

Alternative Work Arrangements: Tax Policy Issues Related to Worker Classification, Benefit Coverage and Tax Compliance

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A rising share of American workers earn their income outside of the traditional employer-employee relationship. In 2014, about 17.3 million sole proprietors reported earnings from self-employment, an increase of 34 percent from 2000. The self-employed are an economically important group because they are a sizable share of employment, labor earnings, and business activity. For most sole proprietors, the income from their businesses is the largest source of their earnings. Moreover, they are a challenging area for tax and fiscal policy. Many important employee benefits, labor protections, and tax provisions operate through the employee-employer relationship, including many health insurance and retirement coverage provisions, tax compliance and administration, and legal protections under labor, occupational safety, discrimination, and other laws. Hence, the implications of increases in self-employment and shifts between formal employment and contracting are important for understanding and improving policy.

However, self-employment is increasingly poorly measured in traditional surveys and those surveys provide an incomplete picture of income, demographics, and benefits relevant to policy. This paper draws on administrative tax records to provide a more complete picture of self-employed sole proprietors and how they differ from employee wage earners. We examine the rise in the number of self-employed workers, describe the characteristics of those workers, and examine the implications for filing behavior and benefit coverage.

Sole proprietors engage in a variety of business activities, ranging from operating substantial businesses, providing labor services to other businesses and consumers, participating in the “gig economy” through online markets, or supplementing wage income. We categorize individuals with Schedule C income (or self-employment earnings) based on size of receipts, expenses, and source of receipts from information returns. This classification is intended to reflect arrangements corresponding to real-world employment like independent contractor, contract worker, and worker engaged in alternative work arrangement.

We find that essentially all of the increase in the number and propensity to earn self-employment income is due to increases in what we call small and medium contractors, individuals who have few business-related expenses and appear to provide almost exclusively labor services. Furthermore, a large share of these workers appear to earn all or most of their income from one firm.