Inflexible Friend

By John Burton

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The new flexible economy and professional services

by

Professor John Burton

Adam Smith Institute

1999

Bibliographical information

This edition first published in the UK in 1999 by
ASI (Research) Ltd, 23 Great Smith Street, London, SW1P 3BL
www.adamsmith.org.uk

ISBN 1-902737-13-X

Set in palatino 12pt
Printed in the UK by Imediaprint Ltd

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John Burton is Professor of Business and Management at the University of Westminster, and Emeritus Professor of Business Administration at the University of Birmingham. He formerly held professorships at the Leeds Business School and the European Business School, and in 1984-7 he was Research Director of the Institute of Economic Affairs; in 1987 also he was a Special Advisor to the House of Commons Treasury and Civil Service Select Committee. Professor Burton is the author of 11 books and numerous journal articles in both business and economics.

Acknowledgements
The author would like to make acknowledgement to Andy White (Chairman) and David Ramsden (Director) of the Professional Contractors Group, the Chartered Institute of Taxation (CIOT), the Federation of Recruitment and Employment Services (FRES), the Association of Temporary and Interim Executive Services (ATIES) and the Federation of Small Businesses (FSB) for their help in the production of this study; and also for their invaluable specialist advice, to Kevin Miller (MA and FCA), and Tony Askham of Bond Pearce (Law Firm). All errors remaining are the sole responsibility of the author.

1. Introduction

All of the UK's major political parties, the Conservatives, the Liberal Democrats and the Labour Party, would today openly profess themselves to be pro-enterprise. This represents a *major* change in attitudes and emphases across the UK political-party spectrum: as compared with those witnessed in the 1950s and 1960s.

In those decades, the Labour Party was committed to the old Clause IV of its constitution — the gradual Parliamentary abolition of private enterprise via the nationalization of the means of production, or, at the very least, the commanding heights thereof. The Conservatives, although ostensibly committed to a more private enterprise stance, were in practice (with the exception of the steel industry) willing to accept the degree of nationalization adopted by the first post-WWII Labour Government. And the Liberals, now the Liberal Democrats, were, perhaps, somewhere in between. Moreover, in those decades, all major political parties were implicitly or explicitly committed to a philosophy of high volumes of public expenditure, and thus, taxation. All of this, it appears, has now changed. Why?

There can be no question that much of the explanation for this change may be directly attributed to two remarkable political entrepreneurs and leaders: Margaret Thatcher (Conservative Premier, 1979-90) and Tony Blair (Labour Premier from 1997). Mrs Thatcher, during her reign of power, massively rolled back the extent of nationalization in the UK via the strategy of privatization and, indeed, eventually, brought down the level of taxation as a percentage of Gross Domestic Product. Measures were also undertaken to deregulate the economy to increase competition and, more generally, to unshackle the forces of entrepreneurship in the UK.

It was Mr Blair's political genius to see that the Labour Party might never again win power in the UK *unless* much of the Thatcher Revolution was taken on board; and that there could be, under contemporary economic circumstances, no return to the conventional policy wisdom of a past age. The general message that he sent to his party was that we were living in a new economic environment: not just one shaped by Thatcherism, but also the requirement to adapt to a turbulent, global environment that was highly competitive. The skills of *adaptation* and *enterprise* would, of necessity, be at a premium, to allow the attainment of a successful UK economic performance. This was to become a basic theme of the ‘New ‘Labour Party, led by Tony Blair.

The New Labour government and the New Economy

On entering 10 Downing Street as Prime Minister in May 1997, Mr Blair declared, with the backing of a massive Parliamentary majority, that “We were elected as New Labour; we will govern as New Labour.” From the perspective of our analysis here, two themes within this broad vision are of special importance:

b) New Labour's acceptance of the New Economy

It is widely recognised by analysts from across the politico-economic spectrum that the conditions we face approaching the Second Millennium require a radically different economic policy paradigm to that which was widely held as correct in the UK and elsewhere in the old days of the 1950s and 1960s.

In those decades, the politico-economic consensus within the UK economics establishment, and within the UK's leading political parties, was towards the use of *macro*-economic policy (ie aggregate monetary and fiscal measures) along variations of Keynesian principles, in order to boost, or to slow, the overall workings of the UK economy. *Micro*-economic analysis, and associated policy measures — regarding incentives, entrepreneurship, competition and efficiency — were then very much on the back-burner of the economic policy debate, compared to macro-economic analysis and policy.[1]

The deficiencies of this simplistic bastardised Keynesian approach were to become apparent towards the end of the 1960s and during the 1970s in the UK and elsewhere. The advent of Mrs Thatcher's successive governments (1979-1990) were to see a switch towards an emphasis upon *micro*-economy policy — privatization; the attempt to resurrect an entrepreneurial culture; and the shaping of general government and fiscal policy to seek to create a UK regulatory climate in which entrepreneurship might flourish more widely.

This emphasis has continued, at least in theory, under the UK's ‘New Labour’ Government since May 1997. To quote from amongst many possible examples, Prime Minister Tony Blair made a major speech in early July 1999 extolling the role of entrepreneurship in today's ‘New Economy’. The Prime Minister said:

> I exaggerate to make a point, but there was something fundamentally anti-meritocratic about our culture [in the past]. The old Right-wing elite regarded entrepreneurs as beneath them. The Left regarded them as anti-social. It [this attitude] is changing, but not nearly fast enough.[2]

The Prime Minister praised the USA for promoting innovation and enterprise, and argued that Britain and, indeed, the entire EU, must follow this same general route. This overall line is followed by *all* of the present UK Government's primary economics and business ministers: for example, the Secretary of State for Trade and Industry, Stephen Byers:

> 'Yesterday, Trade Secretary Stephen Byers repeated the New Labour Mantra about promoting enterprise. "We want to create an environment where more entrepreneurs emerge and are successful"'.'[3]

Virtually all of us, citizens in a mature democracy, and with a free press and media, are aware that politicians of all persuasions sometimes make political statements to which, in fact, they are not totally committed: eg, "We will not devalue the Pound Sterling" — statements which were made with immense emphasis prior to the governmental devaluations of Sterling by both Labour and Conservative Governments over the past 30 years.

There seems no reason to doubt the sincerity of Mr Blair and his governmental team in their enthusiasm for promoting enterprise. This philosophy was, in particular, emphasised by Mr Gordon Brown, the Chancellor of the Exchequer, in his Budget statement of March 1999. In opening his speech, he declared it was a `pro-enterprise' Budget — one for a `new economy and a new century'.[4]

There are, however, certain questions to be asked of the Government's economic policy towards promoting enterprise. Crucially, what is the 'New Economy'? And, in practice, are governmental policies and proposals likely to promote the elements of flexibility and enterprise that the New Labour Government clearly sees as major elements within this?

c) New Labour and 'Joined-Up Government'

The foregoing questions are emphasised when we also take into account Mr Blair's commitment to 'joined-up government.' In general, this concept is common-sense and indeed commendable. It is based upon the often accurate observation that, historically, British government economic and other policies have often been disjointed, and indeed in conflict with one another — emanating as they did from varied Departmental fiefdoms, each of which had a different portfolio of responsibilities and objectives. The result, too often, was a mish-mash of policies in apparent or implicit collision with one another.

It was Blair's intention, upon assuming office, to alter this chaotic system by providing 'strong pressure from above, infusing the policies and action of the departments below' in a more integrated manner than before.[5] This has involved, *inter alia*, a boosting in the quality of the members of the No 10 Policy Unit; the strengthening of Prime Ministerial control over the Cabinet Office; and the downgrading of cross-departmental committees, which used to conduct inter-departmental horse-trading over policies, by the establishment of two Cabinet Office units. These are the *Social Exclusion Unit* (SEU), which is concerned with the matters of social deprivation; and the *Performance and Innovation Unit* (PIU) which, theoretically, covers everything else requiring co-ordinated governmental decision-making. Moreover, these powerful units have the power to invent their own policy initiatives, rather than simply seeking to mediate between the Departmental baronies.

At the same time, in the general cause of 'joined-up government,' the powers of the Treasury have been considerably enhanced also. It might seem on paper that the Treasury's span of control has in fact been reduced since 1997, since control of the level of interest rates has been given over to the Bank of England; whilst Government Debt management policy is now also under the control, not of the Treasury, but instead of a new and independent Debt Management Office.

These changes, however, have simply given the Treasury more time to *expand* its activities into areas that

> used to be the preserve of other departments. The justification, say Mr Brown's advisers, is easy. The Chancellor's job is to shape *any* policy with a bearing on Britain's economic performance. And in his view this includes not just boring old macro-economic stability, but also productivity, labour markets and inequality.'[6] (my itals).

On rhetoric and realities

We have recorded New Labour's commitment to both the 'New Flexible Economy' and to 'Joined-Up Government:' so that, in theory, policy practice across the board should reflect overarching policy goals.

It is an old saying, but nevertheless a very true one, that 'some things are easier said than done.' For example, whilst the trio of Mr Blair, Mr Brown and Mr Byers have been avidly proclaiming their pro-enterprise credentials, it is being reported widely that the mounds of new legislation affecting employment currently emanating from Brussels and Whitehall is seriously affecting the ability of UK small-to-medium-size enterprises (SMEs) to simply ingest, let alone cope with, this torrent of new legislation. It includes:

- The *Working Time Regulations* (limiting the average working week to 48 hours across 17 weeks)
- The *Asylum and Immigration Bill* (requiring employers to provide documents *proving* an employee's right to work in the UK)
- The Introduction of the *Minimum Wage*
- The Implementation of *Working Families' Tax Credits*
- The *Employment Relations Bill*, which stipulates that part-time workers must not face discrimination by, for example, unfair dismissal
- The forthcoming *Employment Agencies Act*, which is expected to place new restrictions on such agencies
- Changes in *VAT and NI Charges*
- Forthcoming regulation requiring companies to *grant recognition to Trade Unions*.

Much, although by no means all , of this tidal wave of employment-affecting regulation emanates from Brussels, and not just Whitehall. It would take a treatise in itself to even begin to evaluate its impacts upon the UK economy. Fortunately, this has been done already elsewhere in large part, with the general conclusion that the overall results of this wave of new legislation are likely to lower the level of employment in the UK economy, and to reduce its labour market flexibility.[7]

This new wave of employment legislation will also add considerably to the costs and risks of small businesses in particular:

> A recent Peninsular Business Services survey of more than 2,000 [small, UK] business owners found that 71% did not understand the minimum wage [complexities] and 42% did not understand the working time regulations, six months after their introduction. About 70% said they had experienced disputes about individual workers' rights because of uncertainties about the new legislation...'[8]

Clearly, many small UK firms are likely to simply pray that what they are doing is correct, but if they are caught, the financial penalties involved could well bankrupt them.[9]

The outlines of this wave of employment regulation have been extensively reported in the press — and have inevitably engendered a considerable reaction from businesses both large and small. This political reaction was, apparently, sufficient to induce the government to promise, in mid-July 1999, a halt to the new tide of business regulation:

> Trade Secretary Stephen Byers yesterday promised anxious business leaders: no more red tape. He promised the Government will put a block on new and burdensome regulations until the next general election.[10]

Unfortunately, as we shall see in the next chapter, despite Mr Byers' general and blanket assertion, there are in fact major developments embedded in the Government's existing plans which can only create a morass of red tape and other complications for a key component of the UK's New Flexible Economy: the provision of professional services via limited companies. Moreover, as we shall see, the costs and consequences of these proposed developments in policy may well dwarf those of the measures referred to above.

The further contents of this monograph are as follows. Chapter 2 outlines the governmental proposals in the pipeline that will affect the provision of professional services via limited companies and by other means. Chapter 3 then outlines the role of such provision within the context of the developing 'New Economy' in the UK, and the forces that have been driving this development. Chapter 4 examines the organisational and market implications. Chapter 5 then examines the consequences of implementing these proposals as they stand; and Chapter 6 offers some brief final conclusions.

Notes to chapter 1

[1]. It needs to be added, not least for reasons of historical accuracy, that John Maynard Keynes (1883-1946) — unquestionably one of the Great Economists of the Twentieth Century — was *himself*, in all of his writings, keenly aware of the vital role of entrepreneurship, and the "micro-side" of the economy. Subsequent to his early and untimely death, these subtleties in Keynes's thought were down-played in many interpretations; so that Keynesianism became equivalent to an overly-simplistic macro-view of the economy.

[2]. P O'Flynn, `Copy US and Don't Envy the Rich, says Blair', *Daily Express*, 7 July 1999, p.2.

[3]. *Daily Mail* `Comment', `The Betrayal of British Enterprise', 1 July 1999, p.12.

[4]. Quoted in the `Bagehot' column: `All Men are Created Fair', *The Economist*, 13 March 1999, p.48.

[5]. *The Economist*, `Whitehall's Cultural Revolution', 21 August 1999, pp. 19-21.

[6]. Cited from the article quoted in Note 5.

[7]. J T Addison and W S Siebert, *Regulating European Labour Markets: More Costs Than Benefits?*, London, Institute of Economic Affairs, Hobart Papers 138, 1999.

[8]. S Gracie, `Coping With a Tide of Red Tape', *Sunday Times*, 30 May, 1999, p.13.

[9]. It is estimated that companies with only between one and four employees in the UK need to pay *already* something of the order of £288 per worker in order to meet full compliance with employment legislation, whereas the comparative figure for companies with more than 5,000 workers is around £5 per head, owing to the spreading of overhead personnel administration and legal costs. Quoted in S Gracie, *op cit*.

[10]. Quoted in S Doughty, `No More Red Tape, Byers Tells Business', *Daily Mail*, 15 July 1999, p.32.

2. Undermining self-employment and enterprise by stealth

It has been commented widely that the Budget announced by Mr Gordon Brown in March 1999 was, when considered historically, one of the most complicated ever to be presented to a UK Parliament. As *The Economist* noted in a lead article at the time:

> Critics will charge that this is a [Budget] policy of all things to all men ... [W]e question only whether he has any idea what he's doing.'[11]

It also assessed, in a more detailed account, that `for small and medium-sized enterprises, peculiarities [in the 1999 Budget] abound' in particular.[12] One such peculiarity that *The Economist* did not pick up , however, was the text of an Inland Revenue Press Release of 9 March 1999 relating to the Budget, numbered 'IR35' for short, and sub-titled 'Countering Avoidance in the Provision of Personal Services'.

This chapter briefly explains the implications of IR35; and also comments on the seemingly associated new Clauses 70 and 71 of the Welfare Reform and Pensions Bill currently before Parliament. It will also examine Clause 20 of the Employment Relations Bill, also before Parliament at the time of writing.

The content and intentions of IR35

The press statement announced the Chancellor's intention to introduce fiscal changes in the year 2000 'to counter avoidance in the area of personal service provision'. To quote more fully, IR35 alleges:

> There has for some time been general concern about the hiring of individuals through their own personal services companies so that they can exploit the fiscal advantages offered by a corporate structure. It is possible for someone to leave work as an employee on a Friday, only to return the following Monday to do exactly the same job as an indirectly engaged 'consultant' paying substantially reduced tax and national insurance.'[13]

The statement claimed also that there 'is no intention to redefine the existing boundary between employment and self-employment'; only to catch those cases which in effect constituted 'disguised employment' through the use of an intermediary such as service companies or partnerships. Moreover, the professed intention of the proposed legislation is to ensure fair competition between those enterprises employing labour directly and those utilising 'disguised employees'; whilst also protecting the latter group, which, IR35 argues, lose out on significant employment rights (for example, entitlement to notice, redundancy pay, sick pay, maternity or holiday leave, social security benefits, etc).

In subsequent, sparse, material on these matters emanating from the Inland Revenue, it was to appear that implementation of the proposed legislation would involve:

1: A test of ‘control’ regarding the catchment of ‘disguised’ employees; and
2: some form of associated ‘Certification Scheme’.

A brief commentary is necessary upon both of these matters:

a): The test of ‘Control’

According to the limited information revealed by the Inland Revenue, whether or not a ‘disguised’ employee is caught by the proposed legal provisions in IR35 will depend upon the workings of a control test. This concept has sources both in law and economics.

On the legal side, this apparently was one of the first tests drawn up by the courts to determine whether or not a worker constituted an ‘employee’, and derives from early Victorian case law. Under this, it was the legal right of the master to issue orders, and for the servant to obey these instructions; in other words a servant is subject to ‘control’ by the master — in a way that an independent contractor was not.

On the side of economics, the control test may also be seen as emanating from the Coasian view of the distinction between firms and markets.[14] Outside of the firm, Coase argued, production was co-ordinated by transactions and contracts; inside of the firm by *command and control* — by bosses giving orders to employees.

Is, then, the proposed control test firmly grounded in both law and economics? This, very definitely, is not the case. First, it appears that the courts in reality since early Victorian times have used a *far wider* series of tests to determine whether or not a worker is an employee than that merely of the control test — taking now into account, for example, the economic reality of the situation (eg, who bears the risk of losses and the prospect of profits); the duration of the relationship; and how the individual is paid, amongst other criteria.[15]

In short, the control test is *not*, according to contemporary employment lawyers, sufficient on its own to establish whether a worker is an employee or not. Indeed, cases may be cited whereby an independent contractor has been subject to the same degree of control as a ‘servant,’ yet the courts have held that contractor *not* to be a servant or employee.[16]

Second, as regards economics, the Coasian view of the firm, as a mini-planned economy/command and control system, has come to be increasingly superseded in contemporary economic analysis by what is sometimes called the ‘contracts view’ of the firm, and which sees no clear distinction between relations inside the firm and those outside.[17] Thus:

> From a contracts point of view, the economics of firms does not differ sharply from the economics of markets. There is no ‘firm mode of production’ ... separate and distinct from the market mode. Both firms and markets entail contracts, the firm differing only in the nature of those contracts.[18]

In summary, if this control test is to be the basis for the application of the legislation proposed under IR35, then this is highly inadequate from the perspectives of both employment law and contemporary economics.[19] The application of such a simple — and clearly poorly founded — test is bound to give rise to innumerable anomalies and inconsistencies in our complex New Economy.

b) The IR35 certificate or registration scheme

No details of the associated certification or registration Scheme have as yet been published at the time of writing. It is therefore impossible to gauge at this stage how arduous and time-draining compliance with this requirement will be for independent professional contractors. The promise of the introduction of such a scheme in year 2000 , however, does not sit well alongside the claim by Stephen Byers (See Chapter 1) that the Government has introduced a moratorium on *any* more red tape facing businesses until after the next General Election, which, presumably will be in 2001 or 2002.

New Clauses 70 and 71 of the Welfare Reform and Pensions Bill

These amendments to the Welfare Reform and Pensions Bill, currently before Parliament, seek to give the government powers to impose national insurance contributions that parallel the tax consequences of IR35.[20]

The clauses make clear that the regulations will apply not only to personal service companies, but to any body, corporate, unincorporated or partnership, of which the worker is a member; and that they will apply with regard to any such certification procedure as may be established for these purposes by the Treasury or Inland Revenue.

Clause 20 of the Employment Relations Bill

This also is a complex Bill covering many matters — including parental and maternity leave, trade union rights and the definition of unfair dismissals.

Clause 20 is of particular significance in regard to our concerns here as it will provide the government with powers to grant to all workers employment rights that are currently given only to employees. In short, ‘we are all employees now’?

Some interim conclusions

Whilst IR35 was at pains to stress that ‘a primary concern is to minimise any impact of these [proposed] changes on ordinary businesses not involved in [tax] avoidance', it is difficult not to foresee that the entire trend of the prospective legislation described above may have far-reaching consequences for the survival of self-employment and micro or small enterprises in the UK:

- IR35 itself could or would imply that a large majority of such workers are liable to deduction of income tax as if they were employees (subject to the details of the ‘control test’ and the ‘certification or registration scheme’);

- New Clauses 70 and 71 of the Welfare Reform and Pensions Bill will allow the Government to charge national insurance contributions in these circumstances also; and

- Clause 20 of the Employment Relations Bill also, in effect, grants to Government power to transform the formerly self-employed into employees, in terms of employment rights.

A very plausible scenario, as a result of these manifold proposed changes, is the virtual emasculation of the self-employment sector of the UK economy. Under the proposed rules, workers with their own companies will need to get a certificate before they are allowed to accept payments before tax, and to get the certificate they will have to agree to paying themselves the fee as a salary only, with tax deducted through the PAYE system, as well as NI contributions. Without the certificate, the contractor will be treated as if they are direct employees of the firms with whom they contract — with tax and NI contributions deducted at source.

In short, the implementation of these proposed legislative changes is likely to result in a considerable reduction in the area of self-employment and micro-enterprise in the UK, and the transmogrification of this entrepreneurial sector into a category of employment — or *unemployment*. It is, in effect *a tax on entrepreneurs*. As one leading accountant, John Whiting of Price Waterhouse Coopers, has suggested:

> The [current] government is using a sledgehammer to crack a nut — thousands of small businesses could be forced to shut up shop.[21]

To come to this conclusion at this point is perhaps to jump the gun. This chapter has been concerned primarily to itemise, rather than to analyse, a series of governmental legislative proposals.[22] The next chapters are concerned more with the latter objectives.

Notes to chapter 2

[11]. `Toil and Muddle', *The Economist*, 13 March 1999, p.17.

[12]. `Business and Competition', *The Economist*, 13 March 1999, p.35.

[13]. Inland Revenue Press Release No IR35, 9 March 1999, Para.2.

[14]. So called because it was first put forward by Ronald H Coase in a famous article, `The Nature of the Firm', *Economica*, Vol 4, 1937, pp.386-405.

[15]. An Inland Revenue booklet (IR56 / N139) entitled *Employed or Self-Employed* follows the same general criteria as those emanating from contemporary UK employment law tests.

[16]. See *Ready Mix Concrete (South East) Limited v Minister of Pensions and National Insurance [1968] 2QB 497*.

[17]. S N S Cheung, `The Contractual Nature of the Firm', *Journal of Law and Economics*, April, 1983, pp.1-21.

[18]. T Cowen and D Parker, *Markets in the Firm: A Market Process Approach to Management*, London: Institute of Economic Affairs, Hobart Paper 134, 1997, p.44.

[19]. Coase has himself conceded in much later writings that in his original (1937) paper he had emphasised the employment relationship / "command and control" aspects far too much as the distinguishing feature of firms. See R H Coase, `The Nature of the Firm: Origins' in O E Williamson and S G Winter (eds), *The Nature of the Firm: Origins, Evolution and Development*, Oxford: Oxford University Press, 1991.

[20]. Currently a contractor who operates through a personal services company (PSC) may avoid national insurance contributions to some degree by paying themselves dividends instead of income.

[21]. Quoted in A Wyllie, `Self-employed Face Assault from Taxman', *The Sunday Times*, 25 July 1999, p. 4.6.

[22]. Although the present writer has "some" familiarity with the interface of business, economic and legal issues, I can in no way claim to be an expert upon employment law. In this regard, I must express here my deepest gratitude to Mr A J Askham, of Bond Pearce lawyers, for his invaluable guidance on some of the legal intricacies involved in this chapter. Any errors remaining are of course my own responsibility.

3. The New Flexible Economy: some key forces

Chapter 1 detailed the New Labour Government's ostensible commitment to the 'New Flexible Economy' that, it is argued, the UK will need to survive in today's competitive global economic environment, and for the foreseeable future. But what exactly is this 'New Economy'? We need to ask this question in order to assess whether the proposed legislative measures outlined in this chapter are likely to help or hinder the workings of the 'New Economy'.

What is the 'New Flexible Economy'?

Some commentators identify the 'new flexible economy' which has emerged primarily in the USA and the UK with the growth of what is often termed the *contingent work force* — that is, the component of the overall workforce which is composed of part-time, (and often lower paid) semi- or unskilled workers. In the most disparaging descriptions, this component of the work force is sometimes referred to as 'Mcjobs' (ie low-paying, usually part-time, and routine service sector work).

Two points need to be noted at the outset concerning this. First, the growth of the contingent work force is much less than is widely presumed — in fact, between 1983 and 1993 the fraction of the US work force in this category did not vary significantly *at all*.[23, 24] Secondly, the contingent work force is not the same thing as the *flexible work force*. According to conventional definitions in labour economics, the latter refers to self-employed persons — particularly independent contractors — and those obtaining jobs through the personnel supply services (PSS) industry.[25] The common characteristic in both latter cases is that the parties involved expect the contractual relationship to dissolve at some point in time, and for the worker to become engaged with other parties and projects, whereas part-time work may be of a long-term character.

This study will be concerned much more with the *flexible* work force as defined, rather than the contingent work force.

The flexible labour force and the new flexible economy

Is, then, the 'New Flexible Economy' to be identified solely with the existence and size of the flexible labour force? The answer is, decisively, in the negative. The role of the flexible work force *is* an important aspect of the 'New Flexible Economy' — but it is only *one* aspect of the overall concept — and in part derives from, or is closely intertwined with, other aspects of the overall notion and system that is evolving.

For our purposes 'New Flexible Economy' can be defined in terms of the following criteria:

1. The growth and importance of business and professional services
2. The refocusing of firms

3 The growth of outsourcing
4 Strategic networks and the boundaries of the firm
5 Economic turbulence in the contemporary industrial revolution
6 The role of entrepreneurship, micro-enterprises and the flexible work force.

These are discussed in turn below.

1 The growth and importance of business and professional services

A notable feature of general economic development over the past three decades in particular has been the rise in the share of Gross Domestic Product (GDP) accounted for by the services or tertiary sector, as against the manufacturing (secondary) and the agricultural or extractive (primary) sectors of the economy.[26]

Indeed *all* of the supposedly advanced industrial economies, including the USA, the UK, France, Germany, Japan, etc, are now — in terms of employment and GDP — *primarily* service-based economies.

For example, in the USA — which is the most tertiarised of all economies today — over 70 per cent of jobs are in the service sector.[27] Despite fears about the economic consequences of such de-industrialisation, it also has to be noted that this tertiarisation of the US economy has not exactly made it poor. According to the World Bank's latest World Development Indications, the USA still ranks — after tiny Luxembourg[28] — as the country with the second-highest GDP *per capita*, adjusted for differences in living costs; what economists call ‘purchasing power parity'.[29]

This trend towards a service based-economy was foreseen by the pre-eminent American sociologist, Daniel Bell, a quarter of a century ago.[30] Bell also foresaw, presciently, the vital importance of what he called `the professional and technical class' in the occupational structure of the emerging post-industrial society. This, too, is indicated by the longitudinal data, as we shall see directly below.

National accounts statisticians do not classify workers into classes using sociological terms; but they do record a category known as *business or professional services*, which is commonly taken to include:

- Management and economics consultancy
- Accounting and auditing
- Advertising and market research
- Public relations and governmental relations
- Computing, IT, and MIS services
- R&D work (eg, applied science; new product development)
- Engineering and related consultancy
- Operational services (eg, logistics; facilities management; exim management)
- Recruitment, personnel and training services
- Design consultancy
- Legal services

- Architectural firms
- Security management

The data reveals that, within the service sector in general, it has been this seemingly polyglot category of *business and professional services* that has seen the most rapid growth in many advanced countries over the last three decades. For example, one study found that:

> In most countries [business and professional services] have more or less trebled their share of the total work force between 1980 and 1987.[31]

Some analysts see the providers of business and professional services as 'mediators' between individual enterprises and their complex outer environments.[32] I shall argue, to the contrary, that a business and professional service contractor does not typically supply an intermediary function but, rather, complex types of advice and capabilities to other organisations, which are then used as inputs by the purchasing concern (eg, engineering advice on project work; the sale of research on biotechnology by specialist producers of such knowledge to major pharmaceutical firms; the provision of IT / MIS advice to organisations installing major new systems; management consultancy to advise firms undergoing complicated restructurings; etc).

Such suppliers of complex-capability based *services* are to be distinguished from other types of producer services, such as the routine provision of contract cleaning, catering, and laundry to other firms, by their intensive utilisation of knowledge capital and human capital.

In this role, the provision of business and professional services constitutes one of the main avenues whereby society's often rapidly changing stocks of knowledge capital are formed, augmented, and inserted into the general process of value production within the modern or 'New' economy.

Consider the case of the computer — which must be seen as a central component of the contemporary economic revolution. The production of the modern personal computer

> involves almost trivial expenditures upon new materials and unskilled labour. The primary constituent of their cost (and value) represents payments to science / engineering / design-based firms (such as Microsoft and Intel).'[33]

More generally, it is clearly the situation that modern manufactured goods of absolutely all types — from trucks to TVs, and from aeroplanes to agrichemical products — embody very significant inputs of the services which I have styled as of the complex capability type: or what the national accountants label as 'business and professional services;' or, even more simply, what the business guru Peter Drucker terms as the outputs of 'knowledge workers.'[34]

This leads on to an important question, however: *why* it is necessary in the New Economy for so many of the cadre of knowledge workers — who are so vital to contemporary economic progress — to be independent contractors: Is tax avoidance the answer (as IR35 seems to imply)? We shall see below that there are, to the complete contrary, other powerful forces in the New Economy that explain this development.

2 The refocusing of firms

Historically, in what might be called the 'Old Economy' (in the 1950s and 1960s), the trend in America and Britain seemed to be towards large firms — and for these large firms to become larger and larger, by means both of greater vertical integration and by diversification into other lines of business.

It was this trend that the Harvard economist John Kenneth Galbraith projected as the 'future of capitalism,' in a number of his writings.[35] However, what we have actually witnessed in the 1980s and 1990s in both the US and the UK is the very opposite of Galbraith's prophecies — that, over these two decades, there have in fact been trends observable amongst the ranks of large American and British firms towards:

- Vertical de-integration
- The divestment (eg, by management buy-out) of many subsidiaries; and
- A tendency towards the breaking-up of large conglomerate firms.

Of course, large firms remain in America and Britain; but the evidence on the trends referred to above is clear.[36] What has been going on? Why did Galbraith get it wrong?

Essentially, there has been an increasing realisation — driven and backed by market pressures — that many of the 'Old Economy' behemoths were extended quasi-bureaucratic empires that managers and executives had allowed to over-expand and become flabby. In this context it is pertinent to remember that executive compensation in large companies in the West during earlier decades was most commonly tied to the size and growth — rather than the *profitability* — of the corporations that they headed, theoretically on behalf of shareholders.[37]

The growth of competition — and especially *international* competition, due to the increasing liberalisation of international trade — over recent decades, was to expose the unprofitability of many parts of the old-style vertically-integrated, diversified, conglomerate-style company. Many of those companies — or, at least, the ones that survived — were increasingly to realise that they might be likened to dinosaurs rather than invincible giants. Moreover, this recognition was to be keenly enhanced from the mid-1960s onwards by the increasing salience of the market in corporate control — ie, the threat of takeover for underperforming corporations.[38]

These forces have encouraged, if not often impelled, a return to corporate specialisation.[39] Or, to put the matter in other terminology, large British and American companies have increasingly been led by the competitive and market pressures described above to try to refocus down into what really are their underlying core competencies and capabilities — meaning by the latter, the special skills embedded in the corporation that are capable of generating unique customer value, and which are difficult for their competitors to imitate, or to procure via the market..[40]

This refocusing towards core capabilities by large companies has been especially marked in America and Britain during the 1980s and 1990s; and less evident in continental Europe, in many of the countries of which the market in corporate control works in a less efficient manner to police managerial empire-building. However, the same trend is increasingly evident today in France, Germany and Italy.

3. The growth of outsourcing

The converse side to the trends described in (2) above has been the growth of 'outsourcing:' that is, the increasing use of external suppliers to provide activities and functions previously undertaken within the firm.

The incentives for firms to outsource some of their activities include:[41]

i It allows them to delegate to other suppliers the provision of their non-critical activities, and to free up their ability to concentrate upon their own firm's core activities and capabilities;

ii It allows the external suppliers and contractors to achieve economies of specialisation by concentrating their own efforts upon certain activities, and spreading their overhead costs by providing similar services to a number of different client firms;

iii It is also likely that specialised business service / external professional providers are likely to be more efficient than within firm units as the former are subject to the spur of open market competition, whilst the latter are not so pressured (and, indeed, may often be treated as an overhead cost of production).

It is clearly these forces, emanating from factors (2) and (3), which account primarily for the rapid growth of business and professional service contractors over the last couple of decades, rather than the dubious tax advantages held by the Inland Revenue to be involved. I would also suggest strongly that this would represent a commonplace and consensus view of the matter amongst experts in the fields of business and management.

In principle it would be possible for a firm to outsource any of their functions and activities, ranging from accounting through computer services and customer service provision, to engineering and manufacturing, and materials management. Indeed, it is also possible to outsource the human resources management aspects of the firm or its very administration.[42]

In reality, however, it would be obviously unwise for a firm to outsource any of the core competencies upon which it relies for the sources of its unique competitive advantages. Contemporary developments and forces have thus created in the 'New Economy' far greater possibilities for outsourcing functions and activities to independent, external contractors than existed formerly. But, at the same time, there are limits to this process which will vary from firm to firm, according to their own realm of core capabilities. We return to the implications of this important point in Chapter 4.

4. Strategic networks and the boundaries of the firm

The foregoing discussion has led to the conclusion, thus far, that in the ‘New Economy’ of companies refocused down to concentrate upon their core capabilities, it is both necessary and economical for the new streamlined company to rely upon an array of external independent contractors to some degree. It would be possible, however, for a firm to *over*-subcontract.

These relationships between firms and their trusted subcontractors are commonly now termed as networks or strategic networks.[43] These networks may assume a variety of forms,[44] but of particular relevance to our concerns here is the so-called *dynamic network* structure, in which a firm retains its core activities in-house, and then outsources many other functions to separate small companies or individual contractors who are coordinated or brokered by a small headquarters which is connected to other elements of the network electronically. For example, a fashion company may typically operate as only a small HQ, but broker its distribution, design, advertising, accountancy, and manufacturing to other independent contractors.

Moreover, these networks may change dynamically; that is, the array of partners and contractors may change — as the hub firm changes its product or project array over time. These dynamic networks are of especial salience to fast-moving industries in which either the product line, as with fashion and films, or technology, as with IT and engineering, are in an almost perpetual state of flux.

The phenomenon of strategic networks has become so pervasive in the ‘New Economy’ that they are being deployed not only by small companies but also by the remaining industrial giants such as GE , the world's largest engineering corporation and General Motors, the world's largest car company. Indeed, some authors now assert that the very nature of ‘the firm’ has changed dramatically in the setting of the ‘New Economy’. Once upon a time, these analysts argue, the typical firm was properly as envisioned in the Coasian analysis (see Chapter 2 above) as some sort of command-and-control ‘fortress’. But

> In a world of strategic alliances [networks], the idea of a firm as a medieval fortress that invents, owns, controls all of its critical assets has faded... [A]s a result firms are enmeshed in spheres of alliances that link them with other organisations'.[45]

In the ‘New Economy’ some therefore argue that firms are no longer Coasian-style citadels but, rather, to be seen as open, porous and borderless organisations.[46]

This line of analysis might be seen as supportive of what could be labelled as ‘IR35-type’ thinking. If firms are now typically borderless organisations, enmeshed in a dense set of network relationships, are not then the network contributors effectively employees of the hub organisation?

On the contrary, however, the strategic network aspect of the ‘New Flexible Economy’ radically undermines the presumed thinking behind IR35 and associated legislative proposals, as explained in Chapter 2; and in a number of ways.

First, we need to remind ourselves that the old Coasian notion of 'the firm' as a little pool of planning with a 'command-and-control' system set amongst an area of markets was always basically flawed: the firm has always been a nexus of contracts and treaties with other parties.[47] The development of the 'New Economy', with its strategic network mazes, is simply making this underlying economic reality clearer to economic and business observers.

Second, and relatedly, the utilisation of independent contractors is not some tax avoidance mechanism (as IR35 implicitly assumes), but, rather, an ineluctable trend that enterprises are having to face up to in the context of the 'New Economy', especially.

Third, all of this talk about borderless organisations is, to use a technical economic phrase, completely up the creek. Enterprises in the 'New Economy' still, have to manage their 'boundaries' — meaning by this their contract structure and treaties, in a formidable network context. In *dynamic network* contexts in particular, which typically involve the extensive utilisation of external business and professional contractors, all partners are aware that, from project to project, and from problem to problem, the network structure can and often does change, often rather quickly and dramatically. The independent contractor of professional and business services to another firm in a network structure has always to be aware of these risks and uncertainties, as compared to an employee; they thus take on a greater element of uncertainty as compared to the latter. This matter is expanded upon in Chapter 4.

5. Economic turbulence in the contemporary industrial revolution

It is recognised widely that the world is undergoing an economic revolution: though of a different form to the first Industrial Revolution which emanated from England from about 1750 onwards.[48] An economic revolution is typically a multi-faceted phenomenon; the first Revolution involved, visibly but inter-relatedly, the widespread introduction of machinery into the process of production; the creation of a transportation system to both facilitate the specialisation of labour and to allow the distribution of the new mass-produced products. The first Industrial Revolution was also accompanied and allowed by major technological developments, such as the use of coal instead of charcoal in the production of iron; the application of the flying shuttle, the spinning jenny and the mule in the production of textiles; and the application of steam power.

The contemporary Economic Revolution is different in substance, but not in its fundamental nature. We have already noted that this, contemporary Economic Revolution involves services, particularly complex capability-based services, in the process of value creation; the refocusing of firms down to core capabilities, and the associated growth of outsourcing and of strategic networks, harmonised not only by the price system, but also by the pervasive utilisation of information technology and the computer; and associated information-transportation methodologies such as networked computers and the Internet. As part and parcel of the general transformation

> ... companies have found ways to achieve even greater efficiency — not by vertically integrating, but by *virtually* integrating. Today, operationally excellent companies view themselves and their suppliers and distributors not as discrete ... entities, but as members of a single product supply team. Streamlining the connections amongst team members eliminates duplications, delays, and even payment complications that come

> from arms-length hands-offs. ... Wal-Mart, a pioneer in creating these cost-cutting systems, today uses an electronic data-interchange system to send daily sales data to suppliers. The suppliers' computers integrate this data with, for instance, warehouse inventory information and sales forecasts to generate a new order, if one is necessary.'[49]

Once again, we are back to the question: if the modern economy is virtually integrated rather than vertically integrated, as in the 'Old Economy' of 1950s and 1960s vintage in the West, why not for tax purposes simply treat the independent contractors who are servicing these new virtual systems simply as employees of the new system? The next section of this chapter examines this question.

6. The role of entrepreneurship, micro-enterprise and the flexible work force in the contemporary economic revolution

An Economic Revolution is, by definition, a period of an accelerated rate of change, usually on many fronts simultaneously. In this process entrepreneurship plays a vital role,[50] not only in triggering the Revolution but also by generating a swarm of imitator entrepreneurs who follow the leaders, fill in niches, and provide the opportunities for new employment that are opened up by the Revolution.

In the context of the 'Old Economy' it was believed by many that economic dynamism and jobs growth sprang from the expansion of large companies, in countries such as the US and the UK. This was the message of J K Galbraith's *The New Industrial State*, referred to above.

Then in 1979 and the early 1980s came David Birch's famous research in the USA which suggested that most of the jobs in America actually came from small firms, not large firms.[51] This unleashed much controversy, but

> The role of small businesses in [US] economic growth and development is reasonably well documented for the past 20 years. The smallest firms, those with only one to nineteen employees created a disproportionate share of net new jobs in six of the seven two-year period between 1976 and 1990...... since approximately [in the US] three to four hundred thousand firms begin new every year, firm formations create 1.5 to 2.0 million jobs annually.'[52]

Such figures intimate that in the 'New Economy' the majority of net new jobs are generated by small, not large, companies — and that the 'New Economy' is being driven by new firm entry created by entrepreneurs in an era of extensive innovation.

To remind ourselves (see chapter 2) it is precisely this flexibility of the US economy that Prime Minister Tony Blair has praised, and argued that Britain must emulate.

Interim conclusion

This chapter has reviewed a number of key features and forces in the emerging 'New Economy.' In the next Chapter we will review and examine some of the organisational and market consequences of these developments.

Notes to chapter 3

[23] See L M Segal, `Flexible Employment: Composition and Trends', *Journal of Labor Research*, Vol XVII, No 4, Fall 1996, pp.525-542.

[24] Nor should "Mcjobs" be disparaged as sources of ultimately much higher earning power: `McDonald's Corporation, in testimony before Congress [in 1995] ..., stated that more than 40 per cent of McDonald's corporate executives began their careers as crew members in their restaurants'. Quoted in E A Linz, `Flexible Employment: Positive Work Strategies for the 21st Century', *Journal of Labor Research*, Vol XVII, No 4, Fall 1996, pp.555-566.

[25] See Segal, *op cit*.

[26] See CAP Braga, *et al*, *Liberalizing Trade in Services*, New York: The United Nations and the International Bank for Reconstruction and Development, 1994, p.4.

[27] See S Illeris, *The Service Economy: A Geographical Approach*, New York: John Wiley and Sons, 1996, p.3.

[28] No doubt the *per capita* GDP of Manhattan would compare "favourably" with that of Luxembourg.

[29] See `Rich and Poor' *The Economist*, 9 May 1998, p.152.

[30] D Bell, *The Coming of the Post-Industrial Society*, London: Heinemann, 1974.

[31] S Illeris, *op cit*, p.59.

[32] eg, P P Tordoir, *The Professional Knowledge Economy*, Amsterdam: University of Amsterdam Press, 1993.

[33] Quoted from J Burton and Rul-Haq, `Adjusting to the **GATS**: Prospects, Problems and Prescriptions Regarding the Business Services Sector of the **UAE** Economy', forthcoming.

[34] P Drucker, *The New Realities*, London: Heinemann, 1989, Part IV especially.

[35] See, for example, his book *The New Industrial State*, London: Hamish Hamilton, 1967.

[36] See, for example, C Sutton, *Strategic Concepts*, London: Macmillan, 1988, chapters 4, 5 and 7 in particular.

[37] See D J Collis and C A Montgomery, *Corporate Strategy: Resources and the Scope of the Firm*, Chicago: McGraw-Hill, 1997, chapter 8 especially.

[38] The *locus classicus* on this topic is H Manne, `Mergers and the Market for Corporate Control', *Journal of Political Economy*, Vol 73, April 1965. See also A Shleifer and R W Vishny, `Takeovers in the 60s and the 80s: Evidence and Implications', *Strategic Management Journal*, Winter 1991, pp.51-59.

[39] See S Bhagat, A Schleifer and R W Vishny, `Hostile Takeovers in the 1980s: The Return to Corporate Specialization`, *Brookings Papers on Economic Activity: Microeconomics*, 1990 Special Issue, pp.1-84.

[40] The Literature on core competencies / capabilities is now very extensive, two major references would be G Hamel and C K Prahaled, *Competing for the Future*, Harvard Business School Review, 1994; and D J Collis and C A Montgomery, `Competing on Resources: Strategy in the 1990s', *Harvard Business Review*, July / August 1995, pp.118-128.

[41] See M E Porter, *The Competitive Advantage of Nations*, London: Macmillan, 1990, pp.243-247 especially.

[42] For a discussion of each of these (and other) types of outsourcing, see S M Bragg, *Outsourcing*, New York: John Wiley and Sons, 1998.

[43] There is also now a massive literature on this aspect of the "New Economy". A useful introduction is provided by J C Jarillo, *Strategic Networks: Creating the Borderless Organization*, Oxford: Butterworth-Heinemann, 1993; which contains many further references.

[44] See R E Miles and C C Snow, `Fit, Failure, and the Hall of Fame', *California Management Review*, Vol 25, Spring 1984, pp.10-28.

[45] J L Badarocco Jr, *The Knowledge Link: How Firms Compete Through Strategic Alliances*, Boston, Mass: Harvard Business School Press, 1991, pp.13-14.

[46] See Jarillo, *op cit*, Badarocco, *op cit*.

[47] See M Aoki, B Gustafason and O E Williamson (eds), *The Firm as a Nexus of Treaties*, London: Sage, 1990; and also S N S Cheung, `On the New Institutional Economics', in L Warin and H Wijkander (eds), *Contract Economics*, Oxford: Blackwell, 1992, pp.48-65.

[48] There was no "overnight" transformation of the British, American and European economies, of course. Historians argue about the conditions, and time, that it took for pre-conditions of the Industrial Revolution to "flower".

[49] M Treacy and F Wiersema, *The Disciplines of Market Leaders*. London: HarperCollins Publishers, 1995, pp.52-53.

[50]. See J Burton, `Innovation, Entrepreneurship and the Firm: a Post-Schumpeterian Approach', *International Journal of Technology Management*, Vol 17, Nos 1/2, 1999, pp.16-36.

[51]. See D Birch, `The Contribution of Small Enterprise in Growth and Employment', in H Giersch (ed), *New Opportunities for Entrepreneurship*, Tubingen: J C B Mohr (Paul Siebeck), 1984, PP.1-17.

[52]. See B A Kirchoff, `Self-Employment and Dynamic Capitalism', *Journal of Labor Research*, Vol. XVII, No 4, Fall, 1996, pp.626-643; also the book by the same author, *Entrepreneurship and Dynamic Capitalism*, Westport, Conn: Praeger, 1994.

4. Some organisational and market consequences of the new economy

The trends and forces described in the previous chapter were bound to have, and are still having, profound consequences on the world of work, organisations and jobs. In some of the more alarming accounts, some writers talk of the 'jobless future,' or the 'post-job organisation.'[53] Such millennial prophecies no doubt make for a striking book title and an unnerving theme to worry the reader. However, it has been noted pithily by one labour analyst that

> ... to paraphrase Mark Twain, reports of the death of the permanent job may be greatly exaggerated.'[54]

Nevertheless, the trends we have described are not without consequence for organisations and workers. The general nature of these consequences are more adequately encapsulated in the notion of 'the shamrock organisation' put forward by the leading business organisation thinker, Charles Handy.[55]

The 'Shamrock' organisation

The traditional shamrock is, of course, a plant with three leaves upon each stem. It is Handy's contention that business firms in the New Flexible Economy are increasingly coming to resemble one, with three organisational components. Hence comes the idea of the 'Shamrock' enterprise. The three elements of this new type of enterprise Handy diagnoses as follows:

A: **The core**

These are the typically professional permanent employees of the organisation, who are essential to its maintenance, as between them they have 'ownership' of the organisational and knowledge capital that distinguishes their firm from others. It is Handy's observation, as with many others, that over the 1980s and 1990s, this core component of the large organisation has typically been declining, owing to the refocusing of firms described in chapter 3, and the 'downsizing' and 're-engineering' efforts that have accompanied this refocusing in a world of tougher international competition.

These core, permanent employees have to work hard and long, but, typically, are also well-remunerated for this commitment. However, if the core is getting smaller, who does the work? Here enter the other two elements of the Shamrock.

B: Independent contractors

As argued in chapter 3, there has been a strong trend for organisations in the US and UK especially to outsource their non-critical work to independent contractors so that the firm may concentrate upon its core capabilities. As Handy himself puts it:

> All non-essential work, work which could be done by somebody else, is therefore sensibly contracted to people who make a speciality of it and who should, in theory, be able to do it better for less cost. Manufacturing firms are now almost totally assembly firms, while many service organisations are, in effect, brokers, connecting the customer with some intervening advice.'[56]

Handy calls this element of the 'Shamrock' the *contractual fringe*:

> This is made up of both individuals and organisations. These organisations, though often smaller than the main organisation, will have their own shamrocks, their own cores and their own subcontractors. It is a Chinese box type of world. These individuals will be self-employed, professional or technicians.'[57]

These independent contractors, at whom IR35 is in particular aimed, are typically paid by results, not for time: they get fees not wages. In this connection (re IR35) Handy in another of his publications made a telling prophecy:

> The number of self-employed professionals in this country [the UK] is creeping towards 20 per cent if you include people in partnerships. This is going to be the desired way of life for the majority of people. That's a big problem, because of lot of these people will want to sell their services into corporations, so unless corporations are good at relating to and using this group the [UK] economy will drift downwards.'[58]

The general thrust of IR35 goes against this new deep-set vein, with the consequences of 'downwards drift,' as explored in the next chapter.

C: The contingent labour force

The third element of Handy's Shamrock organisation is what we have labelled above as the *contingent work force*: part-timers and temporary workers, who are often young and female. Some may desire more permanent jobs — and some (such as women with a young family) may not, desiring only a job to supplement the family income, and with some outlet for meeting people.

It is possible to argue that this three-level organisational structure has always existed: firms have always, to some degree, been an admixture of permanent staff working with independent contractors and contingent, temporary workers. But what Handy is indubitably right about is the *scale* of the phenomenon today. Nor, given the underlying forces that drive it (see chapter 3 above) is the phenomenon likely to be reversed, except perhaps at considerable cost to the workings of the economy (see chapter 5 below). The 'Shamrock' is here to stay for the foreseeable future;[59] and so are the 'portfolio people' with their 'portfolio careers' that constitute the second leaf of the Shamrock.[60]

Back to basics: the relevance of Adam Smith

The New Economy is being shaped by new forces such as global competition and the Information Technology Revolution, but these do not obviate the underlying relevance of market forces to the shaping of remuneration packages.

The fundamental market analysis that we are concerned with here was developed and described by Adam Smith in the first ten chapters of Book I of his famous treatise, *The Wealth of Nations*;[61] and is sometimes termed by economists as the 'theory of equalising differences' and also as the 'theory of compensating differentials.' Most economists would see this as the fundamental long-run market equilibrium concept in labour economics today.[62]

In the absence of barriers to movement between occupations, and given that workers are knowledgeable, the theory of compensating differentials predicts, amongst other things:[63]

(i) Workers will be paid higher 'compensating' differentials for undertaking jobs with bad job characteristics such as greater risk, or poorer prospects of work;

(ii) Wage differential will reflect the costs of acquiring the skills necessary to enter the varied occupations;

(iii) Non-wage aspects of occupations, such as differential tax treatment, will affect wage differentials;

(iv) Wage differences will also exist because individuals differ in their atitudes towards different aspects of jobs (eg, some might be attracted by 'portfolio' work; others may find it rather risky).

In summary, in competitive markets ,in the long run, at least, workers whose jobs have extra, desirable characteristics such as differential tax treatment; or less risk than others; or lower costs of skill acquisition should, other things being equal, end up with lower incomes than those whose work entails the opposite characteristics.

The assumption which seems to underlie IR35 (see Chapter 2) is that individuals hiring themselves out through their own professional service companies enjoy an *advantage* over permanent employees — that they can exploit the fiscal advantage offered by corporate structure. No other aspects of differences between the two types of professional service supply are mentioned in the memorandum.

If this were truly the case, then the theory of equalising differences would predict that independent contractors would earn *less* than comparable permanent employees, and not more. In fact, as is well known, the opposite happens: contractors typically earn a premium over permanent staff.

There is a massive amount of evidence to support and corroborate Adam Smith's theory of compensation differentials.[64] This would indicate, to the contrary of IR35, that independent contractors face net disadvantages in other aspects of their work as compared with permanent employees, and therefore require a ‘positive compensating differential’ in pecuniary terms to induce them to work in this leaf of Shamrock organisations. Obvious candidates for these disadvantages include:

- The greater risks assumed by independent contractors, and their employees both in terms of the volatility of their earnings stream, and the risks of business failure;

- The absence of welfare benefits. !ndependent contractors have to set aside earnings to allow for periods between contracts when they are not earning;

- The costs of skills maintenance and upgrading. Unlike employees, independent contractors have to fund their own training and skills upgrading; and this is obviously a very significant cost in the context of knowledge-based industry and complex-capability-based services;

- Absence of other employment benefits. Permanent employees in the ‘core’ of Shamrock organisations typically enjoy benefit packages provided by the employer including pension and holiday entitlements. This is not the case with independent contractors, who have to make their own provision for such matters;

- Expenses. Independent contractors typically have to provide for these out of their fees, whereas employees can reclaim them from their employers through the ubiquitous system of expense claim forms;

- Liability. Contractors are liable for errors; whereas an employee is not. This makes a limited liability company essential for contractors.

All in all, independent contractors face, not as IR35 presumes a net *advantage* over employers in other aspects of their work, but, taken together, significant net *dis*advantages. In accord with Adam Smith's analysis of equalising differences, we should therefore expect contractors to earn significantly larger amounts than comparable employees in order to compensate for these other factors. And this is what we do observe. For example an IT professional working in the City might earn perhaps £60,000 as an employee, or £80,000 as a contractor, the difference pertaining to the items mentioned above.[65]

This conclusion also makes a mockery of the claim in IR35 that `businesses employing their workers directly are unable to compete' with those employing contractors. The fee costs of contractors are higher. But the non-wage costs of employees are also higher, even if their wage costs are lower. Or, as Charles Handy notes:

> The Shamrock organisation has to remember that in the contractual fringe it is money paid for work done. There is no longer a residual loyalty to be relied on, no longer any implied promise of security in return for obedient labour. Good work must, in the long run, receive good rewards or it will cease to be good work.'[66]

In short, in a world of competitive market forces, the TANSTAAFL Principle applies: There ain't no such thing as a free lunch.

Notes to chapter 4

53 See, for example, S Aronowitz and W Difarzis, *The Jobless Future*, Minneapolis: University of Minnesota Press, 1995; and W Bridges, *Jobshift*, London: Nicholas Brealey, 1995.

54 E A Lenz, \`Flexible Employment: Positive Work Strategies for the 21st Century'. *Journal of Labor Research*, Vol XVII, No 4, 1996, p.555.

55 C Handy, *The Age of Unreason*, London: Arrow, 1990; see also his books: *The Empty Raincoat*, London: Arrow, 1995; and *Beyond Certainty*, London: Arrow, 1996.

56 C Handy, *op cit*, *The Age of Unreason*, pp.73-74.

57 C Handy, *op cit*, *The Age of Unreason*, p.77.

58 C Handy interviewed by B Lloyd, \`Careers for the 21st Century' *Long Range Planning*, Vol 21, No 3, 1988, pp.96-97.

59 The "Shamrock" organisation has been alternatively labelled and described by two American scholars as the "Shadow Pyramid" organisation; which complements Handy's analysis. See A A Vicera and R M Fulmer, *Crafting Competitiveness: Developing Leaders in the Shadow Pyramid*, Oxford, Capstone, 1996.

60 These terms were also coined by Charles Handy, in the books cited above; for further discussion see M Comfort, *Portfolio People*, London: Century Ltd, 1997.

61 First published in 1776.

62 Quoted from S Rosen, \`The Theory of Equalising Differences', in O Ashenfelter and R Layard (eds), *Handbook of Labor Economics, Vol I*, Amsterdam, North Holland, 1986, pp.641-692.

63 For further explanation of the theory of equalising differences see S Rosen, *op cit*, or any textbook on labour economics, eg, D Bellante and M Jackson, *Labor Economics: Choice in Labor Markets*, New York: McGraw-Hill, 1979, ch 8; or A Rees, *The Economics of Work and Pay*, New York: Harper and Row, Part V.

64 In addition to the references cited in endnotes 10 and 11 directly above, see also W S Siebert, \`The Market Regulation of Industrial Safety', in C Veljanovski (ed), *Regulators and the Market* , London: Institute of Economic Affairs, Readings, 35, 1991, pp.180-209, and the references cited therein.

[65] Some estimates suggest, for example, that the rate of obsolescence of knowledge in the IT sector are of the order of 20 per cent per annum.

[66] C Handy, *op cit*, *The Age of Unreason*, p.79.

5. Consequences of implementation of IR35

The foregoing chapters have developed a critique of IR35 and associated measures, drawing upon well-established economic and business analysis. The Inland Revenue has stated that the purpose of these measure is to 'claw back' some £475 million of 'tax avoidance' ... although they have also, apparently, declined to explain the basis for this calculation. (No small wonder – given the woeful lack of statistics on the extent of independent contractors in the business and professional services area collected by UK governmental statistical services).

Suppose, then, that the Revenue decides to push ahead with these measures, despite the criticisms of the thinking behind these proposals enunciated above. What are the likely consequences? This chapter explores the matter, drawing upon an extensive survey of 2000 commentators based primarily in the IT and engineering sectors, and conducted by the Professional Contractors Group (PCG).[67] It must be emphasised that this endeavour constitutes the *only* available data base in the UK relevant to these matters.

These respondents to the PCG survey were typically mobile, and highly professionally qualified, with 44% of them aged between 25 and 34 years. Some 98 per cent of them provided their professional services through the vehicle of a limited liability company in which they were typically the major shareholder. Amongst other interesting statistics, it is to be noted that 88 per cent of this sample retained earnings to allow continuation of salary payment when they had no contract work available. Consequently, only 1 per cent of them had claimed any state benefits over the past two years. Some two-thirds of them typically charged fees of between £30 and £60 per hour. Furthermore, some 22 per cent had carried out contract work overseas.

This, then, is the general background for the sample of independent contractors examined in the PCG study. The latter also examined questions relating to what will happen if IR35 is implemented, along with the associated measures noted in Chapter 2 above?

We may perhaps delineate the probable consequences as follows:

(1) Consequences for contractors;
(2) Consequences for the UK economy;
(3) Consequences for taxation and benefit payments.

Each of these is examined separately below.

1: Consequences for contractors

It is impossible to establish how many companies would be caught by IR35 and associated measures — because (as we saw in chapter 3) — the supply of business/professional services covers such a wide array of different types of enterprises, in different sectors. One estimate is that 'if the Revenue interprets the rules in the broadest sense, up to 300,000 people could be affected ... including lawyers, accountants, and many other professionals'.[68]

In order to deliberately understate the (probable) impact, the PCG survey assumed the existence of a mere 100,000 companies (located in the IT and engineering sectors — ignoring all others), and assumed a low fee of £30 per hour for each individual.

Under the present system, limited companies in the UK face relatively low administrative burdens; the proposed system would increase those burdens significantly for such companies. The PCG survey indicates that to assess and implement these regulations (according to the companies' responses) would incur a non-recurring initial cost of £188 million. Moreover, there would be *recurring* costs as well, as typically firms would need to charge an extra one per cent to two per cent, in order to run Schedule Arrangements for contractors changing jobs frequently. Again, this is difficult to estimate, but the PCG sample indicates that this could be of the order of between £58 million and £115 million per year.

Obviously, the more time consuming the control / certification / registration tests and regulations involved, the greater would be the administrative cost to contractors involved. Moreover, it cannot be assumed that the population of small businesses would stay the same: as one small business software supplier has commented; `if it [IR35 and associated measures] passes into law as it is, small firms could go out of business'.[69]

2: Consequences for the UK economy

To meet the test for self-employment, contractors would need to take on fixed price contracts rather than 'cost plus' ones. Clearly the former are of a much higher risk nature to contractors than the latter. The PCG survey therefore asked what premium would typically need to be charged in order to cover for the enhanced risk. The results are quite staggering — implying additional costs to UK industry of using the 'second leaf' of the Shamrock organisation of an order of magnitude ranging from approximately £5.9 billion to approximately £8.4 billion.[70]

As an alternative means of estimating the costs to UK industry, the respondents to their survey were asked to estimate the costs involved of passing on the extra tax burden to their clients. This gives a much lower — but still very substantial — estimate of £1.58 billion.[71] Moreover, this estimate does *not* include any element for increased employment costs for contractors arising from such factors as holidays, sick pay, or matters such as any rise in unfair dismissal claims, as contractors exploit the new possibilities opened up by the proposed legislation.

Clearly such large costs could be passed on; and firms might turn to overseas suppliers for contracted professional services. By the same token, UK independent contractors will be provided with a strong incentive to relocate overseas to a country where the tax regime is less onerous. For example, it is to be noted that Holland currently provides significant tax incentives for workers coming into that country to work in the engineering and IT sectors, whilst the USA, as the PCG report notes, has recently doubled its visa quota allocation for skilled / professional workers.

I have noted above that many of the contractors working in these UK sectors are (a) relatively young, (b) highly mobile and (c) many (22 per cent of the sample) have worked abroad as contractors already. The resultant brain drain would probably be the most significant of all costs to the British economy, not in terms just of the loss of tax revenue (discussed below), but in terms, more severely, of the undermining of UK-based knowledge industries.

3: Consequences for Taxation and Benefit Payments

To continue the point in the foregoing paragraph, let us assume that 30,000 contractors were to leave the UK as a result of the proposed legislation, and to set up shop in another country. The PCG report calculates that this would result in the loss overseas of around £1.9 billion of fee-earnings that would otherwise arise in the UK economy. Moreover, by definition, this could not be taxed by the UK Inland Revenue, implying a potential *loss* of £760 million to the Exchequer.[72] So much, then, for the clawing back of £435 million, the supposed goal of IR35. Moreover, there would be knock on effects of their departure, in tax loss terms: when in Holland, the US, or elsewhere, the departees would be likely to use local, rather than UK, accountants, lawyers and other services.

This, however, would not be the end of the negative consequences to the Exchequer. It was noted above that of those sampled, only one per cent of contractors had claimed any state benefits over the last two years. Clearly this number could increase substantially under the proposed new regime (and under which they would be entitled so to claim), by an amount that it is impossible to predict. Nevertheless, this would be a further source of drainage from an already hard-pressed Exchequer.

Summary

In this chapter we have briefly reviewed the consequences of implementing IR35 and associated measures as they stand, drawing upon estimates provided by the Professional Contractors Group. It is to be emphasised that their sample covered only the engineering and IT sectors, rather than the full array of independent contractors throughout all of the business and professional services. It could be argued that the PCG has a vested interest in exaggerating the potential losses, but, as explained above, their estimates ,covering only a couple of the business and professional services complex; and using *very* low figures for remuneration probably must be understood as a deliberately probable underestimate of the scale of losses that could be involved.

The previous chapter concluded with the observation that `There ain't no such thing as a free lunch'. The implications of this chapter are somewhat different: whilst there may be no ‘free lunches,' in tax collection as in other endeavours, it is possible to order up some damnably *expensive* ones!

On all counts, for the independent contractor sector of the UK; for the UK economy generally; and even for the Exchequer; the consequences of implementing IR35 and associated measures as they stand look to be onerously expensive.

Notes to chapter 5

67: ‘Survey to investigate the impact of planned changes to the tax regime affecting service companies working in the knowledge sector, specifically IT and engineering’, Southampton: Professional Contractors Group; (mimeo) 16th May 1999

68: Quoted in L Whitney, ‘Taxman gets tough with “consultants”’ *Daily Mail,* 21 July 1999 , p.51

69: Quoted in L.Whitney *op cit*

70: See appendix 4.6 of the PCG Report

71: See appendix 4.7 of the PCG report

72: see appendix 4.9 of the PCG report

6. Some brief conclusions

This monograph has been concerned with the New Labour government's commitment to:

(a) TheNew Flexible Economy; and
(b) Joined-up Government.

Chapters 3 and 4 have explored in some detail the meaning and consequences of the New Flexible Economy. As we have seen, a central component of this New Flexible Economy is the existence of a large contractual fringe of highly qualified professional workers, who make up what Charles Handy describes as the ‘second leaf’ of the Shamrock organisation of today's modern business enterprise.

We have in particular explored (in chapters 2 and 5) the consequences of implementing IR35 and associated legislative developments for this vital component of the New Flexible Economy. As chapter 5 itemises, these could be quite devastating in their impacts if the Government proceeds as it currently proposes.

Is this ‘joined-up government’? The government's Second Annual Report states categorically that it:

> `has strengthened ways in which we control ‘red tape’ to ensure regulatory burdens on business are kept to a minimum.'[73]

The proposals that I have examined seem to run directly contrary to this claim; and also to Mr Byers' promise (see Chapter I) of a moratorium on any more red tape imposed upon businesses before the next General Election. If these proposals go through unchanged, the likelihood is that we will not be advancing Mr Blair's vision of a New Flexible Economy, but, rather, creating a ‘New Gummed-up Economy’.

Notes to chapter 6

[67] `Survey to Investigate the Impact of Planned Changes to the Tax Regime Affecting Service Companies Working in the Knowledge Sector, Specifically IT and Engineering', Southampton: Professional Contractors Group; (mimeo) 16th May 1999.

[68] Quoted in L Whitney, `Taxman Gets Tough with "Consultants"', *Daily Mail*, 21 July 1999, p.51.

[69] Quoted in L Whitney, *op cit*.

[70] See Appendix 4.6. of the PCG Report referred to above.

[71] See Appendix 4.7. of the PCG Report.

[72] See Appendix 4.9. of the PCG Report.

[73] Quoted in *The Economist*, `The Economic Record' 31 July 1999, p.23.