RICE UNIVERSITY'S
BAKER INSTITUTE
FOR PUBLIC POLICY

ISSUE BRIEF 10.22.20

The Future of Work and Tax Policy Considerations – Part 2: The Changing Nature of Employment

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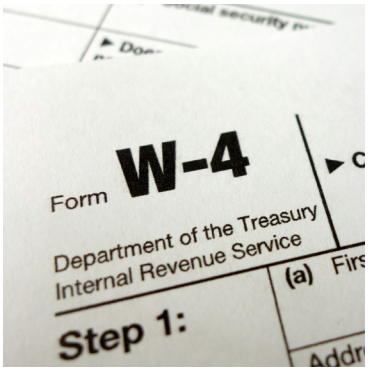
Covid-19 has not only drastically changed how we work, but also how we define work. The previous brief in this series discussed designing tax policies for an increasingly mobile workforce, a trend that has been accelerated by the pandemic. This issue brief, the second in the series, reviews the changing definition of "employment" and the associated tax implications. Specifically, this brief discusses the growth of self-employed workers in the sharing economy and the current policy measures for providing better benefits and protections for these workers. It then reviews the issues associated with the increasing trend of automation and tax incentive considerations.

EMPLOYEES OR INDEPENDENT CONTRACTORS?

A recent Internal Revenue Service (IRS) publication shows that the agency expects a 15% drop in workers with employee status in 2021 compared with the projections it made a year ago.[1] The publication also reveals that although the number of W-2 filing employees will slowly increase every year after taking a dip in 2021, it will not return to the 2019 pre-recession level until after 2028, the last year the IRS provides estimates. Specifically, there were 265.7 million W-2 filings in 2019, and the IRS expects 229.4 million copies of W-2 forms in 2028. However, one type of filing that is expected to increase every year, even during the pandemic-induced recession, is Form 1099-MISC, which is typically used by independent contractors, including workers in the gig economy and freelancers. Gig economy companies generally refer to companies that operate as online intermediaries and use app- or web-based software platforms to match suppliers of goods or services with consumers. Many studies use the term gig economy interchangeably with other terms, such as sharing economy or platform economy. The gig economy is expected to grow significantly in the next decade; in 2019, the IRS received 102.4 million copies of 1099-MISC forms, and it expects to receive 122.6 million forms in 2028.[2]

Recent application data for IRS employer identification numbers (EINs) corroborate this pattern. Compared with a year earlier, filings for the EINs, typically used by business entities for tax reporting purposes, increased between 87% and 142% during July.[3] Many of the self-employed EIN applicants are sole proprietors without payrolls.

The reasons for the surge in self-employment status vary,[4] ranging from companies laying off employees, the accessibility of gig work, or even furloughed workers trying to become entrepreneurs. However, even before the pandemic, there was a gradual increase in the number of workers with non-employee status. Whether the increase in Form 1099-MISC filings is primarily driven by the growth of sharing economy workers, employers temporarily switching their workers to



As a higher portion of the workforce experiences alternative work arrangements, an employment system that accommodates the rapidly changing technological landscape and changing nature of work will create a more stable foundation for the economy.

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independent contractor status, or other factors, will be clearer in the next few filing seasons as the IRS collects more taxpayer filing data. A new form for tax year 2020—where the IRS requests that payers report non-employee compensation (NEC) payments that exceed $600 on Form 1099-NEC instead of the traditional Form 1099-MISC—may also provide more clarity, as it potentially covers payments to sharing economy workers and independent contractors.[5] Regardless of the primary drivers, recent developments in the sharing economy suggest an increased participation in some segments. As such, this brief focuses on sharing economy workers, who are considered self-employed from an income-tax perspective.

During the first half of the year, massive layoffs and the near absence of demand made some observers wonder whether sharing economy companies would survive the pandemic, especially when many of them, including Uber, Lyft, and Airbnb, were still not profitable.[6] The recession generated by Covid-19 is the first nation-wide recession many sharing economy companies have experienced since their inception, which has certainly tested the strength of the sharing economy from several perspectives. The pandemic diminished the major advantages touted by the gig economy: the scheduling flexibility and the ease of getting gig work. Additionally, many platform companies have not been able to provide workers with opportunities to bridge employment during the pandemic. During the longest government shutdown in early 2019, furloughed public employees could drive for Uber and Lyft to scrape by.[7] This time around, the demand for ridesharing services has plummeted as a result of health and safety concerns. Airbnb bookings were also cancelled due to shelter-in-place orders, and tasks were dropped on TaskRabbit out of concerns that taskers entering customers' homes could spread Covid-19.

The less pessimistic observers indicate that the reduced ride-hailing and home-sharing traffic is offset by the increased demand for food delivery services and goods from sites like Etsy, since people's increased time at home has enabled more online purchasing. For instance, Etsy's second quarter revenue grew 137% compared with one year earlier.[8] Uber's quarterly financial report shows its ride sharing revenue decreased by 67% in the second quarter compared with the revenue generated during the same period in 2019, whereas its delivery revenue grew over 104%.[9] Recent mergers have validated the profit potentials of the food-delivery sector. In June, the Netherlands-based company Just Eat Takeaway acquired Grubhub for $7.3 billion,[10] and in July, Uber acquired Postmates for $2.65 billion.[11] Although the initial public offering (IPO) plan of DoorDash, the food delivery company with the largest market share, was placed on hold, it raised another $400 million in capital from investors during the pandemic.[12] Overall, these businesses are still attractive to the market. The sharing economy platforms are here to stay, although the competitive nature of the industry may lead to more consolidations.

Despite the intriguing growth potential and intense market competition at the industry level, it is important to consider the benefits available for workers, who facilitate the sharing economy phenomenon. From the workers' perspective, the most noticeable legal challenge for labor-based platforms, especially Uber, is whether the workers are classified as employees or independent contractors.[13] Most platform companies view providers as independent contractors instead of employees because of their flexibility to schedule jobs and ability to decide work hours. Platform companies are not required to provide benefits and protections—including minimum wage, overtime pay, sick pay, unemployment insurance, health insurance, and retirement benefits—to independent contractors, whereas employees are typically entitled to these benefits.

Uber's worker classification has been debated in court for several years, and the most recent dispute involves California's Assembly Bill 5. In September 2019, California passed the bill and codified a state Supreme Court decision that tightened the criteria for classifying workers as independent contractors, a decision that essentially implied that Uber

and Lyft drivers are employees. The bill was hailed as a victory by gig economy workers, but platform companies have never implemented the rules. The issue did not simply go away unnoticed. In July, California's attorney general asked a state judge to order the companies to immediately start classifying their drivers as employees,[14] though the sharing economy companies have been working to overturn the rules. Companies, including Uber and Lyft, have endeavored to put a measure on the November ballot and have collectively provided $110 million to support the movement. This proposition, known as Proposition 22, will permanently prohibit the state from taking actions to classify drivers as employees, if it passes in November.

Many observers, including Uber,[15] believe the root cause of the dispute is the binary employment classification between employees and independent contractors. Over time, there have been several proposed solutions that will grant sharing economy workers more benefits and protections.

First, some argue that because of the unique nature of sharing economy workers, there should be a third employment category besides employees and independent contractors. The "dependent contractors" status signifies these workers are not employees of a company but remain economically dependent on the given company through some kind of contractual relationship. Although there has not been a comprehensive or universally accepted definition of "dependent contractors," the intent for creating this separate employment category is to provide gig workers with better benefits and pay by adding to the current distinction between the dependent contractor role and self-employed status.

A different approach, endorsed by several lawmakers, is to provide clarity regarding the definition of gig workers. The New Gig Act was proposed in 2017 and 2019 but with limited traction.[16] Besides filing and withholding requirements, this bill establishes other factors—including the relationship between the parties, the place of business, and the ownership of the equipment—that are used to determine the independent contractor or employment status.

Finally, instead of delineating the employment classification, another group of lawmakers focuses on making benefits transferable between jobs. The Portable Benefits for Independent Workers Pilot Program Act was first introduced in Congress in 2017 and again in 2019.[17] Portable benefits are work-related benefits that are connected to the workers instead of to the companies they work for; as a result, workers can carry these benefits from job to job without interruption in coverage or loss of funding. These benefits can be funded by multiple sources, including the hiring entity, workers, nonprofit organizations, consumers, or state and local governments. The coverage can include anything that is typically provided to traditional employees, such as workers' compensation, paid leave, skills training, disability coverage, health insurance coverage, retirement savings, income security, and short-term savings.

A recent bipartisan proposal, the Emergency Portable Benefits for Independent Workers Act,[18] references a 2017 Bureau of Labor Statistics survey that shows over 10% of the workforce, equivalent to 16 million workers, are in alternative work arrangements as their primary occupation. This bill proposes to establish a $500 million fund for emergency portable benefits for states, where the federal government will provide funds and assist states with setting up a portable benefits program for independent workers. States can use the funds to implement portable benefit programs or to experiment with innovative proposals such as paid leave, health care, retirement, training, and other programs specific to local economies.

The solutions that major sharing economy companies propose are similar to the portable benefit model. In essence, the platform companies will guarantee minimum pay and access to certain benefits such as health care coverage in exchange for not being required to classify drivers as employees. For instance, Uber proposes to have state-level legislation that requires all platform companies to establish benefit funds, which will give workers extra accrued cash and allow workers to choose

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the benefits they want. Supporters view this as Uber offering an olive branch and being willing to compromise,[19] whereas opponents argue this is just a negotiation tactic and believe Uber should pay drivers a fair amount instead of asking state governments to intervene.

Preliminary statistics show that there is a growing number of independent contractors whose jobs do not follow typical work patterns, do not tie to particular employers, and do not fall within the traditional contractual employer-employee relationship. Although the total employment or income level in the sharing economy might still be small compared to the employer-employee category, continuing on the current path means an increasing number of workers will not be qualified for many basic worker protections and benefits. From a worker's perspective, it is essential to consider providing better protections and benefits that are not linked to specific entities, either through offering portable benefits, modifying the existing labor classification system, or both. From a tax-administration perspective, it is equally important to ensure that independent workers comply with tax rules and follow the appropriate withholding, payment, and filing requirements. As a higher portion of the workforce experiences alternative work arrangements in the coming years, an employment system that accommodates the rapidly changing technological landscape and changing nature of work will create a more stable foundation for the economy.

WORKERS OR ROBOTS?

Even before the pandemic, workforce automation was a popular topic of discussion. The debate ranges from whether technological advancements, such as artificial intelligence, blockchain technologies, and cloud computing, will create new job opportunities that require different skills, to whether robots will replace human workers. The pandemic has caused an unexpected disruption to the labor market that not only brings up new considerations (for instance, robots are not susceptible to viruses or illness), but also generates concerns regarding whether some jobs may permanently disappear.

This discussion involves not only employment levels but also structural changes to the labor market. In the short term, previously laid-off and furloughed workers will be hired back as the economy reopens. Indeed, many sectors that lost the most jobs at the onset of the pandemic reported the highest number of hiring increases in subsequent months. For example, the unemployment rate in the leisure and hospitality sector reached around 40% in April, but there was a strong bounce back in May with the industry reporting the highest employment gains among all sectors. Furthermore, the unemployment rate in August was about half of what it was in April.[20] Certain service sectors, such as personal care, laundry, and dry-cleaning services, had unemployment rates of 48% in April but added many jobs by the end of the summer, with the unemployment rate dropping to around 12% in August.[21]

Although the economy shows an initial robust recovery, some economists predict that the level of unemployment may remain stubbornly high for an extended period of time. Specifically, the "reallocation shock" may cause about 32% to 42% of pandemic-induced layoffs to be permanent, and the impact may vary across different industries.[22] However, these economists predict most of the job reallocation will take place within, rather than across, industries. For instance, although the restaurant industry was hurt badly, within the industry, there is a shift from dine-in to take-out and delivery-focused establishments. In some cases, the take-out and delivery-focused restaurants have even experienced increased demand, needing to recruit more workers, which is consistent with the experiences of the food-delivery services in the sharing economy. In addition, online grocery shopping and delivery services also witnessed higher requests for their services. Walmart is testing new technology to autonomously fulfill orders and expects to hire more workers to join its e-commerce fulfillment centers, whereas Amazon is experimenting with robot-powered

distribution centers. On the other hand, traditional brick-and-mortar establishments unwilling or unable to make the change to e-commerce or automation will be replaced sooner and need to reduce headcount.

For manufacturers, the increased utilization of automation, robots, and other new technologies means companies can realign their supply chains and create new opportunities. Specifically, companies may rely less on low-cost, overseas manufacturers and instead may locate their production facilities closer to their consumers and markets in the United States. It remains to be seen how this trend will evolve and whether the cost savings from automation will be sufficient to offset the higher regulatory and administrative expenses, as well as the costs associated with sourcing raw materials from the United States.

In recent decades, the federal government has been offering incentives for domestic production activities. The recent tax reform, the Tax Cuts and Jobs Act (TCJA) of 2017,[23] replaced the domestic production activities deduction with the broader qualified business income (QBI) deduction. As a result, owners of pass-through entities are eligible for a 20% deduction on qualified business income after 2018, which includes income from production and manufacturing activities. However, the QBI deduction is not without opposition. Some view it as overly generous, while others think the calculation is too complicated. Still others believe the provision disproportionally favors certain industries.

In addition, intellectual property (IP) has become one of the most important assets for many U.S. companies, including manufacturers, distributors, and service providers. The TCJA includes several provisions that reduced the incentives for U.S.-based multinationals to place their IP overseas, such as cutting the statutory federal corporate income tax (CIT) rate from 35% to 21% to narrow the tax rate arbitrage, discouraging multinationals from making deductible payments to foreign-related parties to erode the U.S. tax base, and taxing income from exporting products imbedded with domestically-owned IP at a lower rate. However, preliminary evidence shows limited on-shoring of IP as a result of these provisions. [24]

The limited responses are partly driven by companies' view that these provisions could be short-lived. For instance, Democratic congressional members have advocated for increasing CIT rates to fund the elimination of the state and local tax deduction cap, and many Democratic presidential candidates proposed similar tax increases on corporations to fund various policy priorities.[25] Recently, Democratic presidential candidate Joe Biden proposed to increase the CIT to 28%.[26] In addition, he plans to impose an additional 10% tax penalty on companies migrating manufacturing and service jobs offshore and a 10% tax credit for domestic production. Some observers praise these measures as they will ensure that companies pay more taxes in the United States. However, others do not believe these provisions will provide enough incentives for multinational companies, especially on top of the CIT increase that will increase their tax burdens.

Finally, state and local governments often provide tax credits and incentives on business property, sales and use, or income taxes to attract companies to establish offices or factories in their jurisdictions. In theory, these arrangements not only generate new job opportunities, but they also indirectly strengthen the local economy. The food, housing, and other services needed to support these workers will further create more employment and business opportunities. Workers in these establishments may collectively pay more sales, personal income, and personal property taxes to the state and local governments than the subsidies provided to the businesses. In some cases, jurisdictions may even compete with each other to get businesses they deem lucrative, such as Amazon and Tesla.[27]

However, some of these projects are not applauded by local residents, while others may not achieve the employment, scale, or other economic targets specified in the initial plan. For instance, Amazon reversed its decision and decided not to

build its second headquarters in New York City after strong opposition from the local community,[28] even though the arrangement originally promised 25,000 jobs. Some researchers also show a large number of investments would have been made even without the tax credits or incentives.[29] As such, authorities need to carefully examine these arrangements and balance them with local interests, especially during a time when state and local governments are facing substantial budget shortfalls. When technology and automation are transforming the U.S. workforce, it is increasingly important to ensure that any tax incentives for corporations are geared toward developing the local labor force, enhancing worker skills, and improving local infrastructure.

ADDITIONAL CONSIDERATIONS

The pandemic has forced workers to adapt to new circumstances—ranging from working remotely, working for a platform company, or working with unfamiliar technologies. It has also pushed consumers out of their comfort zones to explore technologies such as online purchasing, distance learning, telemedicine, and cashless payment methods. All of these experiences have created new opportunities for entrepreneurs and have enabled established companies to evaluate their current operations. In turn, this is accelerating the speed of automation and the digital transformation.

Although the meaning of "employment" is still evolving, it is important to be mindful of how these developments will shape the future of work and the associated tax considerations. These changes may also lead to lifestyle and purchasing power migrations.[30] For instance, to the extent that there are more telecommuting workers or more workers utilizing alternative work arrangements (such as working in the sharing economy), there will be fewer workers commuting to central business districts, traffic patterns will be different, and workers' activities and consumption will shift to the residential areas closer to where they live. These lifestyle changes will eventually lead to changes in the tax base, tax revenue, and tax administration. The pandemic has been destructive; however, governments can use it as an opportunity to design a set of truly comprehensive, forward-looking policies that accommodate tomorrow's workforce.

ENDNOTES

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Cite as:
Beebe, Joyce. 2020. *TThe Future of Work and Tax Policy Considerations – Part 2: The Changing Nature of Employment.* Issue brief no. 10.22.20. Rice University's Baker Institute for Public Policy, Houston, Texas.

https://doi.org/10.25613/dv6r-nt46