FEDERAL RESERVE BANK OF MINNEAPOLIS

JANUARY 2012
VOL. 26 NO. 1

fedgazette

Regional Business & Economics Newspaper

minneapolisfed.org

See the enhanced *fedgazette* online at **minneapolisfed.org** including *fedgazette* Roundup, the regional economy blog

Self-employed: To be, or not to be

Unfortunately, that's a question without easy answers

By RONALD A. WIRTZ
Editor

Entrepreneurs and other self-employed workers have long been celebrated as the heart of the American dream. They are the alchemists turning blood, sweat and tears into a successful, self-directed adventure.

But since the recession, there is considerable debate over whether they are suffering a heart attack or feeling a surge of adrenaline. Even the most basic trend-spotting is tricky because recessions both boost and depress self-employment: On one hand, a struggling economy punishes both existing and prospective do-it-myselfers. At the same time, self-employment is a common path for jobless individuals desperate for some income, even if on a temporary basis.

Out on the proverbial street, it's hard to tell which side is winning. Many sources, for example, argued that self-employment spirits are getting restless and more energetic because unemployment is stubbornly high, while workers with jobs face flat wages, cutbacks in hours and benefits, and other job-security concerns.

Patrick Boulay is the head of New Business Minnesota, a networking organization for startups and other small businesses based in the Twin Cities. "I talked to an accountant friend … and both of us have anecdotal evidence that entrepreneurship [and] self-employment [are] being seen as an alternative to a job. I had two calls last week from people in their 50s who were starting businesses because they don't think they have a chance at another job."

The Quick Take

Anecdotes abound regarding the direction of self-employment in today's economy, and the overall trend can be tricky to read. Recessions are brutal on existing and prospective self-employed individuals, but self-employment is also a common path for many jobless people looking for income. Available data, though spotty and not very timely, suggest that self-employment, variously defined, has declined since the onset of the recession.

Continued on page 2

Self-Employment from page 1

He added, "My accountant friend is seeing more [self-employed] as well. … She runs into people whose work environment has been hit hard by layoffs. They are working twice as hard as they used to for the same money just picking up the slack. For that kind of effort, they are finding self-employment more and more attractive."

Nonsense, say other observers. A recession and torpid recovery are the worst times to strike out on your own, whether chasing a dream or merely hustling to put food on the table. Riley Johnson, state director of the National Federation of Independent Businesses (NFIB) in Montana, said the majority of new business owners "really want to go into business for themselves." But he noted that prospective entrepreneurs must carefully consider the economic environment. Conditions today, with depressed demand for goods and services, are likely to keep many on the sidelines.

Editor's note: The nomenclature of this topic can complicate the explanation of trends. Self-employment implies a nonemployer status, but most databases also do not clearly delineate the matter. Other terms also serve as common proxy measures for self-employment. For example, "sole proprietor" is often used interchangeably with self-employment (including in this article), though they are slightly different from each other. Sole proprietorships are not prevented from having employees—"sole" refers to the number of owners, not workers; nonetheless, data suggest that only about 5 percent of sole proprietors have employees. Where possible, this article attempts to point out small distinctions in populations being measured and discussed. But for the purposes of this article, self-employment refers to those who work at a small business (incorporated or unincorporated) that they also own, regardless of employer status.

"Times are too unsure. We don't have predictability," Riley said. "And when a mom and pop sit down at the kitchen table [to consider the pros and cons], they say now is not the time to do this."

This self-employment debate is important because research (profiled in the July *fedgazette*) shows that overall job growth in an economy comes largely from growth at new firms, including self-employment endeavors that might start with modest expectations and means.

The unfortunate part of this "yes, they are; no, they aren't" debate regarding self-employment is that there are no definitive answers. Getting an accurate picture of the self-employed, especially since the recession, is more complicated than it sounds, and the results are laden with footnotes. Government data, which sniff the trail of employment and business activity with varying degrees of obsession, track the activities of the self-employed with difficulty—partly because this population comes in all shapes, sizes and activity levels, and tracking it becomes the research equivalent of herding cats.

As a result, what follows might best be called a kaleidoscopic view of self-employment. Seen from several data angles, a complicated, multifaceted picture of self-employment emerges. By most broad measures, self-employment appears to be declining, at least through 2009. At the same time, certain hard-to-measure types of activities might be on the rise as more people seek stopgap income opportunities while they wait for the economy and the traditional labor market to right themselves.

The self-employed outnumber all other businesses combined by a large margin. Minnesota had 362,000 so-called nonemployer firms in 2009. That's almost two and a half times the number of business establishments with at least one employee.

Self-defined

The self-employed are all around us. They care for children, fix homes and computers, crunch tax returns, cut hair, move freight, plan your retirement, sell you knick-knacks and offer myriad other goods and services to consumers and other businesses.

In fact, the self-employed outnumber all other businesses combined by a large margin. Minnesota had 362,000 so-called nonemployer firms—someone working solo, with no employees—in 2009. That's almost two and a half times the number of business establishments with at least one employee, according to the latest figures from the Internal Revenue Service (IRS), and about 13 percent of total employment in the state.

But recessions are bad for business, and that includes businesses where owner and worker are the same person. From 2007 through 2009, the number of nonemployer firms in each district state dropped between 2.4 percent and 6.3 percent, according to data from the U.S. Census, using income tax returns (see Chart 1).

Maybe worse, receipts from these businesses saw an even bigger drop across district states. Riley, from the Montana NFIB, is a public affairs consultant, and the NFIB has been a client—thankfully—for the past 28 years, he said. But since the recession, "my clients have gone down, and my income has gone down steadily for several years."

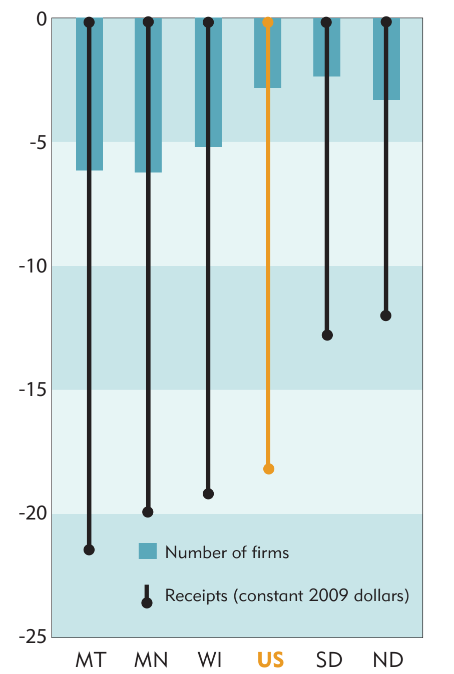
Todd Klingel, president and CEO of the Minneapolis Chamber of Commerce, said sole proprietors and other small businesses are getting squeezed from two sides. "Companies are postponing work, and there is more competition for [remaining] jobs, creating lower margins."

In early November, the *fedgazette* polled members of New Business Minnesota (the survey was not a random sample, so its results are not necessarily representative of the broader business population). Among more than 100 respondents, about one quarter said their business income was down since 2008, and about half said their income had stayed the same. A number said they were working harder to stay afloat financially. An accounting consultant in Richfield said, "My hourly rate has not changed in the last four years due to the recession, but my billable hours have gone up to make up the difference."

Chart 1

No longer the boss

Nonemployer firms and receipts
Percent change, 2007 to 2009



Source: U.S. Census Bureau, from Internal Revenue Service tax returns

The recession has hit self-employment in certain industry sectors harder than others. Self-employment grows and declines in tandem with all firms in a particular sector. For example, the housing boom fueled growth in construction and real estate, and helped nonemployer firms in these sectors grow by 13 percent to 15 percent (respectively) in Minnesota from 2003 to their peak in either 2006 or 2007. And when these sectors slumped with the recession, so did self-employment in them (see Chart 2).

Yes, but

The self-employment story doesn't necessarily end there. While instructive, nonemployer data are but a single, crude brush-stroke on the portrait of this expansive, shape-shifting endeavor. Unfortunately, data limitations mean there's a fair amount of conjecture involved in interpreting trends.

Some people are self-employed by choice, for example, while others go solo involuntarily because it's the only labor opportunity available. Among New Business Minnesota respondents, almost half said they became self-employed after losing a job. Some said they were ultimately thankful for the opportunity, however unsolicited it might have been, because many wanted to take the plunge but were unwilling to take the risk previously. The job loss was merely the push, the unavoidable excuse, they needed.

fedgazette
FEDERAL RESERVE BANK OF MINNEAPOLIS
Regional Business & Economics Newspaper

ISSN 1045-3334

Subscriptions are available without charge. Back issues are available on the Web. Articles may be reprinted if the source is credited and Public Affairs is provided with copies. Permission to photocopy is unrestricted. Send correspondence to Public Affairs, Federal Reserve Bank of Minneapolis, 90 Hennepin Avenue, P.O. Box 291, Minneapolis, MN, 55480-0291; (612) 204-5255.

E-mail: letters@mpls.frb.org
Internet: minneapolisfed.org

One of the Minneapolis Fed's congressionally mandated responsibilities is to gather information on the Ninth District economy. The *fedgazette* is published quarterly to share that information with the district, which includes Montana, North and South Dakota, Minnesota, northwestern Wisconsin and the Upper Peninsula of Michigan.

The opinions expressed in the *fedgazette* are expressly those of the authors or of attributed sources and are not intended to represent a formal position of this bank or the Federal Reserve System.

EXECUTIVE EDITOR	Kei-Mu Yi
SENIOR EDITOR	David Fettig
EDITOR	Ronald A. Wirtz
MANAGING EDITOR	Jenni C. Schoppers
REGIONAL ECONOMIST	Tobias Madden
ECONOMIST	Rob Grunewald
ECONOMIC ANALYST	Joe Mahon
SENIOR WRITER	Phil Davies
GRAPHIC DESIGNERS	Rick Cucci Mark Shafer

For others, however, self-employment is merely a way of making some money.

Klingel, from the Minneapolis Chamber, said that his organization doesn't work directly with a lot of sole proprietors "because they are usually not in a position to join the chamber." But he's seen a number of chamber members laid off, he said, and based on those experiences, "I have encountered more people launching their own businesses [in the past two years] than I had in my previous seven years here."

New Business respondents to the *fedgazette*'s online poll told similar stories. An independent insurance agent in a Twin Cities suburb believed more people were becoming self-employed by necessity because, simply, "I talk to them all the time."

Said the owner of a three-year-old high tech and IT marketing firm in Minneapolis: "I do a lot of networking, both online and in person since starting my business. I'm amazed at the number of people I have met that have started a home-based business. Many have been laid off and are consultants, [and] others start a business that will bring in some revenue."

And what better place to feel the vibe of the self-employed than a coffee shop, the second office for those without a corporate gig? The owner of a Minneapolis café said, "I am aware of many customers who have had reduced hours or lost jobs [and] chosen to try to do some work on their own, mostly as contractors but also starting up businesses."

Not everybody is hearing the same stories, however, or reading the same tea leaves. Asked if there is possibly more bootstrapping out of necessity, especially given high unemployment, NFIB's Riley said. "I don't hear that at all. If you're out of work, you don't have the money to start a business."

"Entrepreneurship is in vogue, but the threat level of failure in a down economy—lose your house, no cash reserves—are weighing heavily on folks. It becomes a self-reinforcing negative cycle: bad economy, high risk, low returns, don't start anything new, repeat as necessary."

—Matt Kramer

Matt Kramer, head of the St. Paul Chamber of Commerce, agreed. "I think entrepreneurship is in vogue, but the threat level of failure in a down economy—lose your house, no cash reserves—are weighing heavily on folks. It becomes a self-reinforcing negative cycle: bad economy, high risk, low returns, don't start anything new, repeat as necessary."

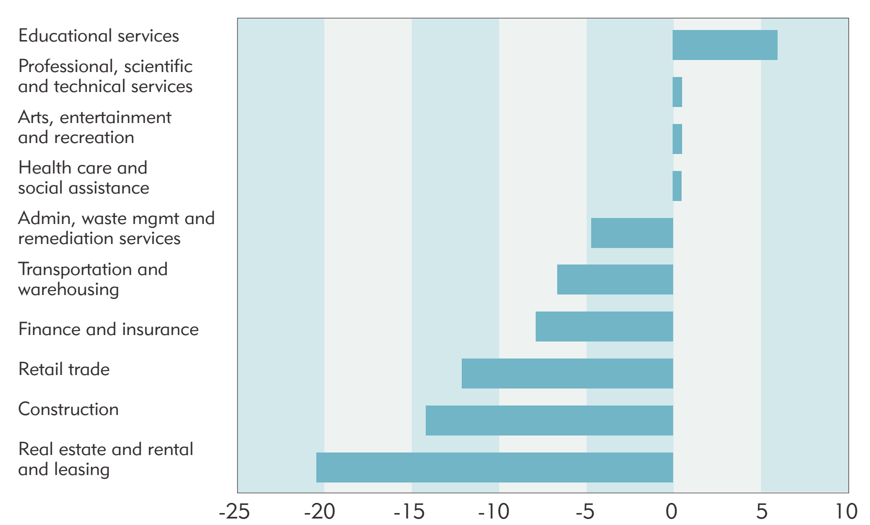
Given the economic conditions, those in a financial pickle face daunting obstacles to generating income on their own. "There aren't a lot of side jobs, so when people lose their job, it isn't like they can find side work. And if they do, it is likely to be very intermittent and not reported," said Kramer.

Data from the Bureau of Labor Statistics (BLS) support the idea that there is not a lot of work out there for the self-employed. In 2006, 5.3 percent of the [unincorporated] self-employed were working part time involuntarily. By 2009, the total number of self-employed had fallen slightly, and the percentage involuntarily working part time had risen to almost 13 percent, with the vast majority citing "slack work or business conditions" as the main reason. (Figures for incorporated sole proprietors are not tabulated by the BLS because the agency considers them part of wage and salary employment. See sidebar on page 5 for more detail.)

Chart 2 **Tough solo sledding in Minnesota**

Percent change in Minnesota nonemployer firms, 2007 to 2009

Sectors with at least 10,000 nonemployer firms



Source: U.S. Census Bureau, from Internal Revenue Service tax returns

Diving into the (data) pool

The nature of self-employment—its diversity and flexibility, its durability as well as its fickleness—makes it a difficult matter to pin down with much certainty. The data are only as good as the underlying reporting system, and there are a variety of shortcomings with tax returns.

For example, sole proprietors usually file Schedule C tax forms on self-employment income. This represents one of the few direct measures of proprietor activity.

But as Kramer alluded, many people work on a cash basis or otherwise underreport their income, a practice that likely increases when a household is strapped for cash. Field audits in recent years by the IRS suggest that up to 13 percent of the self-employed underreport their income or overestimate expenditures to reduce their tax liability, and that doesn't include those who file no tax return on self-earned income.

A comprehensive review by the U.S. Treasury Department a decade ago showed that unreported business income by sole proprietors accounted for 20 percent of the estimated $345 billion gross tax gap (the amount the IRS would collect if everybody followed the rules). Yet the IRS audits only a relatively small portion of proprietors each year. It also has little ability to audit the phantom tax returns of those who get paid under the table.

Trends in sole proprietorships and nonemployer firms mirror each other closely (see sidebar on page 5 for description). Data on adjusted gross income also show that sole proprietors at all income levels suffered during the recession. But returns at the high end saw the biggest drop in number and total income from 2007 to 2009 (see Chart 3).

But in most respects, tax data leave a lot to be desired. The IRS has historically seen itself as a tax collection agency, not a research institution. It releases comparatively little data and even fewer analyses on trends that might be gleaned from the trove of business data it holds. It also closely guards the privacy of tax returns.

So it's instructive to look at additional proxy measures that might offer insight into the health of self-employment. For example, leading into the recession, states were seeing a strong move toward incorporation among sole proprietors, most often as limited liability companies (LLCs), to take advantage of tax and other benefits.

This is important because incorporated sole proprietorships have different tendencies than their unincorporated brethren: For example, they are more likely to have employees, and their owners are more likely to work full time (41 percent versus 23 percent), according to a 2010 research article by the BLS. In other words, they make a bigger economic splash in the self-employment pool.

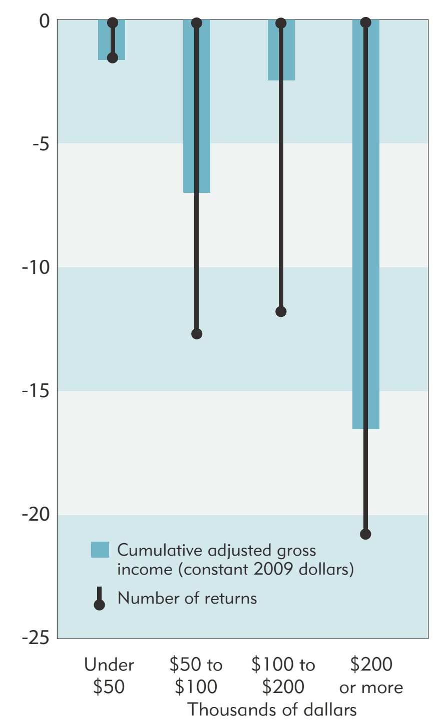
Chuck Nordquist is a vice president with the Minnesota Business Finance Corp., a private nonprofit that acts as something of a one-stop shop for wannabe entrepreneurs and other small businesses. Nordquist said that among businesses seeking financing and other counsel, the large majority are incorporated. Those that aren't "are so nominally small they don't even want to spend the money for the lawyer to set up."

Chart 3

Higher-income sole proprietors taking the biggest hit

Percent change in sole proprietor tax returns, by income bracket, 2007 to 2009

Ninth District states*



*Minnesota, Montana, North Dakota, South Dakota and Wisconsin

Source: IRS Statistics of Income

After seeing tremendous growth in LLCs leading up to the recession, new LLC registrations are universally lower since the recession in all district states, but more so in some than others. LLC registrations in North Dakota continued to tick higher after the recession with the strong economy there, but were flat in 2010. The same was true in Minnesota, which saw growth until this past year (see Chart 4). LLC registrations in Montana plateaued in 2007

Continued on page 4

Self-Employment from page 3

and were 18 percent lower by 2010. In Wisconsin, LLC registrations have declined noticeably since 2006. Wisconsin is also unique in that it tracks the number of business entities still operating at year's end; after straight-line growth leading up to the recession, the number of LLCs still kicking in Wisconsin has leveled off (see Chart 4).

The freelance economy

Another widely reported trend is the growth of independent contracting—consultants and other freelance labor hired to work for a company on a contract basis, rather than as employees. Such work can be the basis of a career or serve as a temporary job.

Oftentimes, companies outsource labor on a contract basis for work that used to be done in house by their own employees.

Nordquist, whose office is in northern vacation territory in Bemidji, Minn., said more resorts in lake country are using contract labor for cleaning and other needs, and they are doing so "because they don't want to deal with the higher costs of hiring."

Glenn Thuringer is the head of the Worthington (Minn.) Chamber of Commerce and a business consultant with the regional Small Business Development Center. He believes that more people are taking on freelance and contract work. "When I talk to people, they say, 'I'm a stay-at-home mom, and I do this work here, and I work there doing that,'" Thuringer said. Whereas working on the side used to be kept quiet, "now it's more socially accepted and may be coming out of the closet more" because people understand the difficulty of making ends meet.

In spite of the reported popularity of independent contracting, there are few clear, rigorous counts. However, available stand-ins throw water on any notions of recent robust growth. For example, an index by the American Staffing Association tracks weekly changes in temporary and contract employment based on responses from more than 100 small, medium and large staffing companies. Though the index rose modestly through the first half of 2011, it has been below its 2006 benchmark for more than three years running.

Another measure of independent labor comes from the IRS. Companies that hire workers on a contract basis for more than $600 are required to report those payments to the IRS using a form called 1099-MISC. Given a firm's cost advantage for using contract labor, it's believed that much of the incentive to underreport is eliminated.

Here again, the data show a recent dip. The number of 1099-MISC filings grew by about 6 percent nationwide from 2005 to 2008, according to IRS records, but then plateaued and subsequently dropped last year by almost 4 percent (see Chart 5).

But those figures leave a lot to the imagination. For starters, no 1099-MISC data are available at the state level, according to agency sources. These figures also do not represent workers, but rather the number of income-generating contracts let by firms; as such, a self-employed individual could have multiple 1099-MISC forms filed under his or her name by different companies. But little information is available on the composition of these filings, such as the average number of 1099-MISC forms filed on behalf of a typical independent contractor, whether that number is increasing or decreasing or how average payments are behaving over time. The 1099-MISC data only say that businesses let fewer contracts over that $600 threshold in 2010. They say nothing about the number of contractors competing for that work.

Companies must follow strict rules and criteria for categorizing certain workers as independent contractors, but big potential savings can entice firms to press their luck with the IRS. Audits of contractor classifications in Minnesota and Wisconsin have shown that 15 percent to 25 percent of audited firms misclassified at least one worker—falsely claiming a worker as an independent contractor. Whereas sole proprietor tax returns likely undercount the self-employed (because of nonfilers), 1099-MISC data might well overestimate this population due to "over-filing"—illegally treating some workers as independent contractors.

There appears to be very little in the way of data to suggest that self-employment is increasing, whether you're talking about temporary, make-ends-meet endeavors or more formal, incorporated businesses designed to shape a new career or fulfill a dream of being your own boss.

Just one more look

In sum, there appears to be very little in the way of data to suggest that self-employment is increasing, whether you're talking about temporary, make-ends-meet endeavors or more formal, incorporated businesses designed to shape a new career or fulfill a dream of being your own boss.

But before closing the employment door of optimism, somewhat obscure data from the U.S. Bureau of Economic Analysis suggest that maybe something's going on that is missed by other, more frequently cited data sources.

The BEA holds the nation's tape measure for economic activity, including the national income accounts—a comprehensive set of figures that measures when, where and how income is produced at the national, state and regional level. Buried in the BEA's state personal income data are estimates on a range of items, including the number of jobs that produce income, including those that are proprietor-based.

BEA data are widely regarded as a careful count of economic activity and certain related items like employment. Jared Miller is a data analyst with Economic Modeling Specialists, an economic and labor market research firm in Moscow, Idaho. But rather than trying to count workers, "the BEA is trying to account for flows of money," said Miller. As a result, "the BEA tends to have a more comprehensive picture" of small proprietors than those generated by the BLS or IRS.

BEA data suggest that, in fact, the number of income-producing jobs has continued to grow through the recession and the sluggish recovery, albeit at a markedly lower trajectory than the pre-recession trend (see Chart 6 on page 6).

But this starkly alternate view of self-employment comes with a laundry list of caveats. For starters, BEA data are based (in part) on the same Schedule C IRS tax returns used to identify sole proprietors. But the agency broadens its definition of proprietor to include partnerships. It turns out that proprietor growth seen in BEA data—nonexistent in the other data—comes almost entirely from growth in partnerships and the number of partners in those entities, according to Mauricio Ortiz, chief of the BEA's regional income division. While the number of partnerships formed rose by less than 1 percent from 2008 to 2009, the number of partners grew by 1.8 million, or almost 10 percent, according to IRS research published this fall.

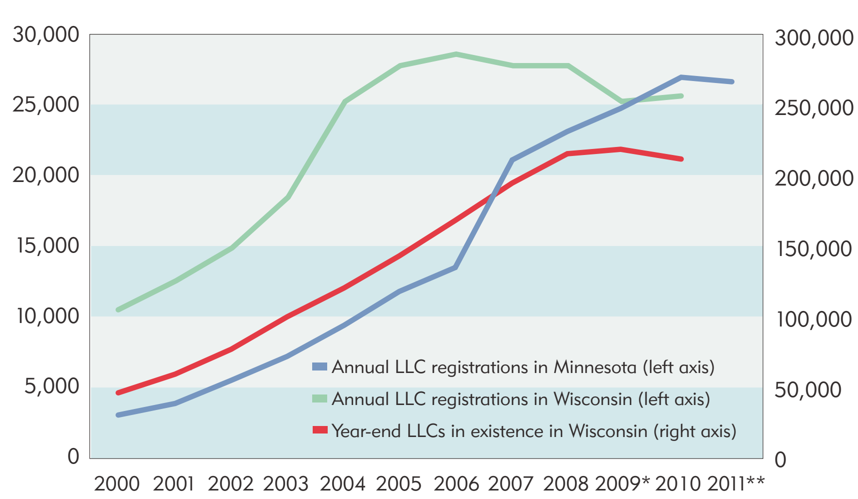
There is also a quirk of methodology that has generated proprietor growth across states. According to Ortiz, the BEA calculates a national figure and then attributes those jobs to states on a historical, proportional basis. The jobs attributed to, say, Minnesota are thus an estimate and are not proof of a growing partnership trend in Minnesota. (In fact, business registration data from the Minnesota Office of the Secretary of State suggest that partnership incorporations have been falling of late.)

BEA data also do not show more *individuals* earning income through self-

Continued on page 6

Chart 4

LLCs slowing in Minnesota & Wisconsin



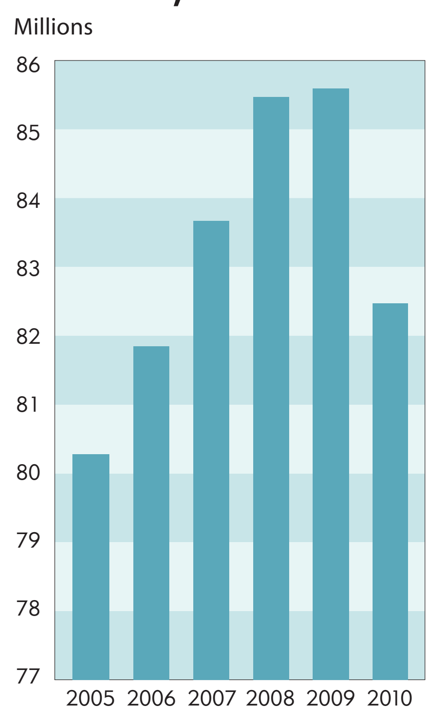
*2009 Minnesota level estimated; legislation passed in 2009 led to a significant and artificial increase in limited liability company registrations.

**2011 Minnesota total includes estimate for December based on year-to-date figures.

Sources: Minnesota Office of the Secretary of State; Wisconsin Dept. of Financial Institutions, Corporate and Consumer Services

Chart 5

U.S. 1099-MISC filings rise, then fall



Source: Internal Revenue Service, Document 6961

Self-Employment from page 4

employment. They only say that through 2010, a rising number of jobs produced at least some income for some workers. Plausibly, some workers are grabbing more part-time jobs and independent labor contracts. BEA job counts also don't measure duration of employment; some jobs may have existed for only a few weeks or months. And lastly, BEA figures contrast with IRS data on 1099-MISC withholdings; federal agency sources were unable to explain the apparent contradiction.

And if all of this is not yet enough data volleyball for you, here's one final serve. Acknowledging the caveats to BEA data, its tally of proprietor income suggest7s that there was a steep, three-year decline initiated in 2007, but a strong rebound in income in 2010 for this group (see Chart 7).

Miller, for one, believes BEA's data match up well with the current economic environment. Given soft labor markets, with widespread job losses and cuts to wages and benefits, "I think it's an indication of people trying to find any income wherever they can," he said.

Given soft labor markets, with widespread job losses and cuts to wages and benefits, "I think it's an indication of people trying to find any income wherever they can."

—Jared Miller

Careful what you wish for

Even if the BEA data are accurate—and more people are earning self-generated income—that's not automatically great news. While it might suggest an improving employment market, it might also suggest a desperate one.

A Minneapolis lawyer who responded to the *fedgazette* poll said that the street-level competition in that field is fierce. "There are more solo [practices] now than before—not because they want to be, but because they need a job. New graduates can't find a job, and experienced attorneys [have been] laid off. The job market … even for temp work is bad."

It's also worth noting that BEA-defined proprietor growth is inversely correlated with unemployment rates; North Dakota, with the nation's lowest unemployment rate, had the smallest growth in BEA-defined nonfarm proprietors among district states. Wisconsin had the highest proprietor growth and also has the district's highest unemployment rate. The U.S. unemployment rate is higher still—and the nation showed even higher growth in proprietor employment.

In the final analysis, available data are only sufficient to draw a crude, crayon portrait of the self-employed—ironic considering the exhaustive and timely data tracking the large majority of jobs covered by unemployment insurance.

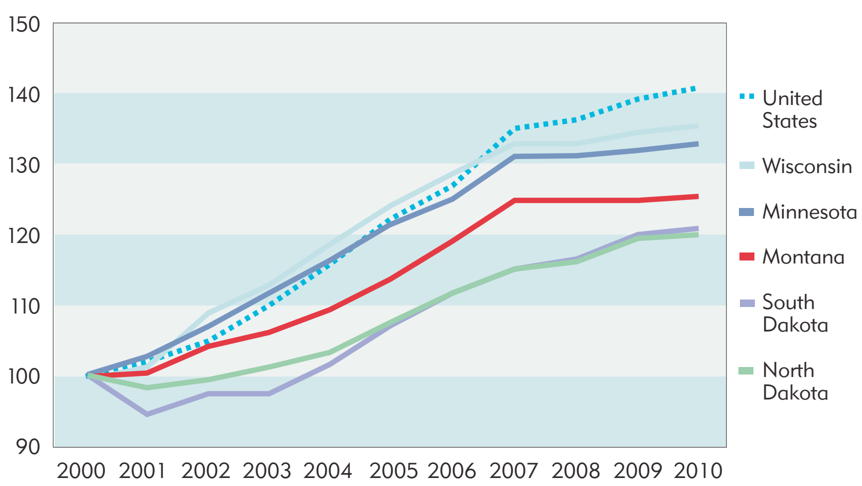
"Getting the covered payroll data is pretty low-hanging fruit. But it takes a ton of work and a ton of data sources" to develop a more accurate picture of this hazy area outside of covered employment, said Miller. "At the end of the day, nobody's measuring it very well. It's a really difficult part of the job market to get a handle on."

On that point—and maybe only that, it seems—there is little debate. f

Chart 6

A view from the BEA

Index of nonfarm proprietor employment
(2000 employment = 100)

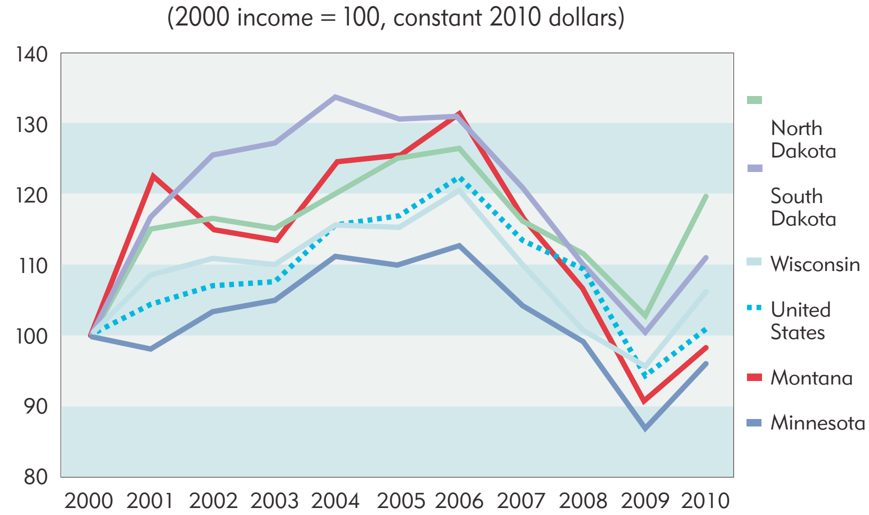


Source: Bureau of Economic Analysis, Regional Economic Information System, Table SA04

Chart 7

BEA: Proprietor income rebounds in 2010 after slump

Index of annual nonfarm proprietor income
(2000 income = 100, constant 2010 dollars)



Source: Bureau of Economic Analysis, Regional Economic Information System, Table SA04