

The Growth of Contractors in the Construction Industry: Implications for Tax Revenue

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Abstract

This paper is a preliminary investigation of the impact of the changing legal structures of employment on the tax system and the tax system on the structure of jobs. This issue is explored with special reference to the growth of contractor employment in the Australian construction industry. The paper shows how tax liabilities for individuals can be halved where they are deemed to be contractors. The paper estimates that in the mid 1990s this resulted in the average construction contractor paying around \$6,000 a year less than equivalent PAYE workers. Losses to tax revenue could, therefore, be up \$2.2 billion annually. 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.

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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: 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.¹ It addressed three questions. First, what are the differences between contractors and employees, especially concerning their tax liabilities? Second, how has the number of contractors increased in the construction industry in recent years? And finally, 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 by consideration of how tax liabilities are reduced by workers taking on contractor status in Section 3. 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. These are identified and one approach for addressing them is provided in Section 5. Section 6 puts these developments in perspective by examining how similar dynamics in the UK became so advanced that then Conservative Government was forced to take remedial action. The paper concludes 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 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.

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: 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: 72). Consequently, as Polanyi noted the 'commodity description of labour is entirely fictitious' (Polanyi, 1944: 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, and 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, 1998,

Volume 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 a case which is now recognised as a leading authority on the issue.² 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:³

1. 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: 370).
2. The 'personal service' test (ie an employee cannot sub-contract (Merritt, 1982: 108-110).
3. The 'risk' test (ie does the person work as their own employer and therefore bear the risk of the enterprise? Eg (Mills, 1982: 276)).

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).⁴ It is this uncertainty which creates the space for many employers and workers to determine how to characterise their employment relations.

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 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 (CCH, 1983).⁵ 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. 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.

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 cate-

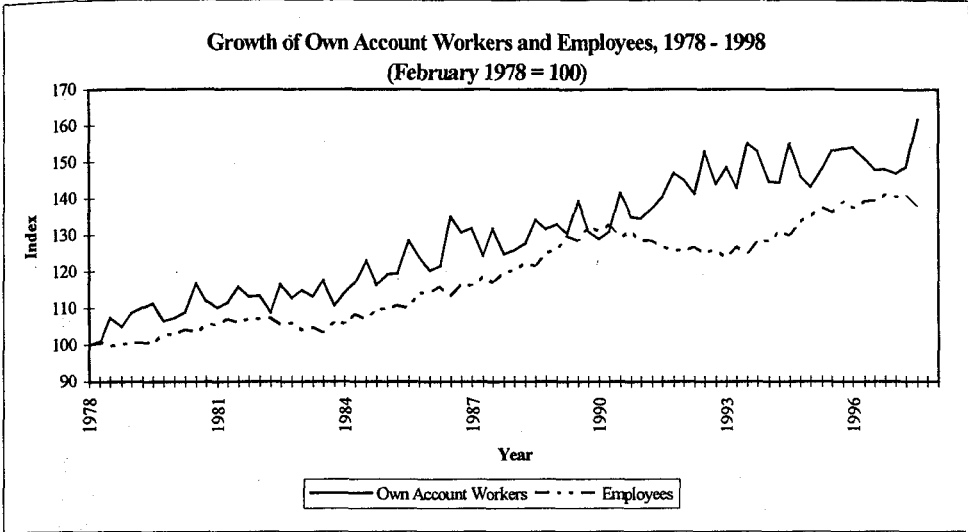
Table 1. Comparison of taxes typically paid by PAYE and PPS Contractors in the Construction Industry, example for worker with gross annual income of \$52,000

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
Taxable Income	<u>51,250.00</u>	Taxable Income	<u>31,800.00</u>
<i>Income Tax Payable</i>	14,689.50	<i>Income Tax Payable</i>	6,834.00
<i>Medicare Levy</i>	871.25	<i>Medicare Levy</i>	540.59
	<u>15,560.75</u>		<u>7,374.59</u>
<i>Less Spouse Rebate</i>	(1,452.00)	<i>Less Spouse Rebate</i>	–
Net Tax Payable	<u>14,108.75</u>	Net Tax Payable	<u>7,374.59</u>
Employer Superannuation Contributions of 2,600 taxed at 15%	390.00	Employer Superannuation Contributions	–
<u><i>Government Revenue Summary</i></u>		<u><i>Government Revenue Summary</i></u>	
Net Income Tax paid	14,108.75	Net Income Tax Paid	7,374.59
Tax on Superannuation Contributions	390.00	Tax on Superannuation Contributions	–
Total Revenue	14,498.75	Total Revenue	7,374.59
Average Rate of Tax	28%	Average Rate of Tax	14%

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.

gory 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

Figure 1



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

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.

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 an 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 No.	1997 No.	1985 No.	1997 No.	1985-97 % Change	1985-97 % 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

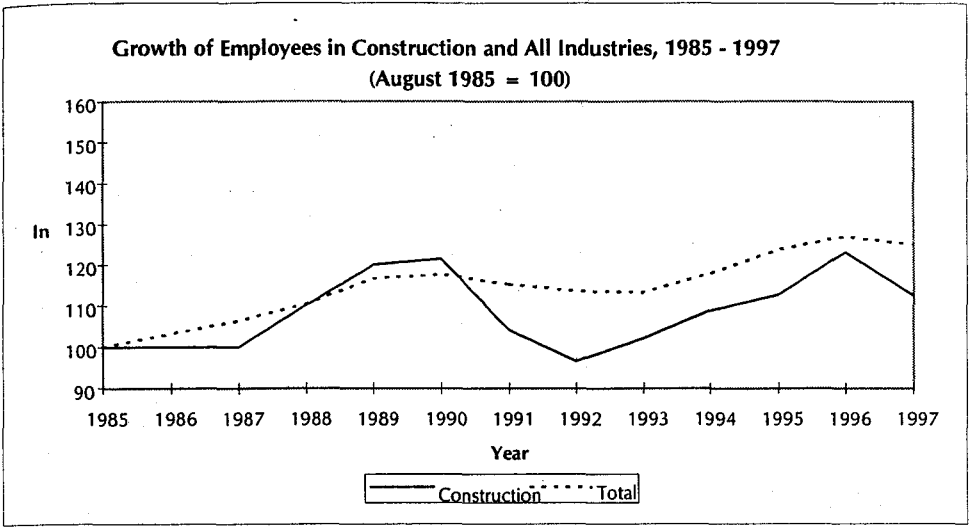
ABS *The Labour Force Australia*, Cat. No. 6204.0 and 6203.0

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

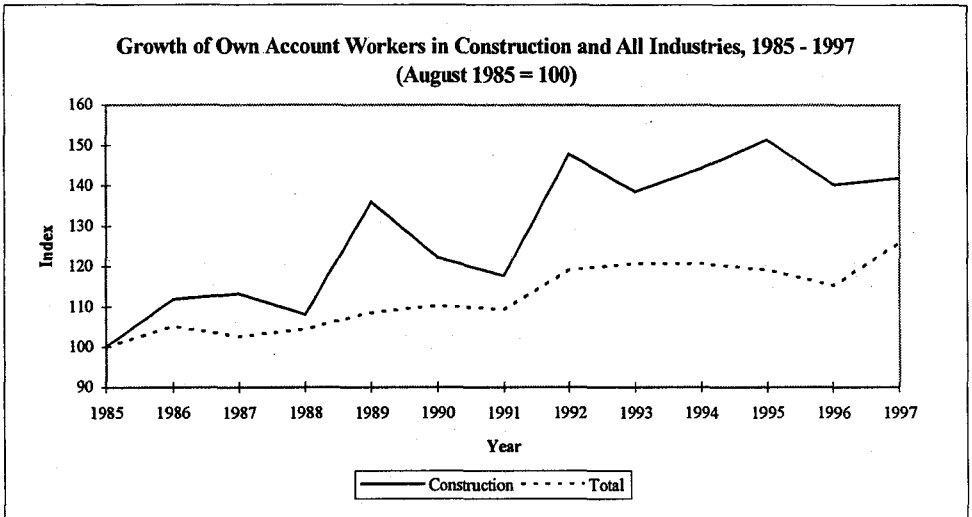
ABS *The Labour Force Australia*, Cat. No. 6204.0 and 6203.0

Figure 2



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

Figure 3

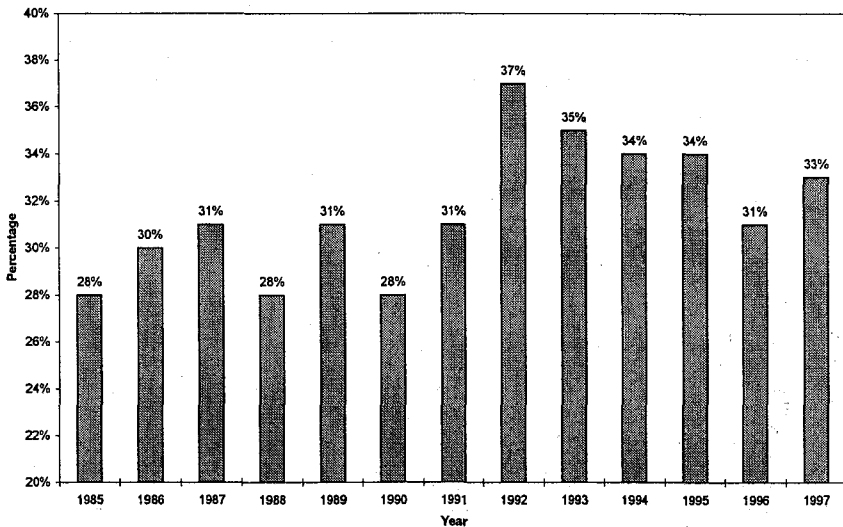


ABS The Labour Force Australia, Cat. No. 6204.0 and 6203.0

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 4. Own Account Workers as a Proportion of Employees and Own Account Workers in Construction, Australia, 1985–1997

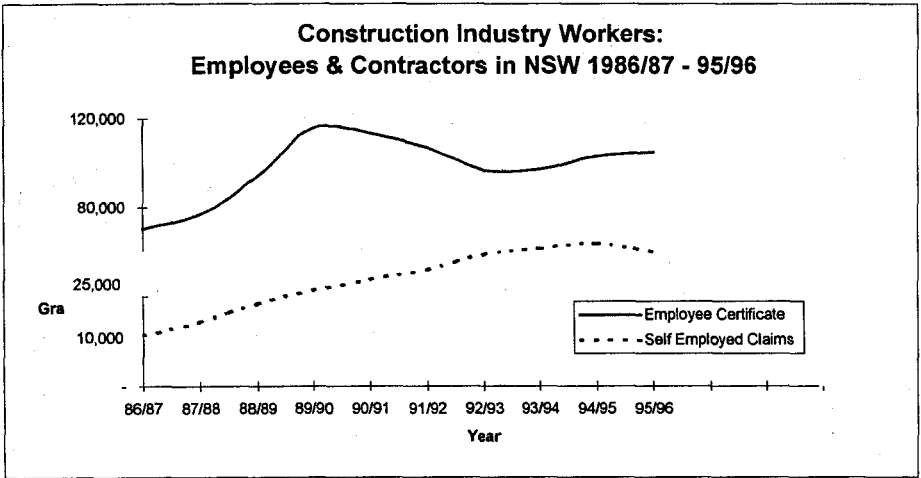


Source: ABS, *The Labour Force Australia*, Cat No 6204.0 and 6203.0

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.

The trends in the ABS data indicate that 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.⁶ 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 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 (Morehead et al. 1997). A number of the key indicators are provided in Table 4. 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 (%)
Workplaces Using		
Casuals	64	70
Agency workers	14	21
Workplaces Reporting Retrenchments		
200–499 employees	26	27
500+ employees	39	44
Unpaid Overtime		
Employees whose hours increased but pay did not		23
Falling Workplace Size		
% 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 indicates significant change in how workers are engaged in production 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: 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.⁷

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. 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

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
Total	63,759

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.

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

Source	Level (\$million)
PAYE	2,533
Prescribed Payment System (PPS)	1,585
Total	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.

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.

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.⁸ 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 7. 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 7. Estimates of tax paid by contractors in construction compared with their tax liability had they been treated as PAYE tax payers, Australia, 1994¹

Tax Status of Contractors ²	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.

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 ¹	3,773.81
Actual level of tax contributed by PPS workers ²	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) p. 85.

It is clear that potentially very large amounts of revenue are associated with people being treated as contractors 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.⁹

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: 2). Some consideration of these developments is important to appreciate just how dramatically a situation can change with considerable implications for public revenue.

Putting the projections in context: contractors in UK construction 1970–1997¹⁰

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 proportion of workers in the industry operating in the ‘black economy’ rose dramatically. It was referred to as ‘working on the lump’ – ie working for a lump sum, often on a cash in hand basis.¹¹ 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.¹² 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 marked 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 ‘contract-

tors'. 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: 13).

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: 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: 10-12 citing material from the UK industry publications *Construction News* 29/8/96 and *Taxa-*

tion, 1996). The losses to public revenue have been estimated to have been of the order of \$A4-8 billion per annum (Harvey 1995).

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 de facto 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 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, and 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. According to union sources it appears that the best way of addressing the sham contractor problem is to increase levels of regulation more generally. For example, regulations concerning safety and building standards covering all phases from design to execution provide 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 fair treatment of workers and discourages the use of legal fictions that reduce employment related entitlements for workers who are not genuine independent contractors.

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 address the potentially serious problem of sham contractors before it gets out of control. The UK experience reveals that the situation can get so bad that even a Conservative Government will eventually act to rectify the situation. The experience also shows it is very difficult to reverse the trend once sham contractors become widespread.

The UK experience shows that the changes required do not have to await legislative action. Major reform can be achieved by changing administrative practices and priorities. For example, improving the quantity and quality of information used to assess contractors is needed to 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. It is difficult, for example, to ascertain from the records of PPS contractors the frequent of hours worked with the same clients from week to week.¹³ Equally important are administrative priorities. By far the most significant feature of the recent UK initiatives has concerned the commitment by tax

authorities to act decisively on the issue. Reform did not have to await legislative change. Without such a commitment 'contractors' and those engaging them can live easy, free of any concern of scrutiny. The setting of deadlines to clarify precisely workers' employment status and the possibility of back payments where sham arrangements are uncovered 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 for situations involving the provision of labour services. Recent developments have highlighted how such legal fictions enable unscrupulous employers to evade employment obligations to their workers. 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.

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, while the evidence is patchy, that which is available indicates that many new contractors are dependent and not independent 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. Indeed this fact appears to be receiving overdue policy recognition with initiatives associated with the 'Pay as you go' system and proposals to restructure PPS arrangements.¹⁴ It is vital that policy debate in both tax and labour market reform examines issues such as these. It is even more important that taxation and labour market researchers examine the underlying 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.

Notes

- 1 It should be noted that the Australian Bureau of Statistics does not collect information on 'contractors' as such. The most comprehensive time series information concerns long standing categories of employment status. These are defined as involving: employers, employees and own account workers. 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. More recently the ABS has released material on what it defines as owner managers of incorporated businesses. While these workers are formally 'employees' of the corporate entities they own in reality they are more akin to employers and/or contractors. See for example the excellent commentary in the July 1997 issue of the ABS's *Labour Force Australia*, Cat No 6203.0 and the latest material in ABS, *Forms of Employment*, Australia, August 1998 Cat No 6359.0.
- 2 *Vabu Pty Ltd V Commissioner of Taxation* (1996) 40 AILR para 5-100
- 3 The CCH *Australian Labour Law Reporter*, one of the leading guides for legal practitioners, characterises the additional tests as falling into five different groups: (i) the pragmatic approach, (ii) the business test, (iii) the integration test, (iv) the 'Ready Mix Concrete' test, and (v) the intention of the parties.
- 4 For a similar sentiment from the academic research see Collins' (1990: 369) comment that the tests for defining an 'employee' are indeterminate and 'do not provide clear criteria for settling borderline cases.'
- 5 For an account of similar developments in the UK see Harvey 1985 pp 10-13.
- 6 The limited information that has been released by the ABS on owner managers of incorporated enterprises confirms, however, the growth in contractor forms of employment. It reveals that the number of construction workers falling into this category increased from 41,500 in 1986 to 77,000 in 1997. As a proportion of the total construction workforce they have increased from 9.5 per cent to around 13.3 per cent. See ABS, *Labour Force Australia*, Cat No 6203.0 July 1997 and allied information on industry employment for those years.
- 7 Statistics recently released by the ABS reveal that levels of 'dependent contractors' are highest in the transport and storage and construction industries. In August 1998 the ABS reported that 15.2 per cent of all contractors were dependent, in however in these industries 34.7 and 24.1 per cent respectively were dependent. See ABS, *Forms of Employment*, Australia, Cat No 6359.0 p. 21.
- 8 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.

- 9 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.
- 10 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 (Union of Construction and Allied Trades and Technicians) 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. For an excellent overview of UK developments see Harvey (1995).
- 11 This expression predates the 1970s. The prevalence of the practice became more widespread, however, from that decade onwards.
- 12 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. See Harvey (1995) for more details.
- 13 It is a major irony of that new tax reforms about to be implemented will further reduce the quality of information associated with contracts workers. Currently those paying PPS have to provide details of the sub-contractors that work for them on an annual basis. Under the new tax system this will not be case – such subbies will simply become another source of supply of services for GST purposes. This streamlining of 'red tape' is more than an administrative change it will amount in reduced levels of accountability.
- 14 It is currently proposed that in 2002/003 a new system to replace PPS will limit entitlement to make deductions against income where, inter alia, 80 per cent of income from the provision of personal services comes from one source. Reforms of this nature were supposed to be introduced at the beginning of the 2001/2002 financial year but were delayed after intense lobbying by building industry employer groups. Whether the reforms are ever implemented remains to be seen. Assessing their labour market impact will also be important because what is intended will not necessarily eventuate as the history of PPS clearly demonstrates.

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