LAW360

Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

The Economics Of Independent Contractors

Law360, New York (February 8, 2016, 11:21 AM ET) --

Charles Diamond, Ph.D.

A recent wave of lawsuits concerning classification of workers as independent contractors has generated tremendous pressure on employers causing them to rethink relationships and voluntary contracts. Ambiguities in laws governing whether a worker is classified as employee or independent contractor expose companies to costly litigation that may result in expensive settlements. For instance, in June of 2015, a Fortune 100 company agreed to pay $228 million to settle a misclassification claim.

Lawsuits challenging independent contractor status are not isolated to a specific industry and affect startups as well as more established companies and some of the most recognized brands in the world. These cases pose several interesting questions: What is the economic rationale for independent contractors? What is an independent contractor versus an employee? Are independent contractors losing economic benefits due to misclassification?

Economic Rationale

Economists frame a firm's choice to use independent contractors or employees in terms of external and internal markets. A firm exists to convert resources into products or services for consumption. Production cannot occur without the firm incurring costs. Firms attempt to minimize costs of production through an efficient economic structure, which can be achieved through internal markets, external markets or a combination of both.

The structure of the firm itself is characterized by a series of implicit and explicit contracts subject to continuous renegotiation in order to enhance efficient production. A firm could procure all resources needed to produce and deliver the final product to the consumer through use of contracts with service providers (independent contractors or proprietors) in the open market.

However, if the work to produce the final product requires more team collaboration and supervision from management, it may be more efficient for the firm to negotiate contracts that internalize these open market service providers and make them employees. This is, in essence, the difference between the firm's choice to use an independent contractor or an employee to produce its output. While some resources or services may be efficiently obtained in the open market, others must be transformed and managed internally by the firm. It is a matter of incentives and experimentation.

While firms make the choice about whether to use external or internal markets, workers also make a personal choice about their employment situation. Regardless of whether it is for a full-time or part-time job, or for work as an independent contractor, the worker enters into an agreement to provide a service in return for pay. Similar to the firm, the worker's decision on whether to enter into such an agreement hinges on economic efficiency for the worker. Workers measure efficiency both financially and through their preferences of different working arrangements.

For example, rideshare drivers sign contracts that allow them to use software in return for a fee for each fare they earn. These contracts do not stipulate when or how often the drivers must work, leaving the drivers in charge of their own hours and how much income they can earn.

In rideshare arrangements, the driver may have decided that working as an independent contractor is preferable to another occupation or working as an employee driver. Independent contractors need to assess if the portion of the fare they receive will cover operating costs: insurance, maintenance and gas.

Does this same portion of the fare generate the revenue needed to cover similar costs associated with employee status: health insurance, retirement savings, unemployment insurance, short-term and long-term disability, social security, and other payroll taxes?

For IRS purposes, independent contractors must impute a wage for personal income taxes that is generally the wage paid to an employee in comparable work. That same fare portion returned to the independent contractor ought to provide something left over as a profit.

From an economic sense, an independent contractor ought to carefully consider the possibility of potential profit before entering into a contract. Further, a driver should decide whether the fluctuation of hours and wages is something that they are willing to accept. While some people may be partial to more structured employment, a federal study of contingent and alternative employment arrangements found that more than eight out of 10 independent contractors prefer their work arrangement to a nine-to-five job (Bureau of Labor Statistics, February 2005).[1] This survey suggests that a significant amount of contractors prefer the flexibility and financial rewards of their work arrangement over the stability and structure offered by the traditional employer-employee relationship. Worker preferences for amenities and factors such as cost of living and leisure play an important role in predicting labor market outcomes and have been studied extensively.[2],[3]

Given this discussion, it may seem surprising that there have been an increasing number of workers claiming that they are misclassified as independent contractors. They claim that regardless of the contract they signed, they are legally entitled to employer-provided benefits enjoyed by traditional employees. In a number of rideshare suits, drivers are claiming that they are misclassified as independent contractors and should be reimbursed for expenses like fuel and vehicle maintenance.

Statutory Concepts of Independent Contractor Versus Employee

So how do regulators determine whether a worker is correctly classified as an independent contractor? No single definition of independent contractor exists. Instead, employers and regulators use vague guidelines and tests to classify workers as employees or independent contractors.

In a series of articles appearing in Law360, Reibstein et al. described the definition of an independent contractor from the legal and regulatory perspectives.[4]

The legal/regulatory perspective is in stark contrast with the economic perspective. For instance, rather than considering the use of internal and external markets to explain contracting work, two federal agencies provide tests meant to classify a worker as an independent contractor or an employee. The IRS uses the "common law approach" to make this distinction, which involves determining whether the employer or the worker is the controlling agent.

Alternatively, the U.S. Department of Labor uses the "economic realities" test in their evaluation of this question. While the "economic realities" test also takes into account the degree of control each party has, it tends to focus on who relies on whom financially in the relationship (see DOL Guidance 2015, 2016).[5],[6] Although states generally consider either one of these tests when ruling on the classification of a worker, they also consider the "ABC rule," which has aspects from both of the aforementioned classification tools.

Increased legal/regulatory effort to circumscribe independent contractor arrangements seems to derive from the theory that independent contractors lose substantial benefits relative to employees doing the same work. We have already noted that it is unlikely that an independent contractor would enter into an arrangement unless all costs were covered as well as an expectation of profit to himself. We next examine if employees are better able to obtain economic benefits relative to an independent contractor.

Lost Economic Benefits

Plaintiffs claim that because they are misclassified as independent contractors, they are deprived of benefits employers must legally provide. Plaintiffs argue they shoulder taxes that should be split between the employer and employee. However, these arguments do not acknowledge the fact that employees who receive these benefits recognize their costs in lower wages. In other words, regardless of whether the law designates the employer as the provider of benefits and payer of taxes, the worker will end up paying for them in the form of reduced wages. This situation can be illuminated through an investigation of tax incidence, or the analysis of who ends up bearing the burden of a tax.

For example, consider Social Security taxes which are levied on classified employees and independent contractors. A 2015 update to Social Security taxes requires that employer and employee each pay 6.2 percent on earnings up to $118,500, while the self-employed (including independent contractors) pay 12.4 percent on earnings up to $118,500. In this case it seems that employers have an overwhelming incentive to misclassify their employees as independent contractors in order to avoid a 6.2 percent Social Security tax, among other taxes.

While it may seem as though the independent contractor is getting a raw deal because they are forced to pay these taxes that the employer "shirks," regardless of who is nominally responsible for the tax, economists agree that the burden of payroll taxes falls exclusively on the worker in the form of lower wages. That is to say that while the law states that employers must pay 6.2 percent, they pass this amount dollar per dollar onto the worker. This same logic can be applied to other benefits workers claim they lose because of misclassification. Economists have found all taxes and employer-provided benefits are in fact paid for by employees.

In the case of employer-provided health care plans, Jonathan Gruber, the architect of the Affordable Care Act, found that the real burden of employer-provided health care was on the employee in the form of reduced wages (Gruber 2001).[7] As a side note, recall that employer-provided health care became popular during World War II when employers granted health care coverage and expanded benefits as a

way to get around wage and price controls and reward employees in lieu of pay.

Economists widely agree that workers pay the full costs of taxes and employer-provided benefits directly or through reduced wages:

Health Insurance

- " ... health insurance is not a gift, but something employees pay for with reduced wages. Even the most generous employer cannot very long pay its employees more than the value of what they produce" (Congressional Budget Office).[8]
- " ... the costs of health insurance are fully shifted to wages" (Jonathan Gruber).[9]
- "This study has found strong evidence that workers pay for their health costs in the form of reduced compensation" (Louise Sheiner).[10]
- "The cost to employ any worker in terms of total compensation is the sum of cash wages and fringe benefits. Employers will offset increases in labor costs from providing health insurance by shifting cost to workers through lower wages" (Anna D. Sinaiko).[11]

General Payroll Taxes

- "Most analysts conclude that both the employee's and employer's share of payroll tax is borne by the employee" (Joint Committee on Taxation).[12]
- "[The] CBO assumes — as do most economists — that employers' share of payroll taxes is passed on to employees in the form of lower wages than would otherwise be paid" (Congressional Budget Office).[13]
- "Individuals pay high payroll taxes — directly and through forgone wages ... " (WSJ Commentary, Martin Feldstein).[14]
- " ... payroll tax is born entirely by the wage earners" (Okner and Pechman).[15]

Social Security

- "Social Security is treated as either exclusively or predominantly as a payroll tax on labor ... " (Davies, St-Hilaire and Whalley).[16]
- "This [his analysis] shows a direct and complete trade-off between the basic wage and the tax per worker, or a 100 percent shifting of the tax burden at the expense of labor's basic wage ... the presence of a payroll tax on employees tends to reduce the wage in dollar by roughly the amount of the tax" (John

Brittain on Social Security Payroll Taxes).[17]

Overtime Pay

Overtime pay is also the focus of numerous misclassification lawsuits. Much like the economic rationale illustrating the equality in real pay between independent contractors and employees, the same intuition can be used to illustrate the trade-off that occurs when employers are forced to pay hourly wages and overtime to once salaried workers.

Take for example a recent reclassification of workers by an international technology giant, where 7,000 salaried and technical support workers were reclassified as eligible for overtime as part of a settlement. Base pay was cut by 15 percent, leaving the total earnings of workers unaffected.[18]

To explore further, consider the fixed-job model of employment, where parties negotiate an employment contract that covers both wages and hours worked. In this type of situation, hourly wages depend partly on how many hours an employee works, including overtime hours. However, employers and employees only concern themselves with total hours worked and total pay for those hours, not wages.[19] This model predicts that employers respond to higher overtime costs by reducing regular wages, in turn leaving total earnings unchanged.

The economic intuition is supported by economists from both sides of the ideological spectrum who recognize that employers offset all or almost all of the cost of overtime premiums with lower base wages:

- David Bell and Robert Hart (2003) examined labor market data from Great Britain, where they found that the average British firm pays a 28 percent overtime premium. They further discovered that these companies in turn pay lower base wages and that average hourly earnings remain constant regardless of how many hours of overtime employees work.[20]

- Stephen Trejo (2003) examined overtime and hours using data on average overtime hours by industry between 1970 and 1989 where he concluded that his “finding is consistent with a model of labor market equilibrium in which straight-time hourly wages adjust to neutralize the statutory overtime premium.”[21] Trejo (1991) also examined data on household pay and earnings from the 1970s. He concluded that employers offset roughly half the cost of overtime requirements through lower base wages.[22]

- Mikal Skuterud (2007) examined the effect of a Canadian law reducing the overtime threshold for nonunion hourly workers from 44 to 40 hours a week. Consistent with the definition and results of the fixed-job model, he found no effect on the overtime hours worked by women, no increases in employment rates, and lower base wages for employees working more than 44 hours a week.[23]

- Kuroda and Yamamoto (2012) examined managers during the most recent economic recession. They found that even in periods of recession, overtime-exempt employees earn the same average hourly pay as overtime-eligible

employees. They also found that in response to court decisions granting overtime eligibility to name-only managers at a major fast food chain, the restaurant cut their base salaries by an amount that offset the exact amount of the increase.[24]

- Recent research from Anthony Barkume (2010) updated Trejo's 1991 work using data from the 2000s. He concluded that employers offset 80 percent of new overtime costs with lower base wages.[25]

Conclusion

It would appear that independent contractors are able to be at least as well-off financially as their employee counterparts. All employer-provided benefits are paid for by employees themselves either directly or in reduced wages. The overtime issue is similar. Employers forced to pay hourly rates plus overtime instead of salaries will adjust pay rates so that compensation is the same. Meanwhile, independent contractors enjoy the ability to exercise greater control over their work arrangements.

—By Charles Diamond, Ph.D., Peter Cahill and William Crowley, Charles River Associates

Charles Diamond is a vice president in CRA's New York office. Peter Cahill and William Crowley are analysts in CRA's New York Office.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] "Contingent and Alternative Employment Arrangements, February 2005," Bureau of Labor Statistics press release July 27, 2005. www.bls.gov/news.release/pdf/conemp.pdf

[2] Stanley L. Brue, David A. Macpherson, and Campbell R. McConnell, Contemporary Labor Economics. 9th ed. Boston: McGraw-Hill Irwin, 2010, pp. 246–247; 18–19; 79–80; 68.

[3] Michael J. Dumond, Barry T. Hirsch and David A. Macpherson "Wage Differentials Across Labor Markets and Workers: Does Cost of Living Matter?" Economic Inquiry, Vol. 37, No. 4, October 1999, pp. 577–98.

[4] https://www.law360.com/articles/672242/the-costs-of-worker-misclassification-part-1

https://www.law360.com/articles/672252/the-costs-of-worker-misclassification-part-2

https://www.law360.com/articles/672263/the-costs-of-worker-misclassification-part-3

[5] "Administrator's Interpretation No. 2015-1: The Application of the Fair Labor Standards Act's 'Suffer or Permit' Standard in the Identification of Employees Who Are Misclassified as Independent Contractors." U.S. Department of Labor, Wage and Hour Division, July 15, 2015. http://www.dol.gov/whd/workers/misclassification/ai-2015_1.htm

[6] "Administrator's Interpretation No. 2016-1: Joint employment under the Fair Labor Standards Act

and Migrant and Seasonal Agricultural Worker Protection Act," U.S. Department of Labor, Wage and Hour Division, Jan. 20, 2016. http://www.dol.gov/whd/flsa/Joint_Employment_AI.htm

[7] Jonathan Gruber, "Taxes and Health Insurance," in James Poterba, ed., Tax Policy and the Economy 16, Cambridge: MIT Press, 2002, p. 37–66.

[8] Statement of Rosemary D. Marcuss Assistant Director for Tax Analysis on The Tax Treatment of Employment-Based Health Insurance before the Committee on Finance United States Senate, April 26, 1994.

[9] "Health Insurance and the Labor Market," in Anthony J. Culyer and Joseph P. Newhouse, eds., Handbook of Health Economics, Vol. 1a, New York: Elsevier, 2000.

[10] Louise Sheiner, "Health Care Costs, Wages, and Aging," FEDS Discussion Paper No. 99-19, Jan. 14, 1999.

[11] Anna D. Sinaiko, "Employers' Responses to a Play-Or-Pay Mandate: An Analysis of California's Health Insurance Act of 2003," Health Affairs, Oct. 13, 2004.

[12] "Overview of Present Law and Economic Analysis Relating to Marginal Tax Rates and the President's Individual Income Tax Rate Proposals," Joint Committee on Taxation, March 6, 2001.

[13] "Historical Effective Federal Tax Rates: 1979 to 2004," Congressional Budget Office, Dec. 1, 2006.

[14] Martin Feldstein, "The Uncounted Trillions in the Inequality Debate," The Wall Street Journal, Dec.13, 2015. http://www.wsj.com/articles/the-uncounted-trillions- in-the-inequality-debate-14500046600

[15] Benjamin J. Okner and Joseph A. Pechman, "Who Paid the Taxes in 1966?" The American Economic Review, Vol. 64, No. 2, Papers and Proceedings of the Eighty-Sixth Annual Meeting of the American Economic Association, May 1974.

[16] James Davies, France St-Hilaire, and John Whalley, "Some Calculations of Lifetime Tax Incidence," The American Economic Review, Vol. 74, No. 4, September 1984.

[17] John Brittain, "The Incidence of Social Security Payroll Taxes," The American Economic Review, Vol. 61, No. 1, March 1971.

[18] Paul Davidson, "More American Workers Sue Employers for Overtime Pay," USA Today, April 19, 2012, http://usatoday30.usatoday.com/money/jobcenter/workplace/story/2012-04-15/workers-sue-unpaid overtime/54301774/1

[19] H. Gregg Lewis, "Employer Interest in Employee Hours of Work," unpublished paper, Duke University, 1969, and Yoram Barzel, "The Determination of Daily Hours and Wages," The Quarterly Journal of Economics, Vol. 87, No. 2, May 1973, pp. 220–238.

[20] David N.F. Bell and Robert A. Hart, "Wages, Hours, and Overtime Premia: Evidence from the British Labor Market," Industrial and Labor Relations Review, Vol. 56, No. 3, April 2003, pp. 470–480.

[21] Stephen J. Trejo, “Does the Statutory Overtime Premium Discourage Long Workweeks?” Industrial and Labor Relations Review, Vol. 56, No. 3, April 2003, pp. 530–551.

[22] Stephen J. Trejo, “The Effects of Overtime Pay Regulation on Worker Compensation,” American Economic Review, Vol. 81, No. 4, 1991, pp. 719–740.

[23] Mikal Skuterud, “Identifying the Potential of Work Sharing as a Job Creation Strategy,” Journal of Labor Economics, Vol. 25, No. 2, April 2007, pp. 265–287.

[24] Sachiko Kuroda and Isamu Yamamoto, “Impact of Overtime Regulations on Wages and Work Hours,” Journal of the Japanese and International Economies, Vol. 26, No. 2, 2012, pp. 249–262.

[25] Anthony Barkume, 2010. “The Structure of Labor Costs with Overtime Work in U.S. Jobs,” Industrial and Labor Relations Review 64 (1). Sage Publications, Inc.: 128–42.

All Content © 2003-2016, Portfolio Media, Inc.