Independent contractor or employee? The changing relationship
between firms and their workforce and potential consequences for
the U.S. income tax


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Extended Abstract
Policymakers and economists are increasingly focused on the changing structure of the U.S. workforce; in particular, the perceived shift away from stable “traditional” employment relationships toward potentially more precarious “alternative” work arrangements, a broad category that includes temporary agency workers, on-call workers, contract firm workers, and independent contractors. Recent empirical studies have documented increases in the prevalence of these non-standard work arrangements over the last decade. This paper focuses on a subset of alternative workers—indeed contractors. While there is evidence of a substantial increase in independent contractors over the last decade, there is much less evidence on which factors—supply or demand side—might be behind this increase. Understanding the changing relationship between firms and the composition of the workforce is critical to the effective design of tax, labor protection and social safety-net policies. We address the questions: how have firms substituted independent contractors for employees over time and in response to policy variation, and what do these shifts tell us about worker and firm valuation of traditional employment and independent contractor labor? We then examine the implications of these patterns for differentiating worker misclassification from workforce reorganization.

The mapping between the economic reality of a worker-firm relationship and the characterization of the relationship for tax, liability and regulatory purposes is complex. This paper uses linked worker-firm administrative tax data from U.S. tax returns to explore the changing relationship between firms and independent contractors (IC). First, we document the increasing prevalence of IC over time, and changes in the income and demographic characteristics of the IC population. We investigate the changing relationship between IC and their hiring firms by documenting characteristics of firms with more or fewer IC, and firms which have had the largest increases in IC over time. In particular, we investigate the relationship between changes in within-firm compensation structures and workforce composition.

Next we use policy variation to examine the value of IC relative to traditional employment for firms and workers. Using size-based regulations which create discontinuities in the cost of hiring an additional employee, we examine incentives for misclassification or workforce restructuring and the corresponding marginal valuation of IC versus employment. Additionally, we identify substitution patterns in response to shocks to high-skilled employee preferences for tax-preferred compensation. The results on substitution patterns allow us to investigate the extent to which the increase in IC prevalence may be attributable to restructuring versus misclassification. Relative to workforce reduction or firm reorganization, misclassification may be attractive due to its low cost. Misclassification of workers as independent contractors (ICs) rather than employees has myriad tax and regulatory implications.

To conduct the analysis, we construct a dataset using the universe of digitized tax filings in the U.S. for tax years 1997-2015. We link individual income tax returns with information reports, and link individuals to their employing firms. This new panel dataset allows us to observe traditional employees and IC working for the same firm, linked with the employment and compensation characteristics of the employing firm. A combination of characteristics derived from income tax returns and information reports are used to establish definitions of IC labor. Following the work of Knittle et al. (2011), we use restrictions on the type and amount of expenses reported to differentiate small businesses from IC. Other criteria such as the number of firms from which an individual receives a 1099 and the share of individual income coming from 1099s are used to create consistent definitions of IC relative to other types of self-employment labor. We also expand on previous methods of identifying IC in administrative data by including incorporated independent contractors (single owner LLCs). Throughout, we test whether our results are consistent under more or less inclusive criteria.

Using these data, we begin by documenting a sharp increase in the number of 1099-MISC payees and payors

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1See Katz and Krueger [2016] for evidence based on survey data and Jackson, Looney and Ramnath (2017) for evidence from administrative tax records.

2In particular, we use income tax reports Form 1040, Schedule C and Schedule SE, and information reports W-2, 1099-MISC and 1099-K.
since 2000, as well as an increase in total reported 1099-MISC income.\footnote{Specifically, when discussing 1099-MISC reporting we focus on the reporting of 1099-MISC box 7 income, which contains “Non-Employee Compensation for Services.”} We find that the prevalence of individuals whose only income is from self-employment has increased by three times more than growth of W-2 employment since 2000. Next we show that contractors’ employment relationships are looking more similar to traditional employment relationships over time. We document an increase in the average tenure of contractors with their employing firm. Over the same period, there has been a decrease in the mean and median number of employing firms for contractors such that the majority of contractors now only receive 1099-MISC income from a single firm.

Though the prevalence of IC labor has been steadily increasing and, on average, the IC labor relationships appear to converge towards employment relationships on several economically meaningful metrics, the evidence from income patterns suggests that IC labor is not a pure substitute for traditional employment. The growth in the distribution of W-2 wage and salary income has outstripped the growth in the distribution of income reported on the 1099-MISC. Since 2000, there has been growth over the entire W-2 income distribution, yet the distribution of 1099-MISC income has remained almost constant even as the number of contractors has dramatically increased. Additionally, we document changes in the distribution of AGI for contractors relative to employees over time. The AGI distribution for contractors has changed in a monotonic fashion since 2000, with an increase in the prevalence of contractors lower in the AGI distribution and a decrease in contractors in the middle and top of the AGI distribution. This is not simply mirroring a trend in employee compensation. A comparison of the AGI distributions of employees and IC in 2000 shows that there was a higher relative prevalence of employees at the bottom of the AGI distribution and a higher relative prevalence of IC moving up the distribution. By 2015 this trend had reversed, with a higher relative prevalence of IC at the bottom of the AGI distribution, and lower relative prevalence of IC in the middle and top of the distribution. Therefore, even as contractor positions bear a closer resemblance to W-2 positions, the income distributions of these workers do not reflect the same trend.

To further understand these changes, we investigate firm-level heterogeneity in the hiring of contractors across firms and over time. In particular, we look at characteristics such as firm size, age of the firm, the within-firm income distribution, and the relative amount and types of compensation and benefits offered by the employing firm. Since 2000 there has been a sharp increase in the average share of IC as a percentage of a firm’s total workforce. Additionally, contractors are increasingly found at the lower end of the employee wage distribution within their firms. For example, there has been a steady increase in the probability that a contractor’s compensation falls below the median employee’s W-2 compensation in their firm; the increase in the probability that they are below the 25th percentile of employee compensation has been even more dramatic. We continue by investigating the differing characteristics of firms with high and low IC prevalence, and those with relatively high growth in IC prevalence over time.

The next sections of the paper focus on identification of causal relationships between the value of contract work for firms and workers and the changes in contract labor practices. We focus on substitution between employee and independent contractor labor in response to i) size based regulations and ii) shocks to high skilled employee preferences for tax preferred compensation. To identify the response to size based regulations, we use the employee thresholds from policies such as the Family and Medical Leave Act (FMLA) and the Affordable Care Act (ACA) as discontinuous increases in the cost of soliciting labor through a traditional employee relationship. Next, we use variation in marginal tax rates over time and across space to test the extent to which firms increase compensation in the form of tax preferred benefits in response to income tax incentives. These responses allow us to test the role of changes in compensation practices in driving substitution toward contract labor at the lower end of the firm’s wage distribution. While it is not possible to positively identify whether workers are misclassified in the absence of an audit, we examine whether the empirical results are more consistent with a “real response,” re-organization of the firm’s labor force, or an evasion response, workers being misclassified as independent contractors.
References


