

Analysis in brief

Growth in self-employment in the UK

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Key points

- There has been a gradual increase in self-employment since 2001.
- The increase in self-employment is not unprecedented and is credible when set against the general economic climate.
- The number of changes to the tax system targeted at supporting small businesses cannot explain the rise in self-employment
- There have been no changes to the design or implementation of the LFS which could explain the increase in the self-employed.
- Analysis of the LFS wave structure has found no evidence of a 'sample rotation' effect or other step-change in the self-employment level.

Introduction

Self-employment in the UK has increased markedly in recent years, and since mid-2002 has been growing faster than at any time since the late 1980s. A previous article gave a detailed analysis of the growth in self-employment over the period 2002 to 2003 by industry, occupation and region (see pp623-8, *Labour Market Trends*, December 2003). That article showed that in the year to September 2003 the number of self-employed people in the UK had increased by 282,000, or by 8.9 per cent. During the same period the number of employees was unchanged. Since then, self-employment has continued to increase, although at a reduced rate, and rose by 108,000 over the year to June 2004. Further analysis has been carried out to look into areas that may have caused the increase since 2002. This article summarises that work, focusing particularly on changes in taxation and on technical issues relating to the Labour Force Survey (LFS).

Background: where has the self-employment increase occurred?

The previous analysis showed that:

- in the year to September 2003 the number of self-employed people increased by 8.9 per cent or 282,000 (see **Figure 1**) compared with an increase of 0.1 per cent for employees;

- the increase was general, affecting men and women, full-time and part-time workers; it was also spread across all regions;
- there were increases in most industries, the largest being in banking, finance and insurance (120,000); construction (53,000); and education, health and public administration (35,000);
- of the increase in banking, finance and insurance, 114,000 was in real estate, renting, and business activities, which includes tax, business and management consultancy, accountancy, and auditing;
- when looked at by occupation there was an increase in self-

► employment among trades consistent with construction (for example, carpenters and joiners were up 27,000), and in a number of the skilled professions across the UK, which would fit with the 'City' industry picture (for example, IT strategy and planning, chartered and certified accountants, financial and investment analysts); there were also increases in the number of self-employed teaching professionals, which fits with the rise in education. However, just as most industries saw increases in self-employment, so the increases were spread across a wide range of occupations.

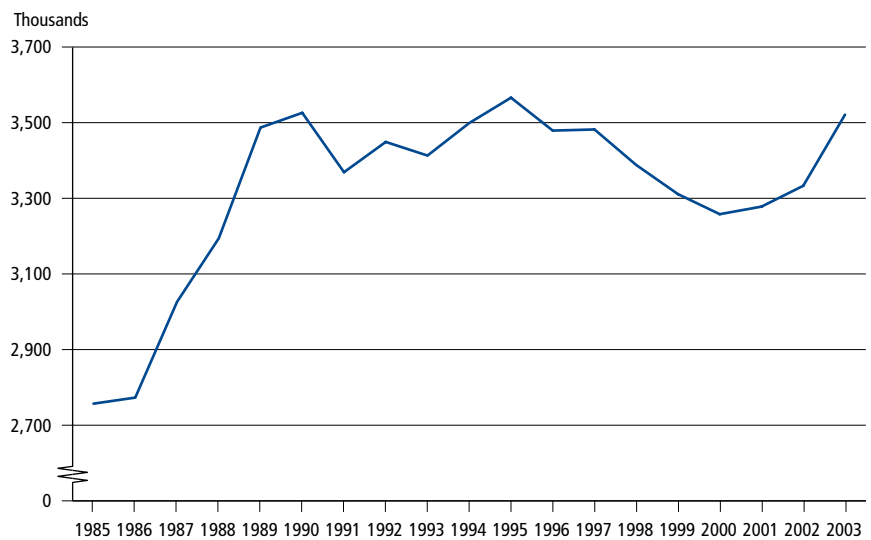
All of the breakdowns referred to were based on pre-Census LFS data. Since this analysis was completed further work has been carried out into issues that could have affected the self-employment figures. For consistency, the breakdowns and longitudinal data used are also pre-Census. This should not affect the conclusions.

Impact of tax changes

There have been a number of changes to the tax system targeted at supporting small businesses. It has been suggested that these may have contributed to the increase in self-employment. These changes include: reform of capital gains tax; reducing the rate of corporation tax for smaller companies; stakeholder pensions; and the abolition of advanced corporation tax. Also, over the past few years, there has been a large increase in the number of companies being registered at Companies House. Setting up a new company has become progressively easier over the past few years. There are various Internet sites to which individuals can pay a small fee to be set up as companies with very little effort on their part. These sites are

Figure 1

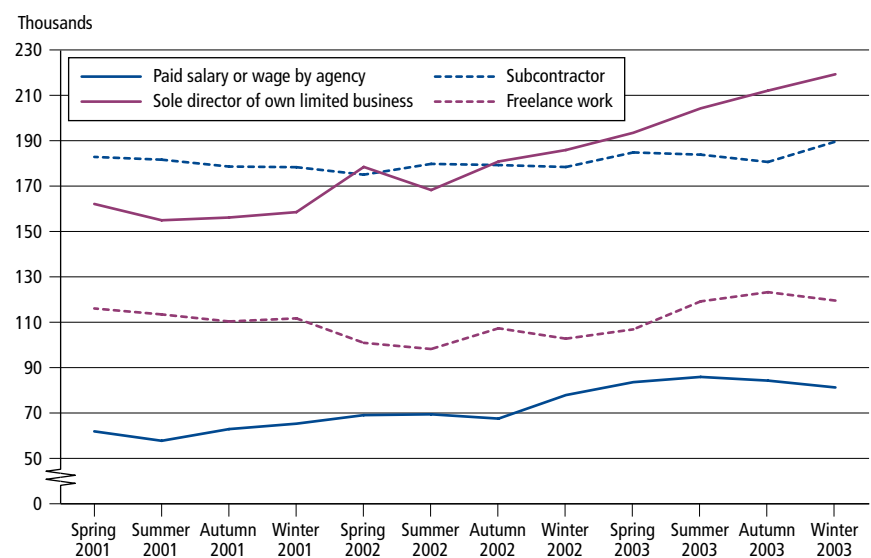
Numbers of people self-employed; United Kingdom; 1985 to 2003



Source: Labour Force Survey

Figure 2

People in self-employment by status; United Kingdom; spring 2001 to winter 2003



Source: Labour Force Survey

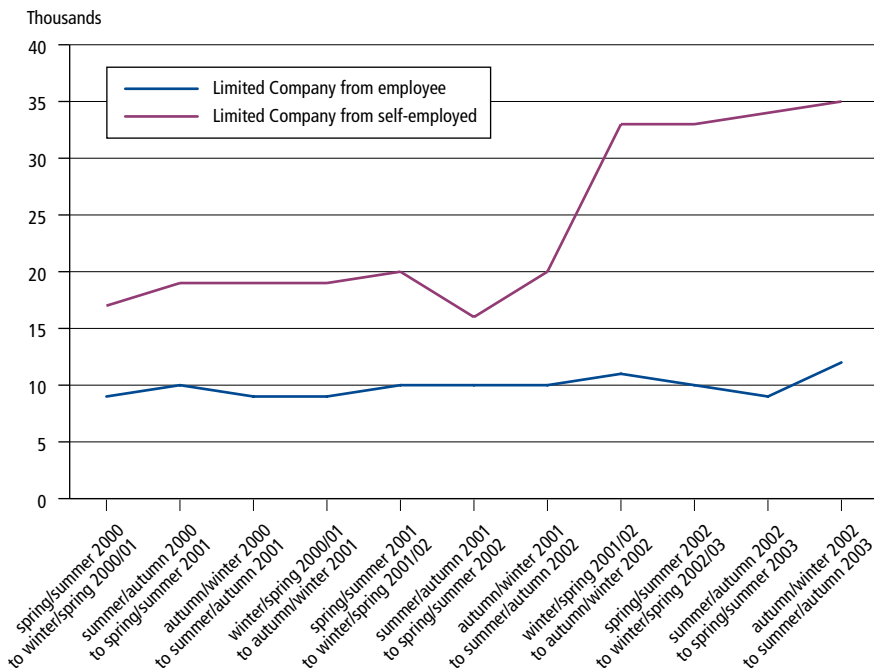
aimed at agency workers as well as the self-employed. During 2003 396,339 new companies registered at Companies House compared with 292,734 in 2002.

One might have expected this increase in incorporations of new companies to have reduced self-

employment, as technically anyone setting up such a company would become an employee of the new business. However, in practice many of these people still consider themselves to be self-employed and report themselves as such to the LFS because of the flexibility and control they have

Figure 3

Flows into sole directorship of limited company by former employment status; United Kingdom; spring/summer 2000-winter/spring 2000/01 to autumn/winter 2002-summer/autumn 2003, four quarter rolling average



Source: Longitudinal Labour Force Survey

over their employment, rather than determine their status according to their tax status. If they had previously been employees, this would have the effect of actually increasing the numbers of self-employed people recorded by the survey.¹

Focusing on the three main sectors identified (banking, finance and insurance; construction; and education, health and public administration) the question was whether the increases could be explained by the tax changes, and analysis has been conducted looking at the issue. Having examined the issue, it is believed that the tax changes cannot explain the rise in self-employment. For example, the LFS longitudinal dataset was used to examine the LFS flows. The LFS classifies self-employed people

according to whether they are:

- paid a salary or wage by an agency;
- sole director of a limited company;
- running a business or a professional practice;
- a partner in a business or a professional practice;
- working on own account;
- subcontractor;
- freelance worker; or
- none of the above.

One way of examining the effect of the tax changes is to look at the impact on the numbers of people reporting themselves as sole directors. Given the tax changes and the rise in incorporation over the past two years, one would expect the number of sole directors to increase. As **Figure 2** shows, there has indeed been a relatively strong increase in the numbers reporting themselves

as sole directors since spring 2002 (up 50,000), although there have also been increases in freelancing (up 20,000) and agency work (up 10,000).

However, when one looks at where the flows into sole directorship have come from, the analysis suggests that the increase in self-employment is not particularly connected to the changes in tax legislation. As **Figure 3** shows, the increase has mostly come from those who previously described themselves as self-employed; there is a clear step-change in the flow to 'limited company from self-employed' between summer/autumn 2002 and autumn/winter 2002. By comparison, the flow from employee status to director of a limited company has stayed broadly flat. This strongly suggests that the tax changes cannot explain the rise in self-employment.

The one industry group where there may have been a marked impact is education, health and public administration. For example, within this group the rise in the number of self-employed female teachers (up 12,000), may reflect supply teachers setting up their own businesses but reporting themselves to the LFS as self-employed. This could also explain the increase in the number of agency workers seen in **Figure 2**. However, in the context of the overall increase these numbers are marginal.

Other external reasons for the self-employment rise

Having discounted both the tax changes and education, health and public administration as major drivers behind the increase in self-employment, two main areas are left to consider: construction; and banking, finance and insurance. ►

► Banking, finance and insurance

Banking, finance and insurance appears to be the main industry group driving the increase in self-employment – it accounted for around 120,000 of the 282,000 increase in the year to September 2003². Looking for explanations, there were media stories of people being made redundant in the City moving into self-employment. This would be consistent with the rise in freelancing noted earlier. To the extent that it is true that the movement was due to redundancy, there will have been substitution from employee to self-employed status. As **Figure 4** shows, this does indeed appear to have been partly the case: while self-employment in business and finance was rising, the employees level was falling.

Construction

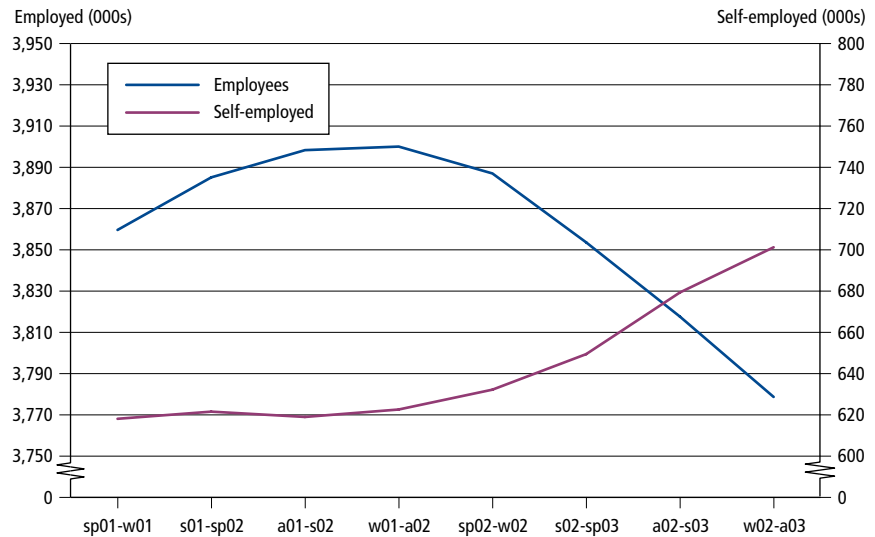
The second major driver appears to be construction. As already noted, self-employment in the construction sector increased by around 50,000 in the year to September 2003.² The increase in construction is a longer-term trend dating back to at least 2001 and generally fits with the expansion of the sector. That said, self-employment has increased more quickly than overall employment (see **Figure 5**) – between winter 2001 and winter 2003 construction employment increased by 177,000, of which 102,000, or 58 per cent, was self-employment. As a result, the proportion of people in the sector who were self-employed rose from 35 per cent to 37 per cent.

Survey effects

Another possible explanation could be the impact of LFS survey methodology that may have affected

Figure 4

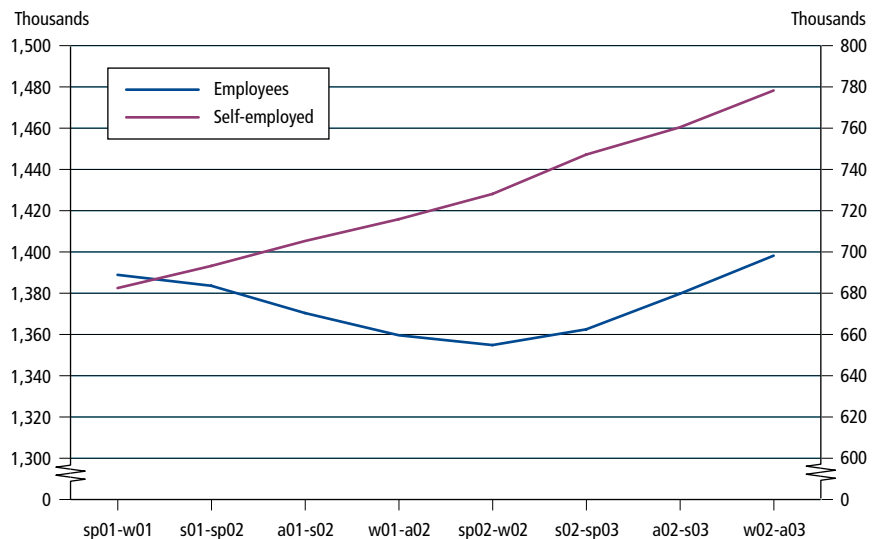
Numbers of people employed and self-employed in banking, finance, insurance, etc.; United Kingdom; spring-winter 2001 to winter 2002-autumn 2003, four-quarter rolling averages



Source: Labour Force Survey

Figure 5

Numbers of people employed and self-employed in construction; United Kingdom; spring-winter 2001 to winter 2002-autumn 2003, four-quarter rolling averages



Source: Labour Force Survey

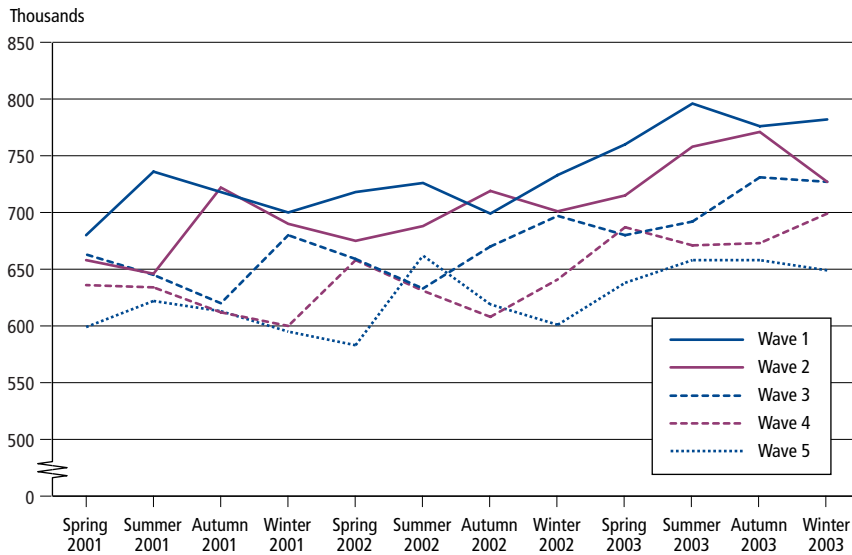
the self-employment data. The two main issues that needed to be investigated were that of the removal of the self-employment edit and the possibility of a sample rotation effect.

Removal of the self-employment edit

The self-employment edit was a system previously used to correct employment status and occupation

Figure 6

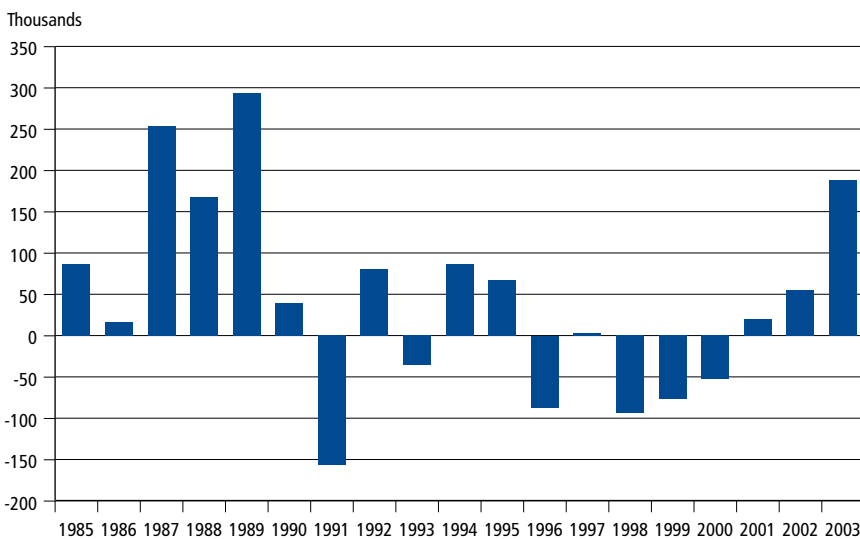
Numbers of people self-employed by Labour Force Survey 'wave'; United Kingdom; spring 2001 to winter 2003



Source: Longitudinal Labour Force Survey

Figure 7

Annual change in numbers of people self-employed; United Kingdom; 1985 to 2003



Source: Labour Force Survey

when they were considered incompatible; for example, if a respondent claimed to be a self-employed policeman. These two characteristics were judged incompatible, and so the respondent's employment status would be altered

to employee. The new occupational classification (SOC2000) introduced in 2001, changed the way in which reported employment status is modified. The number of incompatible combinations of employment status

and occupation was greatly reduced so the 'editing' of employment status in the LFS was removed all the way back to 1992.³ (For further details of the impact, see pp477-83, *Labour Market Trends*, September 2002.) The removal of the self-employment edit cannot explain the growth in self-employment witnessed in the past two years. The removal of the edit did increase self-employment by around 200,000 but it was an increase which applied all the way back to 1992 at almost a constant level.

Sample rotation effect

Respondents to the LFS stay in the survey for five quarters (known as 'waves'), answering during each quarter. Each quarter 20 per cent of the sample leaves and a new 20 per cent begin to respond. Analysis has been carried out to check that the increase in self-employment was not due to any one group of 20 per cent that may not have been representative. This is known as a sample rotation effect. **Figure 6** shows the self-employment figures for each quarter from spring 2001 to winter 2003, broken down to show each wave and indicate that there is no sample rotation effect. If there was a sample rotation effect, one would expect to see a sudden jump in the wave one component as the new sample entered the survey. There is no such jump; rather what one sees is a gradual increase over the period.

Figure 6 does suggest that there may be a seasonal effect of some kind to the entry to the LFS – there is a spike in the self-employment figures in wave 1 summer 2001 which then drops out in the next wave 1. The spike can be seen moving through the waves: in wave 2 in Autumn 2001, wave 3 in Winter 2001, and so on. However, this

► phenomenon does not appear to be associated with the rise in self-employment being investigated: the timing is wrong and the spike has worked its way out of the survey by autumn 2002. Indeed, it looks like it may just be a seasonal effect as there is a similar, if less marked, pattern in the following year's data. More to the point, the chart shows a general increasing trend in self-employment – there is no sudden step change.

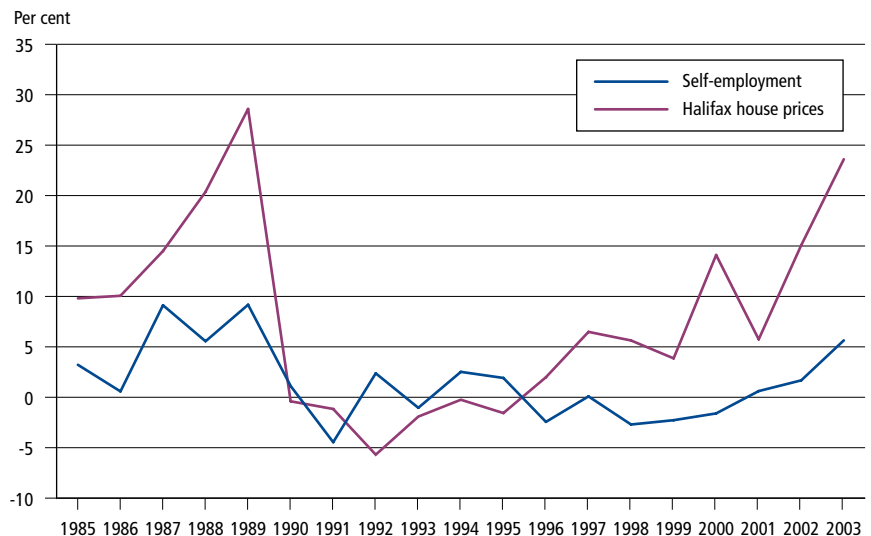
General economic factors

More generally, the figures are plausible given the the economic climate. Indeed, it should be noted that the increase is not unprecedented. As **Figure 7** shows, there were larger increases in 1987 and 1989.

Another more general point to note is that, as the Bank of England suggested in its February Inflation Report, “self-employment may simply be more feasible than in the past, as sharp rises in house prices have increased the collateral at workers’ disposal and so reduced the credit constraints they face”. **Figure 8** illustrates this relationship.

Figure 8

Percentage change in self-employment and house^a prices; United Kingdom; 1985 to 2003



Sources: Labour Force Survey; Halifax House Price Index

a All dwellings.

Conclusions

The increase in self-employment investigated and discussed in this article seems due to a real rise in the number of people self-employed rather than any survey effects or taxation influences. The rise fits with the economic factors and is not an unprecedented increase.

Further information

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Notes

- 1 The self-classification of self-employment used in the LFS does produce differences from definitions of employment status based strictly on UK legal rules. However, the approach of self-classification is internationally accepted best practice.
- 2 Industrial breakdowns are only available from the full LFS quarterly dataset. This means that the increase quoted refers to the year to the summer quarter (June to August) rather than September.
- 3 See 'Labour Force Survey reweighting and seasonal adjustment review', *Labour Market Trends*, April 2004.