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Pass-Through Deduction in 2017 Tax Law Could Weaken Wages and Workplace Standards

By Brendan Duke

A key provision of last year's tax law — a law that supporters claim will boost wages and create good jobs — may contribute to “workplace fissuring,” which occurs when firms¹ acquire workers' services without employing them directly.² Examples include hiring truck drivers as independent contractors instead of as employees or hiring a janitorial services firm instead of hiring janitors directly. Workers employed in some of these arrangements tend to be paid less than workers that firms employ directly, extensive evidence shows. In fact, increasing evidence suggests that some types of workplace fissuring may contribute to growing compensation inequality.

The provision in question is the new 20 percent deduction for certain “pass-through” income — income that owners of businesses such as partnerships, S corporations, and sole proprietorships report on their individual tax returns, which previously was taxed at the same individual tax rates as their wage and salary income. The deduction reflects the tax law's three fundamental flaws: it is heavily tilted toward the wealthy, loses significant revenue at a time when the federal government needs additional revenue, and makes it easier for wealthy individuals to game the tax system.³ Policymakers should be working to alleviate workplace fissuring and compensation inequality, but the pass-through deduction may encourage more of both in two basic ways:

- **Because it provides a tax break for independent contractors but not employees, employers can use it to entice new hires to accept independent contractor positions, even though the drawbacks for those workers could outweigh their tax gains.** The deduction results in a lower tax rate for business owners (including independent contractors) than for traditional employees. Workers may be more inclined to accept independent

¹ “Firm” here refers to both C-corporations and pass-throughs.

² This term comes from former U.S. Department of Labor official and Brandeis University Dean David Weil. Much of this paper draws on his book *The Fissured Workplace* (Harvard University Press, 2014).

³ Chuck Marr, Brendan Duke, and Chye-Ching Huang, “New Tax Law Is Fundamentally Flawed and Will Require Basic Restructuring,” Center on Budget and Policy Priorities, updated August 14, 2018, <https://www.cbpp.org/research/federal-tax/new-tax-law-is-fundamentally-flawed-and-will-require-basic-restructuring>.

contractor positions because of the deduction and employers may try to use it as a way to shift toward hiring independent contractors instead of traditional employees.

Importantly, many of the *disadvantages* of independent contractor status for workers are *advantages* for employers. Unlike employees, independent contractors don't enjoy legal protections regarding the minimum wage, overtime, sexual harassment, and workplace safety. Employers that provide benefits to employees such as health insurance typically don't provide them to independent contractors. And independent contractors must pay the employer's share of payroll taxes. Employers have an incentive to not disclose these drawbacks for employees or understate them relative to the deduction so that contractors won't try to negotiate higher pay to make up for them.

- **It could further encourage firms to adopt arrangements that push workers outside of direct employment, such as contracting out and franchising, which typically lead to lower wages and lower benefits for affected workers.** The profits of a contractor firm organized as a pass-through are eligible for the deduction, while a manager's salary is not. So, with the deduction, the owner-manager of a contractor firm can do the same work as an in-house manager and have the same take-home pay, even though the lead firm pays them less. In this way, the lead firm can capture a portion of the deduction's tax savings.

Similarly, a firm may choose not to open a "branch" (where it employs a manager and workers) and instead expand with a "franchise" (where the manager owns the establishment and pays royalties to the original firm, and the remaining profits are eligible for the deduction). That way, the firm can effectively pay the franchise owner less than a manager without reducing the owner's after-tax income.

Rank-and-file workers would remain traditional employees, but would work for the contractor firm or franchise instead of the lead firm. Considerable evidence suggests that contracting out and franchising lead to lower wages and benefits for workers.

Many tax experts across the political spectrum have already criticized the pass-through deduction because it taxes similar types of income at different rates based on arbitrary distinctions, many based on political influence rather than the economy's needs. An uneven playing field can create numerous distortions in individuals' and businesses' decisions, including those about how to classify and organize work. American Enterprise Institute economist Stan Veuger, for example, called the pass-through deduction "a particularly egregious form of industrial policy: not only does it select winning and losing industries, it also selects winning and losing organizational structures."⁴ David Kamin, a tax and budget official in President Obama's White House and now a New York University Law

⁴ Stan Veuger, "8 Ways to Improve the Tax Code," *National Interest*, January 25, 2017, <https://nationalinterest.org/feature/8-ways-improve-the-tax-code-23963>. See also Amanda Becker, "U.S. Republican tax law's pass-through deduction open to gaming - experts," Reuters, April 25, 2018, <https://www.reuters.com/article/usa-tax-congress/u-s-republican-tax-laws-pass-through-deduction-open-to-gaming-experts-idUSKBN1HV2XW>; Michael R. Strain, "To Help Families, Don't Cut Their Taxes," Bloomberg, November 8, 2017, <https://www.bloomberg.com/view/articles/2017-11-08/to-help-families-don-t-cut-their-taxes>.

School professor, termed it “one of the worst provisions that’s been added into the tax code in the last several decades.”⁵

The law’s supporters may say the pass-through deduction’s incentives for workplace fissuring encourage entrepreneurship. And, on paper, the deduction could create a large number of new businesses. But this is not the type of entrepreneurship that spurs innovation and job creation — instead, it would merely reflect firms breaking themselves into pieces to capture tax savings.⁶ At the same time, federal tax policy is creating incentives that could push workers into employment arrangements that could further depress wages and weaken workplace standards, while creating significant costs and inefficiencies. Policymakers who want to increase entrepreneurship should instead focus on real barriers to it — as the Affordable Care Act (ACA) did by making affordable, quality health coverage more available in the marketplace, thus making it less risky for individuals to start their own businesses.⁷

There are no estimates to date of how much the 2017 tax law will drive fissuring or the exact forms it may take, especially as the IRS has only begun to issue guidance on what’s eligible for the pass-through deduction. But the law’s incentives for a shift toward independent contractors, contractor firms, and franchises appear straightforward, and the evidence showing that workers in some of these arrangements are paid less is significant. Rushing to enact the law, lawmakers did not even acknowledge this risk to workers.

The pass-through deduction has drawn criticism for its regressivity, cost, and potential for gaming the tax system. The fact that it also could also promote outsourcing, wage stagnation, and compensation inequality is another strong argument for its repeal.

Deduction Could Encourage Employees to Become Independent Contractors

The 2017 tax law lets business owners deduct 20 percent of certain pass-through income, effectively reducing the marginal individual tax rate on that income by one-fifth. Before the law, this income was taxed at the same individual tax rates as ordinary income, such as wages and salaries.

⁵ Chye-Ching Huang, “Senate Hearing Testimony Highlights 2017 Tax Law’s Fundamental Flaws,” Center on Budget and Policy Priorities, April 25, 2018, <https://www.cbpp.org/blog/senate-hearing-testimony-highlights-2017-tax-laws-fundamental-flaws>; Marr, Duke, and Huang.

⁶ Shu Yi-Oei and Diane Ring of Boston College Law School examined the legal and other issues that could determine how much employment shifts toward independent contracting (but not contractor firms or franchises) as a result of the deduction. They concluded that much will depend on how the IRS and courts interpret the 2017 tax law and other statutes as well as businesses’ assessments of the risks, their industry’s structures, and their willingness to change their relationship with workers. See Shu-Yi Oei and Diane M. Ring, “Is New Code Section 199A Really Going to Turn Us All into Independent Contractors?,” Boston College Law School Legal Studies research paper, January 12, 2018, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3101180.

⁷ Linda J. Blumberg, Sabrina Corlette, and Kevin Lucia, “The Affordable Care Act: Improving Incentives for Entrepreneurship and Self-Employment,” Urban Institute, 2013, <https://www.urban.org/research/publication/affordable-care-act-improving-incentives-entrepreneurship-and-self-employment>.

Proponents claimed the deduction would create jobs by reducing tax rates on business owners,⁸ but many self-employed independent contractors — such as freelance web designers or plumbers — are also eligible for it.⁹ As a result, independent contractors are now taxed at a lower rate than employees who do the same work.¹⁰ That creates a tax incentive for employees to become independent contractors.

For instance, by switching from employee to independent contractor status, a single earner making:¹¹

- *\$50,000 would get a tax cut of \$900.* \$50,000 is around the median annual salary of electricians (\$54,100), plumbers (\$52,600), and graphic designers (\$48,700).¹²
- *\$75,000 would get a tax cut of \$2,800.* \$75,000 is around the median annual salary of accountants (\$69,400), architects (\$78,500), and chemists (\$74,700).
- *\$120,000 would get a tax cut of \$5,200.* \$120,000 is around the median annual salary of lawyers (\$119,300), pharmacists (\$124,200), and computer hardware engineers (\$115,100).¹³

Independent Contracting Has Significant Drawbacks for Workers

Recent IRS guidance on the pass-through deduction could make it hard for employees to switch to an independent contracting position with their *current* employers and receive the deduction. Yet, how the IRS enforces that restriction remains to be seen. As former Treasury Department official Adam Looney points out, “If you’re an employee one year, and then a contractor the next year, will they [the IRS] actually know that?”¹⁴

⁸ U.S. House of Representatives Committee on Ways and Means, “Historic New Tax Relief to Help Main Street Job Creators,” December 28, 2017, <https://waysandmeans.house.gov/historic-new-tax-relief-help-main-street-job-creators/>.

⁹ Recent U.S. Bureau of Labor Statistics (BLS) data indicate that 6.9 percent of workers were independent contractors in 2017. That’s a slight decline from the 7.4 percent figure for 2005, despite the recent attention to “gig economy” jobs (such as Uber drivers) in which workers are classified as independent contractors. The BLS data, however, measure what workers do for their main jobs; much of this work is likely done as a side job and so is not captured by the survey. See Annette Bernhardt, “Making Sense of the New Government Data on Contingent Work,” Medium, June 10, 2018, <https://blog.usejournal.com/making-sense-of-the-new-government-data-on-contingent-work-97209bb0c615>.

¹⁰ To be sure, as discussed below, independent contractors have to pay both the employer and employee portions of payroll taxes while employees only have to pay the employee portion. The payroll tax rate for employees and independent contractors is the same, however, if one considers the employer’s portion of the tax a coming out of an employee’s pre-tax compensation, as the employee typically “pays” the tax in the form of lower wages. See Jonathan Gruber, “The Incidence of Payroll Taxation: Evidence from Chile,” *Journal of Labor Economics*, Vol., 15, No. 3, 1997, pp. 72-101.

¹¹ Calculations assume that these workers take the standard deduction.

¹² U.S. Bureau of Labor Statistics, Occupational Employment Statistics, May 2018, <https://www.bls.gov/oes/>.

¹³ The potential tax savings are small for workers with low incomes since the pass-through deduction is limited to 20 percent of taxable income. A single earner making \$16,000 in pass-through income (and no other income) who takes the \$12,000 standard deduction only gets \$80 of tax savings from the pass-through deduction.

¹⁴ Brian Faler, “Pass-through regulations take aim at contracting gamesmanship,” *Politico*, August 9, 2018, <https://subscriber.politicopro.com/tax/whiteboard/2018/08/pass-through-regulations-take-aim-at-contracting-gamesmanship-1752512>. Moreover, Congress has not increased the IRS’s enforcement budget to deal with this and other enforcement challenges presented by the 2017 tax law: in 2018, it left enforcement at roughly the same level as in

Perhaps more importantly, the IRS guidance to date does nothing to limit the deduction for individuals who become independent contractors with *new* employers,¹⁵ and workers on the job market may be more inclined to accept independent contractor status because of it. In response, employers could post new positions as independent contractor, instead of employee, positions. These new “independent contractor” positions may not actually meet the legal requirements for independent contractor status — which involves such issues as how much autonomy the worker has — but this type of misclassification is already pervasive, as discussed below.

There are many drawbacks for workers who become independent contractors, and these workers may underestimate them relative to the value of the pass-through deduction. For example, a wide array of labor protections does not apply to independent contractors, such as minimum wage and overtime laws, sexual harassment protections, and Occupational Safety and Health Administration (OSHA) regulations.¹⁶ Nor do independent contractors qualify for programs such as workers’ compensation and unemployment insurance.¹⁷

In theory, a worker considering an independent contractor position could negotiate higher compensation to offset the loss of these protections. But evidence suggests that a significant portion of *current* self-reported self-employed workers don’t know that they don’t have these protections: a study for the U.S. Labor Department found that over a third of workers who reported that they’re self-employed thought they were eligible for the minimum wage, OSHA regulations, or Family and Medical Leave Act (FMLA) protections, even though self-employed workers are not eligible for any of them.¹⁸

Independent contractors also don’t receive employer-provided benefits — e. g., health insurance, paid family and medical leave, vacation, retirement benefits, disability insurance, and long-term care insurance. Independent contractors must also pay the employer’s half of payroll taxes. These are

2017 and \$1.5 billion (23 percent) below its 2010 level in inflation-adjusted terms. Emily Horton, “2018 Funding Bill Falls Short for the IRS,” CBPP, March 23, 2018, <https://www.cbpp.org/blog/2018-funding-bill-falls-short-for-the-irs>.

¹⁵ David Kamin, “Pass-Through Regulations: Doubling Down on Arbitrariness and Breaks for the Top,” Medium, August 8, 2016, <https://medium.com/whatever-source-derived/pass-through-regulations-7298efcb7a>.

¹⁶ Weil, p. 21; Sarah Leberstein and Catherine Ruckelshaus, “Independent Contractor vs. Employee: Why independent contractor misclassification matters and what we can do to stop it,” National Employment Law Project, 2016, <https://www.nelp.org/wp-content/uploads/Policy-Brief-Independent-Contractor-vs-Employee.pdf>; Bryce Covert, “Actresses — and Millions of Other Workers — Have No Federal Sexual-Harassment Protections,” *The Nation*, October 2017, <https://www.thenation.com/article/actresses-and-millions-of-other-workers-have-no-federal-sexual-harassment-protections/>. Employees who have been misclassified as independent contractors by their employers are still entitled to these protections. U.S. Government Accountability Office, “Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention,” August 10, 2009, <https://www.gao.gov/products/GAO-09-717>.

¹⁷ Weil, p. 21.

¹⁸ Kelly Daley *et al.*, “Worker Classification Knowledge Survey Volume I—Technical Report,” Abt Associates, November 16, 2016, <https://www.dol.gov/asp/evaluation/completed-studies/Worker-Classification-Knowledge-Survey-Vol-I-Technical-Report.pdf>; Abt Associates, “Understanding of Employee Protections,” November 2016, <https://www.dol.gov/asp/evaluation/completed-studies/Understanding-Of-Employee-Protections.pdf>.

considerable sums: for each dollar that employers spend on wages, they spend (on average) another 36 cents on benefits and 11 cents on taxes and contributions to unemployment insurance and worker compensation programs.¹⁹ Thus, an employee with a \$50,000 salary could easily have a total compensation package of more than \$73,000, when the cost of benefits and taxes are taken into account. Independent contractors could negotiate additional compensation to cover the cost of these items, but they may not know what they're worth — particularly benefits that typically cost more when purchased independently, like health insurance.²⁰

Independent contractors have other burdens as well. They must calculate their taxes themselves and make quarterly payments to the IRS. (For most employees, their employers calculate their taxes and withhold them from their paychecks.) A recent examination of Uber drivers' online comments, however, found that many didn't understand that they must pay taxes on their payments from Uber.²¹ Further, calculating these taxes can be complicated, especially since independent contractors have to track expenses and figure out which ones they can deduct.²² Those who don't understand these rules or don't budget accordingly may face large tax bills when they file their tax returns, and they may have to pay penalties for not complying with the rules.²³

Independent Contracting Has Significant Advantages for Employers

Many of the *disadvantages* for independent contractors (as discussed above) are *advantages* for employers. Employers are unlikely to fully disclose these disadvantages to workers weighing an independent contractor job or may say that the pass-through deduction will offset them, whether true or otherwise. Since many current self-employed workers don't understand these issues — and many people don't understand which financial decisions, on these and other complex matters, best serve their interests²⁴ — employers have the upper hand to use the pass-through deduction to rely more on independent contractors and cut their labor costs.

The employer benefits of relying on independent contractors are so substantial that many employers apparently already violate tax and labor laws by labeling workers who meet the legal

¹⁹ U.S. Bureau of Labor Statistics, "Table 1. Employer costs per hour worked for employee compensation and costs as a percent of total compensation: civilian workers, by major occupational and industry group," March 2018, <https://www.bls.gov/news.release/ecec.t01.htm>.

²⁰ Lily Batchelder and David Kamin, "The GOP tax plan creates one of the largest new loopholes in decades," *Los Angeles Times*, December 31, 2017, www.latimes.com/opinion/op-ed/la-oe-batchelder-kamin-tax-deduction-pass-through-income-20171231-story.html.

²¹ Shu-Yi Oei and Diane M. Ring, "The Tax Lives of Uber Drivers: Evidence from Internet Discussion Forums," *Columbia Journal of Tax Law*, Vol. 8, 2017.

²² The 2017 tax law also eliminates the ability to deduct tax preparation fees, making them more expensive for some filers.

²³ For more, see Kathleen DeLaney Thomas, "Tax Reform for the Gig Economy?," *Harvard Law Review* blog, October 17, 2018, <https://blog.harvardlawreview.org/tax-reform-for-the-gig-economy/>.

²⁴ For an exploration of some of the literature on the difficulty most people have making rational financial decisions, see The Committee for the Prize in Economic Sciences in Memory of Alfred Nobel, "Scientific Background on the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2017 Richard H. Thaler: Integrating Economics with Psychology," October 2017, https://assets.nobelprize.org/uploads/2018/06/advanced-economicsciences2017-1.pdf?_ga=2.81780823.1940396267.1536071873-1125184579.1536071873.

definition of employees as independent contractors. While “the national extent of employee misclassification is unknown;” a 2009 study by the Government Accountability Office (GAO) found, “... earlier and more recent, though not as comprehensive, studies suggest that it could be a significant problem with adverse consequences.”²⁵ State government audits find that between 10 and 30 percent of audited employers misclassify employees as independent contractors.²⁶ Such misclassification potentially deprives millions of employees of the protections, benefits, and employer-paid taxes to which they’re entitled.

Deduction Could Encourage Outsourcing to Contractor Firms and Franchises

The 20 percent deduction also creates incentives for companies to rely more on contractors and franchises. The profits of a contractor firm or franchise that’s organized as a pass-through are eligible for the deduction, while the salary of the in-house manager of a company division or branch is not. That means, for example, that a manager who makes \$150,000 a year can receive a \$6,600 tax cut from becoming an owner-manager. Higher-salaried managers can receive even larger tax cuts: \$20,200 for a manager making \$300,000 and \$34,200 for a manager making \$500,000. To the extent that owner-managers of contractor firms and franchises effectively share the tax savings with the lead firm, as explained below, these forms of workplace fissuring will become more attractive to lead firms.

Contractor Firms

Outsourcing to contractor firms occurs when a company contracts to obtain the services of workers from another firm. No one knows definitively how widespread this phenomenon is, but research indicates that it’s prevalent and growing.²⁷ One study estimates that the share of all workers employed in “business service firms” — firms that provide services to other firms — grew from under 2 percent in 1950 to over 8 percent in 2015.²⁸ Even more striking, it found that, over the same period, the share of cleaning and janitorial service workers employed by such firms grew from 2 percent to over 25 percent and the share of security workers rose from 3 percent to 35 percent.

²⁵ U.S. Government Accountability Office, 2009.

²⁶ National Employment Law Project, “Independent Contractor Misclassification Imposes Huge Costs on Workers and Federal and State Treasuries,” 2015, <https://www.nelp.org/publication/independent-contractor-misclassification-imposes-huge-costs-on-workers-and-federal-and-state-treasuries/>.

²⁷ The Bureau of Labor Statistics Survey on Contingent Workers and Alternative Employment Arrangements found a very small share of workers employed by contractor firms, but experts on the topic do not believe that the BLS estimate captures the full scope of such arrangements since the survey asks about work for only one type of contractor firm: firms that work on-site at the client firm and for one client. Workers for contractor firms may work for multiple clients (as may be the case for a janitor) or offsite (as may be the case at a call center). Moreover, some workers may not be able to accurately identify their employer. See Bernhardt 2018. For a look at the issues in measuring contract employment and other forms of fissured work, see Annette Bernhardt *et al.*, “Domestic Outsourcing in the United States: A Research Agenda to Assess Trends and Effects on Job Quality,” Upjohn Institute, Upjohn Institute Working Paper 16-253, 2016, http://research.upjohn.org/up_workingpapers/253/.

²⁸ David Dorn, Johannes F. Schmieder and James R. Spletzer, “Domestic Outsourcing in the United States,” unpublished, January 31, 2018, <https://www.dol.gov/asp/evaluation/completed-studies/2016-2017-Scholars-Program/Domestic-Outsourcing-in-the-United-States.pdf>.

Another study found that the share of workers in computer occupations employed by business-services firms grew from 39 percent in 1990 to over 50 percent a decade later.²⁹

A study by a Bureau of Labor Statistics economist measures outsourcing by calculating the concentration of workers in the same occupation at the same worksite, because such concentration makes it likelier that these workers work for a contractor rather than a lead firm. For example, an IT worker employed at a workplace where most other workers also are IT workers is likelier working for an IT contractor than one who works at a worksite where workers have a wide range of occupations. The study finds this type of concentration grew between 1999 and 2015.³⁰ Bloomberg recently reported that contractors at Alphabet Inc., the parent company of Google, outnumber direct employees.³¹

The pass-through deduction could prompt even more firms to embrace these arrangements. Consider a firm deciding whether to retain its 20-person IT department or hire an outside contractor firm to provide 20 IT staff to do the same work with the same management structure. The IT department has five managers: one makes \$300,000 and four make \$150,000, for a total cost of \$900,000. They aren't eligible for the pass-through deduction. The owner-managers of the contractor firm, however, are eligible for it. The latter can earn the same take-home pay as the in-house managers while only charging the firm about \$839,000 — 7 percent less — for their services because of their lower tax rate from the pass-through deduction. That enables the contractor firm to charge a lower price, effectively sharing some of the tax savings with the lead firm in order to win its business.³²

Franchises

Under franchising, a lead firm sells an independent business owner the right to use its name, techniques, materials, and more in operating a business. Again, we have no good estimate of the share of workers employed by franchises, but the trade association representing franchises says that 8 million people work for franchises, and it expects franchise employment to grow twice as quickly as overall employment in 2018.³³

²⁹ Matthew Dey, Susan N. Houseman, and Anne E. Polivka, "What Do We Know about Contracting Out in the United States? Evidence from Household and Establishment Surveys," *Labor in the New Economy*, eds. Katharine G. Abraham, James R. Spletzer, and Michael J. Harper (University of Chicago Press, 2010), pp. 267-304.

³⁰ Elizabeth Weber Handwerker, "Increased Concentration of Occupations, Outsourcing, and Growing Wage Inequality in the United States," unpublished, April 2017, <http://www.sole-jole.org/17733.pdf>.

³¹ Mark Bergen and Josh Eidelson, "Inside Google's Shadow Workforce," Bloomberg, July 25, 2018, <https://www.bloomberg.com/news/articles/2018-07-25/inside-google-s-shadow-workforce>.

³² For the purposes of this section, we assume that the managers have negotiated sufficient additional compensation to make up for the loss of their own benefits mentioned above. Their failure to do so would add to the potential employer savings from outsourcing.

³³ IHS Markit, "Franchise Business Economic Outlook for 2018," January 2018, https://franchiseeconomy.com/files/Franchise_Business_Outlook_Jan_2018.pdf. The federal government stopped tracking data on franchising in the 1980s. See Francine LaFontaine and Roger D. Blair, "The Evolution of Franchising and Franchise Contracts: Evidence from the United States," *Entrepreneurial Business Law Journal*, Vol. 3, 2009, pp. 381-434.

The pass-through deduction encourages franchising because it enables a lead firm to generate cost savings similar to those described above. Instead of opening its own branch with its own workers, the lead firm can open a franchise where one or more managers own the new establishment but pay a royalty to the lead firm's owners. The lead firm can set the royalty so that the firm is effectively paying the franchise owners less than if they were in-house managers, even though the after-tax earnings of both are the same because of the deduction.

Contracting and Franchising Can Harm Rank-and-File Workers

The incentives for lead firms to rely more on outsourcing to contractor firms or expand through franchises also affect rank-and-file workers: rather than work for lead firms, they would work for the contractor firm or franchise. Many of them could end up worse off, with lower wages and fewer benefits.

Outsourcing reduces wages by 4-7 percent for janitors and by 8-24 percent for security guards, while reducing health insurance benefits for both, one study found.³⁴ Other studies have found similar results.³⁵ These workers also may have fewer chances for training or career advancement.³⁶ Labor-law violations are more common at restaurants and hotels that are franchises. Franchise-owned fast-food restaurants were 24 percent likelier to violate labor laws than those owned by the lead firm and the back wages they owed workers were 50 percent higher per violation, one analysis found.³⁷

Pay and benefits tend to be lower at franchises or contractor firms for several reasons, including:

- Inequality among a firm's employees can reduce productivity and morale,³⁸ so large profitable firms may choose to pay above-market wages to their lower-wage employees to reduce inequality within the firm. These firms, however, can cut labor costs *without* increasing inequality within the firm by moving these jobs to a contractor or a franchise paying lower wages.

³⁴ Arindrajit Dube and Ethan Kaplan, "Does Outsourcing Reduce Wages in the Low-Wage Service Occupations? Evidence from Janitors and Guards," *Industrial Labor Relations Review*, Vol. 63, No. 2, 2010.

³⁵ Katharine G. Abraham and Susan K. Taylor, "Firms' Use of Outside Contractors: Theory and Evidence," *Journal of Labor Economics*, Vol. 14, No. 3, 1996, pp. 394-424; Samuel Berlinski, "Wages and Contracting Out: Does the Law of One Price Hold?," *British Journal of Industrial Relations*, Vol. 46, No. 1, 2008, pp. 59-75; Dorn, Schmieder, and Spletzer.

³⁶ The recent decline in employer-sponsored training may partly reflect workplace fissuring. C. Jeffrey Waddoups, "Did Employers in the United States Back Away from Skills Training During the Early 2000s?," *Industrial and Labor Relations Review*, Vol. 69, No. 2, 2016, pp. 405-434.

³⁷ Weil, pp. 122-158; David Weil and Min Woong Ji, "Does Ownership Structure Influence Regulatory Behavior? The Impact of Franchising on Labor Standards Compliance," *Industrial and Labor Relations Review*, Vol. 68, No. 5, 2015, pp. 977-1006.

³⁸ Weil 2014; George A. Akerlof and Janet L. Yellen, "The Fair Wage-Effort Hypothesis and Unemployment," *Quarterly Journal of Economics*, Vol. 105, No. 2, 1990, pp. 255-283; Truman Bewley, *Why Wages Don't Fall During a Recession?* (Harvard University Press, 1999); Arindrajit Dube, Laura Giuliano, and Jonathan Leonard, "Fairness and Frictions: The Impact of Unequal Raises on Quit Behavior," IZA Discussion Paper 9149, June 2015, <https://www.iza.org/publications/dp/9149/fairness-and-frictions-the-impact-of-unequal-raises-on-quit-behavior>.

- Firms have limited authority, under the law, to offer benefits such as health insurance or paid leave to some employees but not others.³⁹ By using franchises or contractor firms, lead firms can eliminate benefits for certain groups of workers by shifting those jobs outside the firm.
- Franchises and contractors make it easier for a lead firm to avoid various labor protections. Lead firms can set a contractor firm's prices so low, or a franchise's royalties so high, that they may find it hard to make a profit without violating some labor laws. The lead firm, meanwhile, avoids the legal or reputational liability from such violations.⁴⁰ Lead firms also can use contractors to avoid having a unionized workforce, which would cost more.⁴¹

Workplace Fissuring May Be Increasing Wage Inequality

Workplace fissuring may have contributed to the increase in wage inequality over the last few decades, growing evidence suggests:

- One study found that about two-thirds of the increase in earnings inequality between 1978 and 2013 reflects growing inequality between workers at different firms, as opposed to workers at the same firm.^a The authors tied most of this increase to high-earning workers increasingly working at firms that pay higher average wages, and being increasingly less likely to work with low-wage workers. Another paper found similar results among worksites.^b That's consistent with the idea that large, profitable firms increasingly outsource the services of low- and middle-wage workers, pushing them into low-wage firms that pay lower wages.
- A study about Germany found that when employers outsource jobs, wages fall 10-15 percent compared to similar jobs that weren't outsourced.^c It also found that the outsourcing of cleaning, security, and logistics services alone accounts for about 10 percent of the increase in German wage inequality since the 1980s. A preliminary study using the same methodology also found wage declines in the United States that resulted from outsourcing.^d
- The study, noted above, which found an increase in outsourcing between 1999 and 2015 — measured by the concentration of workers in the same occupation at the same worksite^e — also determined that this growing occupational concentration helps explain a substantial portion of growing wage inequality over that period.

^a Jae Song *et al.*, "Firming Up Inequality," forthcoming *Quarterly Journal of Economics*, https://fguvenendotcom.files.wordpress.com/2018/09/fui_qje_accepted.pdf.

^b Erling Barth *et al.*, "It's Where You Work: Increases in the Dispersion of Earnings across Establishments and Individuals in the United States," *Journal of Labor Economics*, Vol. 34, No. 2, 2016.

^c Deborah Goldschmidt and Johannes F. Schmieder, "The Rise of Domestic Outsourcing and the Evolution of the German Wage Structure," *Quarterly Journal of Economics*, Vol. 132, No. 3, 2017, pp. 1165-1217.

^d Dorn, Schmieder, and Spletzer.

^e Handwerker.

³⁹ Weil, p. 78.

⁴⁰ Weil, pp. 105, 112, 139-142.

⁴¹ Weil, pp. 101-107.

Pass-through Deduction's Guardrails Won't Prevent Workplace Fissuring

Under last year's tax law, the pass-through deduction has "guardrails" that appear intended to prevent workers from recharacterizing their wages and salaries to get the deduction. But they may turn out to be largely ineffective at preventing workplace fissuring.⁴²

One guardrail, for example, denies the deduction to individuals in certain "personal services" industries (such as medicine, law, accounting, consulting, financial services, and athletics) if they make over \$157,500 (\$315,000 for a married couple). But the overwhelming majority of workers make less than \$157,500 (including most accountants and lawyers) and could therefore become independent contractors regardless of industry.⁴³ The owner of a contractor firm or franchise, by contrast, would be likelier to have an income above the thresholds. But the list of industries in which high earners cannot get the deduction omits many industries that are especially likely to include contractor firms, such as IT and payroll. Moreover, franchising could spread in the long list of industries that are eligible for the deduction.

Another guardrail limits the size of the deduction for high-income business owners to a percentage of the wages the firm pays or the value of the property it owns. But that won't likely prevent many contract firm or franchise owners from receiving the full deduction, as the thresholds are relatively high. This guardrail only limits the deduction if the firm's profits are more than 250 percent as large as the wages the firm pays (a firm that does not meet this requirement can use another formula that also includes the value of property in addition to wages).⁴⁴ Yet, the average S-corporation's profits are only 61 percent as large as the wages it pays, according to IRS data.⁴⁵ In the administrative and support services industry — the industry many contractor firms likely fall under — the average S-corporation's profits are only 25 percent as large as the wages it pays. In those cases when the wage guardrail is binding, an S-corporation's owners can increase the wages they pay themselves in order to increase the deduction allowed for the remaining profits.⁴⁶

⁴² It's hard to know what the authors of the 2017 tax law intended because of "the lack of any underlying logic in deciding who benefits from the pass-through deductions, and who does not." David Kamin *et al.*, "The Games They Will Play: An Update on the Conference Committee Tax Bill," SSRN, December 28, 2017, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3089423.

⁴³ In fact, 90 percent of workers make less than \$96,000. U.S. Bureau of Labor Statistics, "Occupational Employment Statistics," 2018. For the other professions, see the median salary numbers cited above.

⁴⁴ A firm's high-income owner can receive the full deduction equal to 20 percent of profits if that amount is equal to 50 percent of the wages it pays and it is not in one of the industries denied the deduction. The owner of a firm with \$1 million in profits can, therefore, receive the full \$200,000 deduction if the firm pays at least \$400,000 in wages.

⁴⁵ IRS Statistics of Income, Table 1, "S Corporations: Total Receipts and Deductions, Portfolio Income, Rental Income, and Total Net Income, by Major Industry Tax Year 2013," <https://www.irs.gov/statistics/soi-tax-stats-table-1-returns-of-active-corporations-form-1120s>. These figures compare "wages and salaries" to "total net income (less deficit)." They do not include "compensation of officers" — if they did, profits would be even smaller compared to wages.

⁴⁶ Martin Sullivan, "Economic Analysis: A Dozen Ways to Increase the TCJA Passthrough Benefits," *Tax Notes*, April 9, 2018, <https://www.taxnotes.com/tax-notes/partnerships-and-other-passthrough-entities/economic-analysis-dozen-ways-increase-tcja-passthrough-benefits/2018/04/09/27y53>.

Recent IRS guidance may actually *encourage* contracting out. Last year, tax experts identified a strategy known as “cracking” by which high earners could potentially receive the deduction, even in industries that are not supposed to be eligible.⁴⁷ Under it, a firm can split itself into pieces, and income from the pieces that aren’t in industries barred from getting the deduction could get it. A law firm, for example, could spin off its payroll department into a separate company that charges the law firm for its payroll services. This payroll service income would then be eligible for the deduction, while the law firm’s income from legal work would not. The recent IRS guidance rightfully makes it harder for firms to crack but does nothing to prevent firms from capturing tax savings by contracting out. (The difference is that under cracking, the owners of the original firm typically own each of the pieces, unlike with contracting.) Thus, the IRS guidance makes contracting out more attractive.⁴⁸

Deduction an Inefficient Way to Increase Entrepreneurship

Together, the pass-through deduction’s tax incentive for workplace fissuring and the failure of its guardrails to prevent it could shift employment further toward independent contracting, contractor firms, and franchises. On paper at least, that could mean a large number of new businesses. Yet that’s hardly the sort of entrepreneurship that leads to innovation and job creation. Instead, it just means that existing firms are splitting up to capture the tax savings created by the deduction (thereby costing more in reduced federal revenue) and, in some cases, also to reduce their labor costs (thereby increasingly putting downward pressure on wages).

Many economists across the political spectrum view the pass-through deduction as unwarranted and inefficient for various reasons. This aspect of the deduction — the shift to fissured work — may compound the economic inefficiency. Firms may further shift their employment practices toward these arrangements to secure the tax cut. But part of these gains may be offset by inefficiencies that fissuring can produce. Firms surrender control over their workers when they no longer employ them directly; they may, for example, be less able to maintain product quality and prevent delays.⁴⁹ Technological and organizational innovations have made it easier for lead firms to maintain control, but until now they have only needed to weigh fissuring’s labor savings against its potential inefficiencies. The pass-through deduction, however, effectively puts a thumb on the scale in favor of fissuring by offering tax savings as well.

Rather than create an inefficient tax break that increases inequality, policymakers who want to boost entrepreneurship should focus on real barriers to entrepreneurship. The ACA, for example, did that by enabling millions of Americans to obtain affordable, quality health coverage in the marketplace *independent of an employer*, making it less costly and risky for them to start their own small

⁴⁷ Kamin *et al.*

⁴⁸ Kamin.

⁴⁹ Weil, p. 60. See also Oliver Williamson, “The Theory of the Firm as Governance Structure: From Choice to Contract,” *Journal of Economic Perspectives*, Vol. 16, No. 3, 2002, pp. 171-195; Ronald Coase, “The Nature of the Firm,” *Economica*, Vol. 4, No. 16, 1937, pp. 386-405.

business. The ACA's marketplace reforms mean that 1.5 million more people are self-employed than otherwise, Urban Institute and Georgetown University health researchers estimate.⁵⁰

The 2017 tax law itself threatens to reverse at least some of these gains for some small business owners and self-employed people by repealing the ACA's individual mandate; the Congressional Budget Office estimates that that will increase health insurance premiums in the individual market by 10 percent.⁵¹ Small business owners and the self-employed disproportionately rely on this market. The higher costs may not just hurt them financially but could also encourage them to become traditional employees at a firm that offers health care, even if they would prefer to own their own businesses or work for themselves.

Conclusion: Pass-Through Deduction May Further Encourage Harmful Labor Market Trend

The implications of fissured workplaces for workers have received increased attention in recent years. In some cases, policymakers have acted to counter this trend or mitigate its effects. The Obama Administration, for example, issued a rule (known as a "joint employer standard") on whether a lead firm has responsibility to comply with labor law when it directs a group of workers employed by another firm.⁵² The Obama Administration also made it harder for firms to misclassify employees as independent contractors,⁵³ and it attempted to update federal overtime rules so that they covered more workers.⁵⁴ The Trump Administration has sought to reverse progress in these areas by rescinding or re-writing those rules.⁵⁵

In short, the new pass-through deduction moves tax policy in the wrong direction. It may push more workers into low-wage firms or put them outside the protections of labor laws, while weakening their employer-provided benefits. That's one more reason that policymakers should undo this serious policy mistake and repeal the pass-through deduction.

⁵⁰ Blumberg, Corlette, and Lucia, 2013.

⁵¹ Congressional Budget Office, "Repealing the Individual Health Insurance Mandate: An Updated Estimate," November 8, 2017, <https://www.cbo.gov/publication/53300>.

⁵² U.S. Department of Labor, "Joint employment under the Fair Labor Standards Act and Migrant and Seasonal Agricultural Worker Protection Act," 2016, http://www.fissuredworkplace.net/assets/Administrator_Interpretation_on_Joint%20Employment_2016.pdf.

⁵³ U.S. Department of Labor, "The Application of the Fair Labor Standards Act's 'Suffer or Permit' Standard in the Identification of Employees Who Are Misclassified as Independent Contractors," 2015, http://www.fissuredworkplace.net/assets/Administrator_Interpretation_on_Misclassification_2015.pdf.

⁵⁴ Alana Semuels, "The Future of the Department of Labor Under Trump," *The Atlantic*, March 6, 2017, <https://www.theatlantic.com/business/archive/2017/03/the-department-of-labor-under-trump/518307/>.

⁵⁵ Ben Penn, "Outlook 2018: Trump Labor Dept. Looks to Move Agenda Forward in Year Two," Bloomberg BNA, January 2, 2018, <https://www.bna.com/outlook-2018-trump-n73014473725/>.