interesting case is Spain, whose migrant construction workforce recruits from North Africa as well as the rest of Europe. Here too, the overwhelming pattern is for migrants to tend to be more likely to be employed than self-employed, relative to the national workforce. For migrants outside Europe, there are 25 employed for every 1 self-employed, compared to 4 for every 1 in the national workforce.

|         | Nationals |    | EU15 |    | EU25 |    | EU27 |    | Others |    |
|---------|-----------|----|------|----|------|----|------|----|--------|----|
|         | SE        | DE | SE   | DE | SE   | DE | SE   | DE | SE     | DE |
| UK      | 1         | 1  | 4    | 3  | 4    | 3  | 11   | 1  | 1      | 1  |
| Germany | 1         | 5  | 1    | 7  | 1    | 1  | 0    | 1  | 1      | 11 |
| France  | 1         | 3  | 1    | 7  | 1    | 1  | 0    | 1  | 1      | 8  |
| Spain   | 1         | 4  | 1    | 3  | 1    | 8  | 1    | 20 | 1      | 25 |

**Table 2.3.** Ratio of self-employed to direct-employed migrant labour in the construction industry in four European countries, 2006 (rounded). *Source:* European Labour Force Survey. SE = Self-employed, DE = Directly Employed.

These figures clearly demonstrate that characteristics of the national labour markets determine the employment status of incoming migrant labour. There are two main explanations that can be offered for this marked contrast between the UK and the rest of Europe. The first is relatively straightforward. Legislation on migration from the enlarged Europe (the EU 25) with ten new states<sup>3</sup>, and the new accession states of Bulgaria and Rumania (the EU 27), discriminates between employed and self-employed. The former are required to enter on the worker registration scheme,

<sup>3</sup> The ten new states accepted under the Accession Regulations, May 2004, were the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovenia and the Slovak Republic.

whereas the latter can enter without registration, according to the *Accession (Immigration and Worker Registration) Regulations*, 2004, (The Stationery Office, HMSO, and the *European Accession Treaty*, 2006<sup>4</sup>).

But that can only be part of the explanation. The other important aspect is the distinction between false and genuine self-employment. Genuine self-employment requires the migrant to be able to communicate effectively and generate business with clients, submit tenders, manage their own tax affairs – effectively to work, in the language of many European labour markets, as an independent, or in UK terms, as their own boss. This is not just a language barrier, more a question of the independent self-employed having a greater need to understand legal and taxation systems and to acquire skills to deal with clients from a different culture than the directly employed. In most European contexts, this effectively acts as a barrier to migrants entering as self-employed or independents. But, remove these obstacles, and allow migrants into self-employment as paid workers, without having to manage their own business, tax affairs, or contracts with clients. At the same, time relieve their employers from the ‘burdens’ of paying national insurance, holiday pay, sickness pay and any of the normal entitlements of ordinary employment. Then migrant workers are sucked into the evasion economy, and join the ranks of the national false self-employed. If one combines these two explanations – regulate in favour of self-employment, remove the economic obstacles to self-employment – there is a more complete explanation of why there is excessive self-employment of migrant labour compared with the UK national workforce as a whole.

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<sup>4</sup> The relevant regulation of the latter Treaty is *The Accession (Worker Authorisation and Worker Registration)(Amendment) Regulations*, 2007, No. 3012. (The Stationery Office, HMSO)

## Main findings

This chapter has explored in detail the scale of the evasion economy and the emergence of false self-employment in the construction industry. The argument has been based on the extent to which reality departs from any economically sensible understanding of genuine self-employment. In particular, the phenomenon of mass self-employment is a contradiction in terms, and masks the phenomenon of false and illegal self-employment. The main findings of this statistical analysis can now be summarised.

- ❖ The UK construction industry has uniquely high levels of self-employment compared with any other sector in the UK economy. The level is three to four times higher than even those sectors where self-employment is typical.
- ❖ The UK construction industry has more than double the level of self-employment of any other advanced industrial economy.
- ❖ Self-employment has grown from near normality in 1979 to the heights of abnormality by the mid-1980s, when it peaked at over 60% of the total manual workforce. After a dip in the late 1990s, it has again began to rise, and stands at over 50% in 2007.

- ❖ The best estimate of the level of false self-employment in the UK construction industry ranges between 375,750 and 433,000 workers, with 400,000 being a robust round figure.
  
- ❖ Self-employment during the recent construction boom has been boosted by exceptionally high levels of self-employment amongst migrant labour in the construction industry. But the overall scale of migrant labour, at 100,000 in 2006, is relatively modest compared with other European construction industries.

# Chapter 3

## Lost £ billions and the costs of evasion

### **The fiscal costs of tax evasion**

The last chapter took the first step in assessing the extent of false self-employment necessary to calculate the extent of the losses to the taxpayer arising from the evasion economy. A range of the most probable numbers of false self-employed was proven to be between 375,750 and 433,000, justifying the most likely round figure estimate of 400,000.

So, what are the fiscal consequences of false self-employment? To answer this, we need to itemise the tax and national insurance paid by employers, direct employees and the self-employed. In so doing, we identify the flipside to the fiscal consequences to the taxpayer, namely the incentives to evade paying taxes associated with direct employment, both to the employer and employee. As we shall see the incentives to adopt direct or self-employment are very different for engagers of labour and those engaged.

The table below identifies the difference in tax and National Insurance obligations for engagers of labour and workers.

|                               |  | <b>National Insurance</b> | <b>Income Tax</b>     |
|-------------------------------|--|---------------------------|-----------------------|
| Employer of Directly Employed | Class 1 NI                                     | 12.8% of wage*            |                       |
| Engager of Self-employed      |  | 0% of wage                |                       |
| Direct Employee               | Class 1 NI                                     | 11% of wage*              |                       |
|                               | Income tax                                     |                           | 20%*                  |
| Self-employed                 | Class 2 NI                                     | 8% of wage*               |                       |
|                               | Tax on profits                                 |                           | 20%*                  |
|                               | Schedule D tax exemption on allowable expenses |                           | Circa £6,000 tax free |

**Table 3.1** Fiscal differences between employment status, direct and self-employed.

From this table, it is clear that the main fiscal differences between employment and self-employment are the employer's National Insurance rate of 12.8% for an employee as against 0% for the self-employed. For the worker, the difference is far less marked, a difference between Class 1 and 2 of National Insurance of 11% as against 8%, and with taxes on income and profits falling at the same rate, the only tax difference being allowable expenses on Schedule D, available for the self-employed and not for the employee. On discussions with Inland Revenue and the self-employed, a figure of £6,000 per year on allowable expenses is conservative. Out of 'profits', the self-employed can claim payments to the partner for secretarial assistance, office expenses, and such like. So long as these claims are not excessive and therefore challenged, they need no documentary verification. At £6,000

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\* This rate is applicable between upper and lower thresholds or limits, and so does not apply to the whole wage. These exemptions from rates of National Insurance and taxation are taken into account when making the calculation of the total fiscal consequences of direct and self-employment. The upper and lower limits and thresholds were those set in the April 2007 budget.

per annum of allowable expenses, the self-employed obtains an additional £1,300 of net income.

Before making the final calculations of the range of possible fiscal losses to the taxpayer, the wage rates being paid to building workers need to be known. In this case, the relevant wage is that paid to direct employees in the event of the reclassification of the falsely self-employed to the legitimate employment status. Again, we can start with a range, and narrow it down to the best estimate. The Housing and Construction Statistics provide figures of average earnings only up to 2002, when they stood at £411 per week. Wishing to remain conservative in our judgements, it would be safe to say that the average building worker's wage in 2007 stands around £475 per week.

|                        | <b>Number of workers</b> | <b>£300 Per week £</b> | <b>£400 per week £</b> | <b>£500 per week £</b> | <b>£600 per week £</b> |
|------------------------|--------------------------|------------------------|------------------------|------------------------|------------------------|
| At 15% self-employment | 510,250                  | 1,418,719,510          | 1,837,940,910          | 2,257,162,310          | 2,684,274,190          |
| At 20% self-employment | 433,000                  | 1,203,930,520          | 1,559,683,320          | 1,915,436,120          | 2,271,188,920          |
| At 25% self-employment | 375,750                  | 1,044,750,330          | 1,353,466,530          | 1,662,182,730          | 1,970,898,930          |
| At 33% self-employment | 268,150                  | 745,574,986            | 965,887,026            | 1,186,199,066          | 1,406,511,106          |

**Table 3.2** Estimating the fiscal black hole of false self-employment

We are now in a position to estimate the reasonable range within which the scale of tax and National Insurance evasion arising from false self-employment falls. If we take the lowest reasonable figure for false self-employed at 375,750 and an average wage below the 2002 level we arrive at a minimum figure of £1.4 billion per year. If we take a higher but still reasonable figure of false self-employed at 433,000, and an average wage of £500 per week, the fiscal hit to the taxpayer reaches £1.9

billion per year. We can be reasonably certain that the true figure lies somewhere between those limits, and if we were to take our two round figures of 400,000 false self-employed and an average wage of £475 per week we obtain the closest justifiable estimate of **£1.7 billion** per year. As levels of false-self employment have fluctuated over the years, and wages have increased over the decade, the total losses over this period cannot readily be calculated. But a figure of £15 billion would not be far wrong.

Of this figure, the most significant proportion of the evasion economy undoubtedly arises from the employers of false self-employed not paying National Insurance. The extent of their evasion amounts to £985 million per year, or 58% of the total loss. A point made earlier is worth repeating: the difference between tax evasion and avoidance is that the latter is the perfectly legitimate use of all available means, allowances, and offsets, to reduce a person or company's tax liability. Tax evasion means deliberately not paying tax that one is legally obliged to pay. Of course, that has to be proved, and the illegality of false self-employment will be discussed later. But if a worker is in effect employed by an employer as opposed to engaged by a client, under a contract of services rather than a contract for services, then the engager is legally an employer, and liable to National Insurance at 12.8%. We have demonstrated that the employment status of 400,000 workers cannot be other than one of employment. Contractors on the large site mentioned above, for example, are not the clients to 900 separate and independent self-employed workers, in business on their own account. And they know it. So we are talking of evasion, not avoidance. The construction industry is an evasion economy.

## **Incentives and risks**

If one side of the coin concerns the fiscal loss to the taxpayer, the other side concerns the incentives and risks for employers of labour and workers. The figures above might suggest that the balance of incentives for employers and workers is uneven, 58% as against 42% in terms of the difference in fiscal opportunity, but still considerable for both parties in the labour market. But this is only the tip of the iceberg, and as soon as we probe more deeply, the balance of incentives and risks shifts much further in favour of employers. The driver of the evasion economy is unquestionably the competitive pressure, resulting from the tax regime, on employers to drive out good employment for bad self-employment. In this section, we examine the relative gains and losses for employers and the false self-employed.

### *For employers*

The argument has already been made, supported by interviews with contractors and the Construction Confederation, that the mere effect of a choice between paying or not paying the employers 12.8% National Insurance imposes inescapable competitive pressures for employers to engage self-employed workers. But, although National Insurance is undoubtedly the principal trigger, the cost differential of employing self-employed illegally as against employees legally is much greater than National Insurance alone. Ultimately, once the step has been taken to go down the route of lowering labour costs, there is a real risk of 'degenerative competition' (Wilkinson, 1981), with employers investing less and less in the employment relation, so leading to the extreme and casualised labour found in false self-employment. It is a relationship of zero commitment, and zero investment. Later we analyse the impact on skills, but here we focus on the monetary investment, and the immediate short-term monetary incentives to self-employment. False self-employment means employing workers without paying sick pay, without the costs of

managing such systems. Although now entitled under European legislation to holiday pay, in many cases holiday pay is invisible or absent in the pay packets of the false self-employment – effectively time off of any kind is unpaid. Time off for visits to doctors, for child-care needs, for compassionate leave, and many other such attributes of genuine employment are stripped out of false self-employment. Of course, with false self-employment there are no occupational pension schemes, and in future, under the second state pension, the drive to invest as little as possible in the workforce will increase when the employers obligatory contribution of 3%, low though it is, will be evaded in false self-employment. A while ago, it was estimated that the real difference in monetary investment in the employment relation between employment and self-employment was between 25% and 30% (Evans and Lewis, 1989). The trigger of the National Insurance 12.8% thus sets of a competitive drive to the bottom, the lowest level of employment commitment to employees.

The loss to employers are long term, in productivity gains, and in managerial control and efficiency in the organisation of the construction process, and above all, in the barriers to innovate that result from a low skills, low commitment culture. The result of the casualisation of the construction labour force through false self-employment and labour only subcontracting has been a damaging fragmentation in the organisation of production (Harvey, 2002). Degenerative competitive pressures – the Gresham’s law of labour markets – have become ‘locked in’, making it difficult if not impossible for many contractors to buck the trend and break the culture. The short-term cost advantage of false self-employment has become a major obstacle to long term productivity gains through skills enhancement, and organisational and technical innovation. What is needed is framework that encourages genuine self-employment and the benefits of flexibility in combination with genuine employment

stimulating investment in skills and productivity. The distorted competitive pressures arising from current regulatory incentives need to be corrected to achieve a favourably balanced labour market and workforce, more in line with other major advanced economies.

*For the employee*

Where the short-term cost-cutting competitive pressures on employers are all one way, the picture is very different for the employee under false self-employment. In effect, false self-employment downloads all risks onto the employee. Risks of having an accident, bad weather, falling sick, periods of unemployment, and last but not least poverty in old age are borne by individual workers. In periods of prolonged boom in the industry, such as we have witnessed since the early 1990s, some of these risks are mitigated. But evidence of what occurred during that earlier period demonstrated that the category of false self-employed were more than twice as likely to experience periods of unemployment than either the genuine self-employed or employees (Harvey, 2002). It is known that over half of all self-employed have no other pension coverage than basic state pension (Clery, et al. 2007). Those with interruptions in employment and with variation in earnings are the least likely to invest in private pension schemes which depend on both regularity and consistency of earnings. Again, historical evidence in times of a downturn in construction industry, result in real wage cuts as well as interrupted earnings. The false self-employed in the construction industry are amongst the most vulnerable to the risks of economic uncertainty (Burchell et al. 1999). The result is often poverty in old age. It is known that self-employed people in general anticipate continued working into their seventies and eighties, partly as a consequence of inadequate pension provision and security for the self-employed. For manual trades, and in particular construction workers, the

prospects are similar, but combined with yet greater uncertainty and declining incomes. The most likely outcome for many is dependency on means tested benefits, Pensioner Tax Credits, Housing Benefits, and the like.

So, when calculating the fiscal cost to the taxpayer of the loss of National Insurance and income tax revenues, only the most tangible and identifiable costs have been estimated. If the means-tested benefits were to be included, the cost to the taxpayer would be significantly increased. The main point to be made here, however, is that the longer term risks and costs to the false self-employed far outweigh any short-term gains from paying Class 2 National Insurance and making claims under Schedule D income tax.

Perhaps the greatest myth is that the individual worker could make any rational economic calculation of the costs and benefits of being employed or self-employed. An economic genius equipped with the most sophisticated modelling software and powerful computers could not make a rational choice, simply through lack of the necessary information about future developments in the construction economy, about future changes in regulatory or pension institutions, about the likelihood of an accident, or of dependents' circumstances. And, in any case, in current market conditions and on many construction sites, workers in general are not presented with a choice. The only opportunity they have, whether national or migrant, is to work as false self-employed.

### **Government complacency**

One of the more shocking and puzzling aspects of the evasion economy has been failure of the government to tackle the issue of false self-employment, despite its objectives of increased spending on health and education, and its determination to keep within sound financial rules. A recent statement by a junior government minister

gives some insight into the deep level of ignorance and complacency surrounding this issue.

Appearing before a Select Committee for the Department of Business, Enterprise and Regulatory Reform (BERR), on January 22, 2008, Stephen Timms acknowledged the presence of between 100,000 and 200,000 bogus (his term) self-employed construction workers. He stated the figure of £340 million as the consequent loss to the Treasury. And he said he would do nothing about it.

“How the industry organises itself is a matter for the industry. I don’t think it is for Government to regulate how companies are organised.”

Miserably briefed, it is worth dwelling for a moment on the extent of the errors which he voiced. Firstly, were he to be correct about the maximum figure of his admission of bogus self-employment and the level of self-employment reduced by 200,000, it would mean that the proportion of remaining self-employed in the workforce stuck at 38%. If the level of self-employment was reduced by his lower figure of 100,000, the proportion remaining would only drop to 45%. That would mean around double the level in the USA, three times the level of most European countries, and three and a half times the level for any other sector in the UK. These estimates indicate a deep lack of understanding of the nature of industrial and economic organisation in the construction or any other sector. Secondly, even on his numbers of bogus self-employment, the loss to the taxpayer though the lack of employer’s National Insurance contributions alone would amount to £500 million per year. On the basis of the calculations set out above, the true figure would be close to £900 million per year. A trivial amount?

But more astonishing than factual error is complacency. So, it does not matter to the government if companies break the law. It is up to them to enforce the law, he

says. We can stand down the police force and enforcement agencies. After the credit crunch and the Northern Rock failure? After the misappropriation of pension funds? What does it matter if a couple of hundred thousand people do not pay their legally owed taxes? Maybe we can all stop doing so, if Mr Timms does not mind.

Of course, government complacency does not explain how the evasion economy has become so normalised and entrenched in UK construction. It may be a source of embarrassment, but we need deeper explanations as to how such complacency has become possible, how such things come to be said so easily, and before a Select Committee of Parliament. Let us not blame Mr Timms.

## **Main findings**

This chapter has taken the examination of the evasion economy a step further, by identifying the fiscal consequences arising from mass false self-employment. Let us summarise the main findings:

- ❖ The main difference in fiscal costs relating to employment status are constituted by employers' and employees' National Insurance, of which the main difference arises from employers paying no National Insurance for falsely self-employed employees.
- ❖ Given a range of estimates of the scale of false self-employment and level of wages, an upper and lower range of estimates was established for the loss to the tax payer, between **£1.4 billion** and **£1.9 billion** per year. The most likely round figure estimate of a loss stands at **£1.7 billion** per year.
- ❖ Employers are responsible for 58% of this loss, at just under **£1 billion** per year, with employees responsible for **£0.7 billion** per year.

- ❖ The tax incentives to false self-employment were shown to increase considerably when other costs associated to employment status are included. The burden of risk for sickness, unemployment, care of dependents, and old age retirement were downloaded exclusively onto the false self-employed.
- ❖ The effect of this mixture of incentives and risks has resulted in a vicious spiral resulting in a minimum investment in the employment relation and a high level of casualisation. This is identified as a root cause of the failure to develop skills and consequential barriers to innovation and productivity gains.

# Chapter 4

## The Evasion Economy. Causes and origins.

### Introduction

In April 2007, the last in a long line of regulatory reforms of the taxation regime peculiar to the construction industry was implemented. It is called the New Construction Industry Scheme – or new CIS. Its three stated objectives can be fully endorsed. They were:

1. to reduce the regulatory burden of the Scheme on construction businesses
2. to improve the level of compliance by construction businesses with their tax obligations
3. to help construction businesses to get the employment status of their workers right.

However, as with previous attempted reforms, there has been a failure to address systemic regulatory failure, and indeed, as will be argued, the current reform only exacerbates the problem, particularly with respect to objectives 2 and 3. With respect to the first objective, the opportunity was missed to simplify regulation, while introducing some operational reforms. Her Majesty's Revenue and Customs (HMRC) persisted in seeing the problem as one of whether individuals were properly classified as self-employed under the tax rules, rather than one of the tax system of classification itself. The construction industry is the only sector in the country that has two types of self-employed, not one. We see this system as at the heart of the problem, not whether people are correctly or incorrectly designated within it, which is the consequence not the cause. The issue is one of flawed regulation, not over-regulation. This flawed regulation has introduced serious labour market distortions

that have bedevilled the industry for three decades. HMRC not only failed to analyse the nature of the problem, but also, even with their own limited horizons, failed even to correct what they had identified as a level of illegal self-employment. In an exercise undertaken at the time, HMRC came up with a speculative and inadequate number of 120,000 illegal false self-employed. The new system has failed to redress this situation, let alone tackle the true scale of the evasion economy. There has been no shift back in to direct employment. There have been no serious attempts to enforce the rules on employment status on contractors in the industry. All the evidence points to the new system having had the contrary effect, facilitating and further entrenching illegal false self-employment.

The previous two chapters examined the economic and fiscal realities of the evasion economy. In this chapter, we identify its causes and origins in the legal and taxation systems as the central institutions of the construction labour market. The argument can be stated in simplified form at the outset. There are two institutional modes through which employment status of individuals is designated: by law and by taxation classification. We will argue that the law has produced a situation of uncertainty and lack of clarity. It is widely recognised that no one legal criteria, no clear combination of criteria, is able to resolve employment status, to an extent that each individual case needs to be weighed and judged on its circumstantial merits.<sup>5</sup> On its own, this uncertainty and lack of clarity does not generate mass false self-employment however. In most industries, as we have seen, there are quite normal and

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<sup>5</sup> As the HMRC advice on determining employment status confirmed: ‘Recent court cases indicate *there is no single satisfactory test governing the question whether a person is an employee or self-employed* (our emphasis). One must consider all the factors that are present in, or absent from, a particular case; weigh those pointing to employment against those pointing to self-employment; and then *stand back and consider the picture that emerges* (our emphasis). The result may be that a person is considered to be in business on his own account (self-employed) or is an employee.’ HMRC, 2008 *Are your workers employed or self-employed? – advice for contractors*. CIS leaflet 349. See also Freedman, 2001 who argues that ‘great weight is placed by the courts on the facts of each case and there is no definitive list of factors or weighting of factors to be taken into account’, p. vii.

internationally comparable levels of self-employment, higher in some sectors than others, but nowhere excessively so. A taxation regime unique to the construction industry, however, with two classes of self-employment, introduces further confusion to legal interpretations, and by institutionalising a subsidiary form of self-employment, creates the conditions for tax evasion explained in the previous chapter.

This chapter will review the legal and tax regimes to support this argument. It will show how the special tax regime, when coupled with an uncertain and unclear legal classification, produces a phenomenon of mass false self-employment unique to the construction industry. But the clinching proof will lie in a demonstration that the historical patterns of switching between direct to self-employment are directly attributable to the changes in taxation regulatory systems.

In this chapter, therefore, we first examine the legal institutions of employment status, as they have evolved. We then trace the parallel historical development of the special construction tax regime since the 1970s. And finally, we demonstrate the direct impact of the latter on the emergence of false self-employment on a mass scale in the early 1980s, and its subsequent ups and downs.

## **Self-employment and the law**

Throughout this report, false self-employment has been equated with illegal self-employment. In this section and the next, we justify that characterisation. In the terms of the OECD:

‘In some countries...taxation systems, and perhaps labour market policies as well, might have encouraged the development of “false” self-employment – people whose conditions of employment are similar to those of employees, who have no employees themselves, and who declare themselves (or are declared) as self-employed simply to reduce tax liabilities, or employers’ responsibilities.’ OECD Employment Outlook 2000, 156.

Workers who are assigned self-employment status by themselves or by their engagers to reduce of tax liabilities are illegal in so far as courts would adjudicate them to be employees, were the case to be tested before them. Here, however, we are additionally arguing that the taxation system itself introduces conflicts with legal definitions. There is a long history of legal and taxation systems of classification being out of kilter with each other (Deakin and Wilkinson, 2005; Daunton, 2002). Indeed, the famous ‘binary divide’ between employment and self-employment found its sharpest expression as early as the Finance Act of 1922 when a separate tax schedule for self-employed was instituted, only to be more fully enshrined much later in employment law in 1946 National Insurance Act, following the Beveridge Report.

The legal institutionalisation of the binary divide has been continuously evolving, since it emerged towards the end of the nineteenth century. The legal distinction is between a contract **of** service (employment) and a contract **for** services (self-employment). There are now four main groups of criteria for discriminating between the two employment statuses, **control**, **integration**, **economic reality**, and **mutuality of obligation**. These four have successively emerged as tests of employment status, building up precedents through case law. Thus the first to emerge as the principal test was that of control. If a worker is under the control of the engager of services, for example determining when, how, where and to what standard the labour services are performed, then this control was taken to indicate employment, not self-employment. But there are many examples of workers who are clearly self-employed, yet come under the control of their client: window cleaners, cleaners of domestic households, personal service providers, are cases in point. So **control** became one test amongst others.

**Integration** was a later significant additional test focusing on whether a person was part of an employing organisation or not, subject to disciplinary or grievance procedures of that organisation, and owing obligations to that organisation, not undermining its reputation whilst engaged in working for it, and so on. There are many professions, such as doctors or lawyers, who have considerable control over their how, when, and to what standard they work, but are part of an organisation, hence employed. Nonetheless, case law yielded significant counter example – a famous case of a free-lance video-camera operator exemplified a worker who, when filming, was necessarily thoroughly under the control *and* integrated into the organisation producing films.<sup>6</sup> Yet, in every other respect he was self-employed, providing his own equipment, submitting invoices for work undertaken, and working for multiple clients.

Such cases brought to the foreground the **economic reality** test of whether someone was in effect in business on their own account, taking financial risks in making profits or losses, through assuming the responsibility for setting the price for undertaking the service, providing the necessary equipment, or being able to pay someone else to undertake the service in their place. Meeting the independent business test then became a critical indicator – although not the sole one – of self-employment status.

Finally, and more recently, a further test has emerged to address occasions when, when, unlike the video camera operator, there were no signs of operating a business or satisfying an economic reality test, but a lack of any obligation between the engager and engaged. The key test cases invoked here was one concerning guides

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<sup>6</sup> *Hall v Lorrimer*, 1994.

to take visitors around power stations<sup>7</sup>, and another, irregular wine waiters<sup>8</sup>. The lack of **mutuality of obligation** goes both ways, if the engager is under no obligation to offer the contract for services to a particular worker when work became available, and if the worker is under no obligation to accept a contract if offered. The key point is independent choice for either party connected irregular and/or intermittent supply of services.

The **mutuality of obligation** test has introduced a new level of lack of clarity and uncertainty into the legal determination of employment status, because it risks confusing casualised employment with self-employment.<sup>9</sup> Casual workers are often engaged successively by multiple employers. This is a mark of their insecurity and extreme dependency on opportunities for employment, and is frequently accompanied by involuntary periods of unemployment. This test makes it hard to distinguish between casual workers, the most dependent employees, and the genuinely independent workers who may choose to work intermittently, at times of their own choosing, and for multiple clients. In the construction industry today – and in the docks in earlier periods – hiring by the day, being picked at random from a group on a street corner, is a mark of extreme economic dependency combined with absence of mutuality of obligation. For dock labour, there was no question but that the engagement was one of employment. Today, in the construction industry, these occurrences frequently fall into the evasion economy of false and illegal self-employment.

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<sup>7</sup> *Carmichael v National Power, plc.* 1999

<sup>8</sup> *O'Kelly v Trusthouse Forte*, 1983.

<sup>9</sup> Mutuality of obligation 'has had the effect of excluding from protection workers in casual employment relationships, where the existence of mutual obligations to provide work (in the case of the employer) and to accept any work which is offered (in the case of the worker) is in doubt.' Burchell et al., 1999. 7.

As these different tests have emerged, supported by many precedents of case law, legal classification has become complex, uncertain and unclear. As we have just seen, three tests (control, integration, economic reality) might point unequivocally in one direction (employment status), only for the fourth test to point in the other (self-employment). In the words of an authoritative work on labour law we are faced with

‘an open-ended multiple test, in which any one of a number of factors could turn out to be essential in tipping the balance on one side or another.’ (Deakin and Morris, 159)

The table 4.1 below, adapted from Burchell et al 1999, lays out the four tests and some of the criteria grouped within them.

|                         |  | Direct | Self  |
|-------------------------|--|--------|-------|
| Control                 | • Duty to obey orders as to when and where to work                   | Yes    | No    |
|                         | • Determination of hours of work, breaks, etc. by engager            | Yes    | No    |
|                         | • Supervision of mode of working                                     | Yes    | No    |
| Integration             | • Subject to engager's disciplinary or grievance procedure           | Yes    | No    |
|                         | • Integration into organisation of team or coordinated patterns work | Yes    | No    |
|                         | • Subject to engaging firm's or contract's safety policy             | Yes    | No    |
|                         | • Inclusion in occupational benefit schemes                          | Yes    | No    |
| Economic Reality        | • Self-determination of method of payment and level of payment       | No     | Yes   |
|                         | • Freedom to hire others in substitution                             | No     | Yes   |
|                         | • Providing own equipment  | No     | Yes   |
|                         | • Investing in own business  | No     | Yes   |
|                         | • Submission of invoices for completed work                          | No     | Yes   |
|                         | • Payment of own tax and NI  | No     | Yes   |
|                         | • Personal coverage of sick pay, holiday pay                         | No     | Yes   |
| Mutuality of obligation | • Duration of employment   | Long   | Short |
|                         | • Regularity of employment   | Yes    | No    |
|                         | • Continuity of engagement between contracts                         | Yes    | No    |
|                         | • Right to refuse work without adverse effects on future engagement  | No     | Yes   |

**Table 4.1** Legal tests of employment status.

From the multiple criteria contained under these four tests, it is clear that there is much scope for ambiguity and contrary indications, a veritable feast for legal interpretation and discretion. In the above table, there are just eighteen possible indicators listed, and the only unambiguous cases occur when all go one way to point to direct employment, or all go the other way, to point to self-employment, as

illustrated. In many instances, there are combinations of positive and negative indicators, producing conflicting signals under the four tests. It is somewhat disturbing, therefore, that the HMRC's Employment Status Indicator, a website designed to assist contractors and workers to determine their employment status, conflicts with the legal basis for testing employment status. It can yield an outcome for determining the status of self-employment based on one criterion alone<sup>10</sup> – correcting work at one's own expense – thus controverting the principle of weighing all the factors in a complex of contrary indicators.

Yet, the uncertainty and lack of clarity in the law does not of itself generate mass false self-employment, as we can see from sectors other than construction. It is a necessary, but not sufficient, condition. Moreover, even with this ambiguity and lack of clarity, the vast majority of the false self-employed within the construction industry fall unambiguously and clearly in the category of employed. On major construction sites where this phenomenon occurs the typical false self-employed worker fully meets the first three tests, and many, if not a majority also meet the fourth.<sup>11</sup> We can characterise this typical false self-employed worker as follows.

### **Control**

- The worker is engaged for a duration determined by the engager, who also determines lunch and tea breaks. The engager has total control over working time.
- A labour-only subcontractor is the worker's typical engager, often in a long chain of sub-sub-sub-contracting.
- The worker is supervised by the labour-only sub-contractor, and tasks are assigned, as to when, where and how the work on site is to be undertaken.

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<sup>10</sup> For those interested, they can test out the system on <https://esi2calculator.hmrc.gov.uk/esi/app/index.html>. Affirmatively answered questions relating to correcting work at one's own expense prove to be a decisive indicator of self-employment. This is peculiar in so far as many disciplinary procedures typical of employment entail the reduction of pay for unsatisfactory work, or the correction of errors in one's own time. It is certainly not legally correct that this one indicator on its own should be sufficient to override all contrary indicators. It betrays a clear bias towards self-employment.

<sup>11</sup> The evidence for this is given in previous research, Harvey 1995, 2001, 2002.

### **Integration**

- The worker is subject to the main contractor's safety and disciplinary procedures.
- The worker is frequently a member, often long-standing one, of a work team or gang, which is itself integrated into a hierarchical and sequential organisation of the production process (e.g. a bricklayer in a line).
- The worker (see below) is entitled to holiday pay

### **Economic reality**

- The worker assumes no financial risk on his/her own account by setting their own price or estimating the duration for completion of the service.
- The worker's method and rate of pay, normally a wage, but sometimes a price, is fixed by the engager not the worker, often by advertisement.
- The worker does not submit tenders for the contract, in competition with others.
- The worker never engages a substitute to work in his/her place, or pays them to do so, even if they might sign a piece of paper to the effect that they can.<sup>12</sup>
- The worker provides no capital equipment (e.g.diggers, scaffolding, etc.) or materials, other than the normal tools of the trade (including electrically powered tools).
- The worker does not invoice the engager for work undertaken, or materials provided.
- The worker has tax deducted at the normal standard rate of income tax at source by the engager.

### **Mutuality of obligation**

- The worker is regularly engaged by the same contractor/subcontractor across successive contracts, when work becomes available in the sequence of the production process.
- If the worker refuses an offer of continuous working with the same contractor when available to do so, it is likely to jeopardise future opportunities to work for that contractor. There is a two-sided recognition of mutuality of obligation, even in conditions of some discontinuity.

Given that this description is typical for those we have described as the 'mass self-employed' present in large numbers on major construction sites across the country, there can be little doubt that they can be deemed not only false, but illegally, self-employed. When providing numbers ranging from 375,000 to 433,000 for the illegally self-employed, this refers to workers fitting the above description.

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<sup>12</sup> To protect themselves from charges of false employment, many engagers use phoney contracts that bear no relation to the reality of the engagement.

## **Worker, employee or self-employed?**

We have just reviewed the criteria for legally deciding employment status, noting potential sources of confusion and ambiguity. Before leaving the sphere of the law, however, unfortunately there is a further layer of complexity. A number of Acts of Parliament<sup>13</sup> have used the concept of worker, rather than employee, to cover anyone who ‘undertakes to do or to perform personally any work or services for another person’. The term worker therefore has been used to include the ‘dependent self-employed’ (Deakin, 2001; Freedman, 2001) under its umbrella. A worker, under this legislation, has some benefits such as a right to holiday pay. But many of the rights attached to employment status, such as Job Seekers Allowance and sick pay, are still not included. This has created a half-way house, both in terms of rights and status. There have been many industrial tribunals pursued by the construction trades unions to claim holiday pay for the false self-employed under this legislation. Although these cases have in general succeeded, in the next chapter we shall see that many of the dependent self-employed are deprived of basic rights, including holiday pay. In general, the status of worker is not a resolution of illegal and false self-employment. Rather than opening up new areas of rights for those deprived of them, in many ways this legislation has made the status of the false self-employed even more complex, and does little to tackle the central problem of the evasion economy.

## **The tax trap of illegal self-employment**

It can be argued that the evolution of the legal classification generated by the binary divide between employment and false self-employment has always responded

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<sup>13</sup> The Equal Pay and the Wages Act, 1986; the National Minimum Wages Act, 1998, the Working Time Regulations Act, 1998, and the Employment Relations Act, 1999.

to changes in economic organisation of firms (Deakin and Wilkinson, 2005), and, recently, in an age of flexibilisation, the increasing use of external labour services – outsourcing. The development of taxation systems has been driven by quite different imperatives – most significantly, the gathering of revenue to finance the full range of public services, and activities of the state. In this respect, stable employment relations, as they emerged in the 20<sup>th</sup> century, became the principal ‘fiscal handle’ for taxation, and income tax finally emerged as the pillar of the fiscal constitution of the state following the 2<sup>nd</sup> World War, when it became universal to all forms of employment (Daunton, 2002).

However, back in the 1960s and early 1970s, much employment in the construction industry was deemed to be so irregular as to not afford any reliable fiscal handle on which the Inland Revenue could gain purchase. Many payments made by employers to wage workers went untaxed – some of this practice earning the title of ‘the lump’. The unique construction taxation system owes its origins, in significant part, to this background. The Phelps Brown Report (1968), amongst many of its other recommendations, in effect proposed the regularisation of the industry by endorsing mass self-employment. The ensuing Construction Industry Contracts Bill, 1970 (Conservative) was followed by Denis Healey’s Labour Finance Act of 1975 which offered amnesty to tax evaders, at the same time as establishing a self-employment tax system for the industry that for the first time created the two-tier, two status, self-employment classification.

This was the critical and first foundation for the evasion economy, to be followed by two major taxation reforms, the original Construction Industry Scheme in 1999, and the ‘new’ Construction Industry Scheme of April 2007. In its first 1975 manifestation, a unique construction industry tax regime was established. One form of

self-employment classified tax-paying workers as genuine businesses on their own account. The other form, where tax was deducted by the engager at source, was described by the Inland Revenue official responsible for overseeing the system as ‘quasi-PAYE for quasi-employment’ (Harvey, 1995).

It is worth dwelling on this system for a moment, as it was under this regime, and in two phases, that the phenomenon of mass self-employment became entrenched. The first type of self-employment entailed registration of the self-employed with what was then called a 714 certificate, an identity card with a photograph. The person was required to meet a business test of self-employment. Evidence of turnover, business address, and other details supposedly demonstrating a genuine form of self-employment that passed the economic reality legal test, created a ‘business class’ self-employment. The key feature of this self-employment – in common with that in all other sectors – was that taxation was through self-assessment of gross turnover, and on an annual basis. The 714 certificates were later to fall into disrepute, partly because they were widely traded in informal markets.

The other, second-class, form of self-employment was peculiar in that no attempt was made to tax or identify the individual. Instead, the ‘fiscal handle’ of taxation was the contract. So, each time a self-employed worker was engaged under the so-called SC60 tax certificate, tax was deducted at source by the engager for the contract, and, in principle although not always in practice, the tax so collected was transferred to the Inland Revenue. An important consequence of this system is immediately evident. There were no records or means of tracking the number of individuals working under the SC60 system. In short, the system opened the door to an uncontrolled expansion of the numbers of workers engaged under the system. There can be little doubt that, already by 1979, inflated numbers of workers were

being taxed as self-employed, well above the upper limit of legality of 25% of the workforce. In all other sectors, it has been found that the most certain proof of employee status is when the engager deducts tax at source (Burchell et al., 1999). Responsibility for managing one's own tax affairs is a key component of any economic reality test for being in business on one's own account. The SC60 system therefore enshrined an ascription of self-employed status to a characteristic definitive of employee status under law. Furthermore, by imposing the responsibility for collection of tax on the engager, the client for services, effectively the tax system treated engagers as employers. In no other area of self-employment are the clients of contracts for services obliged to collect taxes owed by the providers of those services. A domestic householder does not collect the taxes owed by their window cleaners. So the SC60 tax regime treated both parties to the contract as being in an employment relation, not a relation of a client to an independent contractor for services.

Additionally, however, the very fact of a two-tier system created an artificial and distorting division within the self-employment status between those classified as passing a proper business test, and those not subject to any equivalent business test: a division between those truly in businesses on their own account and those not required to meet such a test, not so clearly in businesses on their own account. We shall see that this division has been exacerbated by subsequent reforms.

Even before Thatcher came into power, therefore, the tax regime sanctioned and established uncontrolled acquisition of self-employment status, and a classificatory ascription in conflict with key legally accepted definitions of genuine self-employment. Soon after coming to power, the Thatcher government, supported by major housebuilding companies, gave free license for unlimited expansion of false self-employment. A new administrative system of self-declaration of self-employment

status was initiated, where a worker filled in a self-employment form, C11. This applied to those on the second-class self-employment, SC60 system, and gave a further regulatory boost to the evasion economy. It was under this system that the dizzy height of over 60% of the total manual construction workforce in the UK became self-employed.

This Thatcherite move, however, cannot be characterised as deregulation. Quite the contrary, by not policing the boundary between two legal employment statuses, the measure introduced unrestricted competition between high and low taxed labour into the market. It is a prime example of flawed regulation of labour markets, establishing severe market distortions. It was as if legal and illegal tender were considered to be mutually exchangeable, without policing or restriction. These are the market regulatory conditions for Gresham's law to operate. Illegitimately low taxed labour drives out legitimately standard taxed labour.

The next alteration of the tax regime occurred in 1997, following a campaign led by UCATT, other construction unions, supported by major employer organisations. In effect, the administrative policy of 1980 was rescinded and tests for self-employment were re-instated. A leaflet (IR148/CA69) was issued requiring contractors to comply with the new arrangements by April 1997. According to the Inland Revenue's own estimates, between 180,000 and 250,000 construction workers changed from self-employment to employment in the two years that followed the new administrative regulation.

However, the 714/SC60 continued in place until the next major reform of the construction tax regime in 1999 when the Construction Industry Scheme was introduced. This reform failed to address the fundamental flaws of the previous system, and retained the two-tier classification of the self-employed. However, there

were significant changes, notably the replacement of a contract-based SC60 tax system, by a worker-based system in which an identified individual self-employed worker had their tax deducted at source by the engager, under what was then called CIS4 registration. The main new features of the reform were as follows:

- A new two-tier self employment system. The first tier was now ‘superior business class’ self-employment status, CIS 5/6, with a threshold of a £30,000 annual turnover and a business test. This set conditions for gross payments and self-management of tax by the self-employed. The second tier, CIS4 self-employed worker had tax deducted at source at a lower rate than standard rate (18% as against 22%).
- A workplace identity card system for both classes of self-employed was introduced, with a photograph (a compulsory system, a significant but relatively unremarked innovation). The card also carried the National Insurance number.
- An obligation was placed on contractors engaging the CIS4 self-employed to deduct tax at source and provide Inland Revenue with taxation vouchers for each payment and transfer the tax owed by the self-employed to the Treasury.

In some respects, the previous business class became ‘superior business class’. By imposing a threshold of £30,000 annual turnover as a condition for a self-employment status where the self-employed retained responsibility for paying their tax (the gross payment method), the new rule in effect excluded a significant proportion of genuine self-employed from the normal rights and responsibilities of self-employment. By so doing, this new regime sharpened the distinction between the

business class self-employed and the dependent self-employed. The certification and voucher system for the latter equally clearly placed greater obligations on the engager, even more consistent with those of an employer. It should be emphasised that thresholds and business tests of this kind operate in no other sector of the economy, for the simple reason that millions of genuinely self-employed working for private clients would be excluded from their legitimate self-employment status by virtue of the £30,000 threshold. So the conflict between law and taxation classification of status in the construction industry became more acute, not less, with the Construction Industry Scheme.

Moreover, far from utilising the new identity card system, and the shift to taxing individuals rather than contracts for the second-class self-employed, in order to control and police employment status, 1,063,728 CIS 4 certificates were issued to individuals within months of the introduction of the new scheme. This was at a time when the total construction industry workforce did not exceed 1 million. At the time, Inland Revenue documents on the new scheme affirmed that ‘the registration card in particular was not proof of self-employment’. Maybe not. But, it was certainly the rubber stamp. The second class self-employed were exempted from the more rigorous test of the business class self-employed, and, in effect walked through an open door to self-employment status. As Jane Kennedy state in a Parliamentary written answer (Hansard, 21 November, 2007)

‘There was no other qualifying test, so refusal was extremely rare..... At the close of the former scheme, there were some 1.9 million CIS 4 holders.’

With the influx of migrant labour into the evasion economy of false self-employment, there is evidence that many have entered without any significant test of self-employment. In answer to written parliamentary questions, John Healy, Financial

Secretary to the Treasury, (Hansard, 16 April, 2008), provided the following statistics for those issued temporary, 3 month, self-employment CIS4 registration without National Insurance numbers:

|              |         |
|--------------|---------|
| 2004-5       | 74,000  |
| 2005-6       | 77,000  |
| 2006-7       | 76,000  |
| <b>Total</b> | 227,000 |

**Table 4.2** Number of temporary registrations of migrant self-employment

From the Labour Force Survey statistics discussed in Chapter 2, it is clear that not all 227,000 remained in the UK construction industry. The point to remark on here is the ease with which migrants can enter into false self-employment and became part of the UK construction evasion economy.

The 1999 CIS reform, having failed to address the fundamental labour market distortions and identify its own taxation system as their cause and origin, provoked considerable disquiet in the industry, both for important sections of employers and for all trades unions. Consequently, an employment status review was initiated in 2004, leading eventually to the New Construction Industry Scheme referred to above, and introduced in April 2007. However, for reasons that will be discussed more fully in the final chapter, once again an opportunity was missed. The two-tier self-employment system remains almost unaltered from its predecessor, with a superior business class self-employment, allowing gross payments on condition of a £30,000 turnover threshold and a business compliance test, and the same false self-employment class with their tax deducted at source by their engagers. Most of the reforms are operational and administrative, relating to how tax is returned to HMRC and how it is accounted for (the previous voucher system and certificates have been dropped).

There are contradictory elements in the new system that give little confidence that much will change. The identity card system has been dropped (ironically). In its place an electronic internet registration and verification procedure using National Insurance and Unique Taxation Reference numbers have been implemented. On the one hand, engagers of labour services are now obliged to sign, on a monthly basis when submitting their taxation returns, that they have checked the employment status of the providers of labour services.<sup>14</sup> There are penalties for false declarations. On the other hand, the Electronic Status Indicator, discussed above, can be used both by engagers and engaged. For the engaged, registration to be self-employed can now be accomplished over the internet, by simply answering questions appropriately. It is difficult to see that this will pose any barriers to entry into false self-employment, indeed the reverse. However, as the system has only just been introduced, statistics on the employment status composition of the workforce are unavailable.

On the evidence so far, HMRC have not penalised any contractor or self-employed person for false declaration of employment status.

At present, no instances have arisen where penalties have had to be imposed because of an incorrect declaration of employment status by a contractor. (Jane Kennedy, Financial Secretary, HM Treasury, Hansard, January 31, 2008).

If the introduction of the New Construction Industry Scheme was intended to bring about the stated objective of shifting many of the old CIS4 self-employed into employee status, there are no signs on the ground that this has either been pursued or achieved.

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<sup>14</sup> The HMRC leaflets explain to engagers: 'Under the New CIS, you 'll be signing a declaration every month to say that you've considered the employment status of the workers you've paid within CIS and that none of them is an employee.'

## **The critical proof of the causes of illegal mass self-employment.**

Reviewing the history of the tax regulation system, it is clear that what had originally been motivated by the need to get some fiscal handle on a chaotic industry has become institutionally entrenched into a unique two-tier employment status taxation system. The term for this is path dependency. Once locked into the two-tier system, all subsequent reforms have modified, even sharpened, the divide. From all the evidence, the superior business class self-employment has been contained and limited in number. For all other sectors of the economy, self-assessed taxation is the norm for self-employment. The critical evidence is that the second-class self-employment status, a taxation status in conflict with key legal tenets of employment status, has been responsible for the expansion and entrenchment of the evasion economy. The lack of clarity and complexity of legal status classification provided the necessary conditions for the tax employment status classification to have a major impact. If the legal classification was less open-ended, requiring each individual worker's case to be judged on its full merits and complexity, there would have been less scope for the tax classification system to generate mass illegality.

The expansion and contraction of mass self-employment, above the upper legal threshold, maps precisely onto the changes and measures taken by the taxation regime. In no other industry or sector have such measures been introduced, or such an explosion of self-employment occurred. Therefore, it is not a general trend or feature of the economy or labour market that is in evidence. Instead, when the first two-tier self-employment taxation regime (the 714/SC60 regime) was instituted in 1975, the officially registered self-employed roughly doubled to approximately 30-35% of the

total construction manual workforce. Following the 1980 Thatcher administrative ruling, the real explosion began, pushing the level of self-employment from below 40% up to 62% by 1996. An administrative reform reintroducing tests for self-employment in 1997 then reduced the level of mass self-employment to 48% in 1999, still a grossly inflated proportion. Following the introduction of the Construction Industry Scheme in that year, the downward shift was halted, and since then, after some fluctuations around 50%, the figure has begun to climb again (see in particular, figure 2.3). Given the growth of construction employment and the influx of migrant labour, self-employment has recently accelerated more rapidly than employment. Although no evidence is yet available to demonstrate the impact of New Construction Industry Scheme introduced in April 2007, given the tinkering nature of these latest reforms, it is difficult to see that the upward trend will be checked.

At each point in this history, changes in the taxation system directly produced changes in levels of mass self-employment. The evidence is thus overwhelming that the cause and origin of illegal mass self-employment lies in the two-tier taxation classification system unique to the construction industry. This system is in conflict with the legal conception and regulation of employment status in all other sectors of the economy. It sets in train competitive pressures and incentives that drive out legal employment, replacing it with illegal self-employment. The evasion economy is a systemic failure. This taxation system and the incentives it incorporates, not how individuals are correctly or incorrectly allocated within it, is where the problem lies. It is the reform of this system that we propose in the final chapter. The answer lies not in more regulation, but in simpler, more consistent and coherent regulation necessary for more efficient labour market functioning.

## Main findings

- ❖ The legal system for determining the employment status of the employed or self-employed has become complex, unclear and uncertain. The four standard tests cannot be applied consistently in conjunction with each other, and in many cases conflict.
- ❖ In spite of the ambiguity of the law, the empirical reality of the vast majority of the false self-employed in the construction industry is that they are also unambiguously illegal, on application of the four tests.
- ❖ The lack of clarity of legal classifications of employment status provided the conditions under which a contrary tax classification of employment system produced a major impact on construction labour markets.
- ❖ The construction industry taxation regime uniquely instituted a two-tier classification of the self-employed. This firstly imposed more stringent conditions for the self-employed to act as businesses on their own account responsible for their tax affairs than in any other sector of the economy. Secondly, it established a deduction-at-source self-employment tax status where the engagers of labour assumed responsibilities for managing the taxation affairs of those they engaged. This is normally one of the strongest indicators of employee status. For both parties to the contract, this tax status conflicts directly with key legal tenets determining the status of self-employment as one of being in business on one's own account.
- ❖ The construction tax regime in the course of its development was shown to directly account for the explosion of false and illegal self-employment, and the subsequent changes in scope and scale of the evasion economy.
- ❖ The Construction Industry Scheme registered 227,000 self-employed without National Insurance numbers, predominantly migrant labour, in the period 2004-2007, so facilitating their entry into and expansion of illegal self-employment in the industry.
- ❖ The problem of mass illegal self-employment rests with the conflictual legal and tax systems of classification, not in workers being misallocated within an unproblematic regulatory system of employment status.

# Chapter 5

## Employment deficits: the skills gap, vulnerability and pensions.

### **The employment deficit**

So far, the evasion economy has primarily been described in terms of the tax evasion economy. But it is much more than that. False self-employment can also be seen as direct employment stripped of all or most of its normal attributes: employment in terms of control, integration, economic reality, even mutual obligation, but no investment, and none of the standard employment rights. In some ways, this minimalist employment is the most vulnerable, subordinate and dependent form of employment, at the opposite end of the scale of genuine, independent, entrepreneurial self-employment. The impulse to drive down all costs of labour, triggered by tax evasion, has induced evasion of all social and economic obligations of employment. Degenerative competition of this kind is economically and socially damaging. In this chapter, we demonstrate the consequences of the evasion economy in this broader sense, first in terms of underinvestment in skills (the skills gap), then in terms of vulnerability and deprivation of employment rights, and finally in terms of pension rights, and the shift of responsibility from employers onto the state.

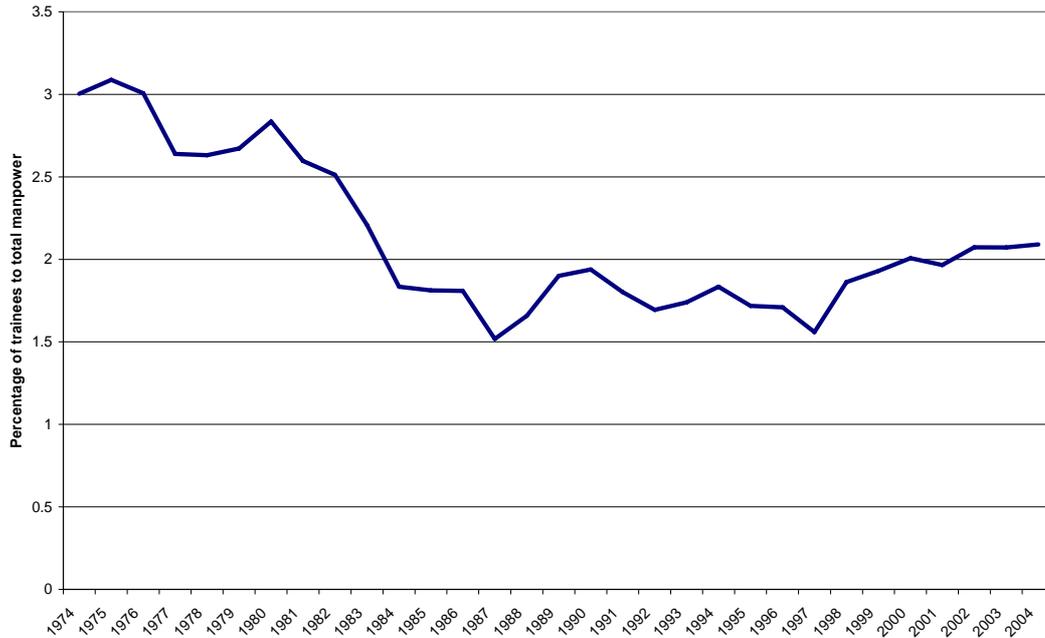
### **Mass self-employment and the skills gap**

The stark contrast between patterns of employment and self-employment in different European countries has already been noted (Chapter 2). The main facts of the skills gap in the UK construction industry compared with other European

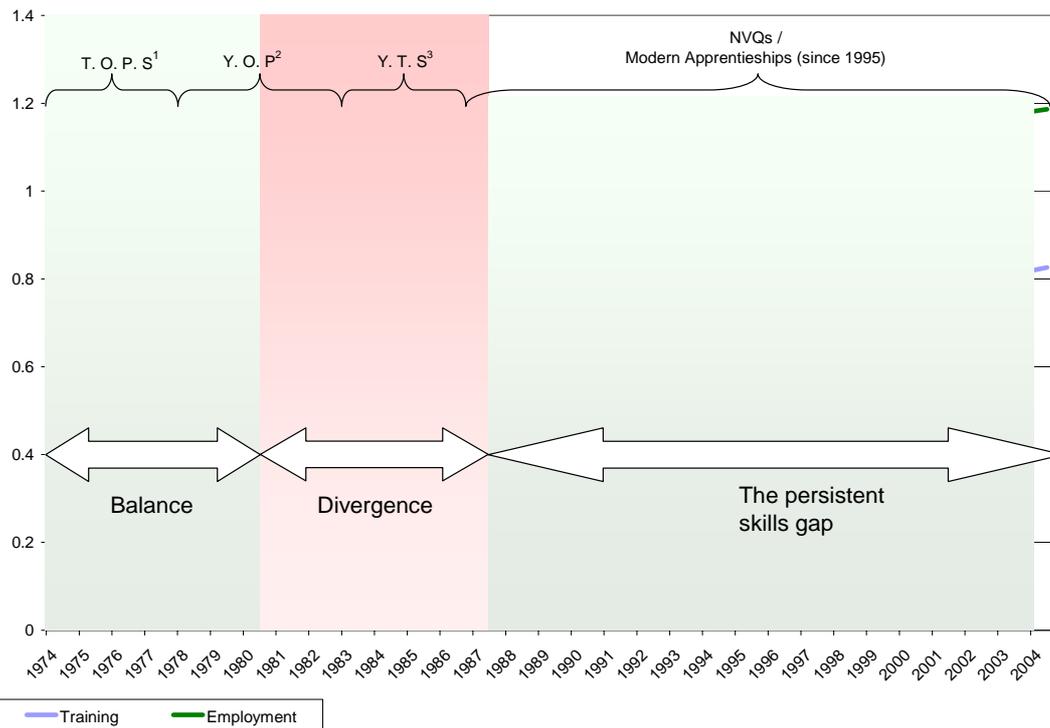
countries are also well known. In the UK, only 36% of the manual workforce achieves National Vocational Level 3 compared with 83% in Germany (Richter, 1998). The proportion of trainees to the manual workforce for carpentry and bricklaying is 4% in the UK, 9% in The Netherlands, 18% in Denmark, and 22% in Germany (Innovative Manufacturing Initiative, 2002). The skills gap reflected in this contrast has not always been so extreme. In this section, we show, first in statistical terms, that the shift from direct to mass false self-employment has been a main contributor to the decline in training. We then demonstrate the nature of the causal link between mass false self-employment and under-training.

In the pre-1979 period, local authority direct labour organisations (DLOs) had been a major source of provision of skilled craftspeople to the construction industry, exhibiting the highest proportions of trainees in their workforces, and exporting their 'surplus' into the private sector. After Thatcher's introduction of compulsory competitive tendering and reduction in the provision of social housing, Direct Labour Organisations were decimated, so cutting off a major source of supply of skills to the industry as a whole. The remnant local authority provision of construction traineeships and apprenticeships has also shown further drastic reductions, cutting by half the number of training placements between 2002 and 2007.

However, the most significant shift occurred in the private sector. The two Figures below demonstrate that the drop in the rate of traineeships to the overall construction workforce was cut by one third (Figure 5.1) in the period that coincided with the most dramatic rise in mass self-employment. Thus, if the same proportion of trainees to total workforce operated today as in 1974, the number of trainees would have to rise from 46, 000 to nearly 70,000.



**Figure 5.1** The decline in training in the UK construction industry. *Source: CITB-Construction Skills<sup>15</sup>*



**Figure 5.2** The emergence and persistence of the skills gap in UK construction.

<sup>15</sup> We are most grateful to Kirsty Woolsey and Martin Turner, Research Analysts at ConstructionSkills for this data, which I have adapted for this report.

This can be taken as the skills gap, by UK historical standards, created by the decline in DLOs and growth in mass self-employment, an annual shortfall of 24,000 or more. This assumes, of course, that the required skills level has remained static since 1974, when in other European levels, trainee ratios to the workforce have reflected demand for increasing levels of skill.

However, as is shown in Figure 5.2, once the divergence opened up between the total workforce and the percentage of trainees, the gap never closed. There has been a persistent and cumulative lack in training for skills within the UK industry. The stabilisation of high levels of mass false self-employment persisted with the rise and fall of the total workforce, as did the gap. Each year there is a lack of replacement of skills, the skills gap grows. To make up the cumulative shortfall, it has been estimated by the CITB that over 87,000 trainees are needed every year for the next decade, double the level of current training. This gap, as Figure 5.2 shows, has persisted despite the implementation of new training provision, on the supply side of training, leading to the introduction of NVQs and the Modern Apprenticeship.

These broad statistical relationships between training and false self-employment, however, require explanation. Why does mass self-employment lead to low levels of training? It has been powerfully argued that the absence of a clear link between qualification and wages, especially as secured by collective bargaining, results in a lower social valuation of skills, both by employers and employees (Clarke, 2005; Clarke and Hermann, 2004; Clarke and Wall, 1998). In many European countries, payment is directly related to recognised qualification. Clarke has also shown that the UK construction industry has failed to develop and modernise the concept of skills appropriate to the modern industry, and is still largely bound to the traditions of the established crafts, exemplified by bricklaying and carpentry.

The downward competitive pressure focused narrowly on cost rather than quality of labour, and the descent into the minimalist employment relation, drives out investment in training by employers. Thus, according to CITB figures, 75% of firms in the contemporary construction industry do not offer any apprenticeship training. The labour-only subcontractor, as the dominant type of firm engaging labour, constitutes the core of the trainee-free zone in the industry. For them, their false self-employed workers are paid to work, not to assist the training of trainees. The employment relation is stripped of everything except the exchange of a wage for immediate labour performance. Everything above and beyond that minimalist relationship disappears. The employer commitment to develop skills over a period of time disappears along with the employer commitment to employ over a period of time. As a consequence, the industry as a whole is the loser, having abandoned any collective stakeholding in the interests of the industry to maintain levels of skill. The resultant skills crisis, arising from the lack of national regeneration or expansion of skills, inevitably leads to importing skills through migrant labour. The phenomenon has been seen in other sectors where there has been a failure to regenerate skills, as in the National Health Service. Uniquely in the construction sector, migrant labour has entered into the evasion economy that is the cause of the skills gap in the first place. It stimulates further the downward spiral.

### **Underinvestment and deprivation of employment rights**

The narrow focus on the exchange of a wage for immediate labour performance has consequences for every aspect of this most vulnerable and dependent form of employment. Although technically many such workers may be entitled to working hours prescribed by the European legislation and the 1998 Working Time

Regulations Act, many construction sites employing mass self-employment work a 10-hour shift, five and a half days a week. A 55 to 60 hour week has been common in the industry for decades. This has encouraged an extensive rather than intensive approach to productivity, using longer hours to make up for efficiency and technological advance. There is no overtime pay, simply a flat rate for the shift. As noted in Chapter 4, such dependent workers are also entitled to holiday pay, yet the evidence on the ground from surveys and recent UCATT officials' reports suggest that absence of holiday payments is widespread.

Beyond these normal attributes of employment, however, the false self-employed have no rights to sick pay, unemployment benefit, or redundancy pay, however long they have been working for the same contractor. Yet, personal insurance provision against these risks is also rare, partly because dependent waged employment of an irregular and income-fluctuating kind has none of the characteristics of entrepreneurship and independent business opportunities. There is no culture of the independent and genuinely self-employed amongst those who are not genuinely self-employed – and why should there be? Although partially masked by the recent boom in the industry, historically the false self-employed have experienced particularly high levels of insecurity of employment, subject to instant dismissal, and to major downward fluctuations in wages. Turnover rates on large sites have reached exceptionally high figures, of 400% in the course of a year (Harvey, 2001, 2003). Visits to the doctor, absences to meet urgent child-care needs, are used as pretexts for dismissal. As dependent and falsely self-employed workers, without control over their own time, they are deprived of the rights of any normal employment relation. Conversely, they lack the discretion to choose how they organise their working time enjoyed by the genuinely self-employed.

From recent investigations by UCATT officials, it appears that many of the practices that have applied to the false self-employed are now extending to agency workers who by law and in principle enjoy employee status. Migrant workers supplied by agencies, particularly vulnerable to exploitation, have been found to work excessive and illegal hours. Holiday and sick pay are frequently absent, and non-payment of wages has been observed on a number of occasions. Some of the major agency labour suppliers, such as Hays and ICDS have been involved, and they have been supplying labour to construction sites managed by leading contractors, Persimmon, Robert MacAlpine, Bovis, Taylor Woodrow, Balfour Beatty, and others. These practices undoubtedly reflect the dominant and corrosive influence of bogus self-employment.

### **The right to retirement and pensions**

The binary divide between employee and self-employee status becomes particularly significant in relation to retirement and the right to pensions. Research and information on the self-employed, pensions and retirement is woefully inadequate. There are no data on the construction industry, the largest sector for self-employment, that takes into account the specific characteristics of construction self-employment. More importantly for this report, it goes without saying, there is no information on the pension or retirement prospects for the bogus self-employed. So much has to be inferred from what little data there is.

Paying Class 2 National Insurance entitles the self-employed to the same basic state pension as the employed. However, this assumes continuity of employment over 40 years for full entitlement. For the self-employed, periods of unemployment reduce their entitlement to basic state pension, unlike the employed who can register as unemployed, so maintaining their contribution record. From previous work, it is

known that the dependent 'second class' self-employed in construction (SC60 and CIS4), are vulnerable to unemployment (Harvey, 2003). During the long boom, this risk may have diminished. Post credit crunch, the pattern can be expected to re-appear. We can infer that many of the false self-employed in the construction industry will be entitled to reduced basic state pensions.

'There are large numbers of people in the UK who are heading towards inadequate incomes in retirement. ..between 9.6 and 12 million people, who are concentrated in certain groups, including the self-employed.' (Sainsbury, et al. 2006)

We can add that the dependent, irregularly employed, construction sector self-employed, as the largest self-employed group, will be highly represented in those with inadequate incomes in retirement.

The official view of the self-employed is that they are independent, entrepreneurial individuals that assume their own financial risks, including that of old age. However, in general terms, although a higher proportion of self-employed than employed invest in personal pensions to supplement their state pension (46% compared with 21%), this leaves over half without any pension entitlements other than their basic state pension. Unlike their employee counterparts, the self-employed have no occupational pensions, and their engagers have no commitments to their employees beyond the last hour they work for them. Moreover, it is well known that the self-employed are a highly heterogeneous group. The genuine, entrepreneurial, high-earning, self-employed are the most likely to be able to contribute to personal pensions (*Security in Retirement: towards a new pension scheme*, 2006; Clery et al. 2007). Those on irregular, middle and low earnings of less than £30,000 per year are the least likely to have any additional pension provision.

Last but not least is the issue of retirement, normally defined at age 65 for the employee, but open-ended for the self-employed. Without adequate pension provision, and without determinate age for cessation of work, the self-employed are far more likely to continue working after the wage of 65 – *if they are able*.

‘For the self-employed, their definition of retirement ...is the point when all work ceases.’ (Clery et al. 2007, 176)

In an industry with a notoriously high accident rate, and reliant on physical fitness and strength to undertake many of the operations, the prospect of continuous working until incapacity or death is a common condition for the bogus self-employed. Again, there are no adequate statistics for this hidden consequence of the evasion economy. These are the life conditions of the forgotten people who build the houses and buildings we continue to inhabit. They build retirement homes and homes enjoyed by the retired. They are the least likely in society to benefit from them.

### **Pensions: the future threat**

As a post-script to the review of the consequences of false self-employment for vulnerability and poverty in old age, a final twist is about to occur with the introduction of the new mandatory second state pension for employees. In terms of the discussion in Chapter 3 of the fiscal and cost gap between employee status and self-employed status, the pension reform will increase the cost differential by a significant margin from 2012. Employers will be obliged to contribute 3% of the salary, and employees at least 4%, in addition to the difference already existing between National Insurance costs. *In the absence of measures to prevent false self-employment in the construction industry, this will significantly increase competitive pressures to drive down genuine employment yet further.* We have seen how the tax

system has induced the expansion of illegal self-employment. As it stands, the pension reform introduces similar labour-cost incentives, and can only intensify the trend towards illegality. If the evasion economy exists on the current scale in 2012, there can be little doubt that it will expand yet further without strong countermeasures. For the bogus self-employed, this will sharpen the contrast between their prospects for retirement and old age and that of their employed counterparts. They will be left stranded with reduced basic state pensions, and means tested benefits – at a significant cost to the state. Their employee counterparts will enjoy the benefits of a certainty of retirement with better pension provision. Little time is left to reverse and shrink the construction industry evasion economy, and prevent this disastrous outcome.

## **Conclusion**

False and illegal self-employment has all the attributes of employment but with none of the costs. In this chapter, the concept of the evasion economy has been broadened from the significant yet narrow aspect of the fiscal costs of tax and National Insurance evasion. Evidence has been given of evasion in the broader sense of a degraded and minimalist employment relation, underinvestment in skills, a shift of the burden of retirement from employers to the state, and deprivation of normal employment rights to holiday and sickness pay, redundancy and unemployment. All risks are downloaded onto the false self-employed, with none of the gains. There is a societal responsibility to maintain employment standards, the enforcement of the law to ensure equity – and indeed efficiency in the working of markets. There has been a chronic failure of successive governments to recognise and address this societal

responsibility, and to tackle an economy of evasion at the heart of one of our principal industries.

## Main findings

- ❖ The growth of illegal mass self-employment has directly contributed to the significant skills gap, and **a shortfall of at least 26,000 trainees per year**. With the dominance of the labour only subcontractor, **75% of construction firms offer no training**. It would take **a doubling of the present level of training** to over 80,000 for every year over the next decade to redress the skills gap. In the meantime, **the construction industry is reliant on migrant labour to meet the demand for skills**.
- ❖ The rights to holiday pay and to normal working hours are routinely breached, with excessive working hours and no provision for holiday pay.
- ❖ Without effective control over their time as their self-employed status should entitle them, the false self-employed are deprived of basic rights to respond to needs of child-care, sickness and injury.
- ❖ The false self-employed in the construction industry are particularly prone to poverty in old age and dependence on means-tested benefits. A common prospect is to work until incapacity or death, without the benefits of retirement. **Over half of the bogus self-employed are without personal pension, and a significant proportion will be entitled to less than the full basic state pension**.
- ❖ The pension reform act coming into effect in 2012 will increase competitive pressures to drive out good employment practices with false and illegal self-employment, unless there are powerful measures in place to restore genuine employment status within the industry.

## Chapter 6

### What needs to be done? Proposals for reform

The report has demonstrated the existence of mass false self-employment in the construction industry. The number of false self-employed can reliably be estimated as standing between 375,000 and 433,000 construction workers. The phenomenon refers to a type of employment that has arisen on large construction sites, where the main suppliers of labour are labour-only subcontractors. It does not refer to the hundreds of thousands of genuine self-employed, who bear financial risks, and are properly in business on their own account. The report recognised the contributions made to the industry by the genuinely self-employed, and the virtues of entrepreneurship and flexibility that they exhibit. The key aim of any reform must be to distinguish and re-establish the true meaning and reality of employment and self-employment for the benefit of both. The immediate and identifiable fiscal costs to the taxpayer are considerable, estimated at between £1.4 billion and £1.9 billion per year.

The support for reform is widespread amongst employers' associations, including the Construction Confederation, the Health and Safety Executive, and trades unions. The industry has suffered from the blight of false self-employment with detrimental effects on the management of construction process and especially the disappearance of effective skills training. The erosion of direct employment has led to a steep decline in on-site training, with 75% of firms not offering any training places. It is necessary to restore a collective stakeholding by the industry in the skills infrastructure essential for a productive, modernising and technologically advanced industry.

The report was able to identify and demonstrate the key cause and origin of the growth of mass illegal self-employment in a conflict between a tax regime peculiar to the construction industry and the legal case law on employment status. The case law itself gives rise to opportunities for uncertainty and complication in assessing employment status. The tax regime introduces tax incentives and the use of an instrument for revenue collection that directly conflicts with one of the main legal tests, the ‘economic reality’ test for self-employment of being in business on one’s own account. A defective but unambiguous tax incentive, combined with a conflict between taxation and legal regulation of status, has driven out genuine direct employment from the industry, and replaced it by bogus self-employment. Several reforms in the construction taxation regime have signally failed to rectify the situation, and the most recent one show clear signs of continuing to promote the economy of tax evasion. There is a major and imminent risk that the pension reform to be introduced in 2012 will add to the competitive pressures towards illegal self-employment unless the industry can be first restored to health.

The purpose of the reform therefore has the following aims:

- to correct major labour market distortions
- to recover £1.7 billion of legal tax revenue
- to restore normal employment rights of legal employment, and eradicate the illegal exploitation of vulnerable, particularly migrant, labour
- to re-establish the basis for investing in home-grown skills
- to promote productivity and innovation by investing in employment
- to bring the construction industry into line with all other sectors of the economy with regard to employment status

- to ensure that construction workers are as enabled to enjoy retirement and pensions as are workers in other industries

## The proposals

The main fault-line in the regulatory regime lies in the unique two-tier taxation self-employment status. One category of self-employed currently has a stiffer test than in any other industry as a consequence of a turnover threshold for gross payments that excludes many genuine self-employed. The other category involves taxation at source that places obligations on engagers of labour typical of employers, and deprives the engaged of responsibility for managing their own tax affairs, normally a principal indicator of being in business on one's own account.

It is therefore proposed that the construction industry is brought back into line with all other sectors of the economy, and at the same time to simplify the tax regime by adopting **a single taxation employment status**. We propose abolishing the threshold for self-employed status for all genuinely self-employed construction workers, that creates a special category of 'business class' self-employed. We propose abolishing the secondary, taxed-at-source, self-employed tax status. It conflicts with the law and facilitates unlimited access to false self-employment status.

### Proposal 1

A single self-employed tax status should be established in which all self-employed are paid gross, and are responsible for their own tax affairs

It is recognised that initial responsibility for determining and enforcing correct employment tax status must rest with HMRC, and we suggest that they remain responsible for issuing certificates of gross payment self-employment status. The

default category, as in other sectors, is the direct employment status. There will therefore be two one self-employment tax status for those meeting an appropriate test, and the directly employed. As in all other industries, and particularly on large-scale construction projects, it is anticipated that the large majority of workers will be directly employed. There will be an important minority of genuinely self-employed, around 20% to 25% of the workforce – not a target, but an estimate of the current realities as opposed to fictions of employment practices.

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| <p>Proposal 2<br/>Her Majesty's Revenue and Customs remain responsible for issuing certificates of eligibility for self-employed status, on the basis of appropriate criteria.</p> |
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All self-employed construction workers will have certification with personal identity for working in the construction industry. This continues with existing practice for those receiving gross payments under the New Construction Industry Scheme. It is anticipated that a considerable number of those currently in false self-employment, with their tax deducted at source, will transfer to this new certification. Conversely, a greater number of those currently in false self-employment will shift into direct employment.

We recognise that employers also have a responsibility to ensure that those they engage are genuinely in self-employment, and we suggest that current obligations are retained for monthly declaration of payments to self-employed workers. In order to ensure a return to a level playing field for all contractors in the industry, responsibilities must be shared between all those empowered with assessing employment status. The genuinely self-employed also have an obligation to demonstrate that they are genuinely in business on their own account, and able to provide evidence to that effect, once a track record has been established. In particular,

whereas some criteria for status can be tested prior to engagement, many cannot, and only become manifest at the time of, and following, engagements. This provides a rule of thumb for the respective responsibilities of HMRC, engagers of labour, and the self-employed themselves.

The central criteria for assessing employment status remain those established by case law. However, in issuing certificates or enforcing correct legal status, it is valuable to establish a set of indicative norms, especially to determine whether a worker is in business on his/her own account. Much work has already been carried out in this regard,<sup>16</sup> and the main indicative norms are listed below

Proposal 3

Indicative norms for assessing economic reality of self-employment for certification

- Self-determination of method of payment and level of payment, including price setting.
- Evidence of submitting tenders for work
- Freedom to hire others in substitution
- Providing capital equipment
- Providing materials at own expense
- Investing in own business, office, and infrastructure
- Submission of invoices for completed work
- Payment of own tax and NI
- Personal coverage of sick pay and holiday pay

As suggested above, some of these norms cannot be assessed prior to a person entering into genuine self-employment for the first time. However, many of them are

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<sup>16</sup> A number of additional criteria have been suggested, such as VAT registration, payment of Public Liability Insurance, provision of materials, lists of appropriate trades. Many of these have difficulties in implementation or come into conflict with other indicators of genuine self-employment.

assessable after a period of activity of being in business on one's own account, and evidence can be required. Some criteria might be considered requisite (self-determination of financial risks through price-setting, submission of invoices, tendering for work), others merely indicative (evidence of hiring others, ownership or hiring of capital equipment). We therefore suggest a provisional certification for those entering into self-employment for the first time, to be reviewed after an appropriate interval prior to full certification. The costs of implementation and administration are not significantly greater than those that apply to the current gross payment tax self-employment status. As the self-employment tax status of gross payments by clients is being extended to all self-employed in the construction industry, it is essential that the monitoring and evaluation process is robust but not burdensome.

It is legitimate to ask whether this simplification of the tax regime is an oversimplification with respect to the complexities of the construction industry. One area of concern raised by the report relates to the confusions arising between casual, highly dependent engagements and genuine self-employment for multiple clients on an intermittent and irregular basis. As a general guideline, lack of mutuality of obligation between engager and engaged should not override the other three tests if these indicate the worker is employed, not in business on their own account, and under the control, including for the timing, hours and frequency of work, of their engager. For genuinely self-employed workers the ability to choose when and how to work, to retain significant control of their own flexibility, is a benefit of self-employment status. As stated earlier, the casual employee exhibits the strongest contrast with genuine self-employment, having no independence, control or self-management of their working time, let alone operating as a business on their own account.

The other 'real world' source of complexity concerns the switching from one employment status to another. The current proposal, by removing the threshold for genuine self-employment, enables dual status workers. There is nothing to prevent a worker from being employed for some period, and self-employed for another, provided that the worker can pass the test for self-employment certification set out above. (There is no incentive for either engager or engaged to adopt false direct employment.) The risk of creating an evasion economy rises when attempts are made to assign individuals into either one category or another in ways that do not reflect the realities of the situation. In particular, by assigning individuals to self-employment status in these circumstances encourages tax evasion and illegality.

The proposed simplification of the tax regime brings the construction industry back into line with the tax regulatory frameworks of other industries. However, it is important to stress that there is no regulatory quick fix to an evasion economy that has become deeply embedded over decades. The growth of mass false self-employment has profoundly affected the structure and organisation of the industry (Harvey, 2003). The nature of the firm, both large contract management companies and labour-only subcontractors, has emerged as a consequence of the environment of the evasion economy. A major implication of eliminating the evasion economy is that it will induce, over time, a radical change in the organisation of the industry. The same principle applies to regenerating the skills infrastructure. It will take time to change the culture and organisation of firms to enable and foster a collective stakeholding in investment in skills and provision of on-site training. Historically, the construction industry has always relied on a substantial and positive contribution from migrant labour, stretching back to the 18<sup>th</sup> century. The proposals to restore the infrastructure for developing home-grown skills is aimed at reducing a reliance on imported skills

arising from the systemic training failure within the UK. The move from a minimalist, short-termist, cost-cutting conception of the employment relation to one of investment in employment can only develop over time, and in a favourable environment. The proposed changes to tax regulation are a necessary component for bringing about such change, but only if accompanied by initiatives by the industry and social partners to change the culture and organisation of their sector.

### **Some arguments against reform rebutted**

The evasion economy in the construction industry has grown and become normalised since the 1980s. There are entrenched interests, but also simply ingrained habits of thought, which present obstacles to reform. There are fears and anxieties about changing the reality people in all positions and organisations have come to accept. Here we rebut some of the main arguments against reform.

#### *1. Industry is overburdened with regulation – ‘let business sort it out for themselves’*

There is a government drive to reduce the regulatory burden on industry, and a correlative view that self-regulation is suffocated by state regulation. There are two answers to this point. First, what is being proposed here is not more regulation, but simplification, consistency and clarity of regulation. The current tax and legal regulation is complex, unclear and contradictory. It is also out of line with all other industries. Moreover, faulty regulation has caused major market distortions which the current proposals aim to correct. Second, all markets require regulatory frameworks – Gresham’s law of bad money driving out good, or, more topically, sub-prime mortgage markets threatening the functioning of the whole credit system, demonstrate

the need for regulation for proper market functioning. What we are proposing here is the restoration of the robust distinction between false and genuine self-employment to eliminate widespread tax evasion and illegality, employment of good coin, rather than counterfeit self-employment. In this respect, business – in this case the clear majority of construction industry organisations – recognise the need for this reform of the tax regulatory system to restore a level competitive field. This is the responsibility of government. As argued in the previous section, regulatory reform by government will only address part of the problem. There will be plenty left for business to do in reorganising themselves in a new regulatory environment more favourable for the development of the skills base.

## *2. The reforms will suffocate the entrepreneurialism of self-employment*

The current proposal is aimed at promoting genuine entrepreneurial self-employment. Entrepreneurial self-employment involves assuming the risks and challenges of being in the business on one's own account, including, of course, managing one's own tax affairs as part and parcel of achieving financial success. There are many, indeed an increasing number, of construction skills and services that can innovatively be delivered by the genuinely self-employed. The current proposals remove a significant barrier to entrepreneurial self-employment by removing a turnover threshold as a qualification for full self-employed status.

As a counterpart, the proposals entail the elimination of a debased form of self-employment which in reality is characterised by lack of independence, control, and assumption of financial risk. Alongside the restoration of genuine self-employment, the proposals seek to restore investment in the direct employment status as one in which life-time development of skills can occur. The aim is to achieve a

more balanced labour market combining direct employment and self-employment in the most efficient, forward-looking, and technologically competent mix.

*3. The shift to direct employment will drive up the costs of labour in a labour-intensive industry*

The short answer to this objection – no doubt a major anxiety of government – is clearly that an expansion of direct employment will increase costs of labour. It is always cheaper not to pay taxes than to pay them. The real question is why successive governments have allowed tax evasion – not legal avoidance – on a massive scale. One answer to this mystery must lie in the fact that it has been allowed to grow to a massive scale. The illegal price of labour has become the normal price. To restore legality will mean making industry pay taxes which they have become accustomed to evading. No doubt, a government decision to confront this issue head-on will take courage.

The more substantial answer to the question, however, addresses evasion in the broader sense, the lack of investment in the employment relation over the long term, the most obvious manifestation being the skills gap. For far too long, the industry has been reliant on ‘extensive’ rather than ‘intensive’ productivity gains, cheap labour worked for long hours, and paid for immediate performance. Undoubtedly, the shift to higher investment in employees will take time before it yields the full productivity benefits. The UK construction industry has one of the highest labour-capital ratios, the lowest usages of prefabrication and advanced construction technologies. This, in part, is born of the reliance on cheap, casual, low-skilled labour. The shift to high-skilled, capital intensive, intensive productivity,

culture will take time. But this shift is essential if the industry is to develop its full innovation potential.

*4. The proposals will lead to a loss of revenue to the taxpayer rather than the contrary*

One of the abiding fears of the Inland Revenue, now HMRC, has been to accord self-employed in the construction industry a gross payment taxation status because of the attached risks of tax avoidance. A major rationale for introducing a two-tier self-employment tax status was to ensure taxation at source at least of a proportion of the self-employed. The proposals do entail an expansion of gross payment taxation status, as a mark of genuine, entrepreneurial, self-employment. We note that other countries do not exhibit the same anxieties about revenue collection from the self-employed.

The main answer, however, is that both industry and revenue collecting technologies have progressed enormously since the 1970s when the two-tier tax status was introduced. As was already established with the Construction Industry Scheme, tracking and identification of individuals has advanced considerably, and the New CIS has availed itself of electronic monitoring and control. We believe that there are now the available technologies to ensure revenue collection from a single, gross payment, self-employment tax status. The resistance of the Inland Revenue/HMRC to reform arises partly out of fear of departing from their institutional routines. But there has also been a consistent approach to deliberately downscale the problem of evasion, as it amounts to an admission of major systems failure on their part. No organisation likes to do that.

Of course, the main rebuttal is that any significant shift to direct employment will result in substantial retrieval of lost taxpayers' revenue. We have estimated the gains to the tax payer conservatively at £1.7 billion per year.

## **A time for change**

It might be thought that any time is a good time to recover £1.7 billion of taxpayers revenues lost through evasion. Following two failed reforms of the two-tier tax system to address the systemic faults of the evasion economy, however, we believe that now is finally the time to deal with the fundamental issues. The need for reform has become increasingly manifest with the over-reliance on migrant skilled labour to plug the skills gap of an industry that, because of mass false self-employment, has lacked the necessary skills infrastructure. The need for reform has become more urgent because of the impending implementation of the Second State Pension, which drives a greater cost wedge between direct employment and self-employment status. Unless a robust boundary is re-established between genuine self-employment and employment, the degenerative competitive pressures for false self-employment to grow will intensify.

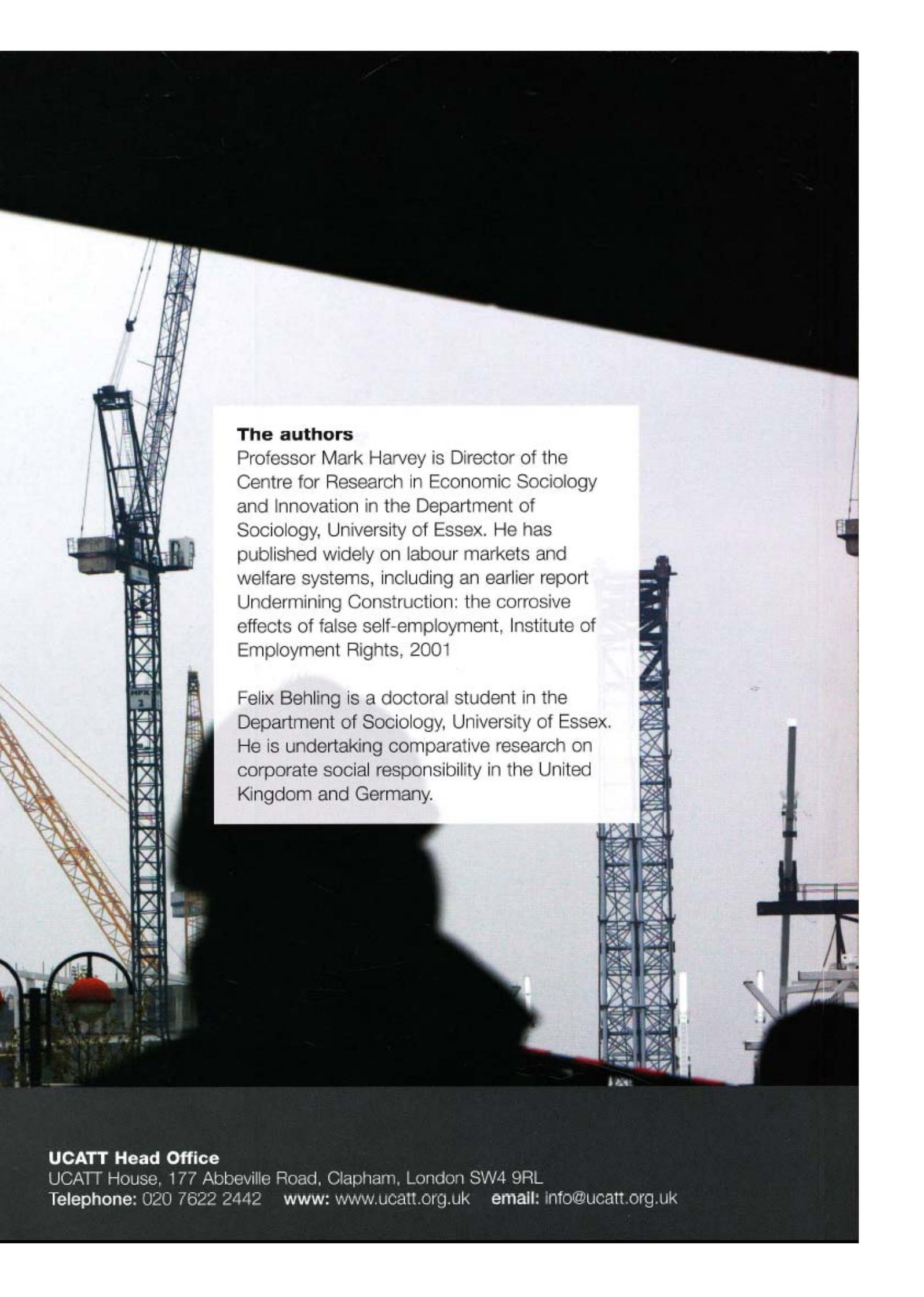
We believe we have advanced a case for urgent reform, and rebutted many of the standard resistances and objections to changing a culture of evasion that has become normalised. The industry needs to break from its past as never before. The restoration of employment rights to hundreds of thousands of illegally self-employed is not only a restoration of justice, but a pre-requisite for an industry advancing into

the 21<sup>st</sup> century, building and advancing home-grown skills, and developing the innovation required for an ecologically sustainable built environment.

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