

THE ECONOMIC BENEFITS OF PRESERVING INDEPENDENT CONTRACTING

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EXECUTIVE SUMMARY

Businesses can
organize themselves
in a variety of forms
to provide products
or services.

“Independent contracting”² is a business arrangement in which a client firm contracts with a small business or an individual to perform work that may be performed by full- or part-time employees at other firms within the same industry. Independent contracting is increasingly subject to constraint by state or federal policy. The purpose of this report is to present a balanced economic perspective regarding independent contracting’s advantages as well as its costs, so that policy decisions are based on facts, not prejudice.

This report shows that opposition to independent contracting is misguided, not supported by available evidence and harmful to economic vitality. The report also demonstrates that many of the arguments leveled against independent contracting are based on myth, not credible data.

Commonly the independent contractor’s (IC) client is a large company or government, and the contractor a small one — often an individual, sole proprietor. In some instances, the IC is an operator of a small business. This report cites strong evidence that new, small businesses are by far the most important creator of jobs in America today.

EXAMPLES OF INDEPENDENT CONTRACTING OCCUPATIONS

Any occupation that can be occupied by an employee can, in principle, be contracted for. In practice, occupations where output can easily be measured without close monitoring are best suited to independent contracting. Both the employer/client and the contractor benefit: the contractor earns great autonomy and higher compensation because they are paid based only on productivity; and the client gains higher productivity and more long-term flexibility from reduced fixed costs.

WHAT TYPES OF OCCUPATIONS ARE REPRESENTED AMONG CONTRACTORS?

The following examples offer some illustrations. They are representative insofar as they include occupations where independent contracting is most prevalent. Occupations are listed in declining order of prevalence. (Alternative employment prevalence in California is shown in parentheses.)



■ CONSTRUCTION WORKERS:

Given the highly cyclical and project-based nature of construction, independent employment arrangements are not surprising. More than one-fourth of all employment in this industry is in alternative arrangements, with about four-fifths independent contractors. (California: 19.3 percent)



■ FINANCIAL ADVISERS:

About two-thirds of this occupation is comprised of independent contractors. (California: 10.2 percent of financial industry — i.e., a larger group than financial advisers)



■ HEALTH CAREGIVERS:

Roughly 15 percent of all personal and home care aids work in alternative employment arrangements, half of them as independent contractors.

■ **DRIVERS AND DELIVERY PERSONS:**

The Bureau of Labor Statistics survey of alternative work arrangements reports that 21.8 percent of all taxi and limousine drivers and 7.4 percent of all couriers are engaged in alternative employment, about three-fourths as independent contractors³.



■ **FOREST PRODUCTS:**

Half of workers in this industry — which is substantially driven by the same demand factors as construction — are self-employed. (California: 15.0 percent)



■ **PHYSICIANS:**

Between one in seven and one in eight physicians are self employed or in an alternative employment arrangement.



As can be seen, the common denominator is not the worker's skill set or industry; it is the occupation's suitability to pay for direct performance.

An extensive body of economic literature establishes that small businesses have been responsible for most of the net growth in U.S. employment for decades.⁴

In particular, the rate at which new firms are created is a critical determinant of long term prosperity.⁵ According to Kane 2010 (p. 2), new firms (“startups”) were responsible for creating three million jobs per year quite consistently from 1997 to 2005. Existing firms’ net job creation was negative (i.e., more jobs were shed than created) in all but five of the 28 years covered. In some years (the early recovery years of 1983, 1991 and 2002), existing firms shed more jobs than new firms created. It is not an exaggeration to say that the rate at which new firms are created may be the single most important contributor to economic growth. As Stangler notes, “The U.S. economy has enjoyed positive rates of new job creation for the past thirty years largely because of the steady pace at which new firms come into existence....[t]he net creation of new jobs among [large established companies] is usually zero.”⁶

Firms that create jobs are, by definition, expanding. In general expanding firms are, by definition, competing successfully in the marketplace.⁷ The fundamental determinant of competitiveness is productivity: the value produced per dollar of input.⁸ It is therefore reasonable to infer that small firms, including many of the self-employed, are more productive than average. This is especially true for the most successful small firms, such as the top one percent that are responsible for 40 percent of new job creation.⁹



PRODUCTIVITY AND COMPETITIVENESS

GENERALLY WORKERS WITH HIGHER PRODUCTIVITY (I.E., WHO CREATE AN ABOVE-AVERAGE AMOUNT OF VALUE PER HOUR WORKED) SHARE IN ITS ECONOMIC BENEFITS THROUGH HIGHER COMPENSATION.

Although this is not universally true, especially in recent years — employers may harvest that higher productivity in higher profits rather than higher labor compensation — it is true by definition among the self-employed, since the employees are also owners. Higher compensation is likely among the reasons for high rates of job satisfaction among the self-employed.

ICS IN CALIFORNIA

CALIFORNIA'S ECONOMIC GROWTH IN PARTICULAR IS HEAVILY DEPENDENT ON SMALL BUSINESSES AND INDEPENDENT CONTRACTORS.

In 2009 (the most recent year available), roughly 1.5 million Californians worked primarily for their own businesses — more than one of every eleven workers in the state. Self-employment is about one-third more common in California (where 9.1 percent of those employed work for themselves) than in the nation (where the comparable rate is 7.0 percent).¹⁰ This is not surprising since California has long had a reputation as an incubator for new businesses. The share of employment attributable to new firms is the seventh highest in the nation, and the highest of any large state¹¹; and California's index of entrepreneurial activity is in the top quintile.¹² Arguably, the state's high rate of new business formation is one of its few remaining competitive advantages.



MYTHS ABOUT ICS

This report refutes the main arguments made against independent contracting by state and federal agencies. Independent contractors' main competitive advantage is not evasion of labor and tax laws. Contracting is not a "fallback" occupation for those who have lost wage employment, but much more often is actively chosen by the contractor. Finally, contracting is a symptom, not a cause, of increasing globalized competition — and through its enhanced productivity, is a powerful weapon in that competition.

EFFECTS OF SUPPRESSING ICS

Restricting independent contracting in California will slow economic growth and add to the state's unemployment rate. To quantify the effects of policies that restricted independent contracting, we examined three sets of information. In each instance, we compared economic outcomes over a past period for groups of states subject, or not subject, to differing degrees of restrictions on labor practices:

- (1) Using the Employment Regulation Index,¹³ we compared GDP growth rates and unemployment rates for the Index's three "tiers" of state labor regimes. We found that significant differences in labor restrictions (between states in the Index's first to third tiers, or vice versa) corresponded to a 1.2 percent change in the state's unemployment rate, and a 0.6 percent change in annual state GDP growth.
- (2) Imprimis magazine (reporting on a speech by National Right to Work president Mark Mix) reports that the 22 right to work states enjoyed 36 percent faster GDP growth between 2000 and 2009 than did the 28 compulsory unionized states: 2.2 percent vs. 1.6 percent per year — again a 0.6 percent annualized difference.
- (3) The National Institute for Labor Relations Research estimates that U.S. GDP in 2006 was \$436 billion (3.08 percent) lower than it would have been if, hypothetically, mandatory union dues had been abolished in 2006. This represents an annualized 0.51 percent reduction over the six years.

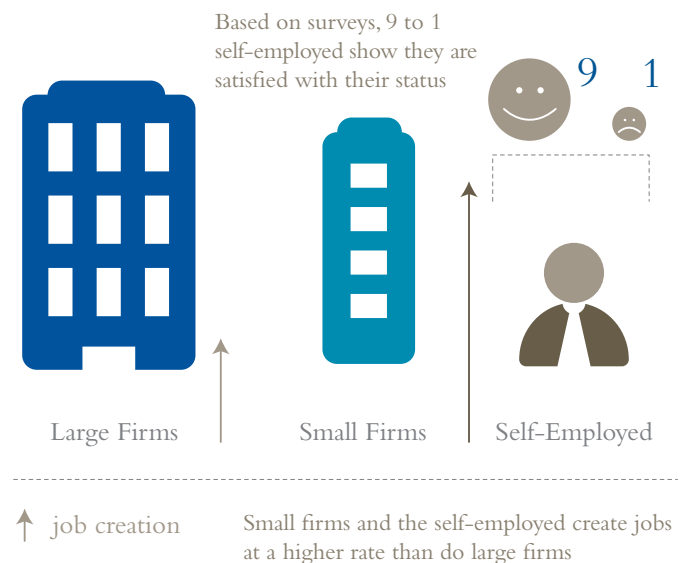
To be conservative, for this report we will assume that added restrictions on labor arrangements — including on independent contracting, which is often at the center of such restrictions — will suppress state GDP growth by between 0.3 percent and 0.6 percent. Likewise, it will add between 0.25 percent and 0.5 percent to the state's unemployment rate. Further restrictions on independent contracting would suppress the California economy by roughly the following amounts:

	CHANGE IN EMPLOYMENT		CHANGE IN PERSONAL INCOME	
	Low	High	Low	High
Restrictions on ICs	-47,700	-95,400	-\$4.16 B	-\$8.32 B
Liberalization of ICS	+47,700	+95,400	+\$4.16 B	+\$8.32 B

ONE OF CALIFORNIA'S FEW COMPETITIVE ADVANTAGES

Because California remains among the leading states in the formation of small businesses — one of the most important determinants of long-term prosperity — its economy would suffer disproportionately if independent contracting was curbed.

Independent contracting arrangements provide a variety of benefits to the contracting parties — otherwise they would not adopt them voluntarily. Less apparent, they also provide benefits to the wider economy. In particular, there is considerable evidence that small firms and the self-employed create jobs at a higher rate than do large firms.¹⁴ They are also more productive (i.e., produce higher value per hour worked), allowing those who work in small firms to achieve higher incomes than equivalent occupations in large firms.¹⁵ It is therefore not surprising that surveys of the self-employed show that those who are satisfied with their status outnumber those who are not by roughly 9 to 1.¹⁶



Therefore, policies that encourage self-employment facilitate productivity growth, and thereby make the state's economy more competitive. They also help workers with entrepreneurial inclinations to pursue higher income (albeit with greater risk), and an autonomy that leads to greater work satisfaction for nine in ten who take the plunge. Policies that inhibit the formation of self-employed businesses such as independent contractors have the opposite effect: muzzled competition, stunted incomes and thwarted dreams.

Three different estimation methods were used to measure how California's economy would suffer disproportionately if independent contracting was curbed: Curbing ICs would increase unemployment by between 0.3 percent and 0.6 percent (approximately 48,000 to 96,000 jobs). Put in perspective, this is about two-thirds as many jobs as were lost in California in the worst year of the recent recession. Such costs would be especially precious, given that California already labors under one of the highest unemployment rates (12 percent as noted on page 16 of this report) in a nation with stubbornly persistent unemployment.

Suppressed employment would also lead to suppressed incomes, costing the state between one-fourth and one-half of a percent of total personal income (\$4 to \$8 billion). This is roughly comparable to losing all income in the natural resources and mining industries, or the salaries of all military personnel within the state.

But as noted, the greater cost of restrictions on independent contracting is not the short-run impact — it is the suppression of innovation and productivity improvements that are at the heart of all economic progress. Curbing ICs will impede the competitiveness of contracting parties, driving down their ability to gain market share from foreign competitors. The greatest victim of such restrictions will not be the unemployed of this decade, but those of the next generation who never know that work that could have been theirs has migrated to other continents.

“...the greater cost of restrictions on independent contracting is not their short-run impact — it is the suppression of innovation and productivity improvements that are at the heart of all economic progress.”

I

THE ROLE OF SELF-EMPLOYMENT
IN A DYNAMIC ECONOMY

Independent contracting is defined in this report as a business arrangement wherein a client firm contracts with a firm or individual to supply services that may be performed by employees in other firms in the industry.

Commonly the client is a large company or government, and the contractor a small one — often an individual, sole proprietor.

The primary labor statistics pertinent to independent contracting are those related to self-employment. Independent contractors are a large subset (80 percent) of the self-employed, differing mainly in that their customers may be concentrated in one or a few clients. (By contrast, some of the self-employed, such as small retail establishments, may serve a wide range of customers.) While the self-employed and independent contractors are not identical, most independent contractors are self-employed. This is true even when the contracted firm is incorporated, although most are not.

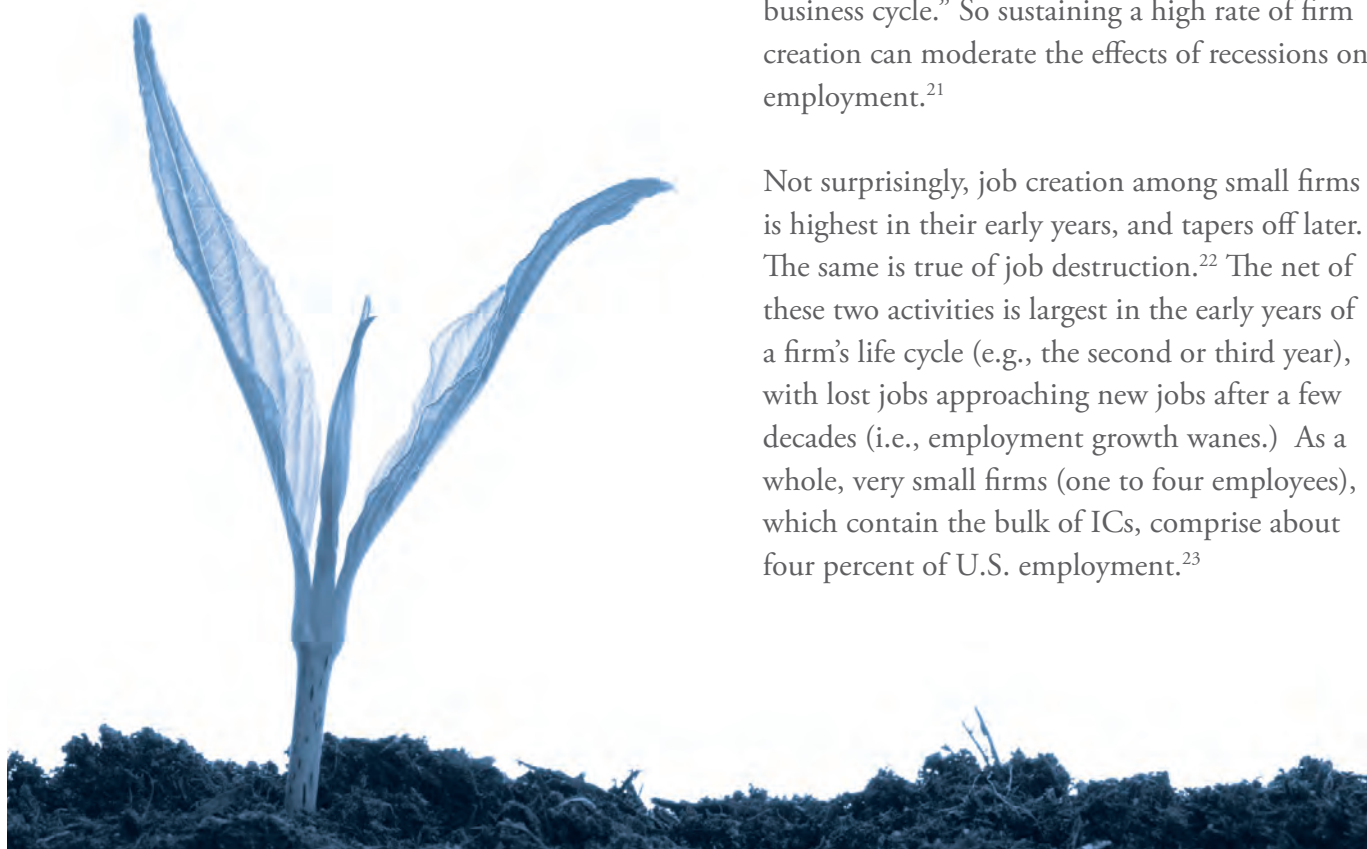
Self-employment is a common early stage in the corporate life cycle — most firms began with their founder as the sole employee. Sometimes it is a lifestyle choice, when a former manager decides to dispense with the hassles of overseeing employees and prefers to work as an individual. Contrary to conventional wisdom, rarely is self-employment a fallback position for those who are unable to secure regular wage employment, as described in a later section.

SELF-EMPLOYMENT AND JOB GROWTH

An extensive literature establishes that small businesses have been responsible for most of the net growth in U.S. employment for decades.¹⁷ In particular, *the rate at which new firms are created* emerges as a critical determinant of long term prosperity. According to Kane 2010 (p. 2), new firms (“startups”) were responsible for creating three million jobs per year quite consistently from 1997 to 2005.¹⁸ Existing firms’ net job creation was negative (i.e., more jobs were shed than created) in all but five of the 28 years covered. In some years (the early recovery years of 1983, 1991 and 2002), existing firms shed more jobs than new firms created. *It is not an exaggeration to say that the rate at which new firms are created may be the single most important contributor to economic growth.* As Stangler notes, “The U.S. economy has enjoyed positive rates of new job creation for the past thirty years largely because of the steady pace at which new firms come into existence....[t]he net creation of new jobs among [large established companies] is usually zero.”¹⁹

Besides its long-run significance, firm creation is a potent weapon during recessions (i.e., it is counter-cyclical). As just noted, net jobs added by startups stayed strong during each recession, while jobs in existing firms fell by an amount greater than the roughly 3,000,000 jobs created annually by startups. Not surprisingly, small business owners believe they can make a disproportionate contribution to job growth in the recovery from the most recent recession. According to a recent Citibank survey, nine out of ten California small businesspersons agreed with a statement that they were responsible for the recovery.²⁰ As Kane puts it, “during recessionary years, job creation at startups remains stable, while net job losses at existing firms is highly sensitive to the business cycle.” So sustaining a high rate of firm creation can moderate the effects of recessions on employment.²¹

Not surprisingly, job creation among small firms is highest in their early years, and tapers off later. The same is true of job destruction.²² The net of these two activities is largest in the early years of a firm’s life cycle (e.g., the second or third year), with lost jobs approaching new jobs after a few decades (i.e., employment growth wanes.) As a whole, very small firms (one to four employees), which contain the bulk of ICs, comprise about four percent of U.S. employment.²³



SELF-EMPLOYMENT AND COMPETITIVENESS

Firms that create jobs are, by definition, expanding. In general expanding firms are, by definition, competing successfully in the marketplace.²⁴ The fundamental determinant of competitiveness is productivity: the value produced per dollar of input.²⁵ It is therefore reasonable to assume that small firms, including many of the self-employed, are more productive than average. This is especially true for the most successful small firms, such as the top one percent that are responsible for 40 percent of new job creation.²⁶

Many small firms begin life as sole proprietorships (i.e., where an individual is self-employed).²⁷ So self-employment is an important transition to the creation of highly productive and rapidly expanding firms that are responsible for a disproportionate share of job creation.

Generally, workers with higher productivity (i.e., who create an above-average amount of value per hour worked) share in its economic benefits through higher compensation. Although this is not universally true, especially in recent years — employers may harvest that higher productivity in higher profits rather than higher labor compensation — it is true by definition among the self-employed, since the employees are also owners. Higher compensation is likely among the reasons for high rates of job satisfaction among the self-employed, described later in this report.

Further comments about the critical matter of productivity are contained in Section IV.

“The fundamental determinant of competitiveness is productivity: the value produced per dollar of input.”



II

SELF-EMPLOYMENT IN CALIFORNIA

In 2009 (the most recent year available), roughly 1.5 million Californians worked primarily for their own businesses — more than one of every eleven workers in the state.

Self-employment is about one-third more common in California (where 9.1 percent of those employed work for themselves) than in the nation (where the comparable rate is 7.0 percent).²⁸ This is not surprising since California has long had a reputation as an incubator for new businesses, and receives a large share of new immigrants, who have a high rate of new business formation. The state's share of employment attributable to new firms is the seventh highest in the nation, and the highest of any large state²⁹; and California's index of entrepreneurial activity is in the top quintile.³⁰ Arguably, the state's high rate of new business formation is one of its few remaining competitive advantages.

Many of the self-employed derive much of their revenues from long-term contracts with a small number of clients (or only one). Often in these relationships the customer is a large business which has the option of hiring full-time employees to perform the same work, but finds it beneficial to contract instead with independent operators.

In 2007 (the most recent year available), there were 15,037,048 businesses in California, almost as many as the total number of people employed (16,790,000). More than half of these (53.8 percent) were “flow-through businesses”: sole proprietorships, partnerships or S corporations; while 46.2 percent were C corporations.³¹ Flow-through businesses are about as prevalent in California as in the nation as a whole, so any policy affecting them will impact over eight million businesses. Since more than 75 percent of workers in flow-through businesses are independent contractors, policies affecting ICs will impact roughly six million persons.

III

MYTHS ABOUT INDEPENDENT CONTRACTING AND SELF-EMPLOYMENT

About one out of every ten U.S. workers is in an “alternative employment arrangement,” with three-fourths of them self-employed.³²

Some observers argue that such arrangements are harmful to the workers’ interests. However, public policy should be made on the basis of facts, not suppositions. This section discusses several misconceptions about independent contracting and self-employment.

While the arguments against independent contracting addressed here are stylized in the interests of brevity, they are not “straw-men.” Each has been made in some form repeatedly by opponents of contracting. Independent contractors’ main competitive advantage is not evasion of labor and tax laws. Contracting is not a “fallback” occupation for those who have lost wage employment, but much more often actively chosen by the contractor. Finally, contracting is a symptom, not a cause, of increasing globalized competition — and through its enhanced productivity, a powerful weapon in that competition.

(1) “TAX DODGE”:
INDEPENDENT CONTRACTING IS MAINLY A DEVICE TO
EVADE TAX AND LABOR LAWS

Hiring a contractor as distinct from an employee removes the client’s liability for payroll taxes, overtime pay and other responsibilities. Opponents argue that this is the primary motivation for such arrangements: to lower the client’s labor costs through tax evasion.

The most authoritative depiction of the realities of independent contracting comes from the Census Bureau’s Contingent and Alternative Work Arrangements (CAWA) survey. As reported in Eisenach, this survey “provide[s] greater insight into the prevalence and characteristics of...independent contracting.” (Roughly 80 percent of respondents were employed as contractors.)³³ The self-employed are especially prevalent in agricultural occupations, but also in professional and business services and construction — industries that would have difficulty staying under the radar of tax or regulatory authorities. Eisenach reports that IRS data indicate that accurate reporting of income from contractors (who receive 1099 forms) is virtually identical to that of employees (who receive W-2s): 97 percent from contractors verses 99 percent from employees.³⁴ According to the U.S. Treasury, “[i]ndependent contractors and their clients tend to pay higher levels of taxes, especially Social Security and Medicare taxes, than employees and employers.” To the degree that revenue effects may pervert incentives to accurately classify employees or contractors, the incentives run the opposite of what critics of independent contracting suggest. Treasury found that classifying workers as contractors actually raises revenues: “... [M]isclassifying employees as independent contractors increases tax revenues...”³⁵

Thus the organization responsible for maximizing federal revenue has attested that independent contracting, not wage employment, delivers greater tax revenue.

Independent contracting also obviates wage and hour laws requiring overtime pay to non-exempt workers, because the “workers” are also owners. But as such, it allows contractors to earn greater rewards for greater effort.

(2) “INVOLUNTARY CONTRACTING”:
INDEPENDENT CONTRACTING IS A SECOND CHOICE
ARRANGEMENT FOR WORKERS WHO WOULD PREFER
FULL-TIME EMPLOYMENT.

Another common myth is that independent contractors have acceded to this arrangement for lack of an alternative. During the recent recession, the prototypical contractor in this view had been laid off from a full-time job and was making ends meet as a free agent, but at much lower compensation.

Several pieces of data belie this caricature. First, the 2005 CAWA survey found that 82.3 percent of independent contractors prefer independent work to regular employment, with only 9.1 percent preferring employment. *This is a very strong statement of preference — by more than nine to one.*³⁶ Second, according to data in Hipple, self-employment rates tend to rise in booms and fall in a recession,³⁷ which appears to contradict those who contend that self-employment is only a second-choice option taken only by those who lack alternatives (e.g., those laid off from large firms). According to the California Employment Development Department (using BLS data), self-employment rates fell during the recent recession — the opposite of what the “involuntary contracting” view would suggest.³⁸ Alternatives are the most widely available during booms, so the choice of self-employment appears to be unquestionably voluntary. The Kauffmann Foundation analysis of Census Bureau data reaches similar conclusions. This is the opposite of what the “involuntary contracting” hypothesis implies.

Finally, participants in small firms, including the self-employed, tend to make somewhat higher compensation than those in large firms. Stangler and Litan show that small firms’ share of total payroll (15.48 percent) is slightly higher than their share of the labor force (14.59 percent).³⁹ This is hardly surprising: the close link between performance and reward inherent in self-employment incents higher productivity that was mentioned earlier. The greater satisfaction among the vast majority of the self-employed stems in part from the greater economic rewards they enjoy, in direct proportion to their effort.

The closer alignment of rewards with effort among independent firms (whose owners only earn what they produce) can be expected to boost labor productivity, and thus competitiveness. Economists generally believe that productivity is the single most important determinant of long-term income growth, and therefore of prosperity. Independent contractors experience a very direct relationship between effort and reward. To the extent that many contractors exploit the opportunity to earn a higher income than as an employee — which many do — their rewards stem from their greater effort. This pays benefits for the competitiveness of the wider economy.

(3) “RACE TO THE BOTTOM”: INDEPENDENT CONTRACTING IMPERILS INCOME SECURITY

This argument asserts that client companies are pushing risk (of income volatility) off their own shoulders, where it traditionally has reposed, onto the backs of workers. It shares many elements in common with the debate about defined benefit versus defined contribution pensions: advocates argue that employers should take responsibility for their workers’ retirement income — even at the cost of loss of investment flexibility or portability.

At its core, this argument has much in common with debates about free trade. Proponents of free trade argue that protection of domestic firms drives up prices and at best succeeds only temporarily — eventually more efficient, unprotected foreign firms will compete in our market and take market share away from the local firms that have been coddled by protections. Those opposed to free trade argue that free trade will lead to a “race to the bottom” in which the lowest cost producers — whose low costs may stem from lax or nonexistent regulation — will dominate the market, often paying wages far below developed country norms.

At its core, the debate is over what the future will be absent policy changes. If American firms can be expected to dominate their industries as many did in the decades after World War II, then they can afford generous treatment of labor, including the maintenance of high fixed labor costs even when demand declines. If — as seems far more likely — American firms are simply a few of many competitors in a global market, then policies that oblige them to absorb high fixed costs (that could be avoided if “employment” was replaced by contracting) severely handicap them in that competition. For recent painful examples, consider auto companies or domestic airlines, each of which were hobbled by very high fixed costs that led to bankruptcy when their sales fell in recession.

IV

NATIONAL EVIDENCE RELEVANT TO IMPACTS OF POLICIES TO RESTRICT INDEPENDENT CONTRACTING

The foregoing sections have demonstrated the economic advantages of permitting entrepreneurs to contract with clients to deliver services that in other arrangements are provided by employees.

But the task remains to quantify the magnitude of those benefits — gains that would be lost if independent contracting were curtailed through policy restrictions. That is the purpose of this section. The following section translates national data for independent contracting curtailment into California consequences.

All of the policy analyses on ICs uncovered in the research for this study were purely qualitative, so it was necessary to develop a new framework for estimating the effects of policy restrictions on ICs. The most persuasive approach is to draw from empirical experience in other jurisdictions that have adopted differing policy regimes towards labor and employment arrangements. A casual observer in this field will see that states or nations with greater “protections” for workers also tend to have higher unemployment rates and slower growth rates. (Firms will be reluctant to expand, and hire more workers, if they will face legal obstacles to firing them due to poor performance or unfavorable conditions.) This pattern has been noted most recently in the sharp disparities in economic conditions in “right to work” states such as Texas verses more heavily unionized states such as New York or California.⁴⁰

For this report, we examined three sets of information. In each instance we compared economic outcomes over a past period for groups of states subject, or not subject, to differing degrees of restrictions about labor practices:

- (1) Using the Employment Regulation Index,⁴¹ we compared GDP growth rates and unemployment rates for the Index's three "tiers" of labor regimes. We found that significant differences in labor restrictions (between states in the Index's first to third tiers, or vice versa) corresponded to a 1.2 percent change in the state's unemployment rate, and a 0.6 percent change in annual state GDP growth.
- (2) *Imprimis* magazine (reporting on a speech by National Right to Work president Mark Mix) reports that the 22 right to work states enjoyed 36 percent faster GDP growth between 2000 and 2009 than did the 28 compulsory unionized states: 2.2 percent versus 1.6 percent per year — again a 0.6 percent annualized difference.
- (3) The National Institute for Labor Relations Research estimates that U.S. GDP in 2006 was \$436 billion (3.08 percent) lower than it would have been if, hypothetically, mandatory union dues had been abolished in 2006. This represents an annualized 0.51 percent reduction over the six years.

As can be seen, these results are very consistent: policy restrictions that are similar to those which would restrict independent contracting lead to lower annual GDP growth of 0.5 percent to 0.6 percent. Summaries of the author's calculations can be found in Appendix A.

Cross-national comparisons lead to similar findings. For example, Ed Prescott shared the 2004 Nobel Prize in Economics in part for his findings about the effect of Western European policies on employment and economic growth, which have long been an annual percentage point or more behind the U.S.

As noted, each of these comparisons is broader than what may be considered for independent contracting alone. But as the Employment Relations Index illustrates,⁴² labor policies generally correlate: a state that restricts (or supports) unionization usually has a consistent stance with respect to other labor issues. Furthermore, independent contracting has special political saliency, so it generally is a "core" political issue for labor and business. Because interstate comparisons cannot completely isolate the effects of independent contracting policy, we will deliberately emphasize smaller effects than we believe likely, so as to be likelier to underestimate than to overestimate the consequences of policy changes. In addition, the nature of prospective policy changes that could restrict ICs is uncertain, so great precision would be spurious.

For the balance of this report, we will assume that added restrictions on labor arrangements — including on independent contracting, which is often at the center of such restrictions — will suppress state GDP growth by between 0.3 percent and 0.6 percent. (We consider 0.6 percent more likely, but we will include the lower number to be conservative, and to acknowledge that independent contracting policy is not the sole determinant of employment levels.) Likewise, it will add between 0.25 percent and 0.5 percent to the state's unemployment rate.

The next section applies these findings to California.



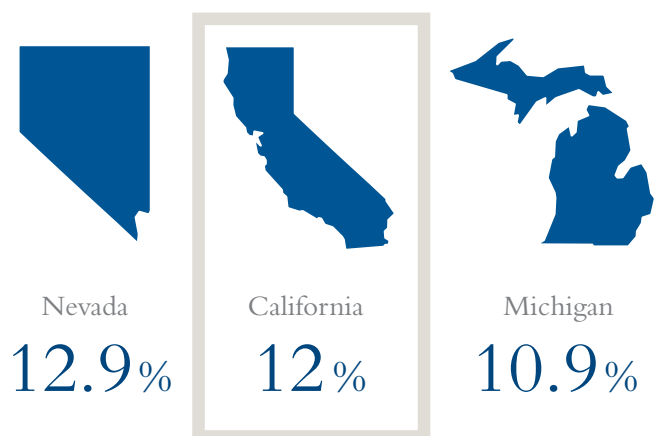
AGGREGATE ECONOMIC IMPACT
OF RESTRICTING INDEPENDENT
CONTRACTING IN CALIFORNIA

Previous sections have established that small firms, including independent contractors, make a disproportionate contribution to employment and economic growth.

California has a particularly high stake in policymaking regarding independent contracting, because it still boasts a small-business sector that is proportionally one-third larger than the national average. The state is seventh highest in its density of employment in startup firms.

Unfortunately, California also suffers under the second highest unemployment rate in the nation (12 percent; just below Nevada's 12.9 percent and well above Michigan's 10.9 percent, according to current BLS estimates⁴³). Policies that discourage the formation of new firms would slow productivity growth and magnify this high unemployment.

California also suffers under the second highest unemployment rate in the nation.



The state's civilian employment in June 2011 (most recent available) was 15,910,000. Personal Income⁴⁴ (the largest component of GDP) was \$1,665 billion. Further restrictions on independent contracting would suppress the state economy by roughly the following amounts:

	CHANGE IN EMPLOYMENT		CHANGE IN PERSONAL INCOME	
	Low	High	Low	High
Restrictions on ICs	-47,700	-95,400	-\$4.16 B	-\$8.32 B
Liberalization of ICS	+47,700	+95,400	+\$4.16 B	+\$8.32 B

The apparent symmetry is a product of the rough nature of the estimating process (described above), and the generality of prospective policy changes. In the author's personal view, liberalization would probably have greater benefits than restriction would impose costs, because of the high level of extant government intervention in labor markets.

Within the limits of the data available, the fairest thing we can say is: restricting independent contracting would further suppress the economy of a state that is already in the cellar of economic performance. Tens of thousands of jobs would be lost over time, because entrepreneurs would be discouraged from forming new firms — an act that has been demonstrated to have the greatest benefit to enduring prosperity. By contrast, liberalizing California's labor policy to encourage new firm creation, including by independent contractors, would help restart the catalyst that drives long-term economic growth.

VI

CONCLUSIONS

Technology and globalization are remaking labor markets throughout the world, including in long-established industries in the U.S.

With this transformation, changes in labor regulations must follow. In some states, including California, efforts are underway to restrict the use of independent contractors to perform functions that once were undertaken by employees. Changes in policy must be premised on accurate information about independent contracting's circumstances, costs, and benefits.

Independent contracting arrangements provide a variety of benefits to the contracting parties — otherwise they would not adopt them voluntarily. Less apparent, they also provide benefits to the wider economy. In particular, there is considerable evidence that small firms and the self-employed create jobs at a higher rate than do large firms.⁴⁵ They are also more productive (i.e., produce higher value per hour worked), allowing those who work in small firms to achieve higher incomes than equivalent occupations in large firms.⁴⁶ It is therefore not surprising that surveys of the self-employed show that those who are satisfied with their status outnumber those who are not by roughly 9 to 1.⁴⁷

Therefore, policies that encourage self-employment facilitate productivity growth, and thereby make the state's economy more competitive. They also assist workers with entrepreneurial inclinations to pursue higher income (albeit with greater risk), and an autonomy that leads to greater work satisfaction for nine in ten who take the plunge. Policies that inhibit the formation of self-employed businesses have the opposite effect: muzzled competition, stunted incomes and thwarted dreams.

Because California remains among the leading states in the formation of small businesses — one of the most important determinants of long-term prosperity — its economy would suffer disproportionately if independent contracting was curbed. Three different estimation methods each produced a similar finding: Curbing ICs would increase unemployment by between 0.3 percent and 0.6 percent (approximately 48,000 to 96,000 jobs). Put in perspective, this is about two-thirds as many jobs as were lost in the worst year of the recent recession. Such costs would be especially precious, given that California already labors under one of the highest unemployment rates in a nation with stubbornly persistent unemployment. Suppressed employment would also lead to suppressed incomes, costing the state between one-fourth and one-half of a percent of total personal income (\$4 to \$8 billion). This is roughly comparable to losing all income in the natural resources and mining industries, or the salaries of all military personnel within the state.

But as noted, the greater cost of restrictions on independent contracting is not the short-run impact; it is the suppression of innovation and productivity improvements that are at the heart of all economic progress. Curbing ICs will impede the competitiveness of contracting parties, driving down their ability to gain market share from foreign competitors. The greatest victim of such restrictions will not be the unemployed of this decade, but those of the next generation who never know that work that could have been theirs has migrated to other continents.

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APPENDIX A

Aggregate Impacts of Labor Policy Regimes

(data from sources; percentage calculations by author)

[A] SORTING STATES BASED ON EMPLOYMENT REGULATION INDEX

TIER 1			TIER 2			TIER 3		
State	Unemp (%)	Growth (GDP)	State	Unemp (%)	Growth (GDP)	State	Unemp (%)	Growth (GDP)
AL	10	2.3	AK	7.7	1.3	CA	12	2.3
FL	10.7	3.1	AZ	9.4	3.6	CT	9.1	1.3
GA	10.1	1.6	AR	8.2	2.2	HI	6.1	2.7
ID	9.4	3.4	CO	8.5	2.1	IL	9.5	1.3
KS	6.5	2.1	DE	8.1	2.2	ME	7.7	1.6
MS	10.4	1.4	IN	8.5	1	MA	7.6	1.6
NC	10.1	2.3	IO	6	2.6	MI	10.9	-0.4
ND	3.3	4	KT	9.5	1.6	MT	7.7	3.1
OK	5.5	2.2	LA	7.6	1.2	NV	12.9	4.3
SC	7.9	1.5	MD	7.2	2.6	NJ	9.5	1.6
SD	4.7	3.5	MN	7.2	2	NY	8	2.7
TN	9.8	2.3	MO	8.7	1.2	OR	9.5	3.4
TX	8.4	3.1	NB	4.1	2.3	PA	7.8	1.6
UT	7.5	3.3	NH	5.2	1.9	WA	9.3	2.2
VA	6.1	2.8	NM	6.7	2.4	WI	7.8	1.5
WY	5.8	2.9	OH	9	0.4			
			RI	10.8	1.6			
			VT	5.7	2.5			
			WV	8.1	1.4			
AVG	7.89%	2.61%		7.69%	1.90%		9.03%	2.05%
Increment one tier	NA	NA		-0.19%	-0.71%		1.33%	0.15%
Increment two tiers	NA	NA		NA	NA		1.14%	-0.56%

Conclusion: Significant expansion of labor legal/regulatory restrictions (from Tier III to Tier I) lowers annual state GDP growth by about 0.6 percent and raises the unemployment rate by about 1.2 percent.

NOTES:

- Tiers based on the Employment Regulation Index detailed in Eisenach et al, undated Unemployment rates (in %) for July 2011 from BLS
- GDP growth rates annualized for 2000-2008 from Census Bureau; constant 2000 dollars

[B] SORTING STATES AS RIGHT TO WORK VS. COMPULSORY UNION

GDP GROWTH IN RIGHT TO WORK VS COMPULSORY UNION STATES, 2000 TO 2009

	TOTAL	ANNUALIZED	DIFE
Right to work states (22):	24.20%	2.2%	0.6%
Compulsory union states (28):	17.29%	1.6%	N/A

SOURCE:

- Patrick Semmen, "The Right to Work: A Fundamental Freedom," <http://www.nrtw.org/en/blog/right-work-fundamental-freedom-07152011>

[C] ECONOMIC EFFECTS OF FORCED UNIONIZATION

	2006	
GDP (\$T)	14.166	
\$436 B saved =	3.08%	(0.51% / yr, 2000-06)
RTW	3.13%	GDP growth/yr
Union	2.11%	GDP growth/yr

"...had Congress abolished federally-imposed union dues at the turn of the millennium, by 2006 the annual national economic output would have increased by an additional \$436 billion in real 2000 dollars."

SOURCE:

- [How Much Is Pro-Forced Unionism Federal Labor Policy Costing America?](http://www.nilrr.org/node/76), <http://www.nilrr.org/node/76>

SUMMARY ANALYSIS FOR CALIFORNIA

	EMP CHANGE (JOBS)		PI CHANGE (\$B)		GDP	Baseline values (2010): 15.91 E+6 Jobs 1665 \$B
	Low	High	Low	High		
IC restrictions	-47730	-95460	-4.1625	-8.325		
IC liberalization	47730	95460	4.1625	8.325		

APPENDIX B

The three methods used in this study are replicable for other states besides California. They generate similar results, which is not surprising since they draw from the same evidence. This gives added credence to their findings.

(1) **Employment Regulation Index:**

This 35-component index groups states in three tiers, termed tiers I, II, and III in the previous appendix. Shifting a state (through policy changes) up or down tiers will have on average a percentage change in unemployment or GDP/personal income growth. Those percentages can be applied to baseline employment or GDP/personal income to estimate the absolute effect on the state in questions. No other state is likely to have absolute effects as large as California's due to its extreme size. State level data is available from the BLS or state labor department, and from the U.S. Dept. of Commerce's Bureau of Economic Analysis (BEA).

(2) **Right to Work (RTW) States:**

The National Right to Work Foundation is a clearinghouse of information supporting the legal regime used in 22 states. Differences between RTW states and compulsory union states are another proxy for the effects of changes in labor policy. Over the decade from 2000 to 2009, RTW states' GDPs grew at 2.2 percent per year vs. 1.6 percent for other states. This differential, when applied to a state's forecast baseline GDP growth, can provide an estimate of the added or subtracted GDP for a period in the future (e.g., five years) due to policy change.

(3) **Forced Unionism:**

The National Institute for Labor Relations Research estimated the effects of a hypothetical elimination of federal procurement requirements from unionized firms, similar to the RTW analysis above. RTW states' GDPs grew 3.13 percent per year from 2000 to 2006, vs. 2.11 percent per year for forced union states. This represents a 0.51 percent annualized difference, and can be used to forecast the effects of policy changes in a state like that described above.

Each of these methods can only approximate the effects of specific state policy changes. For that reason, this analysis for California used boundary values (low and high) to span the range of possible effects. Estimates for other states can do the same.

ENDNOTES

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- ² Hereafter, "independent contractors" will sometimes be referred to as "ICs".
- ³ All references in this section to the BLS' CAWA survey come via Eisenach, 2010, pp. 21 to 28.
- ⁴ See in particular the works by Davis, et al, and Haltiwanger, et al. much of this work was performed in collaboration with the Census Bureau under the auspices of the Kauffmann Foundation.
- ⁵ See Kane 2010, p. 6.
- ⁶ Stangler 2010, p. 4.
- ⁷ There can be temporary exceptions when firms add employees ahead of increased demand for their service, but this overexpansion will be corrected when it becomes apparent.
- ⁸ This is a well-established economic principle. See for example Porter.
- ⁹ Stangler 2010.
- ¹⁰ See Boyce.
- ¹¹ See Haltiwanger, et al, Feb. 2009.
- ¹² Se Fairlie, May 2010. At 0.41%, California's 2009 value in the Kaufmann Foundation's Index of Entrepreneurial Activity was ninth highest in the nation.
- ¹³ See Eisenach, et al, undated.
- ¹⁴ A large literature attests to this; see for example, Davis 2008; Haltiwanger, et al 2009; Horrell and Litan 2010; Neumark et al 2008; and Stangler, 2009 and 2010.
- ¹⁵ This is supported in Autor et al, 2007.
- ¹⁶ See Eisenach 2010.
- ¹⁷ See in particular the works by Davis, et al, and Haltiwanger, et al. Much of this work was performed in collaboration with the Census Bureau under the auspices of the Kauffmann Foundation.
- ¹⁸ See Kane 2010, p. 6.
- ¹⁹ Stangler 2010, p. 4.
- ²⁰ Norman, Jan, "Is Small Business to Blame for Bad Economy?", Orange County Register, Sept. 7, 2011; <http://jan.ocregister.com/2011/09/07/is-small-biz-to-blame-for-bad-economy/63697/>
- ²¹ Note that strong startups did not always entirely compensate for job losses in existing firms: in three of the 28 years in Kane's data, job losses exceeded job gains. But it is likely they significantly reduced net job losses during recessions. Stanger 2009 also treats the cyclical effects of startups.
- ²² See Haltiwanger et al 2009.
- ²³ Ibid.
- ²⁴ There can be temporary exceptions when firms add employees ahead of increased demand for their service, but this overexpansion will be corrected when it becomes apparent.
- ²⁵ This is a well-established economic principle. See for example Porter.
- ²⁶ Stangler 2010.
- ²⁷ See Davis, et al 2008.
- ²⁸ See Boyce.
- ²⁹ See Haltiwanger, et al, Feb. 2009.
- ³⁰ Se Fairlie, May 2010. At 0.41%, California's 2009 value in the Kaufmann Foundation's Index of Entrepreneurial Activity was ninth highest in the nation.
- ³¹ Flow-through businesses from Carroll and Prante, p. 15. California employment from California Department of Finance.
- ³² See Eisenach 2010, and Hipple.
- ³³ Eisenach 2010, pp.14 and 19.
- ³⁴ Ibid, p. 40-41, citing IRS and GAO reports.
- ³⁵ Department of the Treasury, Taxation of Special Services Personnel, March 1991; cited in Eisenach, p. 41.
- ³⁶ Eisenach 2010 p. 33-34, citing CAWA survey data.
- ³⁷ Hipple 2010.

³⁸ See California Employment Development Department, p. 1.

³⁹ Stangler and Litan, p. 3.

⁴⁰ Political demographer Michael Barone has commented frequently on the migration of population from regulated/taxed/unionized states to Texas in the 2010s. Texas' economic performance was emphasized in Gov. Perry's announcement of his candidacy for the presidency in 2012.

⁴¹ See Eisenach, et al, undated.

⁴² Policies regarding ICs are one of 35 variables in this index.

⁴³ BLS state unemployment rates accessed in late Aug. 2010; see <http://www.bls.gov/lau/>

⁴⁴ Personal income represents all payments to households. It correlates with GDP, since income is ultimately dependent on production. PI is used in this section because state GDP figures are produced with greater delay.

⁴⁵ A large literature attests to this; see for example, Davis 2008; Haltiwanger, et al 2009; Horrell and Litan 2010; Neumark et al 2008; and Stangler, 2009 and 2010.

⁴⁶ This is supported in Autor et al, 2007.

⁴⁷ See Eisenach 2010.