

# **Taxation and the Labour Market**

**Edited by John Buchanan**

**WORKING PAPER 55**

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## Taxation and the Labour Market: An overview of the papers

This working paper contains three studies into how taxation arrangements and the labour market interact. The first is by Professor Patricia Apps which examines the likely labour market impact of the Coalition's tax reform package. She notes that the key changes proposed in the plan are:

- a change in the tax mix from direct taxes (eg PAYE) to indirect tax (GST)
- a flatter system of income tax rates
- a shift towards a 'joint tax' system ie from one based on individuals to one based on couples.

Her research shows that the most likely outcomes of changes of this nature are:

- increased inequality arising from high income earners being the major beneficiaries of the tax plan
- increased inefficiency arising from greater disincentives to undertake paid work amongst lower paid workers, especially married women in two income households
- this in turn reduces the level of private savings because dual income families save, on average, at higher rates than single income families.

Professor Apps concludes that the key problems in the tax system concern evasion. These need to be addressed at source. A GST is a totally ineffective response to this problem.

The second paper examines a growing area of tax evasion in the labour market: revenue lost from the growth in contractor forms for employment. It does so with special reference to developments in the construction industry. It addresses three inter-related questions:

- what are the differences between contractors and employees, especially concerning their tax liabilities?
- how has the number of contractors increased in recent years?
- what implications has this had for taxation revenue?

The paper reveals that contractor forms of employment have grown at a faster rate than employees for every year bar one since 1978. It also reveals that, on average, contractors in construction pay \$6,217.22 per annum less tax than their PAYE equivalent. As such they only contribute 42 per cent of what they would have had they been classified as PAYE employees. *It is estimated that in 1996/97 if contractors had contributed taxation at the same rate as PAYE employees on their gross income an extra \$2.2 billion in taxation income would have been raised.* Given the growth in contractor forms of employment the problem is likely to get worse over the coming years. Such projections are not idle speculation. In the UK contractor employment grew from 29 per cent of the construction workforce in the early 1980s to 45 per cent in the 1990s. The losses to revenue have been estimated at between \$A4 and \$A8 billion per annum. These developments did not just affect tax revenue. They have also had adverse implications for work quality, innovation and skill formation. Together these negative consequences have weakened the capacity of the UK industry to

compete internationally. So serious did the situation become that eventually leading employers and the UK Conservative Government launched initiatives to shift workers away from contractor back to employee status.

The third paper by Mark Harvey reflects on the wider analytical and political significance of developments in tax policy. He argues a conception of labour is embodied in different systems of taxation. As such, recent developments in taxation policy form part of the co-evolution of taxation systems and employment relations. Throughout most of this century tax revenue arising from waged employment, standard employment relations and the modern welfare state have formed a 'sacred triangle'. The question he addresses is: does the shift from work to consumption as a basis for tax revenue suggest a more fundamental shift in the relation between state, society and the economy? He answers firmly in the affirmative: '...what we are witnessing are changes in the nature of the state, along with, and in reaction to, changes in the economy and in the fabric of labour and employment.' The shift from income to consumption taxation as a source of public revenue is more than administrative in nature. 'Social welfare and social reproduction become reduced in scope, and less a general political right of the citizen, more a reflection of differential purchasing and consumption choices of individuals.' And in the employment sphere the shift to consumption tax implies a weakening in the centrality of the wage exchange, and is developing simultaneously with the flexibilisation of employment relations, as well as the development of quasi-employment relations such as contracting arrangements.

The challenges for analysis and policy arising from these papers is significant. Researchers and policy makers working in the fields of taxation, social security and work need to better understand the links between these different but highly related subject areas. This is not just an 'academic' problem. At a very practical level this issue has implications for absolute levels of taxation revenue as the analysis of the growth of contractors in construction revealed. The challenge is to make better sense of the current situation and to devise effective policy options to address the increasingly serious problems afflicting our systems of taxation, social security and employment relations.

**Section 1**

**Tax Reform: A Comment On The Coalition's Tax Plan**

**Patricia Apps**

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## ABSTRACT

This paper examines three key design features of the Coalition's tax plan: (i) the tax-mix change associated with the introduction of a GST, (ii) a flatter income tax rate schedule implied by the structure of tax cuts and (iii) a shift towards a 'joint tax' system. The paper argues that the structural changes implied by these features of the reform can be expected to undermine the efficiency and equity of the existing tax system. The analysis of efficiency effects focuses on the impact on household labour supply and saving behaviour and outlines the implications for future living standards in an ageing population.

## 1 INTRODUCTION

The Coalition's proposed tax plan (*Tax Reform: not a new tax, a new tax plan*) contains three key elements: a 10% GST, larger tax cuts for middle and upper than for lower income earners, and increased tax rebates for families targeted on the second earner's income and on joint income. These elements of the package are designed to produce:

- (i) a tax-mix change
- (ii) a flatter income tax rate schedule
- (iii) a shift towards a 'joint tax' system

Ideally, the objective of tax reform is to improve the efficiency and equity of the existing system. A reform involving these structural changes cannot be expected to achieve this objective. Instead, a reform of this kind reduces efficiency and equity because:

(1) A **tax mix change** combined with a **flatter income tax rate schedule** reduces the progressiveness of average tax rates (**ATRs**). It also raises effective marginal tax rates (**EMTRs**), computed as the sum of taxes payable and benefits withdrawn on an additional dollar of income, for lower income workers whose labour supply behaviour is typically found to be more responsive than that of higher income workers.

(2) The **'joint tax'** elements shift the tax burden from single to dual income families and therefore, in effect, to working married women as second earners. A **flatter income tax rate schedule** has the same effect. Both raise the EMTRs faced by second earners whose labour supply is typically more responsive than that of primary income earners.

Section 2 and 3 of the paper examine in detail why (1) and (2) above can be expected to lead to significant efficiency and equity losses. In analysing efficiency effects the focus is on labour supply and saving disincentives. Section 4 considers the impact of these disincentives on future living standards in an ageing population. Section 5 contains a concluding comment and suggests alternative directions for reform.

## 2 EFFECTS OF A TAX-MIX CHANGE AND A FLATTER INCOME TAX RATE SCHEDULE

The Coalition's package offers income tax cuts estimated to cost \$13.5 billion in 2000/01 funded in part by a \$6.1 billion increase in revenue raised by the GST. Overall, therefore, the reform represents a tax-mix change, that is, a shift from income to consumption as the tax base. This presents a major difficulty for achieving **equity** and **efficiency**.

**Equity:** A uniform GST is strongly regressive because the tax base, consumption spending, declines as a proportion of income as income rises. Under a revenue neutral reform the regressive impact of a consumption tax can be offset for those on very low incomes by increasing welfare payments, tax rebates and/or credits targeted on income. Low and middle income groups can be compensated by tax cuts delivered by shifting the threshold and lowering marginal rates above the threshold. This however leads to a problem. While lower and middle income groups can be compensated by cutting taxes in this way, the gains also go to high income groups. It is a matter of simple arithmetic to show that unless marginal rates at the top rise, high income groups must gain overall. Typically proposals for a tax-mix change do not include a higher top marginal tax rate on income.<sup>1</sup> The Coalition's proposed new income tax schedule is no exception.

A fundamental limitation of the reform is a shift to a flatter marginal tax rate schedule in the critical \$38000 to \$75000 range, combined with no increase in the top 47 per cent rate.

The distributional effects of the Howard tax plan are not immediately apparent due to the fact that the reform is not revenue neutral and to assumptions concerning the CPI effects. The CPI assumptions lead to an underestimate of losses for lower income groups and of gains for higher income groups.

Economists are very critical of studies which report results for non-revenue neutral reforms because what really matters - the change in relative tax burdens - tends to be obscured by the reporting of gains for all. In the present case, in addition to the \$6.1 billion from the GST, it is proposed to finance the \$13.5 billion income tax cuts from a projected surplus (which may not eventuate) derived from earlier regressive cuts in government spending and from bracket creep to the year 2000/01.

In the simulation I have run I have indexed all gains and losses to 1997/98 dollars. In the case of employed families, after controlling for demographic variation and employment status, the results indicate that the overall impact of the proposed reform across the lower-middle to higher income groups is strongly regressive.

**Efficiency:** A less progressive structure of ATRs of this kind implies a less progressive distribution of EMTRs. This is important for efficiency.

Whether or not the new EMTRs structure is more or less efficient depends on the behavioural responses of workers at different income levels. Available estimates of labour supply elasticities indicate that incentive effects are much more important for those on lower pay and in part time employment.<sup>2</sup> So for efficiency we require a more progressive structure of EMTRs, not a less progressive one.

In analysing the effects of a GST it is important to distinguish between a reform which involves a tax-mix change and one which has the more limited purpose of changing the structure of existing indirect tax rates. It is the former which gives rise to the problems outlined. A GST designed to replace the WST and other indirect taxes could, on the basis of carefully estimated supply and demand elasticities, offer efficiency gains, although it seems unlikely that the optimal reform would involve a uniform rate.

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<sup>1</sup> For a detailed analysis of previous reforms involving a tax-mix change, see Apps (1997).

<sup>2</sup> For an excellent survey of the literature see Heckman (1993).

A number of studies purport to show that the Coalition's proposed GST will lead to an increase in GDP (see, for example, the study by Freebairn, Johnson and Dawkins reported in the *Australian Financial Review*, 1 September, 1998). These studies need to be interpreted cautiously because they are based on a modelling approach which ignores the labour supply incentive effects of the concomitant higher EMTRs for lower wage workers. For reasons considered in more detail below, the negative effects of the latter are likely to dominate.

A frequent argument in support of a GST is that it is required for base-broadening because of the haemorrhaging of the income tax system due to non-compliance and to tax minimisation schemes involving, for example, the use of trusts, negative gearing and the prescribed payments system. The fallacy of this argument lies in the fact that a GST cannot be expected to do any better. Taxing consumption is simply an indirect way of taxing income, and implies a narrower base because the return on saving is excluded. To broaden the tax base we must tax income which is now untaxed, either directly or indirectly. For this, the focus of reform must be on measures which reduce non-compliance and the use of tax minimisation schemes. The proposed clamp down on tax avoidance through trusts is not sufficient. The Howard tax plan is open to serious criticism for failing to give greater attention to non-compliance - the central problem to be addressed by tax reform.

### 3 EFFECTS OF SHIFTING TOWARDS A 'JOINT TAX' SYSTEM AND A FLATTER INCOME TAX RATE SCHEDULE

The Coalition's tax plan contains a further shift to a 'joint tax' system. The Prime Minister has consistently supported joint taxation in the form of income splitting, asserting that the existing individual tax system is unfair because a single income family pays more tax than a dual income family with the same joint income.

The Coalition proposes a shift in this direction. The package contains increases in rebates for children (Family Tax Benefit (A)) which are means tested on joint income, and increased rebates for the dependent spouse (FTB(B)) which are untargeted on primary earner income but still tightly income tested on the spouse's own earnings from market sector employment.

Any shift in the tax burden from single to dual income families means higher taxes for the second earner, typically the female partner on lower pay. This is **unfair**, particularly in regard to **horizontal equity**, and it is **inefficient**.

**Equity:** Single and dual income families with the same family income do not enjoy the same standard of living - the single income family benefits from the additional untaxed home production of the home carer. The dual income family must buy substitutes for this home production - such as childcare - from taxed earnings.

**Efficiency:** Higher taxes on the earnings of married women in the workforce reduce efficiency. Extensive empirical research on labour supply shows that the work disincentive effects of raising marginal tax rates are much more important for married women as secondary earners than for higher income males as primary earners. In other words, it does not take much of an increase in the marginal tax rate faced by a married woman on a low income for the couple to decide that her time can be used more profitably producing untaxed goods and services in the home.<sup>3</sup>

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<sup>3</sup> For an empirical study see, for example, Feldstein and Feenberg (1996).

Simulations of the Howard's Government plan show that it involves a significant shift in the tax burden to married women in the workforce. The contribution of the 'joint tax' elements to this shift can be identified by comparing lower to middle income families in which the husband has the same annual income. Take, for example, families with two children between 5 and 13 years in which the husband's annual income is \$30,000, as depicted in Table 1. Under the Howard plan, the single income version of this family type would get tax cuts and additional family benefits of \$60.54 per week. But if, as well, the wife earns \$15,000, the family only gets \$29.03 per week. That is, the second earner not only gets no tax cut but also causes the family to lose \$31.31 per week in family benefits. The increase in her EMTR is 10.9 per cent.

**Table 1: 'Joint tax' effect** (couples with two children aged from 5 to 13 years)

	<u>Primary income</u> <u>\$pa</u>	<u>Second income</u> <u>\$pa</u>	<u>Tax cuts +</u> <u>add ben. \$pw</u>	<u>Cut in ATR%</u>	<u>Rise in 2nd</u> <u>EMTR%</u>
Single income family	\$30,000	0	\$60.54	10.5	
Dual income family	\$30,000	\$15,000	\$29.03	3.4	10.9

This 'joint tax' effect is only a part of the problem. The most significant shift in the tax burden from single to dual income families arises from flattening income tax rates on individual incomes. In particular, the large reductions in rates on individual incomes above \$38,000 give higher income individuals (mostly men) a greater proportional reduction in average tax rates. In contrast, the rate reductions between \$6000 and \$38,000 (mostly women) imply much smaller reductions in average rates. The impact of this can be seen by comparing single and dual income families with joint incomes above \$38,000. Take, for example, a single income family in which the husband earns \$60,000 for full time work and a dual income family in which each partner earns \$30,000 for full time work, as in Table 2. The gain for the single income family is \$72.17 pw in contrast to only \$37.67 pw for the dual income family. This difference is due mainly to the much larger cuts in marginal rates over \$38,000, as shown in the table below.

**Table 2: 'Flat tax' effect** (couples with two children aged from 5 to 13 years)

	<u>Primary income</u> <u>\$pa</u>	<u>Second income</u> <u>\$pa</u>	<u>Tax cuts + add</u> <u>ben. \$pw</u>	<u>Cut in ATR%</u>
Single income family	\$60,000	0	72.17	6.3
Dual income family	\$30,000	\$30,000	37.67	3.3

Marginal tax rate  
changes

\$6,000 - \$20,000	-3
\$20,000 - \$38,000	-4
\$38,000 - \$50,000	-13
\$50,000 - \$75,000	-7

Given available empirical estimates of labour supply elasticities, the new EMTR structure implied by the Howard tax plan is clearly the antithesis of supply side microeconomic reform. It is introducing less impediments and inflexibility into labour markets where none need exist. Moreover, a fall in female labour supply implies a decline in the future tax base for funding the age pension. The available empirical evidence also suggests that the level of household savings would drop dramatically with a fall in the workforce participation of married women. This can have a damaging effect on living standards in an ageing population.

#### **4 IMPACT ON LIVING STANDARDS IN AN AGEING POPULATION**

The standard economic analysis of retirement income policy recognises that the key problem concerns insurance against the risk of longevity, and the need for government intervention in response to the failure of the private sector to offer fair and full insurance contracts to cover this risk.<sup>4</sup> Market failure in this context is usually attributed to the high transaction costs of the private sector, information asymmetries concerning the risk class of buyers, and social risk. From a technical point of view the age pension can be seen as a relatively efficient approach to the provision of insurance against the risk of longevity under these conditions.<sup>5</sup>

<sup>4</sup> The analytical framework can be found in any modern Public Economics text. See, for example, Stiglitz, 1988.

<sup>5</sup> There is of course room for improvement, particularly in regard to the moral hazard problem and its implications for the design of income tests.

In contrast to the economics literature, media debate tends to ignore the relevant insurance problems,<sup>6</sup> and instead emphasises the importance of funding retirement from individual savings, and typically supports reforms which raise EMTRs for lower and middle income workers. The frequent claim is that unless the 'baby boomers' save more they will be unable to support themselves in their retirement. The argument is fundamentally flawed.

In the first instance, those below or around average weekly earnings who unexpectedly live beyond 90 cannot hope to finance this event from personal savings - they need insurance.

Second, future living standards will depend on the *true* dependency ratio. At any point in time, the simple fact is that total output must be shared between the working population and dependants, where the latter include children. To argue that the true dependency ratio increases with population ageing it is necessary to assume that the cost of a child, including parental time costs, is less than that of the average retiree. The assumption is clearly implausible. Every child requires an extensive period of full time care whereas relatively few of the elderly do. Moreover, many retirees are engaged in productive work, an important example being childcare in response to government neglect in this area. If the true dependency ratio falls with population ageing as empirical evidence suggests, there can be no population ageing problem - unless we create one. And this we would seem to be determined to do.

With population ageing, the decline in the proportion of children results in a fall in parental time costs for childcare. There is a natural shift from home production to market production, particularly by married women.<sup>7</sup> If we avoid reforms which raise EMTRs for lower income workers, and therefore for married women as second earners, the tax base for funding the age pension can be expected to rise. The rise is substantial as I have shown in simulations based on ABS demographic projections and trends in participation.<sup>8</sup>

There is a second effect. Household saving also increases. Available empirical evidence suggests that household saving rises steeply with the workforce participation and labour supply of married women.

Rates of saving are typically reported for deciles of household income. This can be misleading. Careful analysis with reference to individual incomes shows that at any given wage rate of the primary earner, dual income families save more than single income families, and have positive saving rates even at relatively low wage levels. This is illustrated in Table 3 which reports saving rates for households ranked in ascending order by deciles of household income (Row 1) and by deciles of primary income defined as the income of the higher income spouse (Rows 2 to 4).<sup>9</sup> Rows 2 and 3 of the table give separate results for

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<sup>6</sup> The rising risk of poor health with ageing, and the failure of private insurance markets in this context as well, is also a critical insurance problem. An integrated approach to health and retirement income insurance is required.

<sup>7</sup> The profile of the dependency ratio (calculated as the sum of the percentage of individuals in the 0-14 and 65+ age groups) from 1971 to 2031 is in fact 'U' shaped, with the ratio in 1971 being slightly higher than that projected for 2031. From this it follows that the cost of dependency in 2031 will be significantly lower than it was in 1971.

<sup>8</sup> The effects of tax reform in an ageing population are examined in detail in Apps (1991) using the parameters of a labour supply model estimated on Australian unit record data. Based on conservative workforce projections, the study shows that concerns regarding the fiscal viability of the age pension are unfounded, provided governments do not pursue reforms which discourage labour supply.

<sup>9</sup> The estimates are based on data for a sample of 6094 couple income units with a significant workforce attachment selected from the ABS 1990 Income Distribution Survey file. Saving rates are estimated by

traditional and non-traditional households. The two groups broadly represent single and dual income families respectively.<sup>10</sup>

**Table 3 Saving rates by household and primary income**

Decile	1	2	3	4	5	6	7	8	9	10	All
<b>Household income</b>											
All households %	-15.6	-6.1	-2.2	0.7	3.5	5.6	8.9	10.7	12.6	16.9	7.7
<b>Primary income</b>											
Trad households %	-16.4	-5.8	-2.8	-0.2	0.5	1.5	4.1	4.9	7.9	13.8	3.9
Non-trad households %	-4.9	2.2	3.8	6.1	7.5	9.0	10.4	11.5	13.2	17.1	10.1
All households %	-10.2	-1.1	0.4	3.8	4.7	6.4	7.9	9.3	11.4	15.7	7.7

The results indicate that, overall, the saving rate of dual income families is well over twice that of single income families and, in terms of the average level of household saving, in the order of four times as large. These estimates suggest that the Howard tax plan with its regressive structure of EMTRs can be expected to reduce significantly the level of private saving as well as labour supply and, therefore, the future tax base for funding the age pension.

## 5 CONCLUDING COMMENT

The first question raised by the preceding analysis is: why a tax-mix change? Mr Howard has argued that a GST is required for funding the proposed tax cuts under his plan. However, for the reasons outlined, this argument translates into one for funding tax cuts for middle to higher income groups from revenue raised disproportionately from lower income groups. Why not fund tax cuts for higher income groups entirely from revenue gained from a clamp-down on tax loopholes and non-compliance, as has been argued in tax reform debates in other countries?

A further argument offered in support of the Howard GST plan is that it will raise the additional revenue required for funding health and other services, as well welfare payments. This justification is particularly unconvincing given the shift in recent years towards user charges and a more highly targeted cash benefit system designed to contract the 'welfare state'. While arguments in support of contracting the welfare state are presented using the terminology of economics, such as 'efficiency' and 'competition', in fact they can be shown to demonstrate an extraordinary ignorance of modern economics and, in particular, of the

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regression analysis using data for a complimentary sample from the ABS 1989 Household Expenditure Survey file. The analysis includes various corrections for parameter bias arising from the limitations of ABS HES files as a source of data for computing saving rates. For more detailed discussion of the analysis, see Apps (1997).

<sup>10</sup> Traditional households are selected as those in which the second earner is employed for less than 500 hours p.a. and non-traditional households, as those in which the second earner is employed for 500 hours or more p.a.

economics of insurance. The Government's proposal for a 'user pays' approach to nursing home care provides an obvious example.

The major concern raised by the Howard tax plan is that the GST rate of 10% will be increased for the purpose of funding a cut in the company tax rate and the top income tax rate to 30 cents. If this direction for reform is pursued after the introduction of a GST, the efficiency and equity losses outlined will be even greater.

A second key question raised by the analysis is: why a shift in the tax burden to dual income families? Is the objective to maintain a low paid female labour force in a deregulated labour market? As has been shown, this is neither efficient nor fair, and can be expected to have damaging effects on saving behaviour and growth in an ageing population.

The challenge for tax reform is to design a fair and efficient system by taxing incomes in a way which achieves redistribution across households, compensating for the untaxed household production of the home carer and minimising the disincentive effects of high marginal rates faced by married women entering the workforce and by lower income workers generally.

A reform which focuses on tax compliance and supports a progressive individual income tax, combined with income testing of transfer payments and tax rebates on a basis weighted towards the primary earner's income rather than family income, meets this challenge.

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## **Section 2**

# **The Growth Of Contractors In The Construction Industry: Implications For Tax Revenue**

**John Buchanan and Cameron Allan**

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John Buchanan  
Project Leader

## ABBREVIATIONS

ABS	Australian Bureau of Statistics
ACIRRT	Australian Centre for Industrial Relations Research and Training
ANZSIC	Australian and New Zealand Standard Industry Classification
ATO	Australian Tax Office
AWIRS	Australian Workplace Industrial Relations Survey
CCH	Commercial Clearing House
CFMEU	Construction Forestry Mining and Energy Union
EEE	Employees
EMTR	Effective Marginal Tax Rates
IDS	Income Distribution Survey
OAW	Own Account Workers
PAYE	Pay As You Earn
PPS	Prescribed Payments System
STE	Survey of Training and Education
UCATT	Union of Construction and Allied Trades and Technicians
UK	United Kingdom
US	United States

## ABSTRACT

This paper is a preliminary investigation of an issue hitherto neglected in both the public economics and industrial relations literature: the impact of the changing legal structures of employment on the tax system and the tax system on the structure of jobs. Specifically, it addresses three questions:

- (a) what are the differences between contractors and employees, especially concerning their tax liabilities?
- (b) how has the number of contractors increased in recent years?
- (c) what implications has this had for taxation revenue?

These issues are explored with special reference to the growth of contractor employment in the Australian construction industry (Section 1).

At the heart of this issue is the imprecise distinction between contracts *of* and *for* service - ie between employee and contractor forms of employment. This imprecision gives managers and workers considerable potential to chose the legal status of the employment relationship (section 2).

One of the major implications of characterising an employment relationship as involving a contractor and a principal is that many work related expenses can be written off as business costs for tax purposes. In the construction industry this can halve the average rate of taxation from 28 to 14 per cent on gross income (Section 3).

Since the late 1970s, and especially since the early 1990s the number of contractors has grown in the workforce relative to the number of employees. In construction, for example, the proportion of contractors has risen from 29.3 per cent in the late 1980s to 33.6 per cent since 1991. Evidence concerning the nature of this growth in contractor employment is scarce. The evidence that is available indicates that much of the growth has occurred amongst 'dependent' as opposed to 'independent' contractors. That is, contractors reliant on only one or a limited number of clients - in effect *de facto* employees (Section 4).

There are major difficulties in assessing how these developments impact upon public revenue. The only available data for calculating average taxes paid by contractors and employees that allows for controlling for the effects of labour market and demographic characteristics is the ABS's Income Distribution Survey Sample File. Analysis of this source by Apps (1998b) reveals that on average contractors in construction pay \$6,217.22 per annum less tax than their PAYE equivalents. As such they only contribute 42 per cent of what they would have had they been classified as PAYE employees. *It is estimated that in 1996/97 if PPS workers had contributed taxation at the same rates as PAYE employees on their gross income an extra \$2.2 billion in taxation income would have been raised.* Given the growth in contractor employment this situation is deteriorating as time passes. If such trends continue it is conceivable the potential losses in revenue could run to many more billions of dollars per annum by the end of next decade (Section 5).

Such projections are not idle speculation. In the UK contractor employment grew from 29 per cent of the construction workforce in the early 1980s to 45 per cent in the 1990s. The losses to revenue have been estimated at between \$A4 and \$A8 billion per annum. These developments did not just affect tax revenue. They have also had adverse implications for

work quality, innovation and skill formation. Together these negative consequences have weakened the capacity of the UK industry to compete internationally. So serious did the situation become that eventually leading employers and the UK Conservative Government launched initiatives to shift workers from contractor to employee status (Section 6).

The UK experience has a number of potential policy implications for Australia. The primary one is that if action is not taken soon it is conceivable that contractor employment could grow even more rapidly. This is likely to have adverse consequences for both the capacity of the industry to operate efficiently as well as for tax revenue (Section 7).

The paper concludes that more research is required into the nexus between tax and employment structures. This dynamic has major implications for the future of work as well as the taxation system (Section 8).

## 1. INTRODUCTION

Tax reform has again emerged as a major subject of policy concern. To date most attention has focussed on alleged inefficiencies and inequities in the operation of the system. This is primarily defined as a poor balance in the mix between direct and indirect taxation.

To date the policy debate on tax has devoted little attention to how tax systems and labour market structures interact to affect both public revenue and the nature of employment. This has not been the case in the academic literature. Amongst academic researchers there is an established tradition that examines the effects of taxation changes on labour supply. Here debate has considered such issues as the alleged impact of high marginal tax rates on hours worked by middle and upper income earners. Other researchers (eg Apps et al. 1998a) have examined the sensitivity of lower income earners to changes in the tax system, especially amongst women and those receiving income support. Analyses of women have examined the impact of different tax reforms on household decisions concerning participation in the workforce. Policies of income splitting, for example, tend to discourage many women from participating in paid employment. Studies of social welfare recipients focus on the what are commonly termed high 'effective marginal tax rates' (EMTR) arising from the interaction of the welfare and taxation systems. This refers to social security recipients losing income support at a faster rate than increased income from wages as they enter paid employment.

To date few policy and academic researchers have examined how the tax system interacts with the structure of jobs, especially the legal form they take. Different disciplines have touched on some aspects of this problem. Accountants and employment lawyers, for example, have examined at length the issue of how and when a worker is deemed to be an 'employee' or 'a contractor'. The designation of either status has major implications for tax liabilities and deductions. Debates within these disciplines are usually preoccupied with the critical issue of determining the employment status of people working in particular situations. Accountants and lawyers rarely, if ever, examine aggregate trends in these issues. Amongst labour economists and labour studies researchers there has been growing interest in the labour market significance of contractors and the relative decline of employees (see VandenHeuvel & Wooden, 1994 for Australian developments; Meager, 1996 pp 489-494 for an overview of overseas trends). These writers are primarily concerned with the industrial relations implications of the rise of contractors. They rarely, if ever, explore the implications for taxation policy and practice.

This paper provides an initial attempt to link these analytical traditions. In doing so it builds on a limited but growing literature in the US and UK on the subject. This literature has primarily focused on how developments in tax policy play a critical role in structuring the labour market. Gonos (1997), for example, shows how the growth of the temporary help industry in the US has been underpinned by doctrines in taxation law prevailing over employment law in defining who is the 'employer' of a 'temp' or 'agency' worker. Harvey (1995) has examined how developments in tax law and practice in the UK have underpinned the growth of contractors in that country, especially its construction industry. Building partly on this literature this paper devotes particular attention to one aspect of the tax-structure of work relationship: how developments in the labour market impact on tax

revenue. It does this by way of a case study of the industry in Australia with the highest proportion of contractors - construction.<sup>1</sup> It addressed three questions:

- a) what are the differences between contractors and employees, especially concerning their tax liabilities?
- b) how has the number of contractors increased in the construction industry in recent years?
- c) what implications has this had for Federal Government taxation revenue?

The next three sections provide background information necessary for understanding how changes in the structure of employment affect tax revenue. Section 2 summarises the conceptual and legal ambiguities surrounding the distinction between contractors and employees. This is followed (Section 3) by consideration of how tax liabilities are reduced by workers taking on contractor status. Section 4 then examines how contract employment has grown both nationally and within the construction industry.

There are major difficulties in assessing how these developments impact upon public revenue. The only available data for calculating average taxes paid by contractors and employees that allows for controlling for the effects of labour market and demographic characteristics is the ABS's Income Distribution Survey Sample File. Analysis of this source by Apps (1998b) reveals that on average contractors in construction pay \$6,217.22 per annum less tax than their PAYE equivalents. As such they only contribute 42 per cent of what they would have had they been classified as PAYE employees. *It is estimated that in 1996/97 if PPS workers had contributed taxation at the same rates as PAYE employees on their gross income an extra \$2.2 billion in taxation income would have been raised.* Given the growth in contractor employment this situation is deteriorating as time passes. If such trends continue it is conceivable the potential losses in revenue could be run to many more billions of dollars per annum by the end of next decade (Section 5).

Section 6 puts these developments in perspective. The dynamics examined in this paper have been underway for a longer period of time in the UK construction industry. These experiences are briefly recounted to reveal just how serious the situation can get. By the mid 1990s around 45 per cent of construction workforce were contractors, up from 29 per cent a decade earlier. Deterioration in tax revenue, training and quality of work became so severe that eventually UK employers and the Conservative government initiated a major campaign to reverse the trend. Hundreds of thousands of UK construction workers are now in the process of being shifted back from contractor to employee status. Section 7 considers some of the simple changes to policy and practice that could arrest current trends and prevent the problem ever approaching anything like the UK situation. The paper concludes (Section 8) by noting the importance of devoting more analytical and policy attention to the issue of the relationship between the taxation and the structure of work in the future. The challenge for

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<sup>1</sup> It should be noted that the Australian Bureau of Statistics does not collect information on 'contractors' as such. The categories it uses for employment status are: employer, employee and own account worker. Own account workers cover contractors, but they also include owner operators in industries such as agriculture. The industry category Agriculture, Forestry and Fishing has the highest proportion of own account workers. Many of these supply products direct to market, more often than not statutory marketing authorities. They are not usually defined as or regarded as 'contractors'. Interestingly, workers with 'own account' status are in both absolute and relative decline in this industry. For more details see Table 2 below.

policy is to ensure that simple administrative initiatives are taken to ensure that one industry does not enjoy unfair tax advantages which lower labour costs relative to others. Overseas research reveals there is nothing inevitable about rising levels of contractor employment on the scale experienced in Australia and the UK. In France, for example, only 10 per cent of the construction workforce are contractors. The challenge for researchers is to generate new understandings of why levels of contract employment are growing and thereby lay the foundation for more effective proposals concerning both taxation and labour market reform in the future.

## 2. EMPLOYEES AND CONTRACTORS: HOW DO THEY DIFFER?

In the common law world employees and contractors differ on the basis of the type of contract covering their work. As a matter of definition, an employee is someone who works on the basis of a contract *of service* for a particular employer. A contractor is someone who works on the basis of a contract *for performing a particular service*. There is no simple or unambiguous rule for determining whether a worker is an employee or a contractor. At the heart of the problem is the fiction that labour is a commodity. As the economic anthropologist, Karl Polanyi has argued, the concept of commodity is one of the basic postulates of a market economy. At its core is the assumption that 'anything that can be bought and sold must be produced for sale.' (Polanyi, 1944 p.72). Labour, however, refers to human life, which is not produced for sale. On the contrary, it exists for other reasons and cannot be detached from the rest of life, be stored or mobilised like other resources (Polanyi, 1944 p.72). Consequently, as Polanyi noted the 'commodity description of labour ... is entirely fictitious' (Polanyi, 1944 p.72). But even though the commodity description is fictitious, it is not irrelevant to practice. Indeed, the description provides an organising principle affecting all institutions associated with labour and work.

In a recent comprehensive analysis of the emergence of the treatment of labour as a commodity Richard Biernacki (1995) has extended Polanyi's analysis. He argues that the space existing between the commodity fiction and social practice is not fixed. Biernacki establishes this point with a comprehensive analysis of different commodity forms taken by labour in England and Germany from 1640 to 1914. This basic insight holds true in contemporary Australia. There is nothing fixed or permanent in the way in which labour is treated as a commodity in the past or in current times.

The imprecision in the law surrounding contracts of and for service provide ample testimony to this. The classical basis for making the distinction has been the so-called control test. Employees, it is argued, are workers under the control of the employers. This control concerns such issues as:

- what work should be done
- when the work should be done
- where the work should be done
- how the work should be done.

Contractors, on the other-hand, are engaged by contracts for the provision of a particular service over which they have control. (CCH Vol 1 para 1-015). As time has passed this principle has been increasingly exposed as inadequate. Some of the most recent cases on the

question have endorsed a more encompassing approach. Control is now only one relevant factor. As Mason J put it in *Stevens v Brodribb Sawmilling Company Pty Ltd* (1986) 160 CLR 16 '... it is the totality of the relationship between the parties which must be considered.' (CCH Vol 1 para 1-045). This principle has recently been endorsed by the NSW Court of appeal in *Vabu Pty Ltd V Commissioner of Taxation* (1996) 40 AILR para 5-100 which is now recognised as a leading authority on the issue. In this context it is important to recognise that the control test has never been the sole doctrine guiding legal reasoning in this area. In fact a plethora of doctrines have emerged over time. Characterisations of these differ. For example, academic researchers have identified (and criticised) as least three other approaches<sup>2</sup>:

- the 'integration' or 'organisation' test (ie the use of a mix of indicators to determine whether or not a person is integrated into a business (Collins, 1990 p.370))
- the 'personal service' test (ie an employee cannot sub-contract (Merritt, 1982 pp.108-110))
- the 'risk' test (ie does the person work as their own employer and therefore bear the risk of the enterprise? Eg (Mills, 1982 p.276)).

The CCH *Australian Labour Law Reporter*, one of the leading guides for legal practitioners, characterises the additional tests as falling into five different groups:

- the pragmatic approach
- the business test
- the integration test
- the 'Ready Mix Concrete' test
- the intention of the parties.

As the current CCH commentary notes about recent developments in this area of the law: 'The benefit of flexibility brings with it the burden of uncertainty.' (CCH Vol 1 para 1-085).<sup>3</sup> It is this uncertainty which creates the space for many employers and workers to determine how to characterise their employment relations.

### **3. HOW TAX LIABILITIES CAN BE REDUCED BY WORKERS BEING DEEMED CONTRACTORS: AN EXAMPLE FROM THE CONSTRUCTION INDUSTRY**

The construction industry has long been recognised as having distinctive employment relations (see eg Clarke, 1992; Harvey, 1996). By definition places of employment vary over time. It is an industry characterised by extensive volatility in demand. And the industry has always been characterised by a high level of small business (Buchanan and

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<sup>2</sup> The following commentary on recent academic work has been drawn in part by observation made by Tom Roberts.

<sup>3</sup> For a similar sentiment from the academic research see Collins' (1990, p.369) comment that the tests for defining an 'employee' are indeterminate and 'do not provide clear criteria for settling borderline cases.'

Sullivan, 1996). In the English speaking world this industry is often characterised by high levels of contractor and sub-contractor employment. This is not necessarily the case in other countries. In France, for example, the current proportion of workers with less than standard employee status is just over 10 per cent compared to around 35 per cent in Australia and 45 per cent in the UK (Harvey 1996). The comparatively high level of sub-contracting and especially informal (ie black economy) activities in the Australian and UK industries have meant high levels of tax avoidance, if not complete evasion, have been a feature of this sector. It was for this reason that in the 1980s the Commonwealth government introduced a special arrangement in an attempt to regularise at least some tax contributions from this sector, the Prescribed Payments System, or PPS for short (CCH, 1983)<sup>4</sup>. The scheme involves tax contributions being deducted by the person engaging the contractor on a regular basis. There is little scrutiny or evaluation of the self-declared assertions to ascertain how genuine the 'contractor' status is. Ironically, this tax reform specifically developed to capture high levels of tax evasion is now working to further erode the tax base. For the PPS system now appears to be working to reduce the net tax paid by the industry rather than capturing a part of the industry which previously evaded taxes altogether.

An example of how the arrangements work is provided in Table 1 below. It shows how an income of \$52,000 per annum is handled if a worker is treated as a wage and salary earner compared to his/her treatment if treated as a sole trader operating under the PPS.

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<sup>4</sup> For an account of similar developments in the UK see Harvey 1985 pp 10-13.

**Table 1: Comparison of taxes typically paid by PAYE and PPS Contractors in the Construction Industry, example for worker with gross annual income of \$52,000**

Tax Return Profile of Joe Average Salaried Worker		Tax Return Profile of Joe Average - Sole Trader	
Wages as per Group Certificate	52,000.00	Gross Income	52,000.00
Less: Allowable Deductions	(750.00)	Less: Allowable Deductions	
		Materials & Job Costs	5,000.00
		Motor Vehicle Expenses	6,000.00
		Salary to Spouse	6,000.00
		Sundry Expenses	1,700.00
		Telephone	1,500.00
			20,200.00
<b>Taxable Income</b>	<b>51,250.00</b>	<b>Taxable Income</b>	<b>31,800.00</b>
<i>Income Tax Payable</i>	<i>14,689.50</i>	<i>Income Tax Payable</i>	<i>6,834.00</i>
<i>Medicare Levy</i>	<i>871.25</i>	<i>Medicare Levy</i>	<i>540.59</i>
	<i>15,560.75</i>		<i>7,374.59</i>
<i>Less Spouse Rebate</i>	<i>(1,452.00)</i>	<i>Less Spouse Rebate</i>	-
<i>Net Tax Payable</i>	<i>14,108.75</i>	<i>Net Tax Payable</i>	<i>7,374.59</i>
Employer Superannuation Contributions of 2,600 taxed at 15%	390.00	Employer Superannuation Contributions	-
<b><u>Government Revenue Summary</u></b>		<b><u>Government Revenue Summary</u></b>	
Net Income Tax paid	14,108.75	Net Income Tax Paid	7,374.59
Tax on Superannuation Contributions	390.00	Tax on Superannuation Contributions	-
<b>Total Revenue</b>	<b>14,498.75</b>	<b>Total Revenue</b>	<b>7,374.59</b>
<b>Average Rate of Tax</b>	<b>28%</b>	<b>Average Rate of Tax</b>	<b>14%</b>

Note: This table was prepared by a senior accountant with extensive experience in providing advice in the construction industry. The examples represents a typical situation gleaned from years of providing such advice and observing practice in the industry.

As is clear from the table there are major tax benefits available to workers engaged as contractors. Work related expenses that cannot be deducted by PAYE workers are standard deductions for running a business for the PPS worker. The net effect of such deductions usually halves the average rate of tax payable.

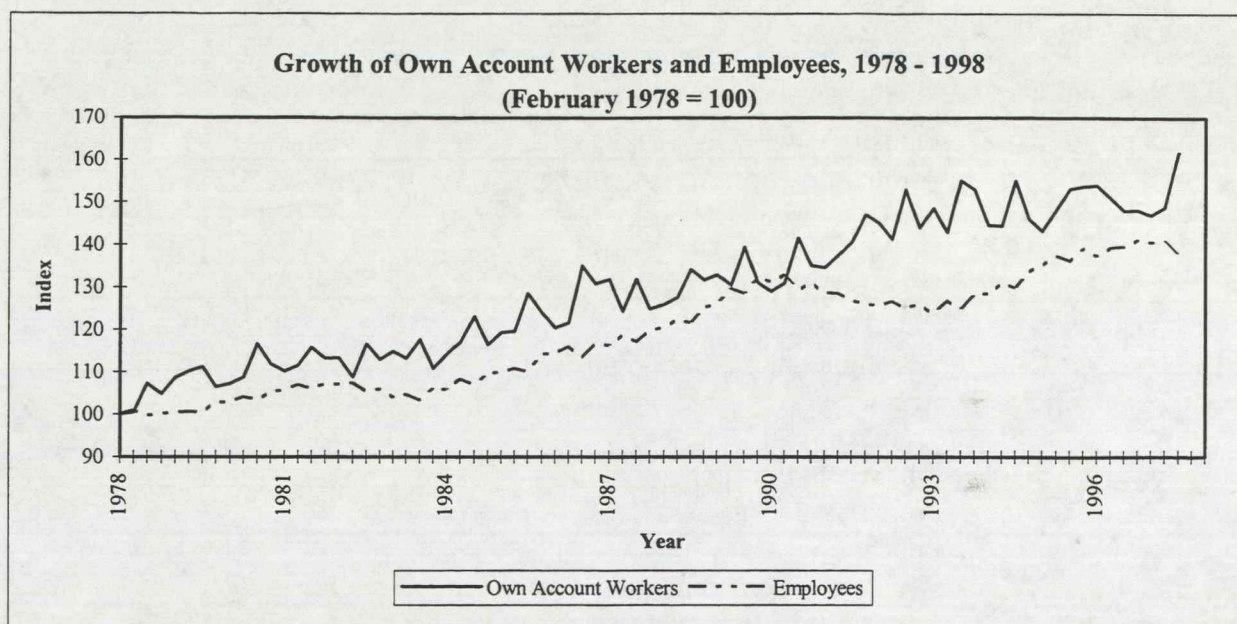
#### **4. THE GROWTH OF CONTRACTOR EMPLOYMENT: ECONOMY WIDE AND CONSTRUCTION INDUSTRY TRENDS**

To ascertain the overall impact of the changes in employment status to tax revenue it is necessary to examine how levels of contractor employment have grown in recent years. Precise data on this subject are limited. Consequently we have to rely on a number of sources to obtain indicators of recent trends. The most comprehensive and easily accessible data are produced by the Australian Bureau of Statistics (ABS). Other information is available from administrative sources such as long service leave boards. Trends from both sources indicate that levels of contractor employment are on the rise, especially in the construction industry.

The most relevant information from the ABS concerns what it refers to as 'own account workers'. These are defined as people who operate their own economic enterprise or engage independently in a profession or trade, and hire no employees, and operate unincorporated businesses. This category was formerly entitled 'self-employed'. An 'employee' is defined as a person who works for a public or private employer and receives remuneration in wages, salary, commission, tips, piece-rates or pay in kind, or in their own business, either with or without employees, if that business was incorporated. This category was formerly entitled 'wage and salary earner'.

Figure 1 provides data on the growth of own account workers and employees in all industries for the twenty year period 1978 to 1998. In the late 1970s, the growth rate of own account workers surged ahead of the growth rate of employees. Growth rates of own account workers and employees then shadowed each other until the late 1980s when growth rates converged. In late 1989 and early 1990, the growth rate of employees temporarily eclipsed own account workers. In the recessionary period in the first half of the 1990s, the two series diverged significantly as the growth rate of employees declined while own account employees continued to rise, albeit somewhat sporadically. In the second half of the 1990s, employee growth picked up and the two series started to converge. The most recent 1998 data suggests that the two series may be starting to diverge again.

Figure 1



ABS *The Labour Force Australia*, Cat. No. 6204

If we break down the data, we can see that the growth of own account workers varies significantly by industry (see Table 2). In 1985, the main industries using own account workers were agriculture, forestry and fishing; construction and retail trade. By 1997, the use of own account workers increased in absolute and relative terms compared to employee growth in most industries. Exceptions here include agriculture, forestry and fishing, wholesale and retail trade which recorded a absolute decline in own account workers. Further exceptions include accommodation, cafes and restaurants which experienced a greater growth in employees (86 per cent) than own account workers (76 per cent) during the period.

**Table 2: Comparison of Own Account Workers (OAW) and Employees (EEE), August 1985 and August 1997, Selected Industries and All Industries, Number ('000) and Percentage Change**

Industry	Own Account Workers		Employees		OAWs	EEEs
	1985	1997	1985	1997	1985-1997	1985-1997
	No.	No.	No.	No.	% Change	% Change
Agriculture, Forestry and Fishing	217.9	185.5	129.8	159.0	-15	22
Manufacturing	34.5	63.0	1,043.3	1,044.1	83	0
Construction	120.7	171.0	310.4	349.3	42	13
Wholesale Trade	27.3	25.3	376.0	430.2	-7	14
Retail Trade	119.4	104.7	676.8	986.5	-12	46
Accommodation, Cafes & Restaurants	10.3	18.1	185.2	344.4	76	86
Transport and Storage	53.5	56.8	298.1	318.9	6	7
Finance and Insurance	8.2	9.8	271.9	298.3	20	10
Property and Business Services	49.6	117.0	351.1	713.9	136	103
Education	9.6	17.0	446.0	565.0	77	27
Health and Community Services	10.4	30.6	511.0	730.0	194	43
Cultural and Recreation Services	14.2	28.9	100.5	160.7	104	60
Personal and Other Services	31.1	50.6	169.0	264.3	63	56
All Industries	713.5	878.3	5,792.3	6,364.6	23	10

ABS *The Labour Force Australia*, Cat. No. 6204.0 and 6203.0

**Table 3: Ratio of Employees to Own Account Workers, Selected Industries and All Industries, August 1997**

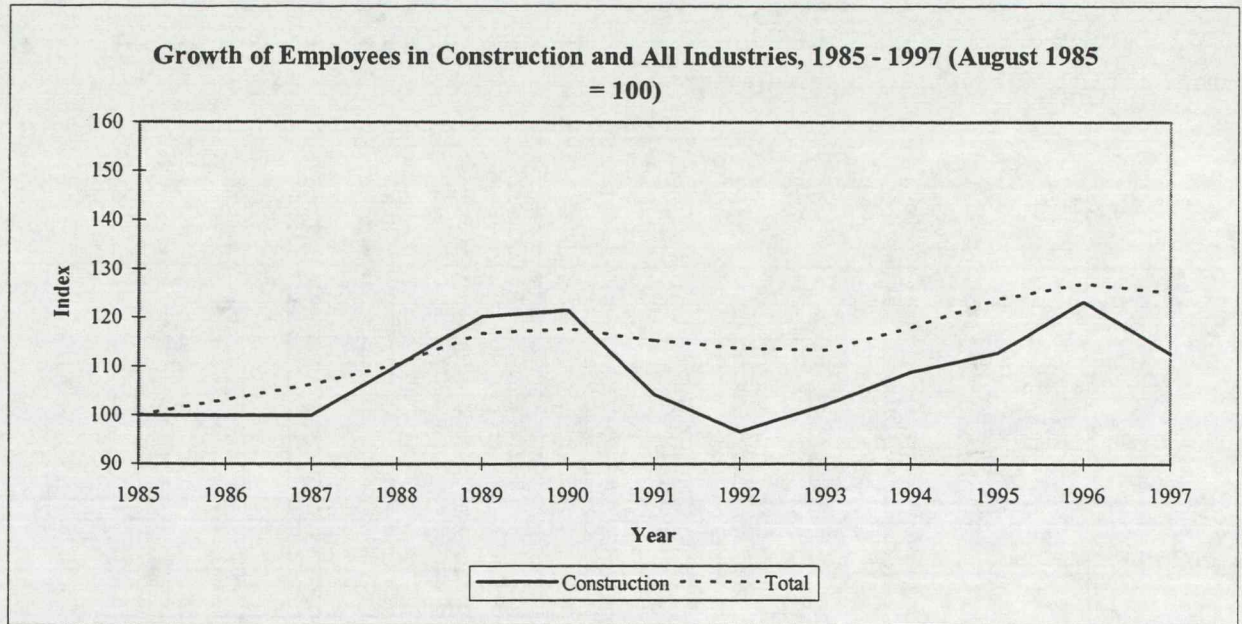
Industry	Ratio
Agriculture, Forestry and Fishing	0.86:1
Manufacturing	17:1
Construction	2:1
Wholesale Trade	17:1
Retail Trade	9:1
Accommodation, Cafes and Restaurants	19:1
Transport and Storage	6:1
Finance and Insurance	30:1
Property and Business Services	6:1
Education	33:1
Health and Community Services	24:1
Cultural and Recreation Services	6:1
Personal and Other Services	5:1
All Industries	7.:1

ABS *The Labour Force Australia*, Cat. No. 6204.0 and 6203.0

Significant growth in own account workers over the period was experienced in property and business services (136 per cent), health and community services (194 per cent), cultural and recreation services (104 per cent) and manufacturing (83 per cent). Despite the strong growth in own account workers in these industries, the size of this component of the workforce is relatively small compared to the size of their employee workforce. This can be seen in Table 3 which displays the ratio of employees to own account workers in these industries. Agriculture, forestry and fishing has the lowest ratio of employees to own account workers. This is followed by construction which has one own account worker for every two employees engaged. These two industries combined employ 40 per cent of own account workforce.

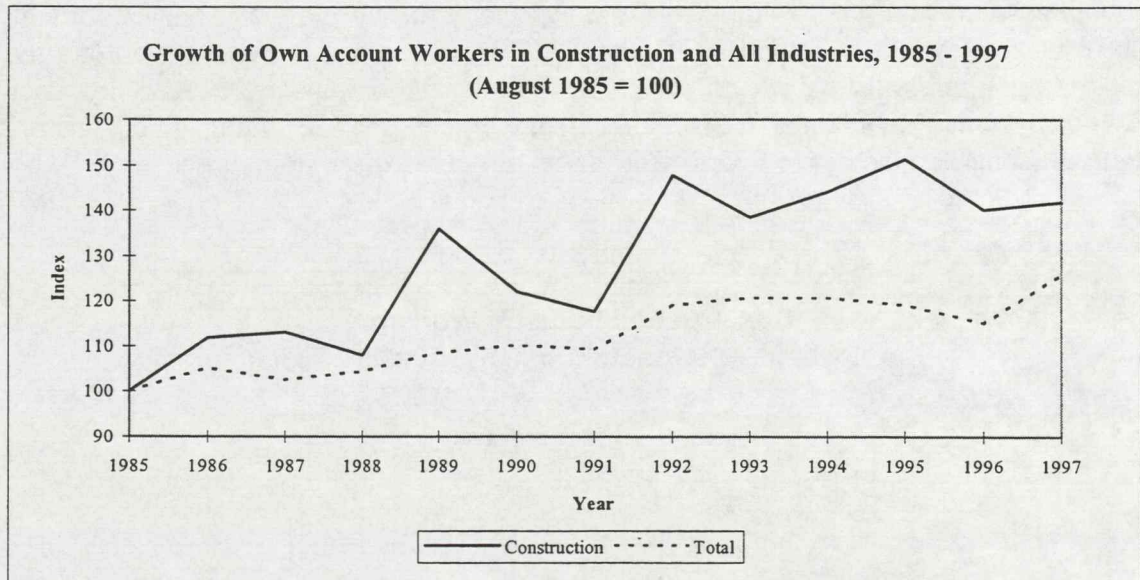
Figures 2 and 3 reveal that the construction industry is accounting for a declining share of employees and an increasing share of own account employment. As shown in Figures 2, the growth rate of employees in construction is below that of all industries. Over the period, the construction industry share of employees in all industries declined from 6 to 5 per cent. Conversely, the growth of own account employment in construction exceeded that of the all industries average (see Figure 3).

Figure 2



ABS *The Labour Force Australia*, Cat. No. 6204.0 and 6203.0

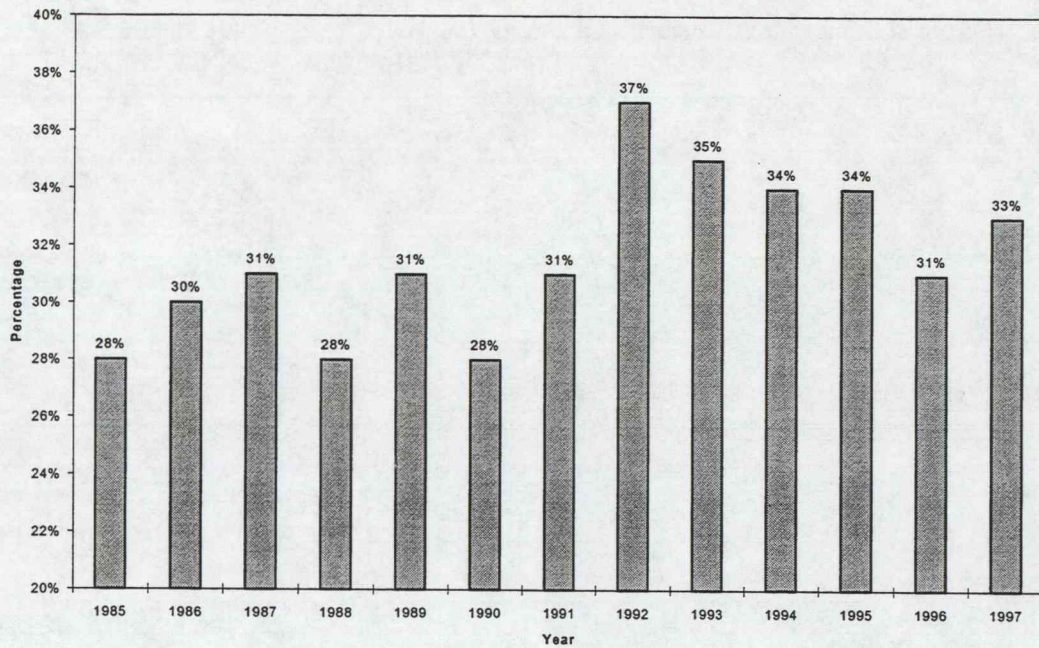
Figure 3



ABS *The Labour Force Australia*, Cat. No. 6204.0 and 6203.0

Within construction, the own account workforce is growing and the employee workforce is declining in relative terms. This can be seen in Figure 4 which indicates that, in construction, own account workers as a proportion of employees and own account workers combined increased from 28 per cent in 1985 to 33 per cent in 1997, peaking at 37 per cent in 1992. Thus while one in four workers in the industry was employed on their own account in 1985, this has increased to one in three by 1997.

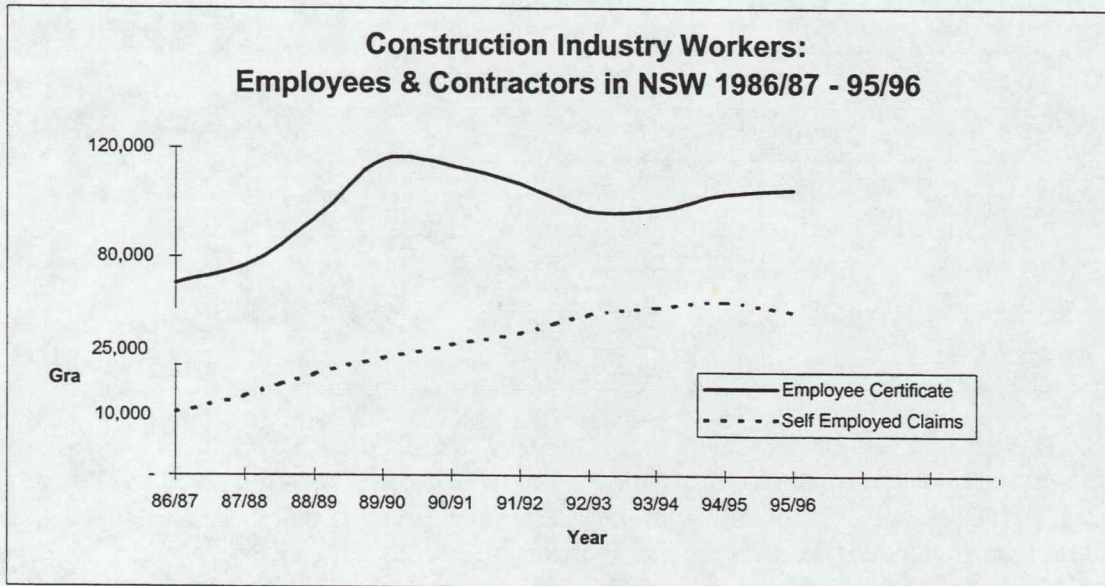
**Figure 4: Own Account Workers as a Proportion of Employees and Own Account Workers in Construction, Australia, 1985 - 1997**



Source: ABS, *The Labour Force Australia*, Cat No 6204.0 and 6203.0

The trends from the ABS data are clear. The number of own account workers is on the rise in both absolute and relative terms. This is especially the case in the construction industry. There is, however, the potential that the ABS definition 'own account worker' gives a misleading impression of events. To corroborate the findings from ABS material we examined statistics obtained from another source: the NSW Building and Construction Industry Long Service Leave Board. These data are summarised in Figure 5.

**Figure 5**



Source: unpublished information obtained from the NSW Building and Construction Industry Long Service Payments Corporation, Sydney 1998

Note:

1. The scale for employee is different to that for the self-employed to help show the nature of trends in both groups.
2. These data refer to the number of certificates lodged to obtain long service leave credits by employees and self employed construction workers in any one year. The certificates are lodged by employers. Compliance is assumed to be high, but in the past was thought to be lower for self-employed workers. Recent marketing campaigns by the long service leave corporation to increase lodgements for this latter category may have affected the number of certificates lodged for this group in recent years.

Great care needs to be exercised in drawing conclusions from Figure 5 for the reasons outlined in the notes concerning this figure. It is based on administrative by-product data. Hence, while they are likely to be accurate for the purposes of running the long service, scheme, they have not been collected for the purposes of policy analysis or research. Even so, we can conclude that the trends identified in the ABS data are confirmed or, at the very least not contradicted by, information from another source. As such we can be confident that the trends identified in the ABS material are real and not simply an artefact of its categories or data collection conventions.

What has been the nature of this growth in contractor employment? Has there been a profound shift in production away from large firms and back to smaller scale, independent contractors? Or are we witnessing something more formal than substantive? The answer to these question requires some consideration of how enterprises, especially larger ones, are restructuring their affairs, primarily to shift risk.

It is now clear that the nature of work is being radically restructured as a result of changes in corporate strategy and organisational design. This has essentially involved larger companies and public sector instrumentalities discarding functions. This development has been analysed by a growing number of researchers. The issues most commonly analysed are outsourcing and contracting out. The causal dynamics behind these trends have been comprehensively analysed by Harrison (1994). He documents the emergence of what he calls 'concentration' without 'centralisation'. That is concentration of power and control without centralisation of assets. Far from representing a neutral, technical increase in efficiency these developments represent a movement in the risk associated with holding assets, especially inventory, from large firms to smaller organisations. Probably the best known example of this has been the emergence of lean production in manufacturing, especially car production. The ability of larger organisations to shift risk and drive down prices paid to suppliers has been thoroughly documented by Williams et al. (1994). In the car industry they refer to this as the reduction of 'process span' within the larger car assemblers. Moody (1997) has shown how lean production principles have spread beyond manufacturing to industries as diverse as telecommunications and banking.

Indicative evidence of these trends in Australia is provided in the latest Australian Workplace Industrial Relations Survey (AWIRS - Morehead et al. 1997). A number of the key indicators are provided in Table 4 below. It summarises some of the most significant changes that have occurred in the structure of Australian workplaces of the first half of the 1990s.

**Table 4: Key Indicators of Restructuring in Australian Workplaces 1990 - 1995**

Form of Restructuring	1990 (%)	1995 (%)
<b>Workplaces Using</b>		
Casuals	64	70
Agency workers	14	21
<b>Workplaces Reporting Retrenchments</b>	26	27
200-499 employees	39	44
500+ employees	39	60
<b>Unpaid Overtime</b>		
Employees whose hours increased but pay did not		23
<b>Falling Workplace Size</b>		
% of workplaces outsourcing since 1990		35
% of employees in 100+ workplaces	46	41

Source: Morehead et al. 1997

Notes: Data on use of casuals and agency workers, retrenchments, unpaid overtime and outsourcing comes from workplaces with 20 or more employees. Data on proportion of employees at workplaces with more and less than 100 employees comes from estimates covering the whole working population.

This table reveals just how profound the nature of change is in Australian workplaces today. To begin with they are becoming smaller. Whereas 46 per cent of employees worked at establishments with 100 or more employees in 1990, only 41 per cent did so in 1995. Part of the reason for this is not a spontaneous growth in the number of small businesses: over one third (35 per cent) of workplace with 20 or more employers outsourced some functions during that period. During the same period these workplaces were significantly more likely to be using labour hire firms. Whereas 14 per cent used them in 1990, the proportion had risen to 21 per cent in 1995. Given these developments it is hardly surprising to learn that over one workplace in four (26 per cent) retrenched workers in the two year prior to the survey. And the chances of retrenchments occurring was far higher in very large workplaces employing 500 or more employees. In 1995 60 per cent of such workplaces reported the occurrence of retrenchments, up from 39 per cent in 1990. In short, Table 4 clearly establishes that workplaces are getting smaller and that a major factor behind this is the quite profound restructuring of how larger workplaces manage their workforce requirements.

Evidence that trends such as these could be behind the growth of contractor employment in Australia has been provided by VandenHeuvel and Wooden (1994, 1996). They define contractors as persons engaged for a fixed period of work and paid a single, encompassing fee for particular services. They distinguish between independent and dependent contractors. Independent contractors are defined as those who provide services to many other organisations. They do not apply it to those supplying one or only a limited number of organisations. As they put it:

the use of the term 'independent' contractor as it is used in the literature may be a misnomer in many instances. Contractors with 'an umbilical cord to the mother company' are not independent . . . there is at least anecdotal evidence to suggest that in recent years, a considerable number of workers have been reclassified by the firm as independent contractors, with little or no change to their work duties . . . Also described variously as 'fake self-employed', 'surrogate employees' or 'de facto employees', we choose to refer to them as 'dependent contractors' to emphasise both the fact that they are in a contractual relationship, and their dependence on the employer for their income (as in a conventional employer-employee relationship) (VandenHeuvel & Wooden 1994, pp.10-11).

These authors subsequently undertook a study of the growth of contractors (1996). On the basis of this work they suspect that much of this growth was of dependent and not independent contractors. Such workers, in reality, are more likely than not employees dressed up in contractor status. As such there is strong evidence to suggest that the trends in ABS data have arisen from the dynamics noted in the above. There is little or no evidence that they reflect a profound shift in the nature of production to being organised on the basis of a larger number of independent, sole trader enterprises.

## 5. IMPLICATIONS FOR INCOME TAX REVENUE: SOME ESTIMATES FROM CONSTRUCTION

What has been the significance of these developments in the construction industry for taxation revenue? This is not an easy question to answer.

The Australian Taxation Office (ATO) releases a considerable amount of information on the tax system each year (see for example ATO 1998). Nearly all of this is administrative by-product data. As such it reports, inter alia, the source of taxation of revenue by the different forms of taxation. Table 5 summarises the most up to date publicly available information on revenue raised from PAYE and PPS sources. It reveals that of the two sources, the overwhelming proportion comes from the PAYE system.

**Table 5: Level of Taxation Revenue from PAYE and PPS sources, Australia, 1996/97**

Source	Level (\$million)
PAYE	61,513
Prescribed Payment System (PPS)	2,246
<b>Total</b>	<b>63,759</b>

Source: Australian Taxation Office 1998, pp.83, 85

Note: This table only summarises tax revenue from the two sources named. Revenue is also raised from other sources such as sales, fringe benefit, company and provisional taxation.

The proportion raised from the two sources is far from uniform across industries. The clearest case of this is the construction industry. While it contributes only 4.1 per cent of

PAYE revenue it accounts for 70.6 per cent of PPS revenue. Indeed, within construction over one third of tax raised from this industry come from PPS. This is clearly evident in Table 6.

**Table 6: Level of tax revenue raised from PAYE and PPS sources in the construction industry, Australia, 1996/97**

Source	Level (\$million)
<b>PAYE</b>	2,533
<b>Prescribed Payment System (PPS)</b>	1,585
<b>Total</b>	4,118

Source: Australian Taxation Office 1998, pp.83, 85

Note: This table only summarises tax revenue from the only two sources named. Other revenue is also raised from other sources such as sales, fringe benefit, company and provisional taxation.

It is difficult to estimate how labour market developments such as those noted above may affect revenue. This is because ATO tax data cannot be easily matched with ABS labour market statistics. The ATO data uses categories that are derived from accounting conventions and the law of business associations rather than labour market definitions of work. For example, contractors are not identified as a separate category. Rather information on taxpayers is reported by business entity (ie individuals, partnerships, trusts and companies). Contractors can use any one of these legal entities to conduct their business. In construction we are lucky that the information separately supplied on the PPS system provides at least some indications of the level of tax contribution made by some contractors. There are, however, limits in what can be done with this material. The problem arises from a number of sources.

Even where the Tax Office uses ABS categories they are applied in a way that limits their use for labour market analysis. For example, levels of tax revenue obtained from individuals are reported by industry using ABS codes from the Australia and New Zealand Standard Industry Classification (ANZSIC). Unfortunately the 'industry' making the largest contribution to tax revenue is a category called 'salary and wage earners'. Modifications to ANZSIC of this nature are unique to the ATO. It groups together all wage and salary earners, irrespective of what they make or do. This convention makes any kind of detailed industry analysis linking numbers of individuals to level of tax paid by source impossible.

A further limitation arises from the fact that many tax payers use different arrangements for different jobs. For example, in the construction industry as workers move between jobs they sometimes work as contractors and other times as employees. From the data released by the ATO it is impossible to tell how one worker has contributed to different parts of the tax system. Such information is necessary, however, if calculations of how different hours worked in different legal statuses have contributed to tax revenue. This is impossible to do with tax data available from the ATO to the public.

Finally, when assessing the impact of different employment statuses on tax revenue it is important to control for the effects of other variables. Variables such as marital and household status can, for example, affect the nature and level of tax obligations. Contractors, for example, may have more legitimate deductions and rebates (eg dependant spouse rebate) than employees. Without demographic information on how the population of contractors compares with employees we can never be certain we are comparing like with like.

Problems of this nature require information from individual workers which reports on both their labour market activities and status as well as their contributions to the tax system. To our knowledge the only source of such information is the ABS's Income Distribution Survey (IDS) sample files. The most recent one of these available is for 1994. The real strength of this survey is that it collects information on a household, family income unit and individual record basis. For each income unit record the file provides information on demographic characteristics. A large number of labour force characteristics are also captured. This includes data on industry and occupation of employment. In addition material is provided on workers' employment status ie whether they are wage and salary earners or people who own their own business but operate without employees. (This latter category is an operational definition of a contractor very similar to that covering PPS type workers.) This provides information on income earned from different sources by the same individual, be it as an employee, contractor or income support.

This unit record data has been used to study issues such as the distribution of income and how the tax and social security systems interact. More recently it has been used to examine how different labour market legal statuses affect tax revenue (Apps 1998b). A number of important findings have arisen from the latter study. It compares those workers who define their main employment status as contractors with those defining themselves as wage and salary earners. As such the paper compares the demographic and labour market features of the two groups in construction. This reveals that, by and large, both have the same fundamental characteristics such as sex, age and levels of income support (eg unemployment benefit). This is important because it means differences in earnings and tax contributions cannot be attributed to variables such as these.<sup>5</sup> On the basis of her previous work in simulating the impact of different tax reforms (eg Apps & Rees, 1996, Apps 1998a) she then models how actual levels of taxation paid by contractors compare with levels of tax they would pay if they had been treated as PAYE tax payers. In generating these estimates she uses the material on typical levels of deduction noted in Table 1 above. It is important to remember that the results are highly sensitive to the assumptions made about these deductions. It is likely that deductions increase with income. Consequently the reported results probably underestimate the impact of contractor status on tax revenue from higher income earners. The key findings from the Apps paper are summarised in Table 5 below.

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<sup>5</sup> The only key variable of relevance which cannot be controlled for in the unit records concerns hours of work. This is because this data item is not collected for the self-employed. To ascertain whether contractors and employees in construction worked roughly the same hours information on this issue was obtained from another source, confidentialised unit record files from the 1993 ABS Survey of Training and Further Education. This revealed that over 90% of both contractors and employees in construction worked 35 or more hours per week. If anything, contractors appear to work slightly longer hours than employees on wages. Differences in earnings and tax cannot therefore be attributed to hours worked.

**Table 7: Estimates of tax paid by contractors in construction compared with their tax liability had they been treated as PAYE tax payers, Australia, 1994<sup>1</sup>**

Tax Status of Contractors <sup>2</sup>	Tax Paid
PAYE Status	\$10,775.01
Contractor Status	\$4,557.79
Difference	\$6,217.22

Source: Apps (1998b)

Notes:

1. Original data used were confidentialised unit records files (CURF) from the ABS Income Distribution Survey 1994.
2. The sub-population studied were construction workers who indicated that their 'labour force status in [their] main job' was 'own business without employees (non-limited liability [organisation])'. This is the group most likely to approximate to PPS tax payers. This meant 168 observations were used in generating these estimates.
3. Average annual work related earnings for these workers were \$3,515.82 in wages and salaries and business related net earnings of \$17,422.77.

Controlling for all the key variables likely to affect work related earnings, contractors in construction paid on average \$6,217.22 less than PAYE construction workers doing comparable work in 1994.

What impact is this likely to have on total tax revenue lost from the construction industry? The information obtained from the Income Distribution Survey allows us to make better use of the Tax Office material summarised in Table 6. The IDS and STE material reveals that PAYE and PPS workers differ little in terms of hours worked, total income and all the other key variables controlled for such as marital status. Table 7 provides information on what the ratio of PPS tax payment is to what the equivalent PAYE contribution would be if PPS workers were treated as PAYE employees. That is, PPS revenue is only 42 per cent of that raised from PAYE employees on equivalent gross incomes. We know from the Tax Office that the PPS generated \$1,585 million in 1996/97. If this represents only 42 per cent of the equivalent of what workers would have contributed had they been part of the PAYE system, the total revenue lost is the equivalent of \$2,188.81 million or just under \$2.2 billion. These estimates are summarised in Table 8.

**Table 8: Estimates of differences in revenue arising from workers being designated PPS workers as opposed to PAYE employees in construction, Australia, 1996/97.**

Type of tax revenue	\$ (Million)
Estimate of revenue that would have been raised if PPS workers had paid PAYE on gross revenue <sup>1</sup>	3,773.81
Actual level of tax contributed by PPS workers <sup>2</sup>	1,585.00
Difference	2,188.81

Sources: Australian Taxation Office (1998) and Apps (1998b)

Notes:

1. This estimate is based on the assumption that reported PPS tax revenue is only 42 per cent of the equivalent tax payment made by PAYE workers earning the same gross income. For details see Table 7.

2. This is taken from ATO (1998) p85.

It is clear that potentially very large amounts of revenue are associated with people being treated as contactors and not employees in this industry. In this context it is important to remember that these estimates only refer to PPS contractors. *No information has been analysed concerning contractors operating as part of the provisional tax system.* PPS workers are, by definition, those engaged in regular employment of some kind. Their tax payments are not made by them directly but by those engaging them. As such, unlike provisional tax payers running a business for multiple clients, PPS workers have one of the essential hallmarks of employees. Moreover, given the magnitude of the potential losses in revenue reported in Table 8, even if the estimates of 'sham contractors' are wrong by 50 per cent, losses to revenue are still over \$1 billion per annum.

It is also important to recognise that this is not a static situation. With the passing of time things are getting worse. The ABS material in Section 4 revealed the significant growth of contractor employment in general and in construction in particular. Figures 1 and 4 revealed a major increase in the proportion of contractors in the early 1990s.

Between 1985 and 1990 the average proportion of contractor employment in construction was 29.3 per cent. Between 1991 and 1997 it was 33.6 per cent. This is a difference of 4.3 percent. In August 1997 there were 520,300 construction workers who were either contractors or wage and salary earners (see Table 2 above). If the proportion of contractors in 1997 were the same as that which prevailed in the second half of the 1980s there would have been 22,371 fewer contractors in 1997. Given the lower tax paid by contractors the additional loss to tax revenue in 1997 compared to the situation in the late 1980s can be estimated at \$138.7million in 1994 dollars. Using private final consumption deflators for 1993/94 and 1996/97 (ABS 1998) this is equivalent to \$146.3 million in 1996/97 dollars. Losses to revenue are, therefore, steadily increasing, with hundreds of millions of extra dollars being lost every year.

These losses to public revenue mark a significant subsidy from the tax system to the construction industry. Construction workers and their companies use roads, hospitals and other public services but contribute proportionately less than other industries to the cost of their upkeep. This is a major distortion in need of rectification. But the problem is more than one of fairness in sharing the tax burden. In the current climate of 'balanced budgets' losses in revenue have serious implications for social services. Consideration of the size of recent cuts to public expenditure helps put these tax losses in perspective. The 1996/97 budget is widely recognised to have been 'tough'. Two of the typical cuts arising from that budget in 1997/98 concerned reduced expenditure on childcare and national highway funding. The reductions were \$147 million and \$138 million respectively (Costello 1996). These, or other measures like them, could have been avoided if the construction industry had complied with the tax system in the way in which most ordinary workers do.

It is important to reflect on the large losses to revenue involved given the relatively small size of the workforce engaged on a contractor basis in the industry. Losses to the system are already in the order of billions of dollars annually. The damage to public revenue and therefore to public services will be even greater if current trends are not halted and reversed. Such concerns are not idle speculation. In 1980 only about 29 per cent of UK construction industry workers were contractors. By 1993 this had increased to 45 per cent (Harvey, 1995 p.2). Some consideration of these developments is important to appreciate just how dramatically a situation can change with considerable implications for public revenue.

## **6. PUTTING THE PROJECTIONS IN CONTEXT: CONTRACTORS IN UK CONSTRUCTION 1970 - 1997<sup>6</sup>**

The emergence and subsequent decline of contract labour in the UK construction industry is best understood as moving through four distinct phases. The first covered the period up to the 1970s. Prior to this time most labour in construction took the form of PAYE wage earners. There was some self-employment, but this was predominantly in the skilled trades amongst those workers moving from job to job, operating primarily in their own small business.

The second phase occurred from the late 1970s and continued until the late 1980s. This period was characterised by the ascendancy of contractor labour. In the early 1970s the

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<sup>6</sup> Most of the material reported in this section was collected from interviews with Rob Cathcart and Andrew Wilson research officers with the UK construction union (UCATT) at the union's offices in Clapham, London, 1 July 1998. Most of this material was then corroborated in an analysis subsequently provided by Harvey (1997) and obtained after the interviews were conducted.

proportion of workers in the industry operating in the 'black economy' rose dramatically. This was known as 'working on the lump' - ie working for a lump sum, often on a cash in hand basis. In the late 1970s the then UK Labour Government introduced the Construction Tax Industry Scheme. This aimed to get some tax revenue out of the black economy.<sup>7</sup> Instead, it provided employers with a powerful means of turning PAYE workers into contractors. Employers were motivated not just by labour cost questions (ie avoiding taxes). The union had some big wins in the early 1970s (eg 27 per cent wage increase in 1972). Employers promoted the use of contractors to undermine the union's organising ability.

Contractor employment steadily became the dominant form of labour use during the booms of the late 1970s-early 1980s and 1984 - 1987. Indeed, from the early 1980s the industry restructured itself, with head contractors contracting out all work. This marked the rise of 'management contracting' as the dominant business form in the industry (See for example Korczynski 1994 and 1996). Opportunities for direct employment all but disappeared as 'pyramid' subcontracting came to encompass all types of work. The process was initially most advanced in the South East, but subsequently spread to the North and Scotland. Key outcomes during this period were that by 1986/87 600,000 construction workers (ie about 45%) were officially self-employed.

Key problems associated with the prevalence of contracting had become apparent by the early 1990s. This marketed the third phase of the contractor phenomenon. These problems took various forms. The most visible were of a legal/industrial nature. From the late 1980s UCATT commenced an aggressive campaign to rectify what it defined as the 'contractor problem'. This involved attacking the problem at its source by challenging its legal basis of existence. Prime amongst its activities in this regard were a series of cases concerning dismissal, redundancy and safety rights for 'contractors'. Nearly all cases conducted established that the workers were in fact employees, despite the fact the Inland Revenue treated them differently. The steady accumulation of legal victories increased pressure on employers and the government to respond to a major anomaly in the legal system ie tax and industrial law treating the same people as having different legal statuses.

An allied set of pressures were of an economic and business nature. The contracting system resulted in a deterioration in key features of the industry. These included falls in product/building quality. Contractors consistently cut corners in undertaking work. As they became more prevalent quality standards steadily fell. Safety standards on sites also fell. Under contracting arrangements it was often hard to find someone who was prepared to take responsibility for safety on a building site. Commitments to skill formation also dropped off rapidly as training costs cut into margins. This affected apprenticeships and the reproduction of trades level skills especially. It also effected the development, diffusion and use of design and project management skills. Because contractors became the basis of organisation most firms discarded inhouse design and development capacity. This impaired the industry's capacity to innovate and provide integrated construction services to clients (Clarke and Wall, 1996; Harvey, 1997 p.13).

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<sup>7</sup> Contractors of the traditional form were known as 714s. The new form were known as SC60s, so named after different tax forms required to be completed for the different forms of employment. The former coincides pretty closely with the Australian provisional tax system, the latter with PPS arrangements. Access to 714 arrangements are now tightly controlled. For example it requires evidence of three years work in the industry and is based on an identity card with photo issued by the Inland Revenue. Access to SC60 status is very easy, with no real scrutiny by the Inland Revenue.

These domestic economic pressures have become more acute with the UK's integration into Europe. The emergence of a single European market has increased competitive pressure on UK construction firms. Few have had any success on the Continent. At the same time overseas firms have started to win market share in the UK. This has arisen because contractor forms of organisation mean UK firms lack the inhouse capacity to provide competitive, integrated building services (Harvey 1997, p.8). European safety standards have also placed more pressure on UK firms to regularise employment so they are better able to meet safety standards (Clarke and Wall, 1996).

Finally, pressure on public revenue drew increasing concern from the national government. The shift to contract status had resulted in a massive loss of revenue from this industry. Contracting was now not marginal, but central to the industry's operations. Hundreds of thousands of workers were therefore able to make claims on the welfare state (eg National Health Service, aged pensions) yet relatively few contributed to the costs. These pressures were so great that even the UK Conservative Government of John Major felt employers in construction were effectively receiving a subsidy that most other businesses did not enjoy (Harvey 1997, pp.10-12) citing material from the UK industry publications *Construction News* 29/8/96 and *Taxation*, 1996). The losses to public revenue have been estimated to have been of the order of \$A4-8 billion per annum.<sup>8</sup>

In the context of these pressures, the recession of the late 1980s and early 1990s hit the industry heavily. Over half a million jobs were lost between 1989 - 1992. In addition there were record bankruptcies. In the depths of this recession the more forward looking employers came to see the problems as more than cyclical - many felt they were associated with the structure of the industry.

In the autumn of 1996 a group of leading construction employers met with the Conservative Chancellor of Exchequer and Minister for Employment. Given the pressures identified above they indicated they would not object to Government initiatives directed at increasing the proportion of direct employment in the industry. They argued Government action was required to lift standards industry-wide because no one employer or even group of employers could change the situation.

The Government accepted these arguments. Consequently the Inland Revenue announced to the industry that it would oblige all contractors to review the employment status of their workforce based on the criteria identified in the test cases run by the union. This initiative was administrative in nature and did not require special legislation.

The Inland Revenue approach was to coax the industry gently into change. This approach, however, created problems. Those employers moving back to direct employment often found themselves disadvantaged relative to more unscrupulous competitors. Consequently several large employers approached the union to pressure the government for a deadline to force employers to move on the issue. After much pressure the Inland Revenue announced a deadline. If after 5 April 1997 contractors had not reviewed their workforces they would be liable to pay back taxes from that date. This not only set a clear target for change, it also amounted to a defacto amnesty for taxes avoided prior to that time.

Unofficially the Inland Revenue claims 200,000 workers have subsequently gone back to PAYE tax status. The Union questions this figure. From its experience while there have

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<sup>8</sup> Mark Harvey, 1995 *Toward The Insecurity Society*, pp.16-17.

been some celebrated 'tax swoops' much remains to be done. The union itself has had to police the policy change which is getting easier to do given the current steady rise in construction activity, especially in London.

While some employers have made the shift others have attempted to evade the change. Some of the most recent attempted evasions have included:

- increasing use of partnerships
- head contractors 'buying' material from their 'contractors', who are in fact employees, with the whole exercise merely involving book entries
- getting workers to advertise in the local paper to prove their 'independent' business status
- use of labour hire companies that only rent out 'contract' workers
- one employer turning all his workers into shareholders and paying them a base rate of \$A120 per week, with the rest paid as 'weekly dividends'.

To date most of these scams have been rejected by the relevant authorities. According to union interviewees it takes constant work by the union, however, because head contractors and the Inland Revenue are tardy in following the issue through.

Generally it appears that the best incentive for winding back contractors is to increase levels of regulation more generally. For example, regulations concerning safety and building standards covering all phases from design to execution provided an incentive for employers to engage a stable workforce. Equally new standards concerning pensions have had the same effect. These developments have meant that in combination 'a climate of rights' was emerging that encourages standard employment.

## **7. IMPLICATIONS FOR AUSTRALIA**

The Australian situation is not nearly as stark as that which prevailed and still prevails in the UK. We do, however, appear to be drifting in that direction. This is already affecting training (Buchanan and Sullivan 1996) and public revenue. The challenge is to stop the destructive dynamic gaining momentum and reversing it. The UK experience reveals that the situation can get so bad that even a Conservative Government can eventually be forced to move to rectify the situation. The experience also shows it is very difficult to reverse the trend once this dynamic is unleashed. If losses of tax revenue from this form of labour market development are to be avoided the UK experience indicates that it is necessary to control and indeed reverse the damaging dynamic before it gets completely out of hand.

The UK experience shows that changes required do not have to await legislative action. Major reform can be achieved by changing administrative practices and priorities. For example, increasing information requirements for contractors would make auditing easier and more effective. Currently the self-reported information is so aggregated it is of little help in making judgements about the validity of the claims made. Equally important are administrative priorities. By far the most significant feature of the recent UK initiatives has concerned the commitment by public authorities to move on the subject and act decisively. Without such a commitment 'contractors' and those engaging them can live easy, free of any

concern of scrutiny. The setting of deadlines and the possibility of back payments would provide an important lever for reform.

Ultimately, of course, serious attention needs to be given to redefining the nature of workers' employment status. The contract model has never been satisfactory. Recent developments have highlighted the potentially long run damage such legal fictions can inflict on public revenue. A number of labour lawyers and industrial relations researchers have argued for moving beyond the contract model for many years (See for example Brooks 1993, Creighton 1997, Ewing 1997 and ACIRRT 1999). It is ultimately only initiatives of this nature that will eradicate legal fictions that make little industrial sense but which can very effectively undermine workers' rights and public revenue.

## **8. CONCLUSIONS**

There is nothing inevitable about the growth in contractor employment. While overseas studies reveal that employment of this nature is on the rise, the rate and direction of growth as well as the overall proportions of a labour force employed on such a basis varies dramatically. More significantly, there is growing evidence that where this form of employment is on the rise it is taking the form of dependent and not independent contractors as classically conceived. This raises important questions about how such forms of employment should be managed in the future.

It is clear that taxation policy and practice play an important part in structuring the legal form of employment. It is also clear that employment structures are having an increasingly important impact on public revenue. It is vital that policy debate in both tax and labour market reform addresses this dynamic interaction. It is even more important that taxation and labour market researchers examine these dynamics in detail. For it is only with a better understanding of how labour market and tax systems interact that we get a better understanding of the likely nature of work in the future. As matters stand we appear to be witnessing the realisation of John Stuart Mills dictum: under conditions of competition standards are set by the morally least reputable agent. It is incumbent on both policy makers and researchers to identify the conditions under which such agents can be controlled in the interests of both efficiency and fairness.

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## **Section 3**

### **GST: General Sales Tax Or ‘Great Social Transformation’: Tax, State And Society**

**Dr. Mark Harvey**

## 1. TAX, STATE AND SOCIETY

Most social scientists, including professional economists, like most people, do not want to know about taxation. Yet taxation systems have existed in most economic systems and for long historical periods. In the recent period of industrial capitalism, almost all markets have traded in taxed commodities, and tax has been an integral part of price, whether it be of tradeable goods, labour, capital, or property. Moreover, taxation systems have evolved with changes in economic structure, on the one hand, and with changes in the nature and role of the state, on the other. The taxation regime is a litmus test of the relation between state and economy, as taxation is the lifeblood of the state - a fact recently brought into relief by the turbulent attempts to establish a capitalist taxation system in the new market economy of Russia.

If 'income tax' was at first a tax on income from landed property, its current form as a tax on income related to waged employment became fully established with the modern welfare state. It was closely linked to the development also of systems of national insurance. It can thus be argued that the modern welfare state as we know it is related to the emergence of 'standard', urbanised, and long-term stable employment relations, on the one hand; and to the whole taxation and social insurance apparatus that co-evolved with those employment relations, on the other. PAYE (Pay As You Earn) income tax and national social insurance became established on the basis of, and in relation to, the 'standard employment relation' of the interwar period and has endured and developed from then to the present day. Both shaping and shaped originally by the predominant pattern of continuous male full-time standard employment, it also represented a strongly gendered basis of the welfare state and its provisions. For a long historical period, therefore, it could be said that wage-income related revenues, standard employment relations, and the modern welfare state have formed a 'sacred triangle' at the core of economy and society. This triangle has been as significant as the Poor Law Reform was to the 'Great Transformation' by which Polanyi described the early emergence of industrial capitalism (Polanyi, 1944). Castel (1995) has argued that the 'standard employment relation' has played a fundamental role in the organisation of social and economic life, but that there are now signs that, from its apogee, it is beginning to lose its purchasing power as *the* organising principle.

The intention of this short 'thought-piece' is to ask whether society, the state and the economy is beginning to shift its centre. In this perspective, the switch by many states to a greater reliance on sales taxes (GST in Australia, VAT in the UK and Europe) marks more than just a tapping-in to another source of revenue. Does it also suggest a much more fundamental shift in the relation between state, society and economy? If the state becomes less reliant on revenues derived directly from the labour-capital exchange (the employment relation) does it mean a shift from a 'production society' to a 'consumption society', and if so, what does that mean, and what might be its consequences?

## 2. THE 'SOCIAL COST' OF LABOUR

"Social insurance is regarded as being too costly for our economies, imposing a heavy burden on labour costs especially." (European Commission, 1995a, 3).

'The measures to be taken should include...reducing non-wage labour costs extensively enough to ensure that there is a noticeable effect concerning the taking on of employees and in particular of unqualified employees.', cited in (European Commission, 1995b, 120).

'The Essen Conclusions' 1995.

This image of the 'heavy burden', often referring implicitly not to its absolute weight, but to the fact that it is perceived as heavier than everybody else's, has been the standard way of looking at taxation and social insurance from Ricardo and Marx through to Milton Friedman and Claus Offe. It is the image of a productive worker struggling to produce at an ever faster rate being dragged backwards by an ever heavier weight. A more sophisticated version of this picture is provided by suggesting that, as the numbers of people in society before and beyond employment age increase in proportion to those in employment (Esping-Anderson, 1997), or as medical technologies restoring those incapable of employment to capability become more and more costly, the burden is being concentrated on the relatively few, so leading to a crisis in legitimacy for the 'bearers of the burden'.

To this logic, a further immense stimulus has been provided by the integration of global commodity markets, which have suggested to some that the relatively heavy burden of those countries with extensive welfare states is unsustainable in current competitive environments. The European Commission's Essen Conclusions cited above can easily be rewritten as a fairly simple equation: more social costs equals less jobs. Global competition, in this picture, becomes a degenerative spiral for competitive undercutting of welfare costs, beggar my neighbour making my neighbour a beggar. And indeed, rhetorically and in policy, some political parties and organisations then become the effective channels through which this competitive pressure is transmitted.

Before exploring further what is meant exactly by the 'social cost' of labour, it should be noted that the attempts to shift at least the *visibility* of these costs have been widespread in Europe. If social expenditure can be supported by indirect taxation, it can appear as if the social cost is no longer directly attached to the cost of labour. This is one way of magicking the perceived problem away. Even the coalition pact between the Social Democratic Party and the Greens forming the new government in Germany can be counted amongst these attempts, with reduction in direct social security contributions and their replacement by 'green' consumption taxes (*Financial Times*, 21.10.98). The switch from direct to indirect taxation therefore needs to be placed within this wider context of fiscal restructuring. It is one amongst many measures listed below to decentre the state's relation to the waged employment relation:

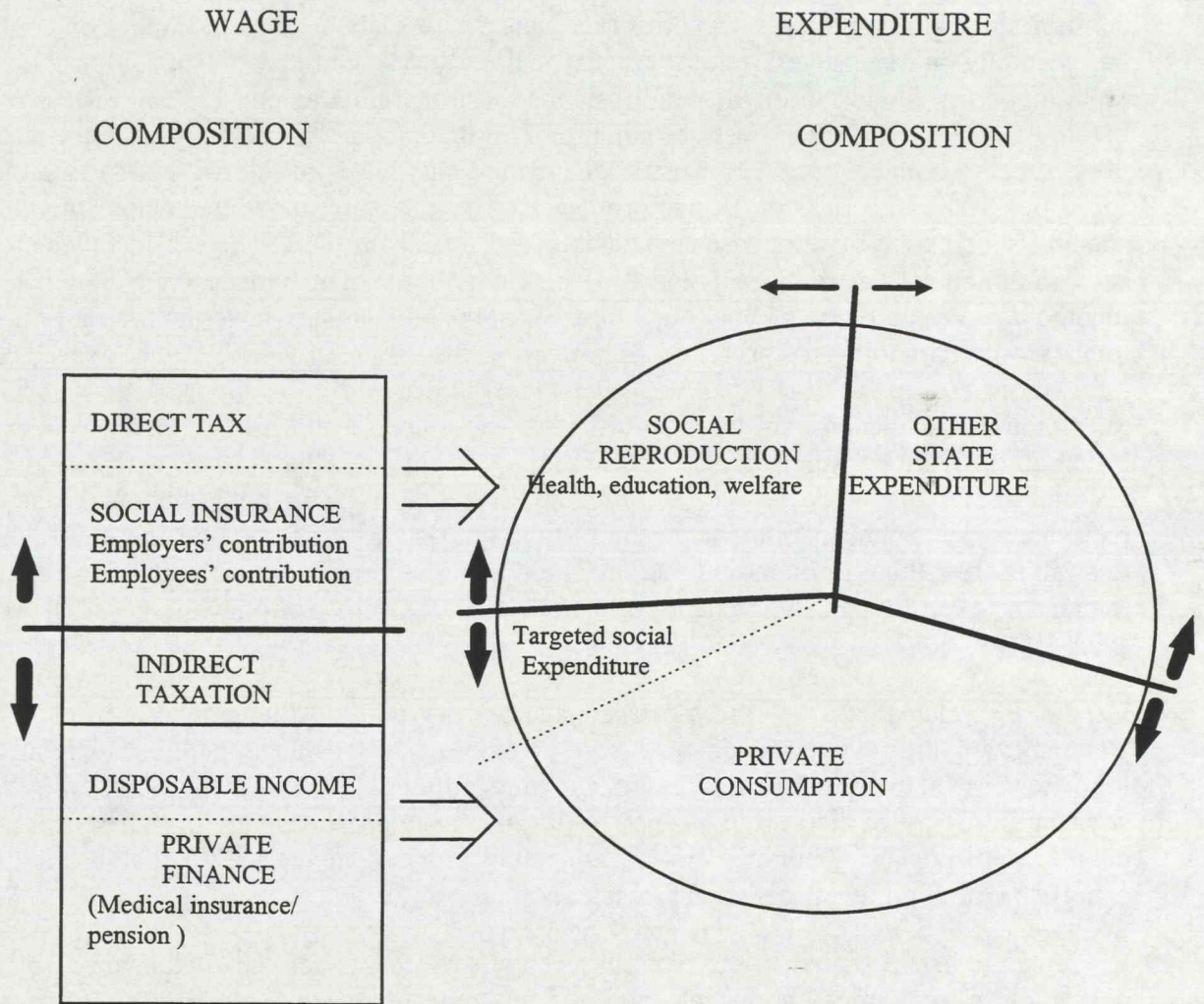
- Income tax is no longer seen as a major instrument of redistribution - Governments across Europe have been seen to hit the taxation buffers, especially in respect to high marginal rates of taxation.
- There is a shifting to private pensions, as top-up for state earnings related pensions, whether by voluntary or compulsory private provision
- There is a shifting to private medical provision, as a top-up for state provision, either as a consequence of rationing of state provision, or by reduction in entitlements to state provision
- There is a shifting to private/personal financing of public 'optional' higher education, by 'graduate taxes' and student fees.

But does all this shifting really make a difference, and if so why? What does it matter if the same level of social expenditure is supported through consumption taxes as through employment taxes? It could be argued that what counts is the level of social provision, and hence of social expenditure as a percent either of GDP, or as a ratio to personal commodity consumption. After all, the exact mixtures between social insurance, income tax, and sales

taxes vary enormously even within Europe to support similar levels of social expenditure (Edling, 1992, 1997). Even if one were to assume that all things were equal, the argument still needs to be made that it does make a difference where tax falls, on waged income, property, or consumption.

### 3. PICTURING THE SHIFT

To simplify the issues at stake, for the composition of the wage, I shall bunch all employment related revenue together, to include direct taxation, and employers' and employees' social insurance contributions. Then, I shall bunch together all personal expenditure and indirect taxation related to it. Thus, for a given level of wages (and of course gross wage levels may vary from country to country), there are two basic parts: the part that is directed at social expenditure and the part that remains for personal consumption, some of which, via indirect taxation, can find its way back into social expenditure. Then, on the expenditure side, again for simplicity's sake, I shall divide the revenue cake into two parts, one of which is further subdivided: state expenditure is the first major part, and this is subdivided into health-education-welfare which can be termed social reproduction, on the one hand, and other state expenditure (military, law and order, administration, etc.) on the other. The second major part is private consumption, the purchase of commodities, or private reproduction not provided by the state, but through the private purchase of commodities or services. The following diagram schematises the flows of revenue and expenditure. The shift from direct to indirect taxation and from social to private reproduction can therefore be represented by the upward movement of the arrows, on each side of the diagram. The argument will be that as the heavy arrows go up on one side, they have a strong tendency, if not requirement, to go up on the other side. If the proportion of the wage allocated to private consumption goes up, then the expenditure on social reproduction goes down, *even if* some of that private consumption is redirected into social reproduction by an increase of indirect taxation associated with a decrease in direct taxation.



FLOWS OF INCOME AND EXPENDITURE

In this diagram, one further point needs to be made concerning the shift from social to private reproduction. Some private expenditure, which in much social accounting falls under consumption and not under 'labour cost', can be termed private financing, dedicated to health, education, or pension. Some of this expenditure is a condition of employment, or may be required by state legislation. Private medical insurance in the US, for example, can be the only route to medical care, and linked to the employment contract. In that way it is hypothecated income, even if not appearing either as taxation or as a 'labour cost' in official statistics. It can best be described as part of necessary private reproduction, in the sense that this income purchases private commodities or commodity-services.

#### 4. VARIETIES OF ARRANGEMENT.

The wide and surprising variety of different ways of packaging taxation and social insurance, and their historical emergence, merits research in its own right. Here, for the purposes of argument, all that needs to be stressed is that this variety means that it is important to look at the whole package of taxation and social insurance as all of one piece. Thus, although both Sweden and Denmark have typically Scandinavian levels of social expenditure, and in relation to total wages, relatively low proportions of disposable income for private consumption, the way that their social insurance is packaged could hardly be

more different (Edling, 1992, 1997). Thus, Sweden has no compulsory employee's contributions, but employer's social insurance are 30% of labour costs. Denmark by contrast has virtually nil employer's contributions, and only 5% employee contributions: social reproduction is funded through social insurance to a marginal extent. By contrast, Sweden has roughly 25% of labour cost accounted for by income tax, as against Denmark at over 40%. Finally, both Sweden and Denmark have moderate levels of indirect taxes, accounting for about 10% and 15% of labour cost respectively. So, virtually the whole weight of funding social reproduction in Denmark is borne by income tax, whereas in Sweden that same function is served by a balance of employer's social insurance contributions, and income tax. Yet, in terms of final outcomes, Sweden and Denmark have the lowest levels of total income remaining for private consumption in the capitalist world, at just over 30% of total labour cost (as against Japan with the highest at nearly 70% or the USA at over 55%). So although the means may be very different, the outcome in terms of balance between social and private consumption is very similar. And although the balance between income tax and social insurance is very different in the two cases, in both the bulk of social reproduction is financed through revenues directly related to income and the employment relation rather than through indirect taxation and the private consumption route. This remains so even though in Sweden too, there has been a shift from income tax to sales tax since 1991.

Here it is perhaps it is worth emphasising an earlier point. Although both Sweden and Denmark rank highly in terms of social costs of labour, and Japan and the US rank relatively low, in these latter countries a significant proportion of income disposable for private consumption may be tied up to finance health insurance and pensions. In that sense, these countries' disposable income is not all 'spending money', in the way that it is for those countries with high levels of social provision.

Having established that it is the overall package that counts for the social versus private reproduction outcomes, and that employment related revenue is also significant in accounting for that balance, one further example of varieties of arrangement further amplifies the main thrust of the argument about taxation, employment and the state. Friot has pointed to very deep seated differences in the whole conception of labour embodied in different taxation and insurance systems in England and France (Friot, 1997; Friot and Abdelmoumène, 1996). In France pensions do not go through private insurance funds, but through a 'social fund' (cotisation sociale). In the UK dual system, in addition to the state minimum pension, a significant proportion of pensions are funded in this way. He argues that in France those currently in work are directly financing those not or no longer in work. Because the employers' contributions (at 30% of labour cost) go into the social fund paying directly for the non-waged, this fund is a collective, and socialised property of both the in and out of work. The labour-capital or employer-employee relation is thus institutionally an integral part of a wider collectivity. In the UK, by contrast, private pensions are individually owned pension rights, each person's savings being their own property, to be cashed in when the time comes. This leads not only to great differences in the functioning of the stock market, but for the present argument to important differences between labour being institutionally part of social labour with collective rights on the one hand, or labour being the private property of each individual to be sold on the market and supporting a personal accumulation fund, on the other.

The consequences of this difference are very important indeed. In France rights to social security are a collective right to be defended politically. In the UK they are private rights, at best to be defended individually through legal channels, in the event of individual injustice.

This has occurred recently when, in a number of cases, private pension companies have bought out employer-based schemes on a false prospectus. Consequently, the two countries have experienced contrasting histories concerning this issue over the past decade: there have been mass campaigns to advance or protect social security and pension rights as a political issue in France, and interminable court cases to recoup individual property-right losses in England.

The broader lesson to be drawn from this contrast is that institutional arrangements for securing social reproduction through direct employment-related revenue do matter, and matter in the fundamental sense of the strengthening or weakening of the institutional linkage between the employment relation and social reproduction implied by different fiscal regimes. I shall return to this point later.

## 5. THE SOCIETAL SIGNIFICANCE OF A SHIFT FROM DIRECT TO INDIRECT TAXATION

The argument that a shift from direct to indirect taxation is a matter of major societal significance, marking an important historical transition, can be made at three levels. At the first and most immediate level, the argument that it matters which source of revenue supports social provision, is that increased use of indirect taxation closes or reduces *possibilities* of wealth redistribution. It limits the scope of the state to act in this regard. If earned-income inequality is viewed as one of the major sources of wealth inequality (naturally not the only one), assuming access to income from employment in the first place, then income related taxation *can be* directed to redress a source of inequality *at the source*. Consumption inequalities are only a reflection of income inequality. Hence a shift to indirect taxation implies, whether for electoral reasons or by virtue of abandonment of egalitarian political philosophies, the end of generalised fiscal redistribution. As a corollary to this shift, welfare provision then becomes a targeted provision to different social 'minority' groups, defined by their various forms of social exclusion. The point here is that indirect tax *cannot be* an instrument for redistribution in the way that direct tax can be, because people pay indirect tax in direct proportion to their personal consumption. Any shift from direct to indirect taxation thus betokens a decrease in the extent to which the state may use fiscal measures for general redistributive purposes. At this level, the shift from direct to indirect taxation could be seen simply as a shift in the relative size of the 'pot' for redistribution in relation to the 'pot' for a social provision which locks recipients into their relative inequality. This could be described as the 'traditionalist' defence of the twentieth century welfare state.

A second stage of the argument takes it to a different level. The whole edifice of the modern welfare state has been built on the basis of securing social reproduction of employability through the state, on the one hand, and provision for the 'unemployed', or for non-participation, on the other. The system is articulated around that social reproduction system, with its centre focused on the employment/un-employment axis. Better and more extended education, better and more extended health care, through social provision, have been central to the increased fitness and range of competencies of the employable labour force. The *linkage* between taxation related to employment and social reproduction related to employability has been a central institutional feature of this historically dynamic process of growth throughout the course of this century. It is that linkage which is being attenuated by the shift away from direct taxation to consumption based taxation. This should not be seen as a simple reversion to the model of reproduction through personal consumption of goods purchased as commodities, as described by classical political economy. But at the very least,

decreasing the linkage signals a weakening of that virtuous circle between the social provision of increased employment fitness and capacity and economic growth.

The force of this argument arises by extension of the Friot analysis outlined above contrasting the UK and France. To the extent that social reproduction is institutionally embedded in the fiscal circuits through the employment relation, it is a social, collective and politically 'public' affair. By contrast, to the extent that social reproduction is embedded in fiscal circuits through private consumption such as sales tax, (especially when combined with other measures such as individual top-up pensions, or graduate tax top-up education finance), reproduction becomes a matter of private consumption, and drops out, partially or wholly, from the realm of political visibility. Social welfare and social reproduction become reduced in scope, and less a general political right of the citizen, more a reflection of differential purchasing and consumption choices of individuals.

The third level of analysis, however, reads a different significance into the shift from employment related state revenue to consumption-related tax revenue. I would suggest that regulatory regimes, including taxation systems and labour law, form part of a dynamic historical process: they do not stand outside and act as independent shaping or moulding agencies in relation to capitalist development. On the contrary, they are an integral aspect of that development.

So, if through its fiscal and regulatory frameworks the state underwrites and is underwritten by the employment relation, and continues to do so in a dynamic way to counter global competitive pressure on 'social costs' of labour, then the employment relation will stand a chance of surviving as a central organising societal principle. But, to the extent that the state becomes less dependent on the employment relation as a source of revenue, its own fiscal framework will further shift the benefits related to the employment relation from social reproduction to private consumption. This then becomes part of a compelling downward ratchet. The more firms outsource, and the more people are excluded from, or opt out of, the employment relation as their primary income source, the more the state is constrained to seek alternative revenue sources. In stimulating the shift from social to private reproduction, the state then provides less and less social benefits linked to the employment relation, which further constrains people to seek private consumption solutions, and the less prized the employment relation becomes the dominant mode of earning a living and constructing an economic, social and cultural life. Of course, employers and firms participate in this downward ratchet by using outsourcing and short-term contracts as competitive strategies. But the central force of the argument being developed here is that there is a self-reinforcing spiral between declining revenue sources and declining social reproduction articulated around the employment relation. As the state retreats from underwriting the employment relation, shrinking revenue resources from direct taxation then impel the state to make further retreats. The fiscal regime becomes held within a socio-economic vortex, which is already sucking in governments of quite diverse political persuasions. At this level, what we are witnessing are changes in the nature of the state, along with, and in reaction to, changes in the economy and in the fabric of labour and employment. State, economy and society are aspects of a shared dynamic process, crucially mediated through fiscal circuits. It is for this reason that it may not be hyperbole to treat the shift to GST as a symptomatic index of a 'great societal transformation'. As such it poses an important political challenge.

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