BREAKING DOWN BARRIERS TO OPPORTUNITY #4

The Small Business Gig:
How the gig economy promotes small business growth and development

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Executive Summary

The gig economy uses technology platforms to enable nontraditional, independent, short-term working relationships. These relationships are possible because gig economy firms create platforms that lower the transaction costs of a deal (i.e., the total costs of an exchange), which creates beneficial exchanges that would not have occurred otherwise. For example, the transaction costs associated with renting a person's house on a short-term basis were prohibitive before the gig economy.

From the renter's perspective, the costs included identifying which houses with the right attributes are available; negotiating the terms of the stay; and trusting that these terms will be honored. From the host's perspective, they include advertising the availability of the property; communicating the properties' attributes; negotiating the terms of the stay; trusting the potential renters; and, receiving payment. Gig economy platforms connect suppliers and demanders in the short-term lodging market and significantly reduce these costs. Consequently, the gig economy has enabled an explosion in both the number and types of properties available to consumers and the income earning opportunities of property owners.

While the consumer benefits of the gig economy are often emphasized, the gig economy also increases people's opportunity to participate in entrepreneurial ventures. According to a report by ADP, one of the major benefits created by the gig economy is the opportunity for workers to have greater control over their work life.[1] And, workers are satisfied with these arrangements. More than 70 percent of gig workers are gig workers by choice, according to ADP.[2] The ADP findings are supported by surveys from the Gig Economy Data Hub that found "more than two thirds of non-traditional workers report[ing] being satisfied with their work arrangements."[3] This wide satisfaction indicates that gig economy platforms empower people to engage in desired work opportunities and increase the amount of entrepreneurship in the economy.

The gig economy also provides essential opportunities for smaller businesses. Small business owners consistently cite that finding people with the right skillsets and the burdensome costs created by taxes and regulations as the most pressing problems facing their business. The ability to find the right people via the gig economy, coupled with the increased ability to manage the size of their organizations, and consequently reduce their tax and regulatory burdens, demonstrates that the gig economy creates a tremendous amount of value for small businesses.

The success of the gig economy raises questions regarding how to regulate the firms operating in this sector. Proponents for imposing more regulations argue that gig economy firms inappropriately skirt current regulations. AB5 in California exemplifies these concerns. AB5 forces gig economy firms to categorize independent contractors leveraging their platforms as employees. The justifications for this reclassification are that gig economy workers are being denied appropriate labor protections and non-gig economy firms are facing unfair competition. But, the allegation that gig economy workers are being inappropriately classified misunderstands the economics behind the gig economy platforms.

Gig economy firms are in the business of developing technology platforms that lower the costs to transact. They are not in the business of providing the transportation, handyman, or professional services coordinated on their platforms. Further, since surveys find that large majorities of workers are satisfied with their gig economy arrangements, it is also difficult to argue that widespread exploitation is occurring. Instead, gig economy platforms offer gig economy workers with desired work opportunities and provide customers (whether they are individuals or businesses) with preferred services delivered in a preferred manner.

The allegation that gig economy firms are unfair competitors also falls short. Of course, businesses are avoiding the tax and regulatory burdens that the government would have imposed if this person were hired as a full-time employee rather than a gig worker. But, if businesses and workers are voluntarily choosing gig-based work arrangements, then this is a demonstration that the regulations create unfair and unwarranted costs. Policymakers should lessen the costs created by these regulations, and consequently, not extend their burden further.

There are several policy implications.

California has been proactively regulating the gig economy and, ideally, policymakers will fully repeal AB5. Since full repeal is likely politically infeasible, an alternative reform gradually expands the large number of professions that are exempted from AB5.

More generally, state, and federal governments should avoid adding new regulations to the gig-economy, such as imposing a $15/hour minimum wage on platform workers. Additionally, policymakers should eliminate unnecessary regulations, particularly those creating competitive disadvantages for the traditional sector, and impose the smallest necessary burden for those regulations that are required (to address problems such as externalities). Finally, regulatory reforms should expand self-controlled portable health insurance accounts, retirement benefits, and other benefits (e.g., disability insurance) to expand gig economy worker access to the same tax-free savings benefits larger businesses receive.

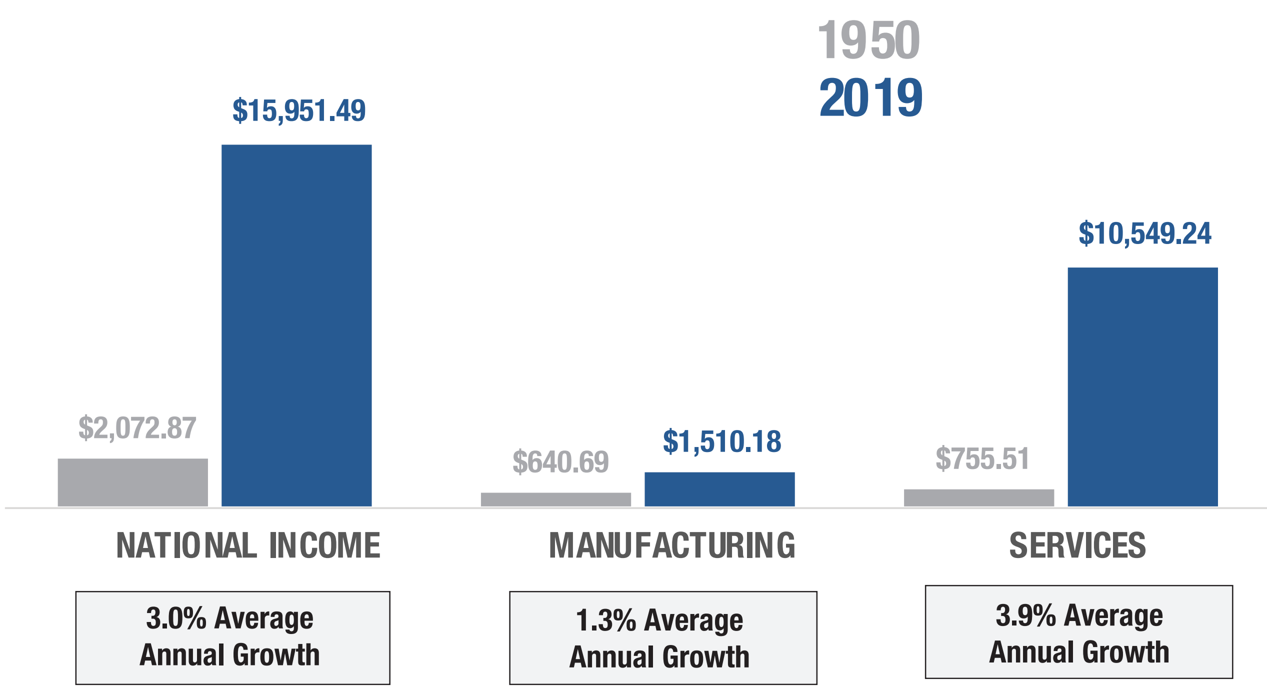
The gig economy exemplifies the typical evolutionary growth of the U.S. economy. As with other evolutions, it creates many benefits, particularly for small businesses and entrepreneurs. Thanks to the gig economy, there are more entrepreneurial opportunities available and small businesses can more efficiently manage long-term problems that include having access to the people with key skills and reducing the large tax and regulatory burdens created by the government. So long as the policy environment continues to foster a vibrant environment, the gig economy sector will continue to be an important driver of innovation and broad-based income growth for the U.S. economy.

Introduction

The U.S. economy constantly evolves in response to changing preferences, technology, and wealth. Manufacturing, for example, accounted for 31 percent of total national income back in 1950.[4] Contrary to perceptions, the output of the U.S. manufacturing sector has grown over the past half century – 1.3 percent annually adjusted for inflation – but manufacturing output growth has not kept pace with overall inflation adjusted economic growth of 3.0 percent annually.

As a consequence, manufacturing's share of the U.S. economy was 9.5 percent in 2019 – less than one-third its contribution from 70 years ago. The importance of the service sector, on the other hand, has grown. Services accounted for 36 percent of national income in 1950, but after 70 years of average annual growth of 3.9 percent, its share of income as of 2019 grew to 66 percent.[5] These trends are displayed in Figure 1.

FIGURE 1. INFLATION ADJUSTED NATIONAL INCOME, MANUFACTURING INCOME AND SERVICES INCOME (IN BILLIONS)



Source: BEA NIPA Accounts, Table 6.1

Seen from this perspective, the rise of the digital economy is nothing new. It is merely the continuation of the economy's typical evolutionary process.

The emergence of the digital economy has empowered consumers to find new and innovative ways to obtain the goods and services that they desire. It enables businesses to leverage the latest technological innovations to create more efficient ways to cut costs and serve customers better. The gig economy also creates new opportunities for workers who are seeking better employment arrangements. These latter benefits – productivity enhancements for businesses and more options for workers – are largely driven by the digital "gig economy".

What is the gig economy?

The gig economy is "a labor market characterized by nontraditional, independent, short-term working relationships."[6] Gig economy firms enable these arrangements by leveraging online platforms that facilitate transactions. The types of transactions will vary depending on the need that the gig economy company has identified. One set of transactions connects buyers and sellers of consumer services. These gig economy companies include:

- Airbnb, Vrbo, 2nd address, and booking.com that create electronic platforms where hosts (e.g., suppliers of short-term lodging services) and renters (e.g., the consumers of short-term lodging services) can meet and transact;
- Uber (and Uber Eats), Lyft, and DoorDash that create platforms that connect riders or people in need of delivery services with willing drivers; and
- Labor services platforms such as TaskRabbit, which provides cleaning and handyman services, Care.com, which provides "care services" such as childcare and elderly care, and talkspace, which connects individuals, couples, and even businesses to qualified therapists and psychiatry services.

Gig economy platforms also connect buyers and sellers of goods together. Etsy, for instance, is a platform that connects sellers of creative goods (e.g., jewelry, clothing, and art) to buyers in the market for these products. Another need fulfilled by gig economy platforms connects buyers and sellers, but in this case the buyers are businesses, and the sellers are professionals selling their labor services. Fiverr and Tongal connect businesses with professionals across a wide range of fields including web designers, web developers, writers, musicians, and marketing professionals. ShiftPixy connects part-time shift workers with business owners that rely on contingent employees.

In all of these instances, the gig economy companies do not provide the actual good or service. Uber is not a taxi firm, Etsy is not a manufacturer, and Fiverr is not a marketing firm. Instead, gig economy companies build platforms that facilitate transactions. By leveraging the technology platforms created by gig economy firms, buyers can now more conveniently purchase goods and services from sellers, and sellers are able to offer their goods and services to buyers at lower costs. Essentially, both the suppliers and consumers find it easier to conduct a mutually beneficial transaction because the gig economy firm created an electronic marketplace (e.g., the platform). These transactions would be difficult, or impossible, to conduct without the existence of the gig economy firm's platform. The gig economy platform service differs sharply from the transactions that occur on a supplier's platform (such as transactions that occur on Wal-Mart's or Target's websites). In these instances, the sellers create platforms to interact with their current or prospective customers more conveniently.

Many people have patronized a gig economy service and working in the gig economy is now impacting a substantial share of the labor force. According to a 2018 Gallup report on the gig economy, "29 percent of all workers in the U.S. have an alternative work arrangement as their primary job" and "36 percent have a gig work arrangement in some capacity".[7]

Lowering the cost to transact

Since the gig economy is simply facilitating mutually beneficial transactions, there is nothing unusual about it. On the supply-side, there are people or firms that have a product or service that they want to sell. On the demand-side, there are people or firms that wish to purchase that product or service. The supplier and demander transact in a market to exchange with one another. It is textbook Economics 101.

What makes the gig economy extraordinary is that gig economy firms leverage social platforms to make beneficial exchanges happen that would not have occurred without these platforms. Essentially, gig economy technologies recognize that they can use technology to lower the total transaction costs of a deal. By lowering these costs to transact, mutually beneficial exchanges are possible that improve both the welfare of consumers and the profitability of suppliers.

Transaction costs refer to the costs that must be incurred to complete an exchange. For example, before Airbnb, the transaction costs associated with renting a person's house on a short-term basis when visiting a city were prohibitive. While not comprehensive, from the renter's perspective, these transaction costs include identifying which houses are available; determining which houses have the right attributes including cleanliness, amenities, and size; negotiating a fair price and length of stay; trusting that the potential host will honor the terms of the agreement; and making the payment. From the hosts' perspective, these transaction costs include ensuring that potential renters are aware that their houses are available for renting on a short-term basis; credibly communicating the attributes of the houses; negotiating a fair price and length of stay; trusting that the potential renters are accurately portraying themselves and will not damage the host's property; and, establishing a means to receive payment.

These transaction costs can be summarized as search costs, information costs, bargaining costs, enforcement costs, and payment costs. Prior to the gig economy, the high transaction costs made short-term home rentals prohibitively expensive in many areas, confining such rentals to select tourist destinations (e.g., summertime beach rentals). The introduction of the gig economy reduced the transaction costs, significantly expanding the opportunities available to both potential renters and potential hosts. In the short-term lodging market, Airbnb's platform has made it easier for hosts to advertise their homes and for potential renters to find homes, enabling both hosts and renters to gain more information about one another, and providing a secure platform for payment.

> "Mutually beneficial exchanges are possible that improve both the welfare of consumers and the profitability of suppliers."

Importantly, there is nothing unique about Airbnb. Tripping.com, a competitor to Airbnb, reduces these same transaction costs for hosts and renters; so does Uber and Lyft for the ride sharing sector, DogVacay in the dog-kennel sector, Turo in the car sharing (or renting) sector, TaskRabbit in the handyman sector, and crowdcube in the crowdfunding sector. In each one of these sectors, a gig economy firm has increased efficiency and/or increased competition by leveraging information platforms and enabling people to share their skills and/or resources with other people in need of these services.

The benefits of the gig economy are best understood from this transaction cost perspective. Munger (2015) summarized the benefits from the platforms at the heart of the gig economy as making "an unimaginable number and variety of transactions…possible by software innovations that solve three problems: (a) information, (b) transaction-clearing, and (c) trust."[8]

The reduction of the transaction costs creates more competition that leads to better goods and services for consumers. Take the taxi industry as an example. Once traditional taxi drivers faced restricted competition from similarly structured firms. Now Uber and Lyft drivers compete against traditional taxi companies to provide driving services to consumers. Similarly, Airbnb has increased the competitive landscape in the overnight lodging industry. This increase in competition creates more choices and better pricing for consumers, and additional income opportunities for the providers of these services.

While creating benefits on net, economic competition is an inherently disruptive process. Companies such as Airbnb (hotels), Uber and Lyft (taxis), and Turo (car rentals), disrupt established industries and negatively impact the revenues of traditional competitors. Therefore, while the gig economy holds great promise, it also exemplifies the inherent creative destruction of free markets as noted by Joseph Schumpeter.[9]

Empowering entrepreneurship and small businesses through the gig economy

The creative part of the gig economy empowers individuals to engage in entrepreneurial efforts that either supplement their income, or gives them greater control over how they earn a living. A report by ADP Research published in February 2020 provides evidence that one of the major benefits created by the gig economy is the opportunity for workers to have greater control over their work life, finding that more than 70 percent of gig workers are gig workers by choice.[10] Other findings from the ADP research included:

- For large organizations, one in six workers is a gig worker, which has increased by 2.2 percentage points to 16.4 percent of workers in companies between 2010 and 2019;
- Gig workers are used in every industry, but the top three industries that use gig workers are recreation, construction, and business services;
- Twenty percent of gig workers are over 55; and,
- Ninety percent of gig workers have health insurance.[11]

Surveys from the Gig Economy Data Hub provide further evidence that most gig workers are satisfied with their current work arrangements.[12] They found:

> more than two thirds of non-traditional workers report being satisfied with their work arrangements. Many report appreciating the control this work allows them over their time and the flexibility of scheduling. In addition, many root their satisfaction in the income their gig work provides. In many cases, gig work income smooths unstable earnings from a traditional job. In others, people turn to gig work to deal with financial hardships, or simply to meet basic needs and pay the bills. Others use their gig earnings for traveling or other discretionary expenses. Another desirable aspect can be these arrangements' low barrier to entry. Some forms of non-traditional work are accessible for workers who may otherwise struggle to enter the labor market, including immigrant and formerly incarcerated populations.
>
> When asked, survey respondents tend to say they pursue non-traditional work out of choice rather than out of necessity.[13]

The wide satisfaction expressed by gig workers is an indication that gig economy platforms empower people to engage in desired work opportunities and increases the amount of entrepreneurship in the economy.

On the other side of these transactions, the businesses engaging individuals through the gig economy have access to expertise that would be less available without the reduced transaction costs enabled by the gig economy platforms. Further, these platforms reduce the costs associated with hiring employees and the regulatory and tax costs associated with employing people. These benefits are particularly valuable for smaller businesses competing with well-funded competitors.

The opportunities created by the gig economy address some of the persistent problems that, based on a monthly survey of small businesses conducted by the National Federation of Independent Businesses (NFIB),[14] small businesses must consistently manage. The NFIB survey asks small businesses to list the "single most important problem" they face. While the top problem has evolved over time, taxes, regulation, and having access to the required quality of labor are persistently top problems for small businesses. Figure 2 summarizes the results from the NFIB survey over time.

> "While the top problem has evolved over time, taxes, regulation, and having access to the required quality of labor are persistently top problems for small businesses."

The blue dots in Figure 2 represent the reported results from the October 2020 survey. These results indicate that 17 percent of the small business respondents cited taxes as their single most important problem, 14 percent reported the regulatory burden as their single most important problem, and 22 percent reported having access to the necessary quality of labor as their single most important problem – in total, 53 percent of the small business respondents in October 2020 cited one of these three problems as their most important problem.

Since January 1974, the highest number of small businesses citing these issues as their single most important problem were 32 percent, 27 percent, and 27 percent, respectively (the top end of the vertical lines in Figure 2). The lowest number of businesses citing these as their most important problem were 8 percent, 4 percent, and 3 percent, respectively (the low end of the vertical lines in Figure 2). However, over time the average responses were generally around the October 2020 reported values, with the quality of labor issue exhibiting the widest variation.

The gig economy creates options for small businesses that help them manage each one of these problems more efficiently.

FIGURE 2. SINGLE MOST IMPORTANT PROBLEM REPORTED BY SMALL BUSINESS TO NFIB MONTHLY SURVEY (DATA AS OF OCTOBER 2020)

Starting with tax costs, just complying with the tax code costs the U.S. economy hundreds of billions of dollars annually. According to the Tax Foundation, "the 8.9 billion hours needed to comply with the tax code computes to $409 billion each year in lost productivity, or greater than the gross product of 36 states".[15] According to the National Taxpayers Union, "the opportunity cost of the billions of hours spent on taxes is equivalent to $270.9 billion in labor – valuable time that could have been spent more productively or more enjoyably was instead lost to tax code compliance. Add to that the $96.5 billion in estimated out-of-pocket costs taxpayers spent on software, professional preparation services, or other filing expenses, and the total economic value of the compliance burden imposed by the tax code can be calculated at $367.3 billion."[16] Laffer, Winegarden, and Childs (2011) estimated "that U.S. taxpayers pay $431.1 billion annually, or 30 percent of total income taxes collected, just to comply with and administer the U.S. income tax system."[17]

Small businesses bear a disproportionate share of this burden. According to SCORE, a nonprofit that "is dedicated to helping small businesses get off the ground, grow and achieve their goals through education and mentorship", "tax compliance costs are 67 percent higher for small businesses than for big businesses".[18] Citing the former chairman of the House Subcommittee on Economic Growth, Tax and Capital Access, Maloney (2016) notes that the "compliance costs for an employer with 1–5 employees range from $4,308 to $4,276 per employee".[19]

The costs imposed by federal regulations are even larger. Crain and Crain (2014) estimate that

> U.S. federal government regulations cost an estimated $2.028 trillion in 2012 (in 2014 dollars), an amount equal to 12 percent of GDP. Regulatory costs are distributed across major business types and among firms of different sizes; the findings of this report indicate that compliance costs fall disproportionately on small businesses.[20]

With respect to the distribution by the size of the business, Crain and Crain found

> Small firms with fewer than 50 employees incur regulatory costs ($11,724 per employee per year) that are 17 percent greater than the average firm. The cost per employee is $10,664 for medium-sized firms and $9,083 for large firms. These estimates are consistent with prior studies completed during the past 25 years, which have shown that the cost of regulatory compliance disproportionately affects small firms.[21]

Reducing these costs is essential if the goal is to help small businesses and entrepreneurs thrive. The gig economy provides options for small businesses to reduce these tax and regulatory burdens, which are major competitive disadvantages for small businesses relative to their larger competitors.

The gig economy empowers small businesses to manage their headcount more efficiently while ensuring that they have access to the talent they need. There is a direct relationship between the number of employees and the size of the tax and regulatory burden small businesses face. Since the gig economy allows small businesses to operate with fewer employees, it enables small businesses to manage their tax and regulatory burdens more efficiently. By leveraging the gig economy, small businesses reduce their payroll tax costs, lower their unemployment insurance payments, decrease their healthcare costs, and reduce their overall regulatory burden. Consequently, the gig economy provides an effective means for small businesses to address the persistent problem of rising tax and regulatory costs.

The other consistent problem facing small businesses is finding the right people with the required talent and skills to help the organization thrive. The gig economy eases this burden too. By reducing the costs to outsource essential, but non-core, functions, the gig economy enables small businesses to focus on hiring employees that fulfill its core competencies. Take web development as an example. For many small businesses, a web and social media presence is either a competitive requirement or an important competitive tool. But, instead of hiring web and social media experts full-time, or going without these skillsets, the gig economy enables small businesses to access qualified web developers on an as needed basis. Having access to the right talent, at the right time, in a more affordable manner meaningfully addresses the quality of labor concerns raised in the NFIB survey. In fact, according to SCORE, the ability to access "specialized expertise" is one of the primary drivers of small businesses hiring gig employees.[22] Other top reasons were only having temporary or seasonal needs, the need to ensure adequate cash reserves to comfortably make payroll, and the cost of employee healthcare.[23]

Just as important as the justification for using gig workers, is small businesses' justification for hiring an employee rather than accessing workers via the gig economy platforms. The SCORE survey showed that small businesses choose to hire employees rather than use gig workers when several key attributes were required. These attributes include work consistency, commitment to the company/brand values, and the ability to have full control of the tasks and hours that need to be completed. Consequently, the gig economy creates a more flexible labor force that helps small businesses better manage the fixed costs of running the business, ultimately improving small business profitability.

In this way, the gig economy expands small businesses' access to the talent required to succeed, empowering them to structure their businesses more efficiently, and helping small businesses more efficiently manage their tax and regulatory costs. These are tremendous benefits that can help reverse some of the headwinds small businesses have been facing.[24]

It should be noted that these entrepreneurial benefits are in addition to the increase in entrepreneurship represented by gig workers themselves.

The gig economy and the regulatory state

The success of the gig economy inevitably raises regulatory questions. While there are some legitimate concerns that need to be addressed, the costs from imposing excessively stringent regulations are even larger. Based on the contributions of the gig economy outlined above, an overly burdensome regulatory structure threatens to dim an industry that is empowering entrepreneurs and helping small businesses address nagging problems that make it more difficult for them to compete with their larger competitors.

Often the regulatory discussions ignore the benefits created when gig economy firms create private sector solutions to problems that are often addressed by government regulation. For instance, regulations are often justified because of the existence of asymmetric information. Asymmetric information refers to the circumstances when one-party to a transaction has an informational advantage over the other party to the transaction. The informational disadvantages of used car customers, compared to used car salespeople, is the typical example used to illustrate the problems that arise due to informational asymmetries. Used car salespeople will have more information about the history and quality of the specific used car for sale than the potential purchaser. This informational advantage can possibly enable the used car salesperson to overcharge the customer. A primary benefit of the gig economy is the ability to overcome information asymmetries by leveraging platform technologies. Whether it is purchasing consumer products or hiring business services, the gig economy is predicated on increasing buyers' and sellers' access to relevant information (e.g., product samples and community reviews) that reduce the information asymmetry problems. The reduction in information asymmetries implies that the need for regulations designed to reduce information asymmetries are becoming outdated.

Another argument that is often used to justify increased government regulation is market power. Market power or market dominance is typically defined as a situation where "a small number of firms hold a commanding advantage over infrastructure (railroad lines), utilities (power or water), or intellectual property (a patent to key technology) …[and], this is where much regulation is focused."[25] When justified based on market power, the purpose of regulations is to increase the amount of competition in order to increase consumers' well-being. Whether it is creating new competitors in transportation, lodging, or business services, the entire premise of the gig economy is to increase overall economic competitiveness. Just as in the case of information asymmetry, the increased market competition enabled by the gig economy implies that regulations designed to decrease market power are also becoming outdated.

Since gig economy firms reduce information asymmetries and increase competition, a comprehensive regulatory review is warranted regardless of the merits of many regulations prior to the rise of the gig economy. This regulatory review should impact both the gig economy and traditional sector and requires an understanding of two questions: (1) Are gig economy firms inappropriately avoiding current regulations? Relatedly, should current regulatory requirements be removed for traditional competitors? (2) Do the activities of the gig economy create the need for new regulations?

How policymakers address these issues will have profound implications for both the sharing economy and our broader prosperity.

Are gig economy firms inappropriately skirting current regulations?

As exemplified by AB5 in California, proponents for imposing more regulations on gig economy firms argue that the business models are inappropriately skirting current regulations. Implemented in September 2019, AB5 codified existing California law and, in practice, forces gig economy firms to categorize the independent contractors leveraging their platforms as platform employees. The justifications for this reclassification offered at the time of the bill's enactment in 2019, as summarized by the Economic Policy Institute, are that

> AB5 will help ensure that California's workers who perform core work under company control versus as independent businesses have access to basic labor and employment protections and benefits denied independent contractors, including minimum wage and overtime protections, paid sick days, workers' compensation benefits, and unemployment insurance benefits. Further, the legislation will protect law-abiding businesses that properly classify workers from unfair competition from companies that cut costs by misclassifying workers: AB5 will make it more difficult for companies to avoid paying their fair share of Social Security, Medicare, and unemployment insurance taxes and avoid providing state workers' compensation insurance.[26]

Neither argument – that gig economy workers are being denied appropriate labor protections and non-gig economy firms are facing unfair competition – stands up to scrutiny. The allegations that gig economy workers are being inappropriately classified misunderstands the economics behind the gig economy platforms. Gig economy firms are in the business of developing technology platforms that lower the costs to transact. As illustrated in the section "What is the gig economy?", gig economy firms are not manufacturers (Etsy), shift workers (ShiftPixy), or taxi drivers (Uber). Consequently, the arguments to impose regulations such as AB5 fail the standards set by the advocates of greater regulation: the core employees of the firm are only those who develop and maintain the technologies that allow potential suppliers and consumers to interact.

Ignoring the reality that gig workers are not "core employees" of the platform companies, there is still no justification to force them to become employees of the gig platforms rather than independent contractors. A study by the Gig Economy Data Hub found that more than two-thirds of gig workers are satisfied with their work arrangements; the February 2020 research report by ADP similarly found that more than 70 percent of gig workers are independent gig workers by choice. Since surveys have found that large majorities of workers are satisfied with their gig economy arrangements, it is difficult to argue that widespread exploitation is occurring. Instead, it is clear that the platforms are offering gig economy workers with desired work opportunities and providing customers (whether they are individuals or businesses) with preferred services delivered in a preferred manner.

The strong support for California Proposition 22 in the November 3, 2020 election substantiates the broad favorability of the current gig economy arrangements. Proposition 22, which passed with nearly 59 percent support, explicitly allows gig workers to be defined as independent contractors, but only for app-based transportation and delivery drivers. While AB5 should be repealed for all gig workers, Proposition 22 is a step in the right direction.

The second allegation is that gig economy firms are unfair competitors. One part of this allegation claims that improperly classifying workers inappropriately circumvents current regulations, creating an inappropriate cost advantage for gig economy firms compared to traditional competitors. Another part of the allegation claims that gig economy firms gain an additional cost advantage by exploiting loopholes that allow them to inappropriately avoid other business regulations. The avoidance of taxi medallions by app-based transportation services is the quintessential example of this alleged loophole. Just as with the claims of labor exploitation, both of these arguments are spurious.

With respect to the first allegation, clearly when a firm hires a web developer through fiverr, the business is avoiding the tax and regulatory burdens that the government would have imposed if this person were hired as a full-time employee. But, if businesses and workers are voluntarily choosing gig-based work arrangements, then this is a demonstration that the benefits created by these regulations pale in comparison to their costs. Businesses, particularly small businesses, are now able to compete more efficiently without the excessive government-imposed costs. Since surveys demonstrate that gig economy workers are widely satisfied with their current work arrangements, gig economy workers are demonstrating that the current regulations provide them with little value relative to their cost. The reduced costs represent the beneficial arbitration opportunity for both businesses and workers.

Put differently, the observed actions of businesses and workers demonstrate that the proponents of greater regulation have it backward: gig economy arrangements allow small businesses to address one of the largest competitive disadvantages they face while providing workers with a preferred labor environment. The gig economy debate demonstrates that the problem is the excessive tax and regulatory costs created by the federal, state, and local governments.

With respect to the second argument, local regulations such as taxi medallions are infamous for creating anti-competitive markets that harm consumers and workers at the expense of the monopolist providers. As Snead (2015) noted, under the current medallion system,

> a medallion is not a license to drive a taxi; it is a license to operate one, and this is a critical distinction. Few medallion holders actually drive taxis. Rather, holders may possess significant numbers of medallions and operate fleets of taxis by leasing those medallions to drivers by the shift. These leasing fees become the primary revenue stream for the medallion holder. Whether a driver has a good shift or a bad shift, he still owes the lease fee. Effectively, medallion holders are guaranteed profits while bearing little or almost none of the actual costs or risks (which can be considerable) that are associated with driving a taxi.
>
> …Under this leasing arrangement, each driver begins his or her shift owing money to the medallion owner. In San Francisco, New York, and Boston, for example, drivers must earn roughly $100 per day (not counting fuel and other incidental costs) just to cover the cost of the medallion rental and break even. These costs seldom decline, simply because there are considerably more taxi drivers than there are available taxis. In New York, more than 50,000 licensed drivers vie for the chance to lease one of the roughly 13,400 available medallions. In Boston, about 6,200 cabbies compete to lease 1,825 medallions. Any driver who balks at the high lease fees can easily be replaced by one that is willing to pay them.[27]

In the case of taxicab medallions, the government regulations are imposing large costs on consumers and workers, while the profits are reaped by the government-protected monopolist/oligopolist. Given this situation, it is hard to argue that the app-based transportation companies are creating unfair competition. These platforms have reduced the transaction costs for driving services to such an extent that the adverse consequences created by government regulations can finally be circumvented. The gig economy has, consequently, turned an anti-competitive market into a competitive one.

What is true for taxi medallions holds for the gig economy more broadly. Instead of creating *unfair competition by skirting current regulations*, the gig economy creates a more competitive market that demonstrates the harmful costs created by inefficient and over-bearing government regulations.

Are there unique regulatory issues raised by the gig economy?

The gig economy does raise important questions, particularly with respect to the problems of externalities. Externalities occur when someone who is not part of the transaction receives a benefit or bears a cost due to the transaction. Pollution is a stereotypical externality. A factory that emits air pollution imposes an externality on local residents who may neither be consumers of the product nor workers at the plant. Since the residents are not part of the transaction, but bear a cost from the air pollution created by the transaction, the air pollution is considered an externality. Externalities can also be positive. An attraction that draws tourists to a town can create positive externalities on local businesses who, while not a party to the original transaction, receive a monetary benefit from its existence.

Not surprising, many regulations are promulgated to address negative externalities. With respect to the gig economy, the issue of externalities is relevant, but only in specified circumstances. Often traditional competitors to the gig economy will claim that gig economy competition is imposing a negative externality on them. But, negative impacts on traditional competitors are not externalities. If the sharing economy provides value, then these traditional providers of services should face additional pressures due to the increased competition. This is the essence of the market process.

Instead, negative externalities are costs such as the costs imposed on apartment owners in the same building as a participant in the app-based housing rental economy, but who could face negative wealth impacts or must endure potential inconveniences from a constant stream of temporary residents cycling through the complex. Of course, it is also possible that positive externalities are created when apartment owners list their residences for rent in the gig economy. For instance, the ability to earn income on an apartment could increase the total demand for apartments, which could create a positive wealth effect on other apartment owners in the complex. Clearly when these externalities are negative, they create a legitimate grievance for the people impacted. With respect to whether federal, state, or local regulations are necessary, the key question is: what is the most efficient way to address the externality? New regulations may be required; however, since there are both positive and negative impacts, and people's view regarding the net impact can vary, it is best to delegate the regulatory decisions to the lowest possible level of government or even to individual neighborhoods and apartment buildings where possible. Allowing each local community to decide these issues for themselves fosters an environment that balances these competing impacts most efficiently.

Policy Implications

Due to AB5 and Prop 22, the policy implications vary slightly in California relative to most other parts of the country. California should fully repeal AB5, but such an outcome is likely to be politically infeasible. Short of full repeal, a second-best approach would gradually expand the number of professions that are exempted from AB5, which is the path California has been taking. When originally passed, doctors, dentists, lawyers, and other high-income professional services were exempted from AB5.[28] Legislation passed and signed into law on September 4, 2020, added more than a dozen more professions to the exemption list. Prop 22 added ride share and food delivery companies. This gradualist approach could ultimately free the vast majority of the gig-economy firms to meet its full potential.

Beyond these California specific considerations, it is imperative that regulatory changes do not add burdensome taxes and regulations on the gig economy. For instance, regulatory proposals will often attempt to impose a $15 minimum wage on platform workers like Uber drivers. Other proposals, following California's lead, designate gig workers as employees of the platform companies in order to burden the sector with the current array of labor regulations. Other ill-considered proposals would impose the outdated regulations that are currently burdening the traditional service providers on gig economy firms. If implemented, these mandates eliminate the efficiencies that the technology platforms enable and provide unwarranted government protection for the traditional competitors. The vibrancy of the gig economy would suffer as a result.

Additionally, justifications for regulating the gig economy often raise questions regarding employee benefits, workers compensation insurance, and the unemployment benefit systems. However, while the estimates vary, most gig-economy workers are engaging in gigs on a supplemental and/or part-time basis and will earn income through traditional work arrangements.[29] Since these gig economy workers will typically obtain benefits and qualify for unemployment insurance through these traditional jobs, the benefit question is irrelevant for most gig economy workers.

Avoiding bad regulations is insufficient, however. For those workers who are engaged in the gig economy full-time, policy reforms should emphasize self-controlled portable health insurance and retirement benefits. Ideally, these benefits should be simple to manage and provide the same tax-free savings that traditional businesses can offer their employees to gig economy workers. The benefits should cover health insurance, disability insurance, retirement savings, and other benefits. Ideally, these accounts would also enable gig-economy workers to seamlessly interact with the traditional economy so companies can make tax-advantaged contributions for gig economy workers if desired by both parties.

“For those workers who are engaged in the gig economy full-time, policy reforms should emphasize self-controlled portable health insurance and retirement benefits.”

Additional reforms should eliminate unnecessary regulations while imposing the smallest necessary burden for those regulations that are required. Of particular importance is eliminating the regulatory burdens that create competitive disadvantages for traditional competitors. Similarly, government unemployment and workers compensation support programs need to account for these changes by emphasizing portability and, ideally, through encouraging privatization. If coupled with reforms to the income support programs that emphasize providing a viable cash support level coupled with work/training requirements, these reforms could help strengthen the social safety net while creating strong pro-growth incentives.

Conclusion

Thanks to the gig economy, small businesses are empowered to more efficiently manage long-term problems that include having access to the people with key skills and reducing the large tax and regulatory burdens created by the government. The gig economy also enables individuals to better manage their work schedules and offers more people the opportunity to engage in entrepreneurial ventures.

The growth of the gig economy raises important regulatory issues as well. Gig economy platforms are transforming industries enabling broad-based reforms that will align the regulatory system with the needs of workers, consumers, and businesses of the 21st century. The driving principle of these reforms should be to lower the regulatory burden and create a more flexible employee benefit and social safety net structure.

Overall, the gig economy exemplifies the evolutionary growth of the U.S. economy. As with other evolutions, it creates many economic benefits for consumers and businesses. The benefits with respect to small businesses and entrepreneurship are particularly valuable due to the importance of this sector for driving innovation and broad-based income growth.

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