

**THE ROLE OF INDEPENDENT CONTRACTORS  
IN THE U.S. ECONOMY**

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# THE ROLE OF INDEPENDENT CONTRACTORS IN THE U.S. ECONOMY

## EXECUTIVE SUMMARY

More than 10 million workers, comprising 7.4 percent of the U.S. workforce, are classified by the Bureau of Labor Statistics as independent contractors, and another 4 million work in alternative work arrangements in which they may be legally classified as independent contractors for one or more purposes. Alternative workers in 2010 will account for approximately \$626 billion in personal income, or about one in every eight dollars earned in the U.S.

Independent contractor arrangements are commonplace throughout the U.S. economy, from computer software engineers and emergency room physicians to home health care providers and timber harvesters. Such arrangements generate substantial economic and other benefits for both workers and employers, allowing both firms and households to use labor services in situations where a traditional employment relationship is either impractical or uneconomic for the worker, the client, or both. Independent contracting is especially prevalent in industries where:

- Workers move frequently from project to project, or work multiple projects at once;
- Firms need to be able to respond to short-run changes in demand, or make up for gaps in supply, by calling on more workers than they could economically maintain as traditional employees;
- It is efficient to be able to evaluate performance, and hence base compensation, on output, as opposed to direct observations of time spent working;
- There are efficiency benefits to having workers own their own capital (e.g., a truck or taxi).

Independent contracting is especially prevalent in such broad industry categories as agriculture, construction and professional services, and in a diverse set of specific occupations, including cab drivers, construction workers, emergency room physicians, financial advisors, mystery shoppers, and truck drivers.

The economic benefits of independent contracting include workforce flexibility, avoidance of fixed costs, the ability to “pay for performance,” the avoidance of legal and economic barriers in efficient contracting, and, perhaps most important, the satisfaction of workers’ desires to “be their own boss” and benefit from the independence associated with independent contractor relationships.

There is an extensive body of research documenting the fact that workers prefer independent contractor relationships to salary/wage employment.

- The Bureau of Labor Statistics reports that 82.3 percent of independent contractors prefer an independent or alternative work arrangement to being an employee, compared with only 9.1 percent who would prefer an employment arrangement.
- A Pew Research Center survey found that self-employed workers are “significantly more satisfied with their jobs than other workers. They’re also more likely to work because they want to and not because they need a paycheck.” Pew reports that 39 percent of self-

employed workers are “completely satisfied” with their jobs, compared with 28 percent of workers in wage or salary jobs.

- In addition to flexibility and autonomy, one important reason workers prefer independent contracting is that it serves as a stepping stone to entrepreneurship and small-business formation.

Policy changes that curtail independent contracting, such as the proposed repeal of the Section 530 “safe harbor” for classification of workers for tax purposes (which would increase regulatory risk for independent contractors and their clients alike), would result in higher unemployment, slower economic growth and reduced economic welfare. Specifically, curtailing independent contracting would:

- Reduce job creation and small business formation. Independent contractors start businesses and create jobs. Of the 10.3 million independent contractors in the most recent Bureau of Labor Statistics survey, nearly 2.4 million had one or more paid employees, with the vast majority employing five or fewer workers.
- Reduce competition and increase prices. By reducing the importance of economies of scale, independent contracting allows small businesses to compete with larger ones, increasing competition and lowering prices for consumers.
- Create sector specific disruptions. Independent contracting is a primary business model in a number of important industries, including construction, emergency medicine, financial advice, timber harvesting and transportation. Limitations on independent contracting could create serious economic disruptions in these and other industries.
- Produce a less flexible and dynamic work force. Independent contracting allows both firms and workers to respond to changes in the economy, reducing “structural” unemployment. Empirical studies show independent contracting facilitates workers’ re-entry into the workforce after being laid off.

Finally, there is no evidence that independent contracting, per se, contributes to the so-called “tax gap.” Indeed, one study by the Department of the Treasury concluded that “with typical patterns of fringe benefits and worker expenses, independent contractors and their clients tend to pay higher levels of taxes, especially Social Security and Medicare taxes, than employees and employers, providing that the income and expenses are reported correctly.”

In sum, independent contracting provides a means for firms to acquire labor in cases where the fixed costs of an employment relationship would be prohibitive; it serves as a means for workers to move into and out of the workforce, and as a transitional mechanism for laid-off workers to find new jobs; and, it provides a first-step on the ladder to starting a small business and creating jobs for others. The economic and social costs of independent contracting are difficult to discern, especially given that independent contractors are far more likely than traditional employees to like their work. The economic benefits of independent contracting, on the other hand, are substantial. Policies that make it more difficult for workers and firms to enter into such arrangements would thus result in slower economic growth, lower levels of employment and job creation, and lower consumer welfare overall.

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## I. INTRODUCTION

Approximately one out of 10 U.S. workers is engaged in an “alternative employment arrangement” – that is, one in which they may not be considered employees for purposes such as payroll tax withholding, deductibility of health insurance and other benefits, unemployment insurance eligibility, and so forth. Such alternative work arrangements are common in virtually every sector of the economy, from computer software engineers and emergency room physicians to home health care providers and timber harvesters, but are far more common in some occupations and industries than in others. As explained below, there are powerful economic reasons why workers and their clients choose to use such arrangements, which typically benefit both the “buyer” and the “seller,” as well as the economy overall.

The most common form of alternative work arrangement – and the focus of this analysis – is independent contracting.<sup>1</sup> While the precise definition of an independent contractor (“IC”) depends on context, in general ICs are workers who either work at multiple projects simultaneously or move frequently from project to project, exercise significant autonomy relative to their “client,” are compensated in a way that allows them to earn a profit, and often bring their own tools or equipment to the project. As a result of these (and other) characteristics, they are not classified as employees, and typically do not participate in employee benefit programs, including statutorily mandated programs such as unemployment insurance and workers compensation; are not covered by overtime and minimum wage mandates; and, are not subjected to payroll withholding (of either income taxes or Social Security). Unlike employees, whose income is reported to the Internal Revenue Service (IRS) on Form W-2, independent contractors’ income is reported on Form 1099-MISC.

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<sup>1</sup> The other types of alternative arrangements, as defined by the Bureau of Labor Statistics, are “On-Call Workers,” “Temporary Help Agency Workers,” and “Contract Company Workers.” See pp. 14-18 *infra*.

Critics of independent contracting allege that it often serves as a mechanism for employers to exploit workers by denying them benefits or paying them below-market wages. Alternatively, or in addition, they suggest that independent contracting is a scheme by which employers and employees jointly conspire to avoid payroll withholding and payment of income and Social Security taxes. Despite the paucity of evidence that misclassification of workers results in significant tax avoidance, the IRS has a long history of challenging independent contractor classifications and, in many cases, imposing onerous penalties on both companies and individuals.

In 1978, Congress – reacting to complaints about overly aggressive IRS enforcement – established “safe harbor” rules for independent contractors under Section 530 of the Revenue Act of 1978. While Section 530 has not completely eliminated complaints about IRS overzealousness, it has provided companies that do business with independent contractors with a modicum of certainty about the circumstances under which they can classify workers as ICs. In recent years, however, complaints by labor unions and others have led Congress to consider legislation to repeal Section 530, and thus curtail the use of independent contractors.

The economic evidence presented here demonstrates that independent contracting serves important economic functions, allowing both firms and households to use labor services in situations where a traditional employment relationship is either impractical or uneconomic for the worker, the client, or both. Indeed, in most cases the advantages of the independent contractor relationship are purely economic, and have nothing to do with either mandated employee benefits or taxes. Eliminating, or raising the cost of, the independent contractor option would effectively prohibit many relationships that provide economic value to both the contractors and their customers. It would, in short, reduce economic welfare.

This study provides an overview of the economic benefits of independent contracting to the U.S. economy. It identifies examples of the types of business models that rely on IC-based relationships, outlines the economic benefits of IC status for both ICs and their clients, and describes the economic costs that would result from curtailing the use of independent contracting.

The remainder of the study is organized as follows. Section II presents a portrait of independent contractors' role in the American economy, beginning with definitional issues, moving to aggregate data on the extent of independent contracting in various economic sectors, and concluding with examples of particular industries and occupations where IC relationships are especially prevalent. Section III reviews the economic efficiency benefits of independent contractor arrangements, first detailing the primary economic motivations for IC arrangements and then moving on to discuss the economic costs that would result from artificially curtailing them. Section IV briefly addresses the relationship between independent contractor relationships and tax compliance (or, as it is sometimes called, the "tax gap"). Section V summarizes the main conclusions.

## **II. A PORTRAIT OF THE INDEPENDENT CONTRACTOR WORKFORCE**

Independent contractors form an important part of the U.S. workforce, consistently accounting for approximately seven percent of all U.S. workers, and for much higher percentages in a number of occupations and industries. The second section below provides an overview of the IC workforce by occupation and industry. First, however, it is important to understand the varying definitions of the term "independent contractor," and the implications of IC status under various Federal and state laws. The first section below addresses these definitional issues.

**A. Assessing Employment Status: When is a Worker an Independent Contractor?**

When is an independent contractor sufficiently “independent” not to be considered an employee? The answer depends on both the legal and jurisdictional context.

For many workers, employment status is clear cut. The tens of millions of workers who report five days a week to a single firm, take regular direction from management on their hours, activities and methods of operation, and are dependent on a single employer for all or nearly all of their earned income, are clearly employees. At the other end of the spectrum, workers who earn income by selling goods or services to multiple customers, at times and on terms of their own choosing, are clearly self-employed and, depending on the context, may be considered “independent contractors” for legal purposes. For an important subset of the workforce, however, the distinction between employee and independent contractor is less self-evident, or depends upon the legal context within which the classification is being performed.

The distinction matters for a variety of reasons. As shown in Figure One below, workers classified as independent contractors are (for example) exempt from employer withholding of both income and Social Security taxes, generally are not covered by overtime and minimum wage laws associated with the Fair Labor Standards Act, may not be covered by unemployment insurance, may have enhanced opportunities for tax advantaged retirement savings, and may be exempt from provisions of the National Labor Relations Act.

**Figure One:  
Legal Implications of Employment Classification<sup>2</sup>**

Entity	Law	Areas potentially affected by employee misclassification
U.S. Department of Labor	Fair Labor Standards Act	Minimum wage, overtime, and child labor provisions
	Family and Medical Leave Act	Job-protected and unpaid leave
	Occupational Safety and Health Act	Safety and health protections
U.S. Department of Treasury–Internal Revenue Service	Federal tax law, including: Federal Insurance Contributions Act Federal Unemployment Tax Act Self-Employment Contributions Act	Federal income and employment taxes
U.S. Department of Health and Human Services	Title XVIII of the Social Security Act (Medicare)	Medicare benefit payments
DOL/IRS/Pension Benefit Guaranty Corporation	Employee Retirement Income Security Act	Pension, health, and other employee benefit plans
Equal Employment Opportunity Commission	Title VII of the Civil Rights Act	Prohibitions of employment discrimination based on race, color, religion, gender, and national origin
	Americans with Disabilities Act	Prohibitions of discrimination against individuals with disabilities
	Age Discrimination in Employment Act	Prohibitions of employment discrimination against any individual 40 years of age or older
National Labor Relations Board	National Labor Relations Act	The right to organize and bargain collectively
Social Security Administration	Social Security Act	Retirement and disability payments
DOL/state agencies	Unemployment insurance law	Unemployment insurance benefit payments
State agencies	State tax law	State income and employment taxes
	State workers' compensation law	Workers' compensation benefit payments

As shown in Figure Two below, the factors that determine employment classification vary depending on the legal and economic context. Broadly speaking, there are three primary categories of classification tests: The common-law test (which focuses on the degree of control an employer exercises over an employee); the economic realities test (which focuses on economic dependence); and, a hybrid test which combines elements of both approaches.<sup>3</sup> As the figure suggests, workers may be classified differently for different purposes, e.g., a worker might be classified as an independent contractor for payroll tax withholding and FICA purposes, but an employee for purposes of the Fair Labor Standards Act or the Americans with Disabilities Act.

<sup>2</sup> U.S. Government Accountability Office, *Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification* (GAO-06-656) (July 2006) at 8.

<sup>3</sup> See, e.g., Charles J. Muhl, "What is an Employee? The Answer Depends on Federal Law," *Monthly Labor Review* (January 2002) 3-11.

**Figure Two:  
Tests for Independent Contractor Status Under Various Federal Statutes<sup>4</sup>**

Test	Description	Laws under which test has been applied by courts
Common-law test (used by Internal Revenue Service (IRS))	Employment relationship exists if employer has right to control work process, as determined by evaluating totality of the circumstances and specific factors	Federal Insurance Contributions Act Federal Unemployment Tax Act Income tax withholding Employment Retirement and Income Security Act National Labor Relations Act Immigration Reform and Control Act (IRS test)
Economic realities test	Employment relationship exists if individual is economically dependent on a business for continued employment	Fair Labor Standards Act Title VII Age Discrimination in Employment Act Americans with Disabilities Act Family and Medical Leave Act (likely to apply)
Hybrid test	Employment relationship is evaluated under both common-law and economic reality test factors, with a focus on who has the right to control the means and manner of a worker's performance	Title VII Age Discrimination in Employment Act Americans with Disabilities Act

In practice, worker classification is far more complex than suggested by the three relatively simple categories of tests shown above. Indeed, worker classification remains a contentious and frequently litigated issue under Federal law,<sup>5</sup> and is further complicated by significant cross-state variation in the tests used to determine employment status under a variety of state programs.<sup>6</sup>

In the primary area of interest here – worker classification under the Internal Revenue Code for purposes of income tax withholding and related tax issues – the IRS has traditionally

<sup>4</sup> Muhl at 6.

<sup>5</sup> See e.g., *FedEx Home Delivery v. National Labor Relations Board*, 563 F.3d 292 (2009); and, *Vizcaino v. Microsoft* 120 F.3d 1006 (1997).

<sup>6</sup> See e.g., Pamela Doty, Judith Kasper and Simi Litvak, *Consumer-Directed Models of Personal Care* (U.S. Department of Health and Human Services, 1996) (detailing differences in state approaches to home health care providers) (available at <http://aspe.hhs.gov/daltcp/reports/lessons.htm>); and, Charles M. Watkins, *Couriers: Independent Contractors or Employees? A State-by-State Survey of Unemployment Compensation Laws* (detailing differences in classification standards for state unemployment insurance programs) (available at <http://www.mcaa.com/Portals/0/ICs-Overview%20of%20State%20Laws.pdf>).

relied upon a list of 20 indicia to implement the common law test.<sup>7</sup> The inherent ambiguities associated with classification, and the IRS' sometimes overly aggressive enforcement efforts, however, have led to taxpayer complaints about ambiguity and inconsistent enforcement.<sup>8</sup>

As discussed further in Section IV below, the primary factor motivating the IRS on worker classification issues has been and remains its essentially unsupported contention that independent contractors are more likely than employees to underreport income. Thus, the IRS traditionally has worried that employees and/or employers may have incentives to misclassify workers as independent contractors when they are actually employees, has sought to narrow the definition of independent contractors for tax purposes, and has pursued enforcement activities designed to discourage and prosecute what it views as worker misclassification.

In 1977, the General Accounting Office reviewed the IRS' application of the common law test for worker classification, concluding that

...the application of the common law rules to specific employee/self-employed situations is open to broad and inconsistent interpretation. For example, not all of these rules are always present in every employment situation. Some of the rules do not apply to certain occupations. Further, the rules vary as to applicability and importance in different situations. Evaluating the weight to be given various rules is often a subjective matter, even though IRS and employers make a strong and comprehensive effort to develop all relevant facts. As a result, many employers cannot, with any degree of certainty, determine who will be considered an employee until after IRS has audited the situation.<sup>9</sup>

GAO also found "inconsistent and conflicting interpretations of the common law rules by IRS personnel,"<sup>10</sup> even in the context of audits:

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<sup>7</sup> See e.g., Muhl at 5-6. See also *Present Law and Background Relating to Worker Classification for Federal Tax Purposes*, Joint Committee on Taxation (May 7, 2007).

<sup>8</sup> See generally U.S. General Accounting Office, *Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions* (GGD-77-88) (November 21, 1977) (hereafter GAO 1977).

<sup>9</sup> GAO 1977 at 7. Then, as now, the IRS interpreted the common law test based on 20 criteria, such as the extent to which the worker performs tasks under the instruction of the employer, and the extent to which a worker's activities are integrated into those of the employer. See GAO 1977 at 5-6, Joint Committee on Taxation 2007 at 3-5.

<sup>10</sup> GAO 1977 at 9.

The difficulty of conflicting interpretations of the common law rules is further highlighted by IRS audit contradictions. IRS individual tax audits sometimes treated individuals as self-employed while agents auditing the business the individuals worked for classified them as employees.<sup>11</sup>

Based on these findings, the GAO recommended a number of reforms, including creating several “safe-harbor” provisions under which workers would be presumed to be independent contractors for tax purposes.<sup>12</sup>

In response, Congress enacted Section 530 of the Revenue Act of 1978, which creates a safe harbor for businesses which classify workers as independent contractors so long as: (a) the business is consistent in its classification as independent contractors for federal tax purposes of all workers who hold positions that are “substantially similar” to positions held by the worker at issue; (b) there is a “reasonable basis” for classifying the worker as an independent contractor;<sup>13</sup> and, (c) the business complies with tax reporting requirements by filing 1099-MISC forms for each independent contractor with the IRS when required.<sup>14</sup> Other changes have created statutory non-employee status for particular occupations, including real estate agents, direct sellers<sup>15</sup> and companion sitters;<sup>16</sup> classified certain other workers (e.g., traveling salespeople) as “statutory employees” for certain purposes;<sup>17</sup> and, exempted certain occupations (including engineers,

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<sup>11</sup> GAO 1977 at 9.

<sup>12</sup> GAO 1977 at iii.

<sup>13</sup> A taxpayer can establish reasonable basis for purposes of Section 530 by showing that its treatment of a worker as an independent contractor was in reasonable reliance on legal precedent or specified types of IRS guidance, Section 530(a)(2)(A); a prior IRS audit of the taxpayer, Section 530(a)(2)(B); or a long-standing practice followed by significant segment of the industry in which the taxpayer operates, Section 530(a)(2)(B). In addition, the legislative history accompanying Section 530 and Rev. Proc. 85-18, 1985-1 C.B. 518 make clear that reasonable basis can also be demonstrated “in some other manner.”

<sup>14</sup> See e.g., William Hays Weissman, *Section 530: Its History and Application in Light of the Federal Definition of the Employer-Employee Relationship for Federal Tax Purposes* (National Association of Tax Reporting and Professional Management, February 28, 2009). As discussed further below, taxpayers must report income on their tax returns regardless of their classification, the main difference being that employment income reported on form W-2 is recorded directly onto IRS form 1040, while income reported on form 1099-MISC is generally recorded on Schedule C and are then, after additional calculations, carried over to form 1040.

<sup>15</sup> See 26 U.S.C. § 3508.

<sup>16</sup> See 26 U.S.C. § 3506.

<sup>17</sup> See 26 U.S.C. § 3121(d)(3).

designers, drafters and computer programmers who work for contract employment companies) from the Section 530 safe harbor rules altogether.<sup>18</sup>

While worker classification remains a complex matter even with the Section 530 safe harbor, it is far less complex than if the common law rules were applied without the safe harbor provisions. The primary IRS publication describing the common law guidelines, Publication 15-A, contains four full pages (complete with examples) on worker classification; the training manual for IRS employees covers 160 pages;<sup>19</sup> and, even with the safe harbor, disputes and litigation are not uncommon. Absent Section 530, the question of what constitutes an independent contractor for Federal tax purposes would be even more ambiguous than it is today, resulting in increased regulatory risk for independent contractors and their clients alike,<sup>20</sup> and biasing the marketplace away from independent contractors towards employment relationships – even when an IC relationship would be preferred by both parties, and most efficient for the economy overall.

## **B. Independent Contractors in the U.S. Economy**

Given the ambiguous legal criteria that define IC status, it is not surprising that statistical agencies also face challenges in quantifying the number and characteristics of independent contractors in the U.S.

The primary source of data on independent contractors and other alternative work arrangements in the U.S. is the Census Bureau's Current Population Survey ("CPS"). Two CPS surveys contain particularly relevant information, the Monthly Household Survey ("MHS"),

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<sup>18</sup> See Tax Reform Act of 1986 (P.L. 99-514), Sec. 1706.

<sup>19</sup> See IRS, *Employer's Supplemental Tax Guide* (Publication 15-A, 2010) (available at <http://www.irs.gov/pub/irs-pdf/p15a.pdf>) and IRS, *Independent Contractor or Employee: Training Materials* (1996) (available at <http://www.irs.gov/pub/irs-utl/emporind.pdf>). Another set of guidelines is offered in IRS Publication 1779, "Independent Contractor or Employee" (2008) (available at <http://www.irs.gov/pub/irs-pdf/p1779.pdf>).

which includes two questions on whether workers are self-employed, and a series of special surveys on Contingent and Alternative Work Arrangements (“CAWA”), which collect more detailed data on “alternative work arrangements,” including “independent contractors.”<sup>21</sup>

### **1. CPS Monthly Household Survey**

The basic CPS Monthly Household Survey asks respondents, “Are you employed by government, by a private company, a nonprofit organization, or were you self-employed?” Respondents who answer that they are “self-employed” are next asked, “Is this business incorporated?”<sup>22</sup> The MHS collects extensive data on both unincorporated and incorporated self-employed workers, but does not provide the information required to separate workers into IC and non-IC categories with any degree of precision. Therefore, for example, the MHS data include workers who operate small retail businesses (e.g., a corner hot dog stand), and thus are not “contractors” in either the colloquial or legal sense. Data from the CAWA survey suggests approximately 60 percent of self-employed workers are independent contractors as defined by BLS.

As shown in Figure Three, the monthly CPS data indicate that approximately 11 percent of the civilian workforce is self-employed, and that this proportion has not changed significantly over the course of the past two decades.<sup>23</sup>

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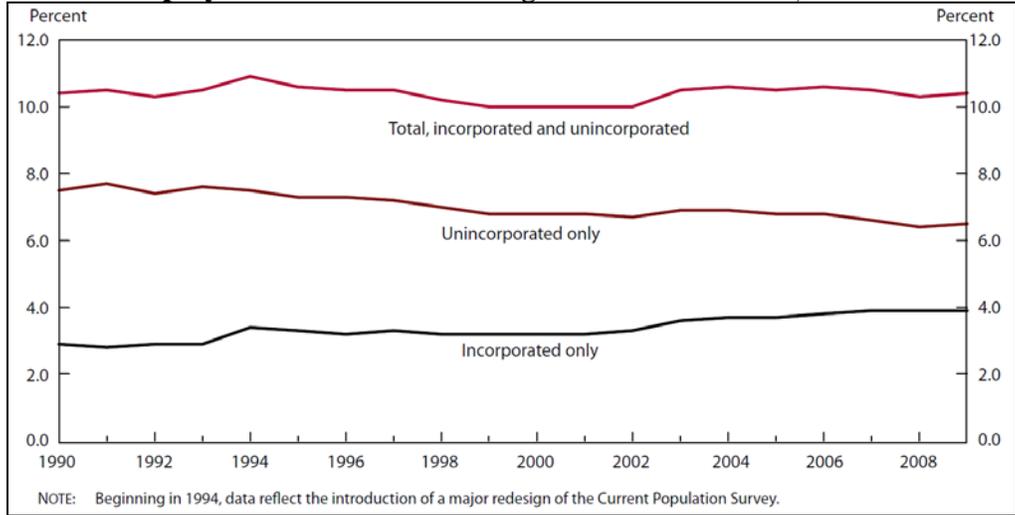
<sup>20</sup> See, e.g., Weissman at 15. (“[T]he need for Section 530 has not diminished over the last 30 years, as there is no less confusion or difficulty in determining a workers status than there was in 1978.”)

<sup>21</sup> As discussed below, neither metric corresponds precisely to the definition of independent contractor that appears to concern the IRS – that is, the worker who, though appropriately considered an employee, is misclassified as an independent contractor, and thus receives a form 1099-MISC rather than a W-2.

<sup>22</sup> See Steven F. Hipple, “Self-Employment in the United States,” *Monthly Labor Review* (September 2010) 17-32, 18.

<sup>23</sup> However, as the figure shows, the proportion of unincorporated self-employed is falling relative to incorporated self-employed. As BLS explains, “Self-employed workers typically incorporate their businesses in order to receive traditional benefits of the corporate structure, including limited liability, tax considerations, and the enhanced opportunity to raise capital through the sale of stocks and bonds.” (Hipple 2010 at 18).

**Figure Three:  
Self-Employment Rates for Non-Agricultural Workers, 1990-2009<sup>24</sup>**



The MHS survey estimates the numbers of agricultural as well as non-agricultural workers. As shown in Figure Four, about nine out of ten self-employed workers are in non-agricultural jobs.

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<sup>24</sup> Hipple 2010 at 21.

**Figure Four:  
Agricultural and Non-Agricultural Self-Employed Workers,  
Seasonally Adjusted, 2000-2010 (000s)<sup>25</sup>**

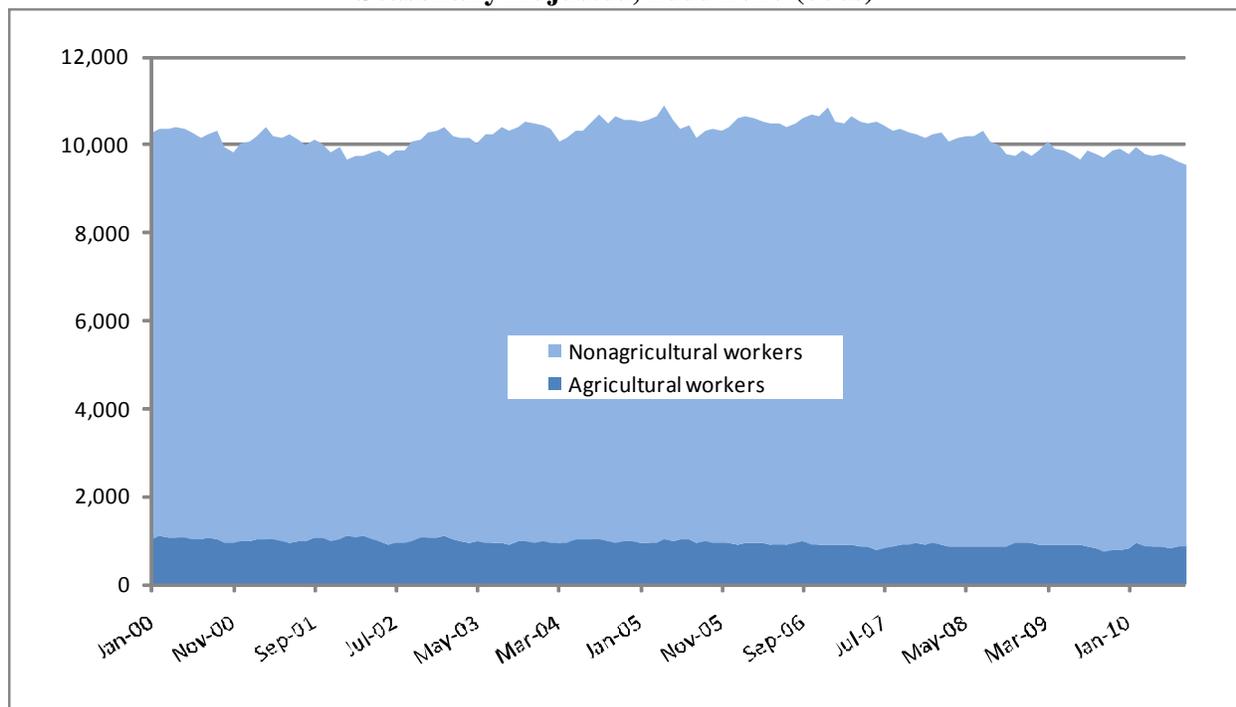
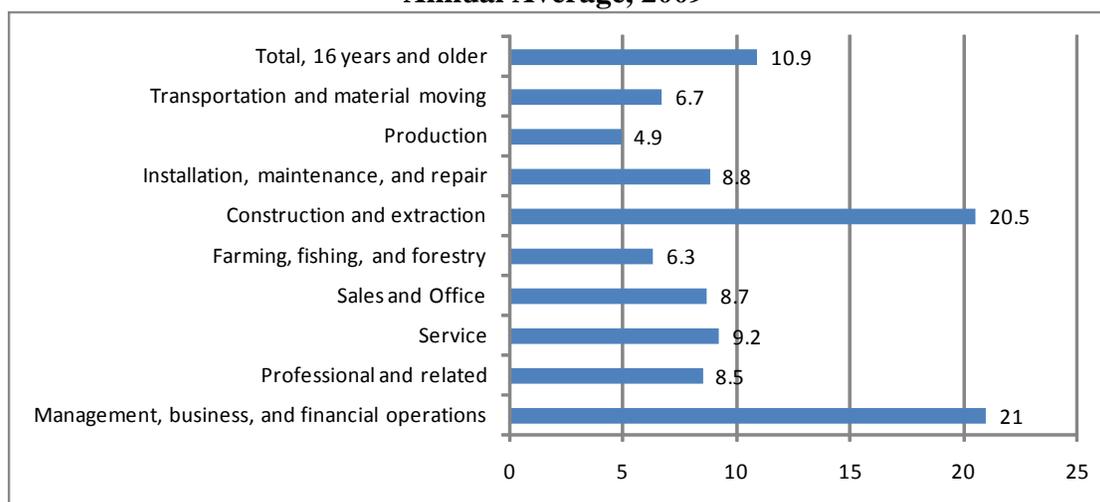


Figure Five shows the distribution of self-employed workers by occupation as of 2009. Overall, about 10.9 percent of all workers are self-employed, but the proportion varies widely by occupation, with more than 20 percent of workers engaged in both Construction and Extraction occupations and Management, Business and Financial Operations occupations classified as self-employed. Conversely, only about one of every twenty workers engaged in production occupations is self-employed.

<sup>25</sup> Bureau of Labor Statistics, Navigant Economics.

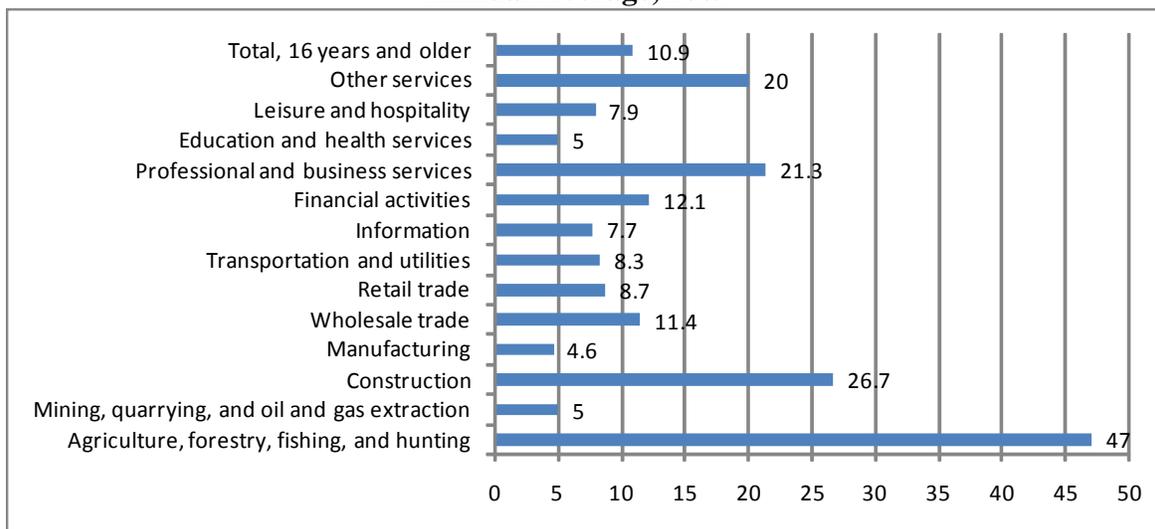
**Figure Five:  
Proportion of Workers Self-Employed, by Occupation,  
Annual Average, 2009<sup>26</sup>**



As shown in Figure Six, there is significant variation in the proportions of self-employed workers across industries as well as occupations. Nearly half (47 percent) of all workers in Agriculture, Forestry and Related Industries are self-employed, and more than one in four (26.7 percent) in Construction are self-employed. By contrast, fewer than one in 20 workers (4.6 percent) in Manufacturing industries are self-employed.

<sup>26</sup> Hipple 2010 at 29, Navigant Economics. Includes both incorporated and unincorporated self-employed.

**Figure Six:  
Percentage of Workers Self-Employed, by Industry,  
Annual Average, 2009<sup>27</sup>**



Overall, the CPS self-employment data show that about 11 percent of all workers in the U.S. are self-employed, but in some occupations and industries, the proportion is much higher, suggesting that the economic benefits of self-employment arrangements (including independent contracting) are especially significant in particular areas of the economy.

## 2. CPS Contingent and Alternative Work Arrangements Survey

The second primary source of data on the IC workforce is the CAWA survey, which was first conducted by CPS in 1995, with subsequent surveys in 1997, 1999, 2001 and, most recently, 2005.<sup>28</sup> While the most recent CAWA survey is now five years old, it is nevertheless useful because it includes questions that provide greater insight into the prevalence and characteristics of work arrangements associated with independent contracting.

<sup>27</sup> Hipple 2010 at 29, Navigant Economics. Includes both incorporated and unincorporated self-employed.

<sup>28</sup> See Bureau of Labor Statistics, "Contingent and Alternative Employment Arrangements, February 2005," *Press Release* (July 27, 2005) (available at <http://www.bls.gov/news.release/conemp.toc.htm>); Bureau of Labor Statistics, "Contingent and Alternative Employment Arrangements, February 2001," (Press Release, May 24, 2001); Marisa diNatale, "Characteristics of and Preference for Alternative Work Arrangements, 1999," *Monthly Labor Review* (March 2001) 28-49; Sharon R. Cohany, "Workers in Alternative Employment Arrangements: A Second Look," *Monthly Labor Review* (November 1998) 3-21; Sharon R. Cohany, "Workers in Alternative Employment Arrangements," *Monthly Labor Review* (October 1996) 31-45. Detailed data reported herein also relies on unpublished tables provided by the Bureau of Labor Statistics, which are available upon request.

First, and of greatest obvious relevance, BLS defines as “Independent Contractors” workers who respond positively to either of the following two questions on the CAWA survey:

1. Last week, were you working as an independent contractor, an independent consultant, or a free-lance worker? That is, someone who obtains customers on their own to provide a product or service.” (Asked of people who were not working for contract companies and who were not on-call workers.)
2. Are you self employed as an independent contractor, independent consultant, free-lance worker, or something else? (Asked of employed people who said they were self-employed.)<sup>29</sup>

As the BLS explains, the purpose of asking these questions is to distinguish “those who consider themselves to be independent contractors, consultants, or free-lance workers from those who are business operators such as shop owners or restaurateurs,” and to identify workers who “obtain customers on their own to provide a product or service.”<sup>30</sup> In both of these senses, the CAWA definition of independent contractor is relevant to distinguishing recipients of form 1099-MISC from W-2 recipients. However, the fact that the BLS definition of independent contractors includes both “wage and salary workers” and “self-employed workers” signals that there remains some ambiguity. As Sharon Cohany, a BLS economist, explained in the 1996 *Monthly Labor Review* article presenting the results of the first CAWA supplement,

It may be tempting to classify independent contractors who were identified as wage and salary workers in the main questionnaire as workers who otherwise

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<sup>29</sup> See Bureau of Labor Statistics, Technical Documentation CPS-05, Current Population Survey, February 2005: Contingent Work Supplement File, Attachment 7. See also Bureau of Labor Statistics, “Contingent and Alternative Employment Arrangements, February 2005 Technical Note” (July 27, 2005) (available at <http://www.bls.gov/news.release/conemp.tn.htm>) (hereafter 2005 Technical Note).

<sup>30</sup> See 2005 Technical Note. (“Independent contractors are all those who are identified as independent contractors, consultants, and free-lance workers in the supplement, regardless of whether they are identified as wage and salary workers or self-employed in the responses to basic CPS labor force status questions. Workers identified as self-employed (incorporated and unincorporated) in the basic CPS are asked, ‘Are you self-employed as an independent contractor, independent consultant, or something else (such as a shop or restaurant owner)?’ in order to distinguish those who consider themselves to be independent contractors, consultants, or free-lance workers from those who are business operators such as shop owners or restaurateurs. Those identified as wage and salary workers in the basic CPS are asked, ‘Last week, were you working as an independent contractor, an independent consultant, or a free-lance worker? That is, someone who obtains customers on their own to provide a product or service.’”)

would have been employees of the company for which they were working or individuals who were “converted” to independent contractors to avoid legal requirements. However, the basic CPS questionnaire does not permit this distinction. Two individuals who are in exactly the same work arrangement may answer the question from the main questionnaire – “Were you employed by government, by a private company, a non-profit organization, or were you self-employed?” – differently, depending on their interpretation of the words “employed” and “self-employed.” It was not possible with the CPS supplement to collect information on the legal aspects of employment arrangements.<sup>31</sup>

In any case, as shown in Table One below, the vast majority of independent contractors – nearly nine out of ten – identify themselves as self-employed.<sup>32</sup>

**Table One:  
Independent Contractors, by Class of Worker, 1995-2005<sup>33</sup>**

	1995	1997	1999	2001	2005
<b>Total, 16 years and older</b>	8,309	8,456	8,247	8,585	10,342
<b>Wage and Salary</b>	1,234	1,044	963	1,156	1,375
Government	63	56	40	79	70
Private, For Profit	1,103	946	876	1,031	1,240
Private, Nonprofit	68	41	48	47	65
<b>Self-Employed</b>	7,075	7,413	7,284	7,428	8,968
Self-Employed, Incorporated	1,608	1,718	1,764	1,731	2,506
Self-Employed, Unincorporated	5,467	5,695	5,520	5,698	6,462
<b>Self-Employed As Percent of Total</b>	85.1%	87.7%	88.3%	86.5%	86.7%

In addition to identifying independent contractors, the CAWA survey also gathers data on three additional BLS classifications, “On-Call Workers,”<sup>34</sup> “Temporary Help Agency

<sup>31</sup> See Cohany 1996 at n. 4.

<sup>32</sup> BLS sometimes classifies self-employed workers who have incorporated businesses as “wage and salary workers,” on the grounds that they are employees of their own businesses.

<sup>33</sup> Bureau of Labor Statistics, Navigant Economics.

Workers,”<sup>35</sup> and “Contract Company Workers,”<sup>36</sup> each of which may include some workers who receive form 1099-MISC rather than W-2, and thus be part of the overall universe of workers relevant to the debate over Sec. 530.

Figure Seven shows the total numbers of workers in each of these alternative arrangements as reported by BLS for each available year from 1995 through 2005. As the figure shows, the number of independent contractors was essentially unchanged from 1995 through 2001, at roughly 8.5 million, but rose significantly to 10.3 million in 2005, the last date for which data is available. The number of workers in other types of alternative work arrangements also remained relatively constant before increasing significantly (especially on-call workers) in 2005. Overall, the number of workers in alternative arrangements increased from 12.1 million in 1995 to 14.8 million in 2005, an increase of 22 percent.

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<sup>34</sup> See 2005 Technical Note (“On-call workers are persons who are called into work only when they are needed. This category includes workers who answer affirmatively to the question, “Some people are in a pool of workers who are ONLY called to work as needed, although they can be scheduled to work for several days or weeks in a row, for example, substitute teachers and construction workers supplied by a union hiring hall. These people are sometimes referred to as ON-CALL workers. Were you an ON-CALL worker last week?” Persons with regularly scheduled work which might include periods of being ‘on call’ to perform work at unusual hours, such as medical residents, are not included in this category.”)

<sup>35</sup> See 2005 Technical Note (“Temporary help agency workers are all those who are paid by a temporary help agency. To the extent that permanent staff of temporary help agencies indicate that they are paid by their agencies, the estimate of the number of workers whose employment is mediated by temporary help agencies is overstated. This category includes workers who say their job is temporary and answer affirmatively to the question, ‘Are you paid by a temporary help agency?’ Also included are workers who say their job is not temporary and answer affirmatively to the question, ‘Even though you told me your job is not temporary, are you paid by a temporary help agency?’”)

<sup>36</sup> See 2005 Technical Note (“Workers provided by contract firms are those individuals identified as working for a contract company, and who usually work for only one customer and usually work at the customer's worksite. The last two requirements are imposed to focus on workers whose employment appears to be very closely tied to the firm for which they are performing the work, rather than include all workers employed by firms that provide services. This category includes workers who answer affirmatively to the question, ‘Some companies provide employees or their services to others under contract. A few examples of services that can be contracted out include security, landscaping, or computer programming. Did you work for a company that contracts out you or your services last week?’ These workers also have to respond negatively to the question, ‘Are you usually assigned to more than one customer?’ In addition, these workers have to respond affirmatively to the question, ‘Do you usually work at the customer's worksite?’”)

**Figure Seven:  
Workers in Alternative Work Arrangements (in Thousands), 1995-2005<sup>37</sup>**

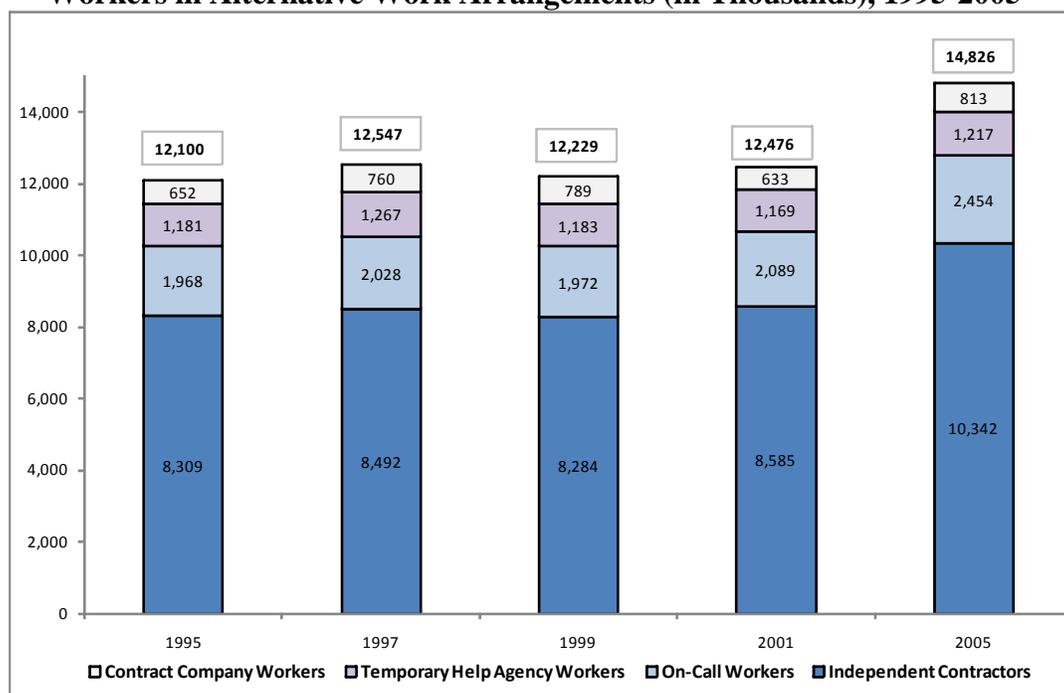
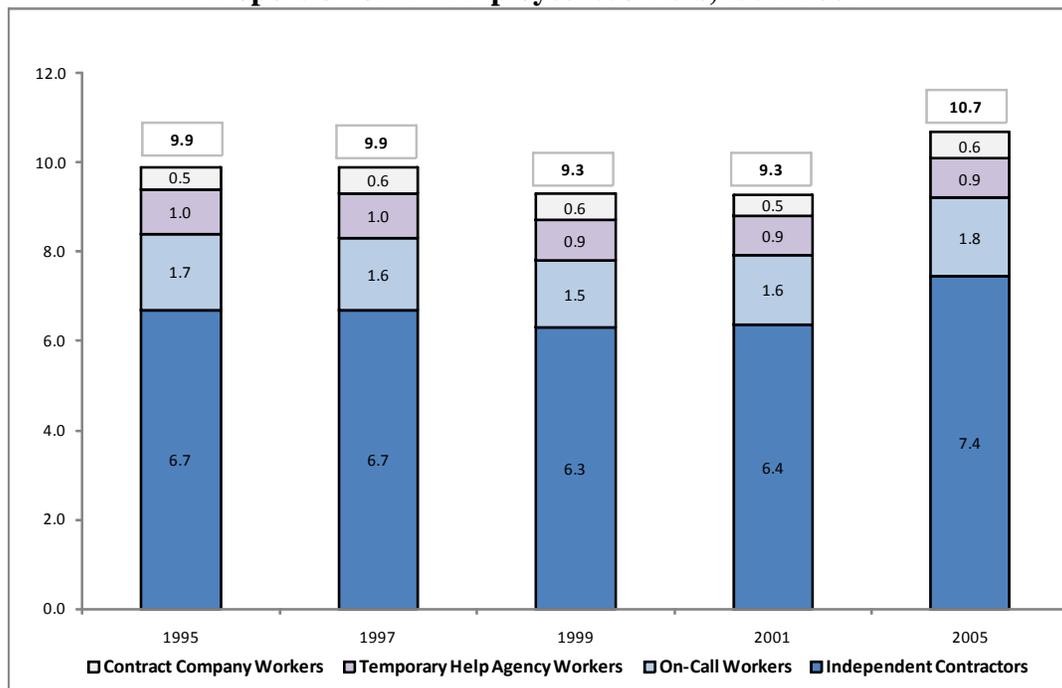


Figure Eight shows the same data as a proportion of all employed workers, and shows that alternative employment in general, and independent contractors in particular, were growing as a proportion of the workforce as well as in absolute terms. Specifically, independent contractors grew from 6.7 percent of the workforce in 1995 to 7.4 percent a decade later, a shift that resulted in an increase in the proportion of the entire workforce accounted for by all alternative workers from 9.9 percent in 1995 to 10.7 percent in 2005.

<sup>37</sup> Bureau of Labor Statistics, Navigant Economics.

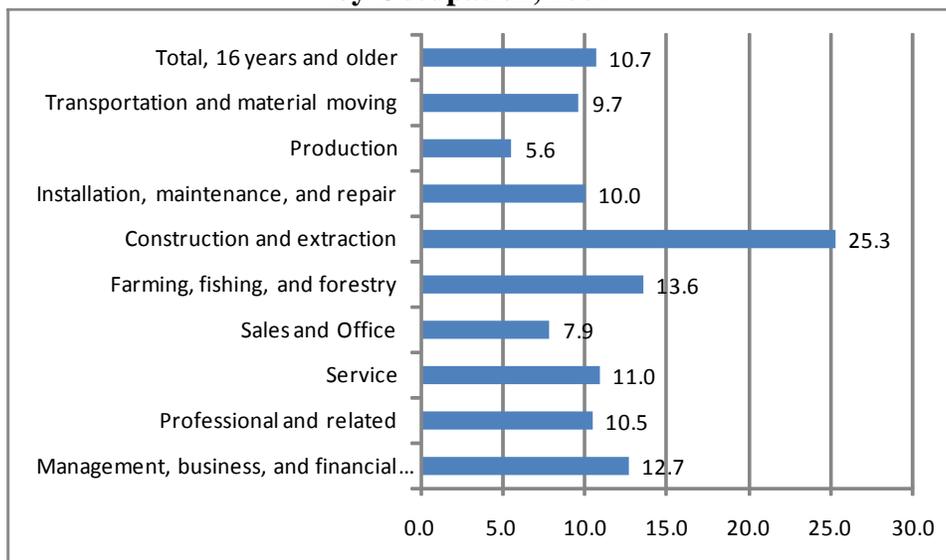
**Figure Eight:  
Workers in Alternative Work Arrangements as a  
Proportion of All Employed Workers, 1995-2005<sup>38</sup>**



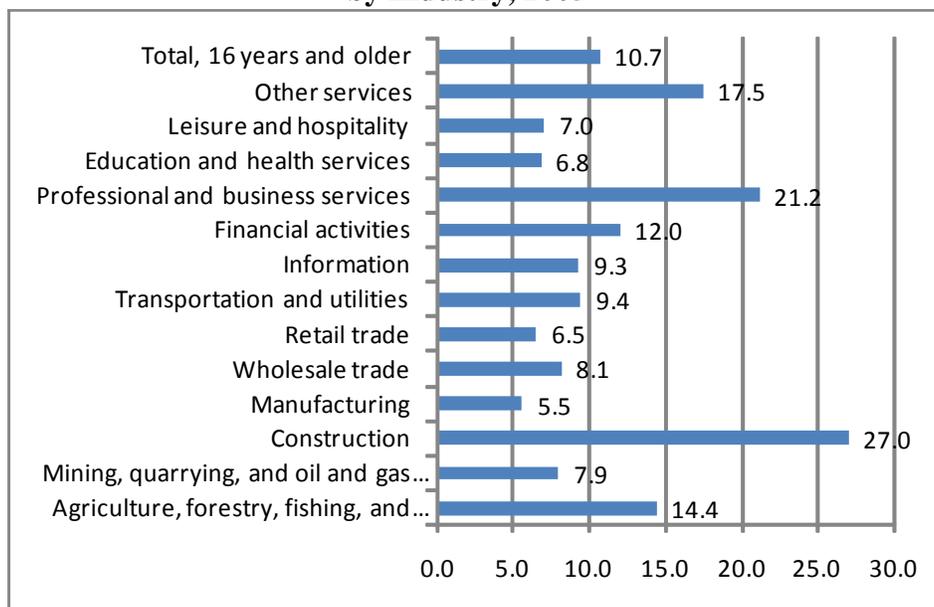
Like the monthly CPS survey data on self-employment, the CAWA data can be broken down by occupation, industry, and so forth. As shown in Figures Nine and Ten, respectively, the breakdowns by occupation and industry bear a strong (but not perfect) resemblance to the same breakdowns for self-employed workers. Again, alternative work arrangements are seen to be present throughout the economy, but most common in Construction and in Managerial occupations, as well as in Agriculture and Forestry.

<sup>38</sup> Bureau of Labor Statistics, Navivant Economics.

**Figure Nine:  
Percentage of Workers in Alternative Work Arrangements,  
by Occupation, 2005<sup>39</sup>**



**Figure Ten:  
Percentage of Workers in Alternative Work Arrangements,  
by Industry, 2005<sup>40</sup>**



<sup>39</sup> BLS July 2005.

<sup>40</sup> BLS July 2005.

### C. Examples of Independent Contractor Relationships

While these data provide a useful overview of the IC sector, they fail to capture the diversity of IC relationships and the disproportionate significance of ICs in particular economic sectors. This section presents some examples – not intended to be comprehensive – of industries and occupations in which independent contracting plays an especially significant role.<sup>41</sup> Specifically, it briefly describes the roles of independent contractors in some representative occupations: Cab Drivers and Couriers; Caregivers; Construction Workers; Financial Advisors; Forest Product Suppliers; Mystery Shoppers; Physicians; and, Truck Drivers.

#### 1. Cab Drivers and Couriers

According to a 2005 study by the Center for Transportation Studies at the University of Missouri, “The use of the independent contractor drivers in the U.S. taxicab, limousine, paratransit and shuttle transportation modes (the private for-hire passenger vehicle industry) has become the standard business model.”<sup>42</sup> As shown in Table Two below, the CAWA survey reports that one out of five workers in the taxicab and limousine business and seven percent of workers in the courier and messenger industry are engaged in alternative employment. Data from the Department of Transportation (DOT), as data collected by Taxicab, Limousine & Paratransit Association (TLPA), suggests the actual proportion is much higher. According to a DOT 1988 study, 74.1 percent of taxi drivers were independent contractors as of 1986.<sup>43</sup> More recent data,

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<sup>41</sup> For reasons explained further in Section III below, IC relationships are most common in occupations and industries in which workers work for more than one firm at a time, or switch firms frequently (e.g., emergency room doctors, messengers and couriers); in which compensation is directly related to output as opposed to hours worked (e.g., truck drivers, real estate agents); and, in which the “other contracting party” is actually acting as a “middle-man” or “broker” between the contractor and the ultimate service recipient (e.g., caregivers, “mystery shoppers”).

<sup>42</sup> See Ray A. Mundy *et al*, *Using Independent Contractor Drivers* (Center for Transportation Studies, October 21, 2005) at 5. See also IRS Revenue Ruling 71-752, 1971-2 C.B. 347 (detailing the circumstances under which taxi drivers are considered independent contractors by the IRS).

<sup>43</sup> See *A Statistical Profile of the Private Taxicab and Paratransit Industry* (U.S. Department of Transportation, 1988) at 16.

from the TLPA, shows that independent contractors comprised 88.3 percent of all taxi drivers in 2009.<sup>44</sup>

**Table Two:  
Alternative Employment in Courier and Taxi Jobs, 2005<sup>45</sup>**

	Independent Contractors	Other Alternative Employment	Total Alternative Employment	Traditional Employees	Percent of Total Employment	
					Independent Contractors	All Alternative Employment
<u>Occupations</u>						
Couriers and messengers	14,511	4,824	19,335	262,053	5.2%	6.9%
Taxi drivers and chauffeurs	26,663	8,140	34,803	181,270	12.3%	16.1%
<u>Industries</u>						
Couriers and messengers	35,598	11,046	46,644	584,573	5.6%	7.4%
Taxi and limousine services	27,219	8,140	35,359	127,087	16.8%	21.8%

Like other types of independent contractors, the workers in these occupations move frequently from client to client and from project to project. In each case, workers are likely to make significant investments in their own equipment (whether a taxicab or a bicycle used to deliver packages). Companies in these fields benefit from having access to numerous suppliers without incurring the fixed costs and commitments of owning capital and entering into traditional employment arrangements, thus allowing them to respond efficiently to fluctuations in demand. By the same token, workers benefit from being able to market their services to multiple buyers.<sup>46</sup>

## 2. Caregivers

The CAWA survey reports that nearly 100,000 personal and home care aides, or about 15 percent, work in alternative employment arrangements, including approximately 49,000 independent contractors, 5,000 contract company workers, 25,000 on-call workers and 19,000

<sup>44</sup> See *2010 Taxicab Fact Book* (Taxicab, Limousine and Paratransit Association, 2010) at 12. There are a number of reasons the BLS data might understate the prevalence of IC status. For example, the BLS data is based on primary employment, and thus ignores second jobs.

<sup>45</sup> Bureau of Labor Statistics, Navigant Economics.

<sup>46</sup> See generally Mundy *et al* at 27-29.

temporary agency workers. On an industry basis, the data breaks out slightly differently: approximately 126,000 out of 745,000 workers (17 percent) in the home health care services industry work in alternative arrangements. Of these, 47,000 are ICs, 25,000 work for temporary agencies, 45,000 are on call workers and 9,000 are contract company employees.

Home care aids (sometimes known as caregivers or homecare companions) who are independent contractors may work directly for their clients or, alternatively, participate in caregiver registries, which perform screening and credential verification services, connect caregivers with clients, and facilitate billing. Such registries play particularly significant roles in certain states. In Florida, for example, there are 345 licensed “nurse registries” which facilitate caregiver services through independent contractor arrangements.<sup>47</sup>

Caregivers share many of the characteristics common to independent contractor and other alternative employment arrangements, including the desire to work for multiple “clients” either simultaneously or sequentially over a relatively short period of time, and to control the amount of time dedicated to work.<sup>48</sup> Clients often prefer engaging independent caregivers, rather than an agency, both in order to save money and because the direct relationship leads to better outcomes;<sup>49</sup> and, they prefer to engage caregivers as independent contractors rather than employees in order to reduce paperwork as well as costs.<sup>50</sup>

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<sup>47</sup> See Gary Uber, *Testimony Before the Senate Committee on Health, Education, Labor, and Pensions, on Behalf of the Private Care Association, Inc.* (June 17, 2010)

<sup>48</sup> See BLS, *Occupational Outlook Handbook*, 2010-11 Edition, Home Health Aides and Personal and Home Care Aides (available at <http://www.bls.gov/oco/ocos326.htm>).

<sup>49</sup> See Doty, Kasper and Litvak at 19 (“As our analysis has shown, states have often found themselves attracted to ‘consumer-directed’ models of financing and delivering attendant care because they seemed to offer a means both to curb costs and to achieve positive outcomes--in terms of greater satisfaction, independence, and empowerment--for clients. Given the accumulating evidence of the value of maximizing consumer-directed care and the impending major changes in U.S. health care, development of workable models for promoting increased consumer choice and control is critical.”).

<sup>50</sup> See, e.g., Marilyn Cleland, Vicki L. Schmall and Sally Bowman, *Hiring & Working Successfully with In-Home Care Providers* (Pacific Northwest Extension Publication PNW 547, January 2002).

### 3. Construction Workers

More than one in four workers in the construction industry – nearly 2.9 million out of 10.2 million in 2005 – is in an alternative employment relationship; the vast majority of these, 2.3 million, are independent contractors. As shown in Table Three, construction-related occupations in which IC relationships are especially common include brickmasons (26 percent), carpenters (28 percent), construction managers (44 percent), and painters, construction and maintenance workers (35 percent).

**Table Three:  
Alternative Employment in Construction, Selected Occupations, 2005<sup>51</sup>**

	Independent Contractors	Other Alternative Employment	Total Alternative Employment	Traditional Employees	Percent of Total Employment	
					Independent Contractors	All Alternative Employment
Construction Industry Total	2,280,429	578,842	2,859,271	7,419,482	22.2%	27.8%
Carpenters	491,970	86,172	578,142	1,205,718	27.6%	32.4%
Construction managers	323,595	734	324,329	410,134	44.1%	44.2%
Painters, construction, maintenance	209,390	46,789	256,179	350,505	34.5%	42.2%
Carpet, floor, and tile installers	145,717	12,063	157,780	209,686	39.7%	42.9%
Pipelayers, plumbers, etc.	79,549	37,665	117,214	528,303	12.3%	18.2%
Brickmasons, etc.	40,906	25,621	66,527	93,270	25.6%	41.6%
Drywall installers, etc.	35,821	26,403	62,224	209,991	13.2%	22.9%

Construction workers are often called from project to project, working for multiple construction companies, or for independent construction managers, frequently for relatively brief periods.<sup>52</sup> On the employer side, many construction companies are not large enough to keep specialized workers fully occupied at all times, or need the ability to respond to changes in demand, and thus benefit from engaging workers on a project-by-project basis.

<sup>51</sup> Bureau of Labor Statistics, Navigant Economics.

<sup>52</sup> See, e.g., BLS, *Occupational Outlook Handbook*, 2010-11 Edition, Carpenters (available at <http://www.bls.gov/oco/ocos202.htm>).

#### **4. Financial Advisors**

According to the Cerulli Associates, approximately 201,000 financial advisors, or about 64 percent of all practicing registered representatives, operated as self-employed independent contractors during 2009.<sup>53</sup> Independent financial advisors typically are affiliated with broker-dealer firms, and earn at least a portion of the income in the form of commissions.<sup>54</sup>

Independent financial advisors share many of the characteristics typical of other independent contractors. They work for multiple customers; they are compensated on the basis of their performance, rather than on an hourly or salaried basis; they work the hours of their choice; and, they often supply most or all of the capital needed to operate their businesses.

#### **5. Forest Product Suppliers**

As noted above, the industry with the highest overall proportion of self-employed and alternative employment workers (based on the CAWA survey) is Agriculture, Forestry and Fishing, where 47 percent of all workers are self-employed. Many of these self-employed workers are independent contractors. According to the CAWA survey data, of the approximately 92,000 workers in the Logging industry in 2005, nearly 21,000 (23 percent) were independent contractors. On an occupational basis, of the 67,000 workers classified as Logging Workers, more than 25,000 (38 percent) were ICs. As the BLS points out, in the United States, “most [logging] crews work for self-employed logging contractors who have substantial logging experience, the capital to purchase equipment, and the skills needed to run a small business

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<sup>53</sup> Data provided by the Financial Services Institute, Cerulli Associates, 2010. Cerulli’s figure represents financial advisors in the independent broker-dealer channel, and independent financial advisors affiliated with insurance and bank broker-dealers. The BLS collects data related to the number of self-employed financial advisors, however, for the purposes of this study the BLS definition of a Personal Financial Advisors is overly narrow and thus under-represents the number of independent contractors.

<sup>54</sup> See Financial Services Institute, “What is an IBD?” (October 2010).

successfully.” It also notes that “many contractors work alongside their crews as supervisors, and often operate one of the logging machines....”<sup>55</sup>

## 6. Mystery Shoppers

In some ways, the mystery shopping business is the prototypical IC industry. Mystery shopping firms contract with individuals to provide market research and quality control services by visiting or telephoning retail establishments and rating the quality of service they receive. Mystery shoppers work outside of the direct control of their clients, who are unable to observe and could not reasonably be expected to monitor their hours of work, etc.<sup>56</sup> Also like some other IC-intensive occupations, mystery shoppers tend to work part time, and may work for multiple clients and on scores of different projects over the course of a year.<sup>57</sup> The mystery shopping business had estimated revenues in excess of \$600 million in 2005,<sup>58</sup> and the Mystery Shopping Providers Association estimates more than 1.5 million independent contractors work as mystery shoppers.<sup>59</sup>

## 7. Physicians

Overall, BLS reports that about 12 percent of physicians and surgeons were self-employed in 2008;<sup>60</sup> the 2005 CAWA survey indicates approximately 14 percent were in

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<sup>55</sup> BLS, *Occupational Outlook Handbook*, 2010-11 Edition, Logging Workers (available at <http://www.bls.gov/oco/ocos351.htm>). Of course, logging “crews” are often comprised of independent contractors rather than employees.

<sup>56</sup> Indeed, mystery shopping services maintain databases with hundreds of thousands of mystery shoppers who can be called upon to conduct research in markets throughout the U.S. See, e.g., Carolyn M. Brown, “How to Set Up a Mystery Shopping Program,” *Inc.* (October 11, 2010) (available at <http://www.inc.com/guides/2010/10/how-to-set-up-a-mystery-shopping-program.html>).

<sup>57</sup> Customers of mystery shopping firms typically desire to have multiple shoppers visit each establishment in order to get a representative sample of experiences. Hence, mystery shopping firms need to be able to employ large numbers of mystery shoppers, who typically work episodically.

<sup>58</sup> See “Mystery Shopping Industry Estimated at Nearly \$600 Million in United States” (Mystery Shopping Providers Association, November 2005) (available at [http://www.mysteryshop.org/news/article\\_pr.php?art\\_ID=69](http://www.mysteryshop.org/news/article_pr.php?art_ID=69)).

<sup>59</sup> See “Mystery Shopping Industry to Send Teams to Capitol Hill in Attempt to Preserve Jobs for Millions” (Mystery Shopping Providers Association, April 2009) (available at [http://www.mysteryshop.org/news/article\\_pr.php?art\\_ID=100](http://www.mysteryshop.org/news/article_pr.php?art_ID=100)).

<sup>60</sup> BLS, *Occupational Outlook Handbook*, 2010-11 Edition, Physicians and Surgeons (available at <http://www.bls.gov/oco/ocos074.htm>).

alternative employment arrangements, including approximately 94,000 independent contractors, 12,000 who were in on-call arrangements, and 3,400 who worked through contract companies. One particularly common form of independent contracting is referred to as “*locum tenens*” (meaning to “fill in temporarily” for another). According to an article posted by the *New England Journal of Medicine*, more than a third of U.S. physicians worked *locum tenens* at some point during 2008.<sup>61</sup>

IC arrangements are especially common among emergency room workers: One survey reports that one in five emergency room doctors are independent contractors.<sup>62</sup> As the American Counsel of Emergency Physicians (ACEP) reported,

Most hospitals in the U.S. choose to outsource their emergency physician services, i.e., to contract with an outside provider group on an independent contractor basis. Some states prohibit direct physician employment, making contracted emergency physician services mandatory in those states.<sup>63</sup>

In the same report, however, ACEP warned that the prevalence of independent contractor arrangements among emergency room physicians was likely to drop, however, in part due to IRS pressure to re-classify them as employees.<sup>64</sup>

Independent contractor arrangements involving physicians share many of the same characteristics as IC arrangements in other sectors: They allow physicians to move easily from

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<sup>61</sup> See Bonnie Darves, “Locum Tenens: Lifestyle, Opportunities Attracting More Physicians,” *New England Journal of Medicine Career Center* (July 2009) (available at <http://www.nejmjobs.org/locum-tenens-medicine.aspx>).

<sup>62</sup> See, e.g., Sandra McGinnis, Jean Moore and David Armstrong, *The Emergency Care Workforce in the U.S.* (Center for Health Workforce Studies, August 2006) at 4 (reporting that “nearly 20% of physicians reporting their specialty as EM worked as independent contractors.”)

<sup>63</sup> Christopher L. Bredeson, “Practice Management Organizations: History, Structure, and Applications to the Practice of Emergency Medicine,” in Nancy J. Auer, Ed., *The Future of Emergency Medicine* (American College of Emergency Physicians, 1998) at 21. Bredeson warns that market forces, combined with IRS pressure on independent contractors, could result in the end of the independent contractor “within the next decade,” but thus far this prediction has proven inaccurate.

<sup>64</sup> See Bredeson 1998 at 22. See also D. Benson Tesdahl, “Are Emergency Room Physicians Always Employees?” *Healthcare Financial Management* (May 1994) (available at [http://findarticles.com/p/articles/mi\\_m3257/is\\_n5\\_v48/ai\\_15484885/](http://findarticles.com/p/articles/mi_m3257/is_n5_v48/ai_15484885/)) (“[E]mergency room physicians have been singled out by the IRS as a category of physicians who are often treated as independent contractors by hospitals but should, in the view of the IRS, be characterized as employees.”)

opportunity to opportunity, while providing hospitals and other health facilities with the ability to acquire services on an as-needed basis.<sup>65</sup> In short, they facilitate workplace and career flexibility that satisfies the needs of both workers and health-care facilities.

## 8. Truck Drivers

The 273,000 independent contractors BLS estimates work in the truck transportation industry constitute one of the largest distinct groups of IC workers in the workforce, accounting for nearly 14 percent of all truck transportation workers. Among all “driver/sales workers and truck drivers,” the CAWA survey reported a total of nearly 302,000 independent contractors; another 121,000 workers were in other forms of alternative employment arrangements.

**Table Four:  
Alternative Employment in Trucking, 2005<sup>66</sup>**

	Independent Contractors	Other Alternative Employment	Total Alternative Employment	Traditional Employees	Percent of Total Employment	
					Independent Contractors	All Alternative Employment
Truck transportation	273,130	66,521	339,651	1,635,575	13.8%	17.2%
Driver/sales workers and truck drivers	301,909	120,793	422,702	2,944,690	9.0%	12.6%

Independent owner-operators are defined by the fact that they own or lease the own equipment, which they may either use to deliver freight directly on behalf of multiple customers, or lease for a defined period to a trucking company. In either case, independent truckers share many of the common characteristics of independent contractors, including the facts that they work “offsite,” have significant control over hours worked, and have freedom to move from employer to employer or project to project.

<sup>65</sup> See, e.g., *Summary Report: 2008 Review of Temporary Physician Staffing Trends* (Staff Care, 2008) (available at <http://www.staffcare.com/pdf/2008scisurveytemp trends.pdf>).

<sup>66</sup> Bureau of Labor Statistics, Navigant Economics.

### III. THE ECONOMICS OF INDEPENDENT CONTRACTING

The discussion in Section II above demonstrates that independent contractors play a significant role in the U.S. economy, accounting for approximately one out of 10 workers overall, with the proportion much higher in some sectors than in others. It also provides some suggestions about the characteristics of occupations and industries in which IC arrangements are most common: The need to move frequently from project to project, or to work multiple projects at once; conversely, the need for firms to be able to respond to short-run changes in demand, or make up for gaps in supply, by calling on more workers than they could economically maintain as traditional employees; the ability to evaluate performance, and hence base compensation, on output, as opposed to direct observations of time spent working; and, the ownership of capital by the independent contractor. These characteristics are suggestive of the types of economic efficiencies associated with independent contracting arrangements.

The first section below provides an analytical framework for thinking about the underlying economic forces that make independent contracting an efficient means for organization production. Those forces can be grouped into four general categories: The need for *efficient contracts* that facilitate workforce flexibility; the efficiency of *pay-for-performance* incentive structures; *avoidance of legal and regulatory barriers* to employment relationships; and – perhaps most importantly – *worker preferences*.

The second section below discusses the economic costs of limiting or prohibiting independent contractor arrangements, including higher labor costs in key sectors of the economy, higher unemployment, reduced rates of job creation, a slower pace of new business formation, and, overall, a less flexible and dynamic U.S. workforce.

## A. Economic Efficiency Motivations for Independent Contracting

As the discussion above suggests, IC arrangements respond to a multitude of economic forces. The discussion below groups these forces into four general categories: Flexibility; Incentives; Regulatory and Legal; and, Worker Preferences.

### 1. Workforce Flexibility and Efficient Contracting: Avoiding Fixed Costs

From an economic perspective, an employment relationship involves both one-time and continuing fixed costs.<sup>67</sup> One-time costs include, on the front end, the expenses associated with setting up payroll and benefit programs, acquiring the capital needed to support the worker's activities (e.g., a logging machine or a taxicab), providing training, and complying with various Federal, state and local mandates. On the back end, they include the costs of separation, including, typically, severance pay. Continuing costs include the employee's weekly or monthly payroll or salary payments (plus benefits) and employee-related overhead, which typically must be paid whether or not the employee is fully occupied.

For a worker expected to work full time in a single position for an indefinite period, these fixed costs may be worth incurring in return for the benefits of the employment relationship, including the assurance that the employee will, barring sickness or other unusual circumstances, always be available, and the ability to task the employee, within very wide bounds, to perform the work of the employer's choice.<sup>68</sup>

In sectors where independent contracting is commonplace, these benefits are – at least for some firms or in some circumstances – overshadowed by the costs.<sup>69</sup> A courier service, for example, would be far less efficient if, rather than being able to call on any one of dozens or

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<sup>67</sup> Fixed costs are costs which do not vary with output – in this case, costs associated with an individual employee which do not vary with the employee's output.

<sup>68</sup> For a scholarly treatment of the employment relationship from a law and economics perspective, see Scott E. Masten, "A Legal Basis for the Firm," *Journal of Law, Economics & Organization* 4:1 (Spring 1988) 181-198.

hundreds of independent contractors when demand surges or a package needs to be picked up from a particularly remote area, it could only utilize its own employees. Similarly, a construction firm would have higher costs if it were forced to hire as employees specialists (such as tile layers) it is able to utilize only occasionally.

On the other side of the coin, workers benefit from the same phenomenon: Caregivers limited to serving only the clients of a single home care agency are not likely to be as well-matched with clients as if they can choose from among clients of multiple registries; doctors benefit from being able to practice medicine at different hospitals which best match their preferences for location.<sup>70</sup>

## **2. Pay-for-Performance: Incentives, Information Costs and the Nature of the Firm**

A second economic rationale for independent contracting finds its foundation in the work of Nobel Prize-winning economist Ronald Coase, whose 1937 article, “The Nature of the Firm,” asked why firms exist at all – that is, why employers enter into employment relationships in the first instance, rather than simply hiring all of their inputs, labor included, through contracts.<sup>71</sup>

A complete reprise of Coase’s thesis – and the massive literature that has grown out of it – is not necessary here. His central point, however, is that employer-employee relationships are most efficient when the costs of using the price mechanism (i.e., of independent contracting) are relatively high – for example, where it is difficult or impossible for the employer to describe in advance specifically what activities workers are expected to perform, or to place a value on

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<sup>69</sup> See e.g., Katharine G. Abraham and Susan K. Taylor, “Firms’ Use of Outside Contractors: Theory and Evidence,” *Journal of Labor Economics* 14;2 (July 1996) 394-424.

<sup>70</sup> When asked, practitioners in a variety of fields indicate that the inability to work as an independent contractor would create significant problems for their practices, in many cases causing them to cease practicing. See, e.g., FSI Quarterly Survey Business Impact Questionnaire, Q2 2010” (Financial Services Institute, July 2010) (available at [http://www.financialservices.org/uploadedFiles/FSI\\_Content/About\\_Us/Publications/Research/Dalbar%20Q2%20Results\\_8.10.10.pdf](http://www.financialservices.org/uploadedFiles/FSI_Content/About_Us/Publications/Research/Dalbar%20Q2%20Results_8.10.10.pdf)).

<sup>71</sup> R. H. Coase, “The Nature of the Firm,” *Economica* 4;16. (November 1937) 386-405.

workers' output.<sup>72</sup> In such situations, employers and employees are more likely to agree on “relational” contracts, that is, contracts in which workers are paid a set wage or salary in return for allowing the employer, within limits, to direct their activities.

Coase's thesis explains why independent contracting is especially commonplace in occupations and industries where output is relatively easily measured and workers can thus be compensated directly for their performance: A trucker may be compensated by the mile, a courier by the package, a financial advisor by the amount of sales or the performance of clients' portfolios, a brick mason by the number of bricks laid, a logger by the volume of wood harvested, and so forth.

Even in situations where output cannot easily be measured empirically, independent contracting can help address the issue of evaluating worker output by “putting the customer in charge.” As noted above, for example, independent contracting for home caregivers is motivated largely by the desire to empower clients, who are in a far better position to evaluate performance than an employment agency which may seldom, if ever, directly observe its caregivers' performance.

### **3. Overcoming Legal and Regulatory Barriers to Efficient Relationships**

In some circumstances, independent contracting relationships have developed in response to explicit legal barriers to employment – for example, state prohibitions on doctors serving as employees in hospital emergency rooms. More broadly, contracting can be an important mechanism for overcoming legal and regulatory barriers to economically efficient employment arrangements.

For example, the application of some aspects of the Fair Labor Standards Act to relationships in which workers are compensated on a “piece rate” basis would severely curtail

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<sup>72</sup> See Coase at 392.

the use of piece rate contracts.<sup>73</sup> The problem is that FLSA requires a clear accounting of time worked so that a firms' adherence to minimum wage and overtime regulations can be demonstrated. But in cases where the effort put forward by the employee is difficult to measure directly, the provision of guaranteed minimum pay dilutes the incentives a piece rate system is designed to create. Similarly, the structure of the piece rate system is such that firms do not compensate workers directly for their time. Forcing overtime restrictions onto such relationships would fundamentally alter the motivational calculus that piece rates are designed to implement.

#### 4. Worker Preferences

Some critics of independent contractor relationships suggest that employers frequently misclassify workers in order to avoid paying overtime or providing benefits, i.e., that independent contracting is a form of exploitation of labor by business.<sup>74</sup> The evidence clearly contradicts this view. To the contrary, one of the most powerful economic explanations for the widespread use of independent contractor relationships is the well-documented fact that independent contractors *prefer* their jobs to an employment arrangement.

Survey data in the U.S. has consistently found that independent contractors prefer their jobs to employment. The February 2005 CAWA survey, for example, found that 82.3 percent of independent contractors prefer an independent or alternative work arrangement to employment,

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<sup>73</sup> Economists say that individuals are paid on a piece rate basis if their compensation is directly tied to their production rather than to the amount of time that they work. For example, a farm worker may be paid per unit of harvest, a salesperson may be paid per unit sold, and a stockbroker may be paid in accordance with the size of the accounts they manage. Of course, by construction, most small business owners are paid on a piece rate in the sense that they earn no income unless their revenues exceed their costs.

Such relationships are typical in situations where the effort put forth by the worker and the variability of conditions are both unobservable to the business engaged with the worker. Under these circumstances, a guaranteed salary provides no incentives for the worker to apply him or herself and, given the limited information available to the business, the “employer” cannot effectively monitor workers’ efforts.

<sup>74</sup> See, e.g., Statement of Seth D. Harris, Deputy Secretary, U.S. Department of Labor, Before the Committee on Health, Education, Labor, and Pensions, U.S. Senate (June 17, 2010) at 1 (“[M]uch worker misclassification is intentional.... Too many workers are being deprived of overtime premiums and minimum wages forced to pay taxes their employers are legally obligated to pay and are left with no recourse if they are injured or discriminated against

compared with only 9.1 percent who would prefer an employment arrangement.<sup>75</sup> More recently, a Pew Research Center survey found that self-employed workers are “significantly more satisfied with their jobs than other workers. They're also more likely to work because they want to and not because they need a paycheck.” Specifically, the Pew study found that 39 percent of self-employed workers are “completely satisfied” with their jobs, compared with 28 percent of workers in wage or salary jobs, and that self-employed workers are also more likely to work because they “want to work” than other workers (32 percent versus 19 percent).<sup>76</sup>

In addition to the survey data, there is a fairly extensive academic literature on the relationship between self-employment and job satisfaction. Daiji Kawaguchi, for example, analyzed U.S. data from the National Longitudinal Survey of Youth to conclude that “Analyses of job satisfaction scores show that self-employed workers are more satisfied with their jobs than salary/wage workers. Moreover, one dollar of earnings while a self-employed worker is equivalent to 2.5 dollars of earnings while a salary/wage worker in terms of job satisfaction.”<sup>77</sup> Benz and Frey have documented similar results using international data.<sup>78</sup>

Research also provides insight into workers’ rationales for preferring IC and other alternative relationships. The vast majority of respondents to the CAWA survey cite personal

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in the workplace. Misclassification is no mere technical violation. It is a serious threat to workers and the fair application of the laws Congress has enacted to assure workers have good, safe jobs.”)

<sup>75</sup> BLS 2005 at Table 11.

<sup>76</sup> Rich Morin, *Job Satisfaction Among the Self-Employed* (Pew Research Center, September 2009) (available at <http://pewsocialtrends.org/pubs/743/job-satisfaction-highest-among-self-employed>).

<sup>77</sup> See Daiji Kawaguchi, “Compensating Wage Differentials Among Self-Employed Workers: Evidence from Job Satisfaction Scores” (Institute of Social and Economic Research, 2002).

<sup>78</sup> See e.g., Matthias Benz and Bruno S. Frey, “Being Independent is a Great Thing: Subjective Evaluations of Self-Employment and Hierarchy,” *Economica* 75 (2008) 362-383, at 362 (“We study panel data from three European countries: Germany (the German Socioeconomic Panel), Great Britain (the British Household Panel Survey) and Switzerland (the Swiss Household Panel). Using job satisfaction as a proxy measure for utility from work, it is shown that the self-employed enjoy considerably higher job satisfaction than employees in all three countries considered.”). See also Matthias Benz and Bruno S. Frey, “The Value of Autonomy: Evidence from the Self-Employed in 23 Countries,” (University of Munich, 2003) at 1 (“We document job satisfaction differences between self-employed and employed persons for an extended set of 23 countries, finding that in essentially all countries considered the self-employed are more satisfied with their work.... The findings thus confirm the widely

reasons (e.g., flexibility of schedule) over economic reasons to explain why they are independent contractors.<sup>79</sup> In addition, as discussed further below, there is evidence that self-employment serves as a stepping stone to entrepreneurship and small-business creation.<sup>80</sup>

To summarize, independent contractor arrangements serve several important economic functions. They provide a means of low-cost contracting as an alternative to the fixed costs of traditional employment relationships; facilitate efficient incentive arrangements and effective quality control, especially in the face of obstacles sometimes created by regulatory and legal aspects of traditional employment contracts; and, perhaps most importantly, respond to workers' desires to "be their own boss" and, in many cases, take the first steps down the road of small business creation.

#### **B. The Economic Costs of Deterring Independent Contracting**

As noted above, workers in alternative arrangements make up over 10 percent of the workforce, with ICs alone accounting for 7.4 percent. Based on their average earnings, as reported in the 2005 CAWA survey, and assuming earnings have grown at the same rate for alternative workers as for the workforce overall, alternative workers in 2010 will account for approximately \$626 billion in personal income, of which independent contractors will account for approximately \$473 billion. By comparison, total private sector wages and salaries in the third quarter of 2010 were about \$5.2 trillion. In other words, about one in every eight dollars

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held notion that greater freedom in the work environment, such as the opportunity to 'be your own boss,' is an important source of happiness at work.”).

<sup>79</sup> BLS, CPS February 2005 Supplement, Unpublished Table AW-25.

<sup>80</sup> See, e.g., Robert W. Fairlie, "Self-Employment, Entrepreneurship and the NLSY79," Monthly Labor Review (February 2005) 40-47.

earned in the U.S. is earned by someone working in an alternative work arrangement.<sup>81</sup> The potential cost to the economy of curtailing such arrangements is thus quite high.

While it is difficult to forecast with precision exactly what would happen if Section 530 were repealed (mainly because it is not possible to know exactly how the IRS would react, nor to predict the outcome of the extensive litigation that would almost certainly follow), repeal would, at a minimum, significantly raise the regulatory risk associated with independent contractor arrangements, and thus raise the effective cost of relying on ICs. The net result would be to artificially reduce reliance on independent contractor arrangements to below the economically efficient level – that is, to prevent workers and firms from capturing the benefits of independent contracting described immediately above.

The costs associated with curtailing IC relationships can be grouped into four broad categories: Reduced job creation and small business formation; sector-specific disruptions; reduced competition and higher prices; and, a generally less flexible and dynamic workforce.

### **1. Reduced Job Creation and Small Business Formation**

As noted above, there is a strong relationship between independent contracting, entrepreneurship, and small business formation. Indeed, of the 10.3 million independent contractors identified in the 2005 CAWA survey, nearly 2.4 million had one or more paid employees – with the vast majority employing five or fewer.<sup>82</sup> Not surprisingly, the proportion of ICs with employees varied significantly by industry: More than a third of ICs engaged in the construction industry, for example, had one or more employees, as did more than half of those in

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<sup>81</sup> Navigant Economics calculations based on data from the Bureau of Labor Statistics and the Bureau of Economic Analysis. Note that these figures do not include earnings of those who engage in independent contracting as a “second job.”

<sup>82</sup> BLS Unpublished Table AW7.

retail trades. The BLS Occupational Handbook reports that self-employment leads to small business creation in fields as diverse as home caregiving and logging.<sup>83</sup>

The connection between independent contracting and small business formation is not incidental. Unlike employees, independent contractors are required to learn how to prepare and send invoices, maintain records, acquire capital, comply with licensing and other regulatory requirements, file taxes, and so on. Any policy that reduced the use of independent contracting would thus almost certainly lead to reduced small business creation, a reduction in small business employment, and less entrepreneurial activity.<sup>84</sup>

## **2. Reduced Competition and Higher Prices**

One of the primary economic motivations for independent contracting is to reduce the importance of economies of scale. A small trucking company, for example, can offer timely and efficient nationwide delivery by contracting with multiple independent truckers; a construction company can take on a complicated job by engaging specialized labor. Another benefit is the ability to support diverse business models: A caregiver registry, for example, can cater to clients who prefer to supervise their own caregivers rather than going through a traditional agency, while at the same time facilitating client opportunities for those who prefer the freedom of working when and where they choose.

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<sup>83</sup> See e.g., BLS, *Occupational Outlook Handbook*, 2010-11 Edition, Home Health Aides and Personal and Home Care Aides (available at <http://www.bls.gov/oco/ocos326.htm>) (“Advancement for home health aides and personal and home care aides is limited.... Some may start their own home care agency or work as a self-employed aide. Self-employed aides have no agency affiliation or supervision and accept clients, set fees, and arrange work schedules on their own.”) and BLS, *Occupational Outlook Handbook*, 2010-11 Edition, Logging Workers (available at <http://www.bls.gov/oco/ocos351.htm>) (“Some experienced logging workers start their own logging contractor businesses, but to do so they also need some basic business skills, which are essential in logging’s difficult business climate.”)

<sup>84</sup> The importance of entrepreneurship for economic growth is well established in the academic literature. See e.g., C. Mirjam van Praag, Peter H. Versloot, *What is the Value of Entrepreneurship? A Review of Recent Research* (Institute for Labor Research, August 2007) (available at <http://ssrn.com/abstract=1010568>) (“All in all, we conclude that entrepreneurs have a very important – but specific – function in the economy. They engender relatively high levels of employment creation, productivity growth and produce and commercialize high quality innovations.”).

In both of these respects – size and diversity – curtailing independent contracting would result in less competition and, ultimately, less choice and higher prices for consumers.<sup>85</sup>

### **3. Sector-Specific Disruptions**

As noted above, independent contractors are not distributed equally across industries and occupations: About seven percent of all workers are ICs, but the proportion reaches 40 percent or more in particular occupations and industries. Thus, the higher prices caused by curtailing IC arrangements would not be distributed evenly across sectors or consumers.

Going beyond higher prices, it is likely that, in the industries and occupations where IC relationships are especially significant, curtailing their use would produce at least short-run (and in some cases permanent) economic disruptions. In sectors such as caregiving and emergency medical care, for example, it seems likely that patients (in the case of home care) and hospitals (in the case of emergency physicians) would have to find alternative means of meeting their needs for these services, with short-run disruptions occurring in the interim; that is, positions that would otherwise have been filled by ICs would, at least temporarily, go unfilled. In other areas, such as mystery shopping, it seems likely that the disruption would be permanent. Most mystery shopping firms could not change their business models to employ shoppers as traditional employees. Thus, it is possible that if independent contracting were curtailed, both the firms and the business models would cease to exist in their current forms, and many of those who currently engage in mystery shopping would simply stop doing so.

### **4. Less Flexible and Dynamic Workforce**

Finally, the evidence clearly demonstrates that independent contracting arrangements contribute to workforce flexibility, allowing firms to contract for labor services without taking on

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<sup>85</sup> See, e.g., Uber Testimony at 8 (“In home care, the employee-based firms would benefit, as they would be able to pay caregivers less and charge consumers more, because the competitive effect of nurse registries that keep

the fixed costs of employment contracts, and also allowing workers to enter, exit, or participate partially in the labor force as they choose. Thus, for example, independent contracting facilitates the transition of laid off workers into new jobs,<sup>86</sup> and provides workers in general, but especially women, with the ability to enter and exit the workforce in response to family, retirement, and other life changes.<sup>87</sup>

Labor force flexibility, in turn, is clearly correlated with economic growth and job creation: Less flexibility, in other words, leads to slower growth and higher unemployment.

For example, since approximately 1970, unemployment rates in European countries have been systematically higher than unemployment rates in the United States, while job growth in Europe has tended to lag behind that of the U.S. Economists have concluded that these trends cannot be easily accounted for by factors such as increased trade with developing countries, trends in technology, or exogenous macroeconomic shocks, because these explanations apply more or less equally to both Europe and the U.S.<sup>88</sup> Instead, in attempting to explain and understand this phenomenon, economists have concluded that most European labor markets exhibit significant rigidities compared with the U.S.

For example, European countries have high rates of unionization, and wages in Europe are typically set through a centralized bargaining process that covers not only union members, but also many non-union employees. Meanwhile, strong job protection legislation has made

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client fees low and caregiver fees high would be eliminated.”)

<sup>86</sup> See, e.g., Henry S. Farber, “Alternative and Part-Time Employment Arrangements as a Response to Job Loss,” *Journal of Labor Economics* 17;4 (October, 1999) S142-S169 at S167 (“I find that job losers are significantly more likely than nonlosers to be in temporary jobs (including on-call work and contract work) and that job losers are significantly more likely than nonlosers to be employed involuntarily part-time. I also find that the likelihood of temporary and involuntary part-time employment falls with time since job loss. Thus, it appears that these *alternative employment arrangements are often part of a transitional process subsequent to job loss leading to regular full-time permanent employment.*”) (emphasis added).

<sup>87</sup> See e.g., Anne E. Polivka, “Into Contingent and Alternative Employment: By Choice?” *Monthly Labor Review* (October 1996) 55-64.

<sup>88</sup> For example, both Europe and the United States experienced oil shocks and productivity slowdowns in the 1970s, but the resulting unemployment rates were quite different.

dismissals quite costly for European employers – which, while generating additional security for those who are already employed, has also dampened the demand for new labor. While there has been some debate among economists as to the precise set of labor market rigidities that are responsible for persistently high unemployment in Europe, there is nonetheless a broad consensus that labor market rigidities matter.<sup>89</sup>

#### IV. INDEPENDENT CONTRACTING AND THE TAX GAP

One of the arguments critics present for curtailing the use of independent contracting is that independent contractors are more likely to underreport income than employees, leading to reduced tax revenues and thus increasing the so-called “tax gap.”<sup>90</sup> While a complete treatment of this issue is beyond the scope of this paper,<sup>91</sup> it should be noted that the evidence does not support the contention that re-classifying independent contractors as employees would increase tax revenues or reduce the tax gap.

While it is true that underreporting of personal income accounts for a large proportion of the tax gap, the vast majority (about 89 percent) of such underreporting involves income for which there is neither withholding nor substantial information reporting – e.g., income for which *neither* a W-2 (for employees) *nor* a 1099-MISC (for independent contractors) is filed.<sup>92</sup> On the other hand, however, there is very little difference in underreporting for workers who receive *either* a W-2 *or* a 1099-MISC: The IRS estimates about 99 percent of W-2 income is reported,

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<sup>89</sup> See Horst Seibert, “Labor Market Rigidities: At the Root of Unemployment in Europe,” *The Journal of Economic Perspectives* 11 (Summer 1997) 37–54; see also Stephen Nickell, “Unemployment and Labor Market Rigidities: Europe Versus North America,” *The Journal of Economic Perspectives* 11 (Summer 1997) 55–74.

<sup>90</sup> See, e.g., Testimony of Catherine K. Ruckelshaus, National Employment Law Project, Hearing Before the Senate Committee on Health, Education, Labor and Pensions (June 17, 2010).

<sup>91</sup> For an overview of the tax gap issue, see Jeffrey A. Eisenach, Robert E. Litan and Kevin W. Caves, *The Benefits and Costs of Implementing “Return-Free” Tax Filing in the U.S.* (Navigant Economics, March 2010) at 44-48.

<sup>92</sup> Internal Revenue Service, Tax Gap Update (available at [http://www.irs.gov/pub/irs-utl/tax\\_gap\\_update\\_070212.pdf](http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf)).

compared with 96 to 97 percent for income reported on form 1099-MISC.<sup>93</sup> Thus, substituting W-2s for 1099-MISCs – which, in this context, is all that would be accomplished by reclassifying independent contractors as employees – would not have a significant effect on underreporting.

In fact, efforts to reclassify workers as employees could easily have the opposite of the desired effect and actually increase the tax gap. First, workers and firms might well react to reclassification by taking some workers who currently receive form 1099-MISC “off the books” altogether, thereby reducing information reporting and, presumably, increasing the rate of tax underreporting. Indeed, as noted above, one of the criteria for the Section 530 “safe harbor” is that firms *must* file form 1099-MISC. Second, it is not at all clear that independent contractors pay lower taxes than employees in the first instance: While ICs may benefit (for example) from the ability to more easily deduct some business expenses, their fringe benefits – most notably health insurance – are not deductible. Thus, according to one detailed study conducted by the Department of the Treasury, “with typical patterns of fringe benefits and worker expenses, independent contractors and their clients tend to pay higher levels of taxes, especially Social Security and Medicare taxes, than employees and employers, providing that the income and expenses are reported correctly.”<sup>94</sup> Thus, the report concluded, “Misclassification of employees as independent contractors increases tax revenues, however, and tends to offset the revenue loss from undercompliance by such individuals....”<sup>95</sup> Third, as noted above, curtailing independent contracting would harm economic growth and job creation, which would in turn reduce tax revenues.

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<sup>93</sup> See, e.g., Internal Revenue Service, “IRS Updates Tax Gap Figures” (IR-2006-28, February 14, 2006) (available at [http://www.irs.gov/pub/irs-news/tax\\_gap\\_figures.pdf](http://www.irs.gov/pub/irs-news/tax_gap_figures.pdf)) and U.S. Government Accountability Office, *Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches* (GAO-06-1000T, July 26, 2006) at 11.

In summary, there is no basis for the argument that simply re-classifying independent contractors as employees would reduce underreporting of taxable income, nor is there any evidence that independent contractors, on balance, are in any way unfairly advantaged over employees when it comes to paying taxes.

## V. CONCLUSIONS

However defined, independent contractors make up a substantial proportion of the U.S. workforce, accounting for approximately one in ten workers overall, and much higher proportions in a number of key industries. In addition, millions of Americans occasionally earn extra money by working as independent contractors in fields such as mystery shopping.

While IC arrangements are extremely diverse, covering virtually every industry, they all have in common that they contribute to the flexibility and dynamism of the U.S. workforce. Independent contracting provides a means for firms to acquire labor in cases where the fixed costs of an employment relationship would be prohibitive; it serves as a means for workers to move into and out of the workforce, and as a transitional mechanism for laid-off workers to find new jobs; and, it provides a first-step on the ladder to starting a small business, and creating jobs for others. The economic and social costs of independent contracting are difficult to discern, especially given that independent contractors are far more likely than traditional employees to like their work. The economic benefits of independent contracting, on the other hand, are substantial. Policies that make it more difficult for workers and firms to enter into such arrangements would thus result in slower economic growth, lower levels of employment and job creation, and lower consumer welfare overall.

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<sup>94</sup> See Department of the Treasury, *Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986, A Report to Congress* (March 1991) at 24-26.

<sup>95</sup> Department of the Treasury 1991, at 5.