

Perverse incentives and productivity

[Coppola comment](#), 8 February 2013

The UK's labour market is something of a puzzle. Employment is at an all-time high, but unemployment is higher than might be expected from the employment figures and productivity is falling like a stone. Numerous explanations have been put forward for this apparent inconsistency, most recently by the ONS¹, the IFS² and the TUC³. Even FT Alphaville⁴ had a go at it. Needless to say, none of these bodies agree on the causes. I've read all these reports, and in my view all of them make useful contributions. If there is one certainty in this matter, it is that there isn't a simple explanation.

But I think they are missing something. The other day I [wrote a post](#) asking why there was such a rise in employment when unemployment was apparently not falling a great deal. Who are all these new people, where have they come from and why weren't they working (or unemployed) before?



This sparked an intense debate on twitter about the nature of the new employment. And from it emerged a picture of perverse incentives that I think goes a long way towards explaining not only the difference between employment and unemployment, but also the falling productivity since mid-2011.

The story starts with the ONS's report⁵ that 367,000 of the new "jobs" are actually people registering as self-employed. The TUC observes that this is 40% of all new jobs and the vast majority are sole traders. 60% of these new self-employment registrations have occurred since 2011 and the vast majority of people registering as self-employed (84%) are aged 50 or older. A high proportion are men. They work longer hours than employees and earn much less. RBS⁶ notes that the remuneration of people in self-employment is generally far lower than the pay of those employed. And it has not recovered since the financial crisis. Average self-employed incomes are still 5% below their 2008 level, whereas average employed incomes are 10% above

¹ ["The Productivity Conundrum, Explanations and Preliminary Analysis"](#), Peter Patterson, Office for National Statistics, 16 October 2012.

² ["The Productivity Puzzles"](#), Institute for Fiscal Studies, IFS Green Budget, chapter 3, February 2013.

³ Trade Union Congress, [Economic Report n°5](#), February 2003.

⁴ ["UK productivity puzzle possibly solved?"](#), Izabella Kaminska, FT Alphaville, February 5, 2013.

⁵ ["Self-employed up 367,000 in four years, mostly since 2011"](#), February 5, 2013.

⁶ ["Start ups or upstarts: self employment in the UK"](#), RBS Group, January 2013.

the 2008 level. The rise in employed income is quite a bit less than inflation in the last five years, so the employed have suffered a cut in their real incomes. But the self-employed have taken a real beating. With real income collapse on that scale, you would expect self-employment to be falling, not rising. So the rise in self-employment is distinctly puzzling.

The ONS also reports⁷ that there has been a vast increase in part-time employment (including self-employment) and a corresponding fall in full-time. Many people say they can't get full-time work. And there is evidence that a high proportion of jobs created are low-skill and poorly paid. All of this supports the IFS's argument that labour is relatively cheap compared to capital and that companies are therefore substituting cheap labour for expensive capital investment. Forcing people to work with inadequate capital reduces their productivity: this may therefore be a contributory factor in the productivity puzzle. But it doesn't explain the rise in self-employment.

We know that the rise in employment in the last 18 months far exceeds the fall in unemployment. Therefore many of these jobs must be people who were neither working nor seeking work (unemployed) before. They aren't people who lost their jobs in the recession: the rise in unemployment in 2008/9 more-or-less matches the fall in employment. So they must be new entrants. It seems we are seeing an influx into the workforce of older people who perhaps had taken early retirement, expecting to live off their savings, and are having to return to work because very low interest rates have clobbered their fixed incomes.

We are also seeing the entry into the workforce of people who previously were on other benefits, notably disabled people - many of whom may also be over 50 - and single mothers, though I suspect many of these people are pushing up the unemployment figures rather than adding to the employed total. And the employment figures, though not the unemployment figures, may also be pushed up by students working their way through college or university. Whatever the cause, the fact is that far more people are now working than was the case even 2 years ago, and a high proportion of these are over 50.

The problem with trying to return to the workforce when you are over 50 and have been out of it for a while is that you are perceived as being out of date, your skills have atrophied and there are younger people with more recent relevant experience. It is extremely difficult for older people, particularly men, to find work in a squeezed jobs market. In my twitter debate a number of older people commented that they had been forced to turn self-employed because they could not get a job. They were supporting themselves with what Rick calls "odd jobs"⁸ - casual work in a range of largely manual or low-skill occupations. This is consistent with the ONS's report that the most common areas of self-employment are cab/taxi driving, "other" construction services, carpentry & joinery, and farming. RBS says there is also a rise in the number of people claiming to be self-employed "managers", which is a useful catch-all for formerly high-skill retired people returning to the workforce. The picture is one of older men, and to a lesser extent women, trying to replace lost benefits or supplement private pensions with casual work until they reach the state retirement age. Entrepreneurial, this isn't.

This might contribute to the productivity problem. Older people may be less fit and energetic than younger ones, so might be slower - though they may have more experience, which would offset this to some extent. And they may not have a great incentive to work hard, since many are simply marking time until they are able to retire. Also, I hate to say this, but people who have been on incapacity benefit for years, or bringing up children, and are now forced to return to the workforce

⁷ [Labour Market Statistics](#), ONS, May 2012.

⁸ ["Don't encourage the odd-jobbers – we have enough already"](#), *Flip Chart Fairy Tales*, 6 February, 2013.

are not likely to be highly productive, at least to start with. But I don't think this is a sufficient explanation of the productivity drop. Older people may be slower but they aren't useless. And what about all the younger people apparently accepting part-time work instead of full-time? How are they surviving, with hugely reduced hours and falling real incomes? No, there must be something else going on too.

The BBC's Five Live programme⁹ yesterday suggested that work programme staff were actively encouraging people to register as self-employed if they were doing a small amount of low-skill, low-paid casual work such as cleaning or gardening. This was supported by a number of people in my twitter debate from their own personal experiences. Now why would job centre staff do this? Well, here is perverse incentive no.1. Getting people who are doing small amounts of casual work off the unemployment register benefits both the claimant and the job centre staff, since it relieves both of the burden of signing on (and off), managing constant claim changes due to casual work and dealing with conflicts between the requirements of job search programmes and the work already being done by the claimant. And it flatters the Government's unemployment figures.

But these people are not necessarily doing much paid work. As I said above, entrepreneurial they aren't. They are living hand-to-mouth, doing odd jobs for low pay interspersed with periods of no work. How can they afford to do this instead of claiming unemployment benefits?

This is where the second perverse incentive comes in. The self-employed, and the part-time employed, can claim tax credits. Working tax credit kicks in at 30 hours for a single person aged 16-59 with no dependents, and at 16 hours for people with dependents, people 60+ and people with disabilities. For a couple, working tax credits start at 24 hours between them of which one person must work at least two thirds. The number of hours a couple had to work to claim working tax credits was raised to 24 in April 2012 (previously it was 16 hours between them). At the time, Unison claimed¹⁰ that the effect would be that some couples would simply stop working - but tougher rules for out-of-work benefits may have forced them to remain in work. One of my twitter commenters stated that he did eight hours a week of very poorly paid self-employed work so that he and his partner could claim working tax credits.

The ability of part-time and low-paid workers to claim tax credits creates a perverse incentive for employers, too, because reducing hours instead of laying people off when companies are experiencing financial problems or depressed sales becomes a realistic alternative. In previous recessions, people have lost their jobs. Many people have commented that this time round, companies have held on to labour but reduced hours and wages. In my view this has been made possible by the existence of working tax credits. When put together with the reluctance of companies to invest in capital at the moment, there is clearly an incentive for companies not only to hold on to existing workers but to create low-paid part-time jobs to keep businesses "ticking over", knowing that people who really want full-time work will accept those jobs because tax credits will top up the wages. This seems like a good thing, because it keeps people in work, but if it means that companies are substituting cheap labour for capital investment and technological innovation, it does not bode well for future growth and prosperity.

But the biggest perverse incentive of all is in the realm of self-employment. Consider someone who is doing odd bits of paid work mainly for friends and family, interspersed with periods of no work. That person has no way of knowing what his hours of work will be from week to week. But to claim tax credits, he must be working a certain number of hours per week. So in his claim,

⁹ ["Work advisers 'pushing jobless into self-employment'"](#), Hannah Barnes, *BBC News*, 3 February 2013.

¹⁰ ["Changes to Family Working Tax Credits"](#), *briefing note*, Unison.

that's what he states. He's not being untruthful: he is stating what he WANTS AND EXPECTS to work, not what he is actually doing at the time of the claim. The newly self-employed are business startups in the eyes of HMRC, so are not likely to have low productivity questioned for at least a couple of years. And as I pointed out above, job centre staff may be actively encouraging people who do casual work to register as self-employed. The assumption by both HMRC and DWP is that newly self-employed people are spending significant amounts of time promoting their business, so actual hours of work can considerably exceed paid hours. And this may indeed be true.

But self-employed work, particularly in services, is actually declining at the moment due to the fall in real incomes of the employed, who are the customers of the self-employed. So our newly self-employed are actually finding life very hard indeed and desperately need the tax credits in order to survive. The choice they have is between giving up the casual work and registering as unemployed, or overstating their hours of paid work. Which would you choose?

For me it is telling that the drop in productivity appears to coincide with the massive rise in self-employment since 2011, which itself is driven by changes to benefit eligibility criteria as well as the Bank of England's monetary policy. I know correlation doesn't necessarily imply causation, but I'm unimpressed with coincidences, especially when correlation would help to explain a perplexing phenomenon. Now if the new self-employed were genuine small business startups, then the fact that they appear to have low productivity in the short term would not be a problem - indeed it would indicate that the new business owners were doing significant amounts of unpaid work to develop their businesses, which would be a good thing. But as far as I can see, that is not what the evidence shows.

What emerges is a picture of mainly older and less able people forced back into the workforce, doing insecure, low-paid and low-skill work and managing to survive on starvation levels of remuneration only because of a generous system of tax credits. If this picture is accurate, it is appalling. Far from indicating that the economy is on the verge of recovery, the apparently high employment levels coupled with low productivity may indicate that it is in terminal decline. For as Rick points out¹¹, the only economies that rely on high levels of subsistence-level self-employment are very poor ones. Over-tight fiscal policy, callousness towards the less able, unnecessary risk-aversion by companies and banks, and unhelpful monetary policy are turning the UK into a basket case.

¹¹ ["What sort of countries have lots of self-employed people? Poor ones!"](#), *Chart Fairy Tales*, 2 April, 2012.