



Regulatory Improvement for Independent Workers: A New Vision

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INTRODUCTION

One of the biggest productivity advances in recent years has been the use of platforms to connect buyers and sellers at lower cost. Platforms offer less rigid contractual arrangements, expanded earnings opportunities for workers and access to essential goods and services for underserved communities. Overall, platforms generate win-win economic activity which benefits everyone.

The flexibility of platforms will play a critical role in helping the U.S. labor market recover more quickly from the Covid recession. In most economic recoveries, companies have been apprehensive about making the commitment to hire given lingering economic uncertainty. That has typically made employment a lagging indicator in recoveries. By contrast, platforms will make it easier for workers to scale up hours worked gradually as the economy expands, which will boost consumer spending and demand, which will in turn boost employment.

The big question, though, is how to regulate platforms in a way that preserves the flexible nature of the work and the benefits to our economy at large, while continuing to protect both workers and consumers. The Progressive Policy Institute believes strongly in the importance of regulation for a well-functioning market economy. Yet we have long advocated for “regulatory improvement” as essential for accelerating growth and job creation.¹

Regulatory improvement is very different than deregulation. Too many sectors of the economy have overlapping and contradictory layers of regulation that get in the way of productivity gains and rising incomes. At the same time, there may be parts of the economy where new rules are necessary. In this case, platform businesses need to step up and provide a baseline level of benefits to their workers.

The labor market, in particular, is struggling with a 20th century regulatory framework imposed on a 21st century economic structure. The first 1099 was issued in 1918² and the first W-2 in 1944.³ To this day the labor market is artificially divided into “employees” and “independent workers”, including freelancers, sole proprietors and other self-employed workers. The dividing line is quite complicated and, in some cases, almost impossible to understand, with different federal and state agencies following different rules for establishing the dividing line. This patchwork of conflicting regulations creates enormous business uncertainty, reducing the incentive to create new work opportunities.

In the current regulatory framework, workers classified as “employees” are subject to a completely different regulatory regime than independent workers, including rules for scheduling and hours worked, working conditions, minimum wages and who pays Social Security and Medicare taxes. Employees are subject to employers’ control in every aspect of how they do the job, which for many low-income workers means shift work tied to a single company, which sets the exact hours. Employees typically get certain benefits, such as workers compensation and unemployment insurance, which are generally paid for by payroll taxes, and possibly access to other benefits, such as group life insurance, defined contribution retirement

plans, and employer-sponsored health insurance or health savings accounts (HSAs).

Independent workers have a unique flexibility that employees do not enjoy at all. Indeed, most freelancers cite schedule flexibility as a major reason why they work independently, according to a recent report commissioned by Upwork and Freelancers Union.⁴ In the same survey, 51% of respondents said there is no amount of money where they would definitely take a traditional job. Part of the explanation may be that independent contractors simply aren’t able to work under the terms of normal employment; in fact, 46% say they could not have a traditional job due to personal circumstances (e.g., health or caregiving duties).

But in exchange, independent workers, almost by definition, are not allowed to get benefits from the companies that they do business with. As an IRS publication states:

Businesses providing employee-type benefits, such as insurance, a pension plan, vacation pay or sick pay have employees. Businesses generally do not grant these benefits to independent contractors.⁵

Unfortunately, the current tax system systematically penalizes independent workers who try to provide their own benefits and companies that want to help these workers maintain flexibility while accruing appropriate benefits or protections. For example, as we explain below, most independent workers have to pay FICA taxes on the money they contribute to their tax-deferred Individual Retirement Accounts (IRA), Simplified Employee Pensions (SEP) or solo 401k accounts. By comparison, the contribution of employers to employee retirement accounts is exempt from both employer and employee FICA taxes.⁶ This saving can be worth thousands of dollars. The same or

similar problems show up with other benefits as well.

This puts independent workers into a catch-22 situation. The companies that they do business with can't provide benefits because that would turn them into employees, an outcome that the overwhelming majority of these workers do not want. But independent workers providing benefits for themselves incur a much bigger tax burden than they would face as an employee.

There are two solutions to this problem for independent workers. One is to double down on the historical dichotomy between employees and independent workers and make the distinction even more rigid. This "Procrustean Bed" solution is best exemplified by California Assembly Bill 5 (AB-5), which imposes rigid tests on who can be classified as an independent contractor. It forces companies to turn many of their independent contractors into employees, leading to the loss of these workers' flexibility and control over their hours and who they can work for.

In the gig economy space, this would almost certainly mean set schedules and the inability to work on more than one platform. Minimum wage rules and other employment regulations would lead to reduced service at certain times of day or in certain geographical areas.

The other alternative is to improve the position of independent workers by creating a new regulatory regime that extends them important new benefits, while still allowing the flexibility that self-employed workers choose.

This new regulatory regime would have several important features:

- It would straighten out the tax treatment of benefits so that independent workers are on a level playing field with employees.

- It would require a baseline level of benefits and protections for independent workers, including a cafeteria style plan with a menu of options for workers to choose what makes the most sense for them.
- It would have a uniform national standard for determining who is an independent worker. One possibility is that companies would have no control over hours of work, and no non-compete agreements.

A separate and important question is whether the new regulatory regime would be opt-in or mandatory. We lean towards opt-in, as discussed below.

THE STRUCTURE OF BENEFITS

What benefits are U.S. employers actually paying to their employees? Table 1 below summarizes the distribution of benefits for full-time and part-time workers for the 2018-2019 period, based on BLS data.⁷ Note that part-time workers get a significantly small share of their compensation in benefits compared to full-time workers. Moreover, almost half of the benefit "package" for part-time employees comes through the legally mandated "benefits" such as employer tax payments for Social Security and Medicare, much of which independent workers already pay on their own.

TABLE 1: BENEFITS FOR FULL-TIME VS PART-TIME EMPLOYEES IN THE PRIVATE SECTOR, 2018-2019

Share of hourly compensation, average of 2018-2019		
	Fulltime	Part-time
Total benefits	31.5%	21.1%
Paid leave	7.7%	3.2%
Supplemental pay	3.8%	1.6%
Insurance	8.5%	4.5%
Retirement and savings	4.1%	2.0%
Legally-mandated benefits, such as employer tax payments for Social Security and Medicare	7.4%	9.8%

In general there are two problems with independent workers providing their own benefits. First, as we will see, the tax laws are written in such a way as to be biased against independent workers compared to employees, especially when the independent workers file on Schedule C. Second, if the businesses hiring the independent workers try to provide benefits, that's taken as prima facie evidence that the independent workers are really employees, which the overwhelming majority of self-employed workers typically do not desire to be.

Example 1: Retirement Savings

We already mentioned that the current tax system systematically penalizes independent workers who try to provide their own benefits.

Let's begin with retirement. Suppose that an employer wants to contribute \$1000 to an employee retirement plan such as a 401k. That employer contribution is deductible from the employer's business income and does not incur Social Security or Medicare Taxes for either the employer or the employee, as long as certain rules are met.⁸

Now suppose a company gives that \$1000 to an independent worker who is filing as a Schedule C sole proprietor or single-person LLC. They deposit the \$1000 in their IRA, SEP, or solo 401k account as a tax-deferred retirement contribution. The independent worker gets to deduct this contribution from their federal income tax (line 15 or line 19 on schedule 1).

However, the independent worker has to pay both the employee and employer FICA tax, minus the net impact of the deductibility of the employer share (Schedule SE and line 14 on schedule 1. So, for example, if the independent worker's marginal federal income tax rate is 22%, they end up paying a bit under 13% on the \$1000, rather than 0%.⁹

In other words, the independent worker is penalized on the retirement savings side. And the company can't offer to bring the independent worker into the company's plan without classifying the worker as an employee.

Example 2: Healthcare Benefits

A similar disparity holds in the case of healthcare benefits. If an employer contributes \$1000 to a health insurance plan for their employee, that contribution is deductible from the employer's business income and exempt from both employer and employee FICA taxes (within limits.¹⁰ And the contribution does not count towards the employee's taxable income.

That same \$1000, paid directly to the independent worker, can also be used to finance health insurance. In many circumstances, that spending on self-employed health insurance can be deducted from taxable income (Line 16 on schedule 1. However, the independent worker still must pay employer and employee FICA taxes on that \$1000, minus the deductibility of the employer share. As before, if the independent worker's marginal federal income tax rate is 22%, they end up paying just under 13% on the \$1000, rather than 0%.

Example 3: Workers' Compensation

Workers compensation is basically an insurance policy that covers employees for on-the-job accidents or injuries. Workers comp benefits are typically not taxable, and workers comp premiums are deductible from business

income. Depending on the particular state, independent workers with no employees are usually not required to purchase workers' comp for themselves. Such individual policies can be quite expensive, so many independent workers go without. But going without workers comp or occupational accident insurance runs the risk of being exposed to large medical bills and a significant loss of income if workers are injured on the job. On the other hand, if the company provides worker compensation to an independent worker, that runs the risk of having them reclassified as an employee, which is not the outcome self-employed workers typically want.

Example 4: Unemployment Insurance

Under ordinary circumstances, the U.S. unemployment insurance system is a fairly small part of benefits. Depending on the year, average state and federal premiums for unemployment in the private sector amounts to between 0.5% and 0.9% of compensation. In 2018—a low-unemployment year—that came to only about \$40 billion, on an annual basis.¹¹ By contrast, unemployment benefits received in 2018 came to only \$27 billion.¹² Unemployment insurance premiums are deductible from business income, while unemployment benefits are subject to income taxes but not to FICA taxes.

On the other hand, during recessions, unemployment insurance benefits received swell far out of proportion to taxes paid in, as the federal government typically appropriates more money to beef up unemployment insurance. In 2009 and 2010, for example, unemployment benefits rose to over \$130 billion annually. Because of these special payments, unemployment benefits paid out over this last business cycle (2008-2019) exceeded unemployment insurance taxes paid in by

more than \$100 billion, none of which went to independent workers.

However, the discussion around unemployment insurance for independent workers is different now than it would have been even six months ago. The Pandemic Unemployment Assistance (PUA) and Paycheck Protection Program (PPP) together covered self-employed workers and small businesses, and showed that it was possible to provide “income insurance” for independent workers in hard times outside of the conventional unemployment insurance structure.

So let’s focus for now on how to provide “income insurance” for independent workers in normal, non-recession circumstances. The key is that independent workers need a cushion not just against economic shocks, but personal shocks such as illness or family needs. One solution is for employers to contribute to a pot of money for the independent worker that could be used for a variety of different purposes. Like unemployment insurance premiums, the contributions to the fund should be tax-deductible.

One variant of income insurance that could apply to independent workers is income averaging for tax purposes.¹³ Because of the progressivity of the income tax code, allowing independent workers and employees to average between good years and bad years could significantly reduce the average tax bill, and cushion the effects of fluctuations. Income averaging was available to taxpayers whose income spiked up until 1986, when it was eliminated by that year’s tax reform (it is still available to farmers and fishermen).

THE WRONG APPROACH

The key goal is to make independent workers better off. One potential solution, as noted in the introduction, is to double down on the historical dichotomy between independent workers and

employees. California AB-5, which went into effect on January 1, 2020, is the exemplar of this approach. AB-5 codifies and expands the “ABC test” which says that a worker is an employee unless they meet all of the following conditions: (A) “the individual is free from direction and control,” applicable both “under his contract for the performance of service and in fact,” (B) “the service is performed outside the usual course of business of the employer,” and (C) the “individual is customarily engaged in an independently established trade, occupation, profession, or business of the same nature as that involved in the service performed.”

Under this extremely stringent test, some independent workers would need to be reclassified as employees. This reclassification is incompatible with business models predicated on independent workers, and as a result, many businesses have cut ties with California-based workers or shut down operations in California entirely. Under the new classification, it’s not illegal per se to allow an employee to completely decide which work opportunities to accept and to set his or her own days and hours (without any intervention from the business), but it certainly doesn’t fit the way employers typically operate.

As a response to this new law, California independent workers have been laid off en masse. In its news coverage of the passage of AB-5, Vox published an article with the headline “Gig workers’ win in California is a victory for workers everywhere.”¹⁴ Its reaction as a business, however, was quite different. A couple months later, the parent company Vox Media laid off 200 freelance writers right before the holidays (and right before the law went into effect on January 1).¹⁵ Deliv, a Menlo Park-based crowdsourced, crowd-shipping, same-day delivery startup, severed its relationship with 591 drivers a few

months after AB-5 went into effect.¹⁶ 7-Eleven halted new California franchises.¹⁷ One estimate from the Berkeley Research Group concluded that switching the status of app-based drivers to full-time employees would reduce the number of drivers by 80 to 90 percent in California.¹⁸

A BETTER WAY

An alternative is to construct a new regulatory framework that explicitly recognizes a middle ground of independent workers who can receive benefits from the (multiple) companies they contract with.

As we noted above, the new regulatory regime would have to address three main issues:

- It would straighten out the tax treatment of benefits so that independent workers are on a level playing field with employees.
- It would require a baseline level of benefits and protections for independent workers, including a cafeteria-style plan.
- It would have a uniform national standard for determining who is an independent worker. One possibility is that companies would have no control over hours of work, and no non-compete agreements.

A separate and important question is whether the new regulatory regime would be opt-in or mandatory. We lean towards opt-in given the wide variety of independent contractor arrangements that exist (e.g., doctors, realtors, etc.). If companies do not opt in, they would remain subject to existing legal tests for determining worker classification.

Note that our proposal is very different from the “marketplace contractor” laws passed in states such as Florida.¹⁹ Such laws merely specify that certain on-demand workers are to be treated as

independent contractors. However, they do not fix the federal tax laws that unfairly penalize benefits for independent workers. They also do not specify baseline levels of benefits and protections.

Straightening out the tax code

As documented in this paper, the current tax treatment of benefits systematically favors employees over independent workers. Sole proprietors and single-member LLCs that file via Schedule C pay a substantial tax penalty for attempting to access the same benefits employees get. That needs to be fixed. For example, when a self-employed worker contributes to an SEP, that contribution should be exempt from payroll taxes. The tax fix here would be a simple one, allowing independent workers to deduct healthcare and retirement contributions from the earnings calculation for the self-employment tax.

The companies need to step up here, too. A company should be able to contribute to an independent worker’s retirement or health accounts without triggering additional tax consequences, just as would happen for an employee. This would require a modification to current law governing benefits.

Simplifying the dividing line

The dividing line between independent workers and employees should not include whether the company contributes to benefits for the independent worker. To the contrary, in this new category, once a worker reached a certain number of hours contracting with a particular company or platform, the worker would be entitled to a required set of tax-advantaged benefits—for example, portable benefits including paid leave, retirement savings accounts and contributions towards an individual’s health insurance premiums. All workers should be

covered by occupational accident insurance for on-the-job injuries. On the other hand, companies would be forced to allow workers in this third category the freedom to choose their hours as well as work for other companies in the same industry.²⁰ In other words, companies would have no control over hours or non-compete agreements.

Baseline level of benefits

The exact level of benefits required in the new category would have to be considered carefully. The optimal mix of benefits will create an option that is preferable to current rules for many companies and workers, creating a win-win proposition. The flexibility, in particular, will be attractive to many workers.

We note that it's especially important to design the benefits package to help low wage workers. For example, one could imagine zero-cost banking as part of the package in order to link the unbanked to the financial system. These zero-cost bank accounts would be designed to be portable and would be subsidized by the companies with which the worker contracts.

Companies would be required to choose, on a year by year basis, whether they treat their independent contractors under this new category. This choice would allow companies to offer benefits to independent contractors without worrying that they would be reclassified as employees at either the state or federal level, while preserving the flexibility and independence that are synonymous with independent contractor status. And independent contractors would be on a level playing field with the tax-advantaged employee benefits.

How the cafeteria style plan would work

The cafeteria plan would allow independent workers to choose from a variety of pre-tax benefits, including health insurance, paid time off, and retirement savings. These benefits would be tied to the individual, not the job, making them truly portable. Plans would be managed by a qualified benefits provider. If an independent contractor ceases work for one company, they do not lose any accrued benefits from that relationship. Companies pay the equivalent of a certain share of the worker's earnings into a dedicated account for pre-tax benefits. There is no required match from the beneficiary -- the cost is fully borne by the business and nothing comes out of workers' pockets. The independent contractor accrues benefits in proportion to the amount of money earned on the platform.

Independent workers can choose to use these funds towards individual health insurance premiums. They can also choose to add the money toward paid leave or retirement. Individuals access the paid leave benefits by self-certifying that they have experienced a qualifying event, such as falling sick, needing to take care of a family member, or living under a state of emergency. Since there is no separation event for an independent contractor similar to an employee being laid off an employer, there needs to be a cutoff when this short-term insurance plan converts into a cash benefit. For example, at the end of the year, the unused benefit funds could be rolled into a retirement savings account.

In order to prevent a patchwork of state and local laws from developing, the new federal law needs to include preemption. This new regulatory model -- in particular the social insurance component -- is critical to solving market failures. To take one illustrative example,

consider the negative externalities created during a pandemic. In the case of a contagious disease, one individual's actions (such as wearing a mask) directly affect the likelihood of others getting infected. Similarly, there is a public interest in ensuring independent contractors aren't financially pressured to work when they're feeling sick. The government needs to create a new regulatory framework that incentivizes private sector companies to fund benefits programs such as sick leave or paid leave to reduce the recurrent negative spillovers in labor markets.

COST

Obviously this new regulatory regime extends certain tax breaks now enjoyed by employees to independent workers as well, which incurs some hit to tax revenues. But note that the alternative solution to the independent contractor problem—redefining the dividing line so that more independent workers are reclassified as employees—also incurs a hit to tax revenues. Reclassification of independent workers as employees costs the federal government FICA tax revenues on employer contributions to healthcare and retirement plans. In addition, reclassification significantly reduces the amount of work (and therefore the amount of taxable worker pay) overall.

Consider, for example, business payments for health insurance. As we saw earlier, for independent contractors who file a Schedule C, those health insurance payments can be typically deducted from taxable income, but not from the payroll tax base. By contrast, business payments for health insurance for employees are not subject to the payroll tax. So, legislation that forces independent workers into employee status ends up reducing payroll tax revenues, all other things being equal. This would reduce the public funds available for vital social insurance programs.

This is not a final answer on the cost question, of course. But it does mean to get a good cost estimate, it's necessary to compare apples to apples. Critically, businesses should incur the full cost of participating in the new framework we are proposing.

CONCLUSION

Independent workers face a dilemma where they cannot currently receive benefit payments from companies without risking their independent status. Meanwhile, they cannot provide benefits for themselves without being unfairly penalized by the tax code relative to employees.

Previous attempts at the state level to define a new category of "marketplace contractors" has not fixed this dilemma, because they did not address disparities in the tax treatment of benefits. Nor did they create a baseline benefit package that companies must provide.

We suggest that it is possible to design a new regulatory regime that is a win-win proposition. It makes independent workers better off by making it easier for them to either get benefits from a company or provide the benefits for themselves, while still retaining the flexibility that is an essential attraction of independent work for most. At the same time, by allowing companies to opt into this new regulatory regime, it ensures that companies have an alternative to a patchwork of state regulations if they are willing to offer a baseline package of benefits.

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The Progressive Policy Institute is a catalyst for policy innovation and political reform based in Washington, D.C. Its mission is to create radically pragmatic ideas for moving America beyond ideological and partisan deadlock.

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