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# *Economic* PERSPECTIVE

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## INCOME TAX VARYING POWERS AND THE SCOTTISH LABOUR MARKET\*

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### 1. INTRODUCTION

In the 1980s, labour market flexibility came to be regarded as a potential panacea for unemployment. Greater wage and employment flexibility would reduce unit labour costs and increase productivity. Firms would become more competitive and profit margins would increase. Investment would be stimulated resulting in increased economic growth and employment. Labour market flexibility would thus trigger a supply-side generated, virtuous circle of investment, growth and employment. In the 1990s, the potential fallout from government policies which have deregulated the labour market and actively encouraged the growth of 'flexible' forms of employment is becoming apparent. There is now real concern that the undoubted increase in these non-standard forms of employment (such as part-time, temporary and sub-contracting work) may have damaged the skills base of the economy and increased segmentation of the labour market. Additionally, there is the often-overlooked question of the link between the increase in (generally) relatively low-paid, flexible jobs and government finances. This article addresses the last issue in the context of the Scottish economy and the decision to establish a parliament in Edinburgh with income tax varying powers. It considers whether the present trend in Scottish labour market restructuring will provide a sustainable base for the forthcoming Parliament's tax

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\*A more comprehensive discussion of the issues and empirical work contained in this paper may be found in Gasteen & Houston (1998).

varying powers and examines what the implications would be if a substitution of part-time for full-time work were to occur.

### 2. LABOUR MARKET RESTRUCTURING IN SCOTLAND

Scotland's economy is service sector dominated with tertiary employment now accounting for just over 80% of jobs (Figure 1). Service sector growth is the primary reason for the increase in part-time work with the Scottish economy having created 2.7 part-time jobs for every full-time job over the period 1985-1996 (Scottish Abstract of Statistics).

Such fundamental labour market restructuring looks set to continue and may combine with other socio-demographic factors to the detriment of the 'Scottish' public finances. Scotland has followed the rest of the Western world with a gentle, but persistent trend towards smaller household units, a steady rise in single-adult headship and increased participation by women in the labour force on an ever more part-time basis. The combination of these trends might suggest that an increasing number of households are likely to be relatively work-poor in the future (headed by single, female adults who are increasingly likely to work part-time, if at all). This is evidenced by the growth in lone-parenthood (Bailey, 1995). The *a priori* expectation would have to be that as households become less work-rich and the traditional 'nuclear' family declines, there would be, *ceteris paribus*, a reduction in the tax take from households and, simultaneously, an increasing call on welfare - in particular on Income Support provisions and in-work benefits. Consequently, the surplus of tax raised (from labour market activity) over welfare paid would be reduced. Clearly, this is of particular relevance given that Scots have voted for the establishment of a Scottish Parliament in Edinburgh with tax varying powers.

During the 1990s Scottish part-time jobs have represented net additions to employment (Figure 2) but it is not automatically clear that the increase of such work will generate positive contributions to the public finances given the growth of 'in-work' benefits. Moreover, if Scottish labour market restructuring came to follow the British pattern, whereby part-time jobs are effectively substituted for full-time work, this could adversely affect the Scottish public finances.

### 3. THE PUBLIC FINANCE CONSEQUENCES OF INCREASED LABOUR MARKET FLEXIBILITY

The Parliament will have income tax varying powers which will allow it to increase or decrease the basic rate of income tax by a maximum of 3p. It is estimated that for every 1p change in income tax, revenue varies by approximately £150m. Thus, the Scottish Parliament will 'be able to levy or to reduce income tax for basic rate taxpayers in Scotland by up to £450m.' (White Paper, 1997). It has been suggested that, under certain circumstances, income tax may have to be increased to effectively support a substantial 'structural' Scottish public sector deficit (McGregor et al, 1997). The continued growth of part-time work in Scotland, however, may affect the country's ability to successfully raise additional income tax revenues and exacerbate this structural gap.<sup>1</sup>

The traditional full-time, permanent mode of employment generated a nation of regular income earners and taxpayers. Any replacement of full-time by part-time (albeit permanent) jobs combined with the continued growth of other flexible forms of employment (such as temporary work) is likely to result in a loss of income tax revenue-earning opportunities. Both direct and indirect tax revenues are likely to reduce. Part-time workers generally contribute less to direct tax revenues than full-time employees. *Ceteris paribus*, their lower incomes will result in the payment of less income tax and National Insurance contributions (NICs). In addition, low paid part-timers are likely to consume less reducing indirect tax revenues to government from VAT and Customs and Excise duty.

There have been numerous changes to the benefit system designed to increase labour market flexibility and thereby improve individuals' employment prospects and stem social security expenditure. As a result a battery of benefits now exist which may provide long-term subsidies for the creation of low paid and/or unstable forms of employment. The widening of wage differentials and the growth of low-paid and/or part-time work would suggest that increasing numbers of people are likely to combine work and welfare. Jobseeker's Allowance (JSA), Income Support,

Family Credit and Housing Benefit all serve to support individuals on low/variable incomes as well as the unemployed and as their numbers increase, *ceteris paribus*, so too will social security expenditures.

The basic hypothesis is that expenditures on these main benefits will rise and direct and indirect tax revenues will fall with increased labour market flexibility in the form of part-time employment. Households' net contributions (taxes paid minus benefits received) to the public purse will decline as their mode of employment changes resulting in a shrinking of the tax base from which to finance public expenditure.

### 4. METHOD

To examine the hypothesis, an integrated spreadsheet model was used to generate the employment composition of Scottish households from 1985 to 1996, attribute their income and estimate their direct and indirect tax payments and received welfare benefits. Households were characterised by the number, age, occupation and work mode of the occupant(s) into 36 'common' types. Each household type was modelled by a 'household' file which compiled information on the consumption, earned income, direct and indirect taxes and welfare benefits of that particular household from supporting files. These individual amounts were then grossed up by the numbers of each type estimated to have existed in each year and then aggregated together to give grand totals for Scotland.<sup>2</sup> The model thus enables the relationship between the structure of employment in Scotland and the Scottish tax take and welfare expenditures to be examined as the representation of different household types changes according to the nature of their labour market activity.

Data from a wide variety of published ONS sources - Labour Force Survey, New Earnings Survey, Family Expenditure Survey, Scottish Abstract of Statistics, Population Trends, Social Security Statistics were incorporated into the model. Ongoing work by the ONS relating to the reconciliation of micro- and macro- data (Stuttard, 1996) would suggest that the small percentage errors between the model-derived aggregates and external data gives confidence in the results obtained.

5. LABOUR MARKET  
RESTRUCTURING AND THE  
PARLIAMENT'S TAX VARYING  
POWERS

In spite of the increasing propensity to part-time working, Scottish households consistently generated a surplus over the period (Figure 3), that is their *aggregate* contribution to the public finances was always positive.<sup>3</sup>

Of the 36 different household types modelled, only five actually generated net *deficits* at any point between 1985 and 1996, and, in fact, recorded a deficit in each and every one of those years. These households were characterised by the absence of any working adult/s (ie they were either 'unemployed', 'inactive' or 'pensioner' households).

Clearly, however, given the aggregate surpluses shown in Figure 3, these five 'deficit' households were being more than compensated for by the 31 'surplus' households which are characterised by having at least one working individual. This can be seen in Figure 4 where the mean contributions for single- and dual-earner, full-time households, 'combination' full-/part-time worker households (one of each), single, part-time worker only and inactive/unemployed, households are charted.<sup>4</sup> The results demonstrate that part-time worker only households do, in fact, generate positive surpluses throughout the study period and that their mean contribution has grown. The implication is that as long as the creation of part-time jobs represents a net addition to employment, then households engaged in such work will contribute positively to the Scottish public purse. However, such households generated significantly lower surpluses than other households with employment. The greatly reduced contribution of part-time only households is explicable not just by the fact that part-time employees work less hours but that their hourly wage rate tends to be less than the pro-rata full-time rate. Indeed, it was generally the case that those households with a full-time worker in a given occupational class and with a given number of dependants, generated a higher surplus than a household that had a part-time worker in that same occupation and with the same number of dependants. This would suggest that if a substitution of part-time for full-time work in the British mode were to occur then the surplus of tax revenues over

benefits currently generated by Scottish households would fall.

6. THE IMPACT OF A  
SUBSTITUTION OF PART-TIME  
FOR FULL-TIME WORK

The Scottish Office 1994-based Household projections (Scottish Office, 1997) which forecast household numbers and types up to the year 2008 were incorporated into the model. Their forecasts continue the trend away from 'nuclear' toward single-parent and single-person households.<sup>5</sup> The model-derived household surpluses and deficits for 1996 were inflated by 3% per annum, whilst the trend away from full-time male-led worker households toward part-time, female-led households was continued. These were then matched with the projected per-household surpluses and summed.

Given the earlier results, the expectation is that any shift away from full-time worker only households will reduce the aggregate surplus compared with the 'base case' (of no shift). Applying various annual percentage rates of shift allowed the differential impact on surpluses to be estimated.<sup>6</sup> As shown in Figure 5, these reveal increasing degrees of reduction in the surplus, which grow through time as the balance tips ever more toward part-time working. Clearly, the more rapid the rate of any substitution of part-time for full-time work, the greater the *reduction* in total household surplus.

The projections indicate that by 2005, a yearly 1% rate of transfer of full-time jobs to part-time would result in a loss of public sector revenue amounting to £900m. This would be *twice* the proposed nominal upper limit of the Scottish Parliament's tax raising powers. In the 'worst case' scenario of a 3% rate of conversion, £2.75 billion in revenue would be lost to the Scottish public sector in 2005. Nevertheless, the indication is that households will continue to generate surpluses well into the next decade, in spite of the increasing propensity for part-time working and smaller and more numerous households.

7. CONCLUSIONS

The growth in 'flexible' forms of employment can reduce the aggregate surplus contribution

(of taxes minus benefit payments) from employed households to the public purse. If low-paid, part-time jobs are increasingly substituted for full-time positions, direct and indirect tax revenues are likely to fall and social security expenditure is likely to rise, worsening any existing public sector deficit. The impact of this phenomenon in the context of the Scottish economy is that although Scottish households will continue to generate surpluses well into the next decade, if a yearly 1% conversion of full-time jobs into part-time work were to occur from 1997, £900m would be lost to the Scottish public purse by 2005.<sup>7</sup> Such a loss is double the current nominal £450m tax-varying limit to be awarded to the new Scottish Parliament. In fact, the projections suggest that the use of the tax-varying powers to raise the upper limit in additional revenues would be negated by the lost surplus as early as 2001 - just a year after the Parliament becomes fully operational.

Clearly, if the growth of part-time work were to proceed at the expense of full-time jobs, increasing labour market flexibility has the potential to seriously erode public sector finances. Thus, the nature of such structural change in the labour market and whether it should be encouraged, ought to be given more serious consideration by politicians purely from a pragmatic budgetary point of view, let alone from the stance of potential training market failure and growing inequality in the distribution of wages and employment opportunities.

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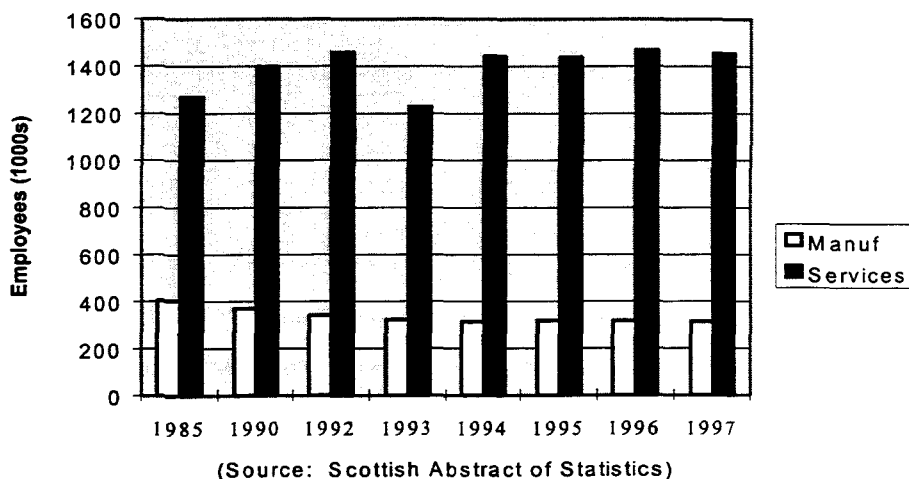
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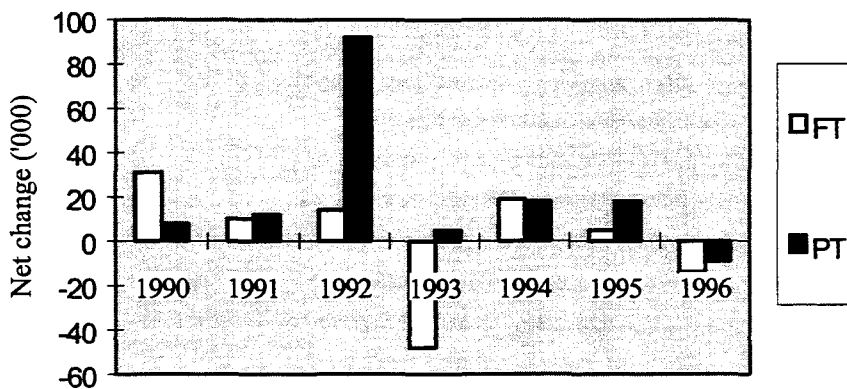
**ENDNOTES**

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- <sup>1</sup> A structural deficit/gap occurs by definition when the tax base is insufficient to support the level of public expenditure.
- <sup>2</sup> The numbers of each household type in each year were calculated by the model ensuring that all known information concerning the composition of the population was taken into account.
- <sup>3</sup> A 'surplus' in this context is defined as the positive difference between the total tax take (both direct and indirect) from a given household and welfare payments into that household. A government budget surplus is, of course, much more than just this.
- <sup>4</sup> There were no dual-earner, part-time household cases given the household types generated to date. The generation of more representative household types vis a vis the linking of partners' occupations/labour market status is the subject of ongoing research as indicated in the earlier discussion of the model.
- <sup>5</sup> The actual number of households themselves is predicted to grow by 14,600 per annum.
- <sup>6</sup> These are the differential impacts compared with no shift from full- to part-time working.
- <sup>6</sup> Clearly, this finding does not take account of the effect of the taxation and welfare reforms currently being proposed by the government.

**Figure 1 Structure of Employment - Scotland (1985 - 97)**

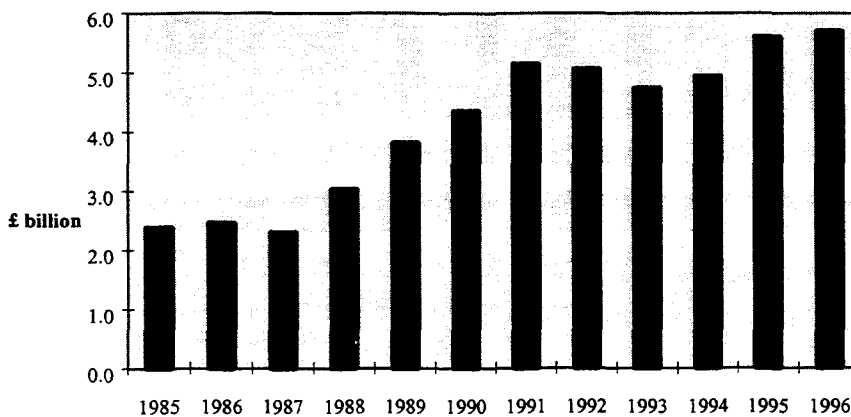


**Figure 2 Net Changes in Full- and Part-time Employment in Scotland, 1990-1996**

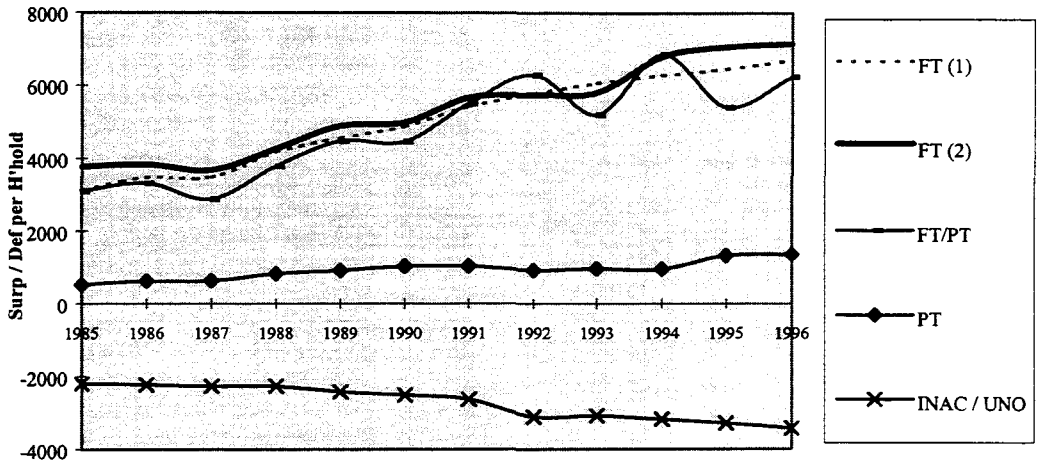


Source : Scottish Abstract of Statistics

**Figure 3 Aggregate Household 'surpluses' - Scotland 1985 - 1996**



**Figure 4 Mean Surpluses/deficits for all main household types (characterised by work mode)**



**Figure 5 Projected impact on Household surplus from increased propensity to part time working in Scotland (1997 - 2005)**

