Analyzing the Implications of the Department of Labor's Rule on Independent Contracting

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The US Department of Labor (DOL) has proposed a rule change to the "economic realities test" for determining whether a worker is an employee or independent contractor for the purposes of the Fair Labor Standards Act (FLSA).

The DOL's proposed rule narrows the definition of "independent contractor." The proposed rule does this first by retracting the 2021 rule that was more favorable to the independent contractor status and second by providing additional considerations to the six-factor economic realities test that significantly limit the circumstances under which a worker can legally be classified as an independent contractor.

My assessment is based on the latter component—the additional considerations included by the DOL for the economic realities test. In particular, the changes to the factors on "nature and degree of control" and "investment by the worker and employer" severely limit the ability for workers to be classified as independent contractors and create more complexity in determining whether a worker is indeed an independent contractor. Therefore, even if a worker is, in theory, properly classified as an independent contractor, the additional considerations add sufficient complexity to deter organizations, especially small businesses, from working with independent contractors altogether.

There are two primary considerations to understand regarding the rule:

1. The DOL rule makes an implicit assumption that 100 percent of impacted contracting jobs will turn into employment jobs, and that allows them to ignore the potential downsides or costs associated with the rule in question.
2. My co-authors and I conducted the first empirical assessment of an independent contractor reclassification policy in the United States using California's Assembly Bill 5 (AB5). Our preliminary evidence indicates that California's AB5 is significantly associated with a decline in self-employment and overall employment. We do not find robust statistically significant evidence that AB5 increased traditional employment. Our findings suggest that AB5 did not merely induce employers to hire former independent contractors as traditional employees, and that the reduction in self-employment was not accompanied by an equal increase in traditional employment.

Improper assumption in the DOL independent contracting rule:

The most important concern regarding the independent contracting rule is that the DOL does not provide a "reasoned determination" that the benefits of the additional considerations to the economic realities test justify its cost.

Although costs and benefits are difficult to quantify, the DOL still must attempt to provide a fair and accurate cost-benefit assessment. This means the DOL should at least include ranges of estimates where specific numbers are unknown. Given how the proposed rule currently reads, the DOL seems to deliberately leave out the most significant negative consequences, in violation of Executive Order 13563. Notably, the DOL implicitly assumes that 100 percent of potential contracting jobs will be turned into employment jobs; this assumption is extremely optimistic and downplays very significant consequences in connection with the rule in question. In addition, the only cost that DOL does include is "rule familiarization costs," and it does not attempt to provide a proper impact analysis of the proposed rule.

The DOL makes an implicit assumption that 100 percent of workers who are impacted by this rule will be extended employment opportunities. This also allows the DOL to treat all changes as mere transfers between employers and workers. There are no research studies that support the DOL's implicit assumption that there will be zero contracting job losses and that 100 percent of impacted independent contractors will be extended employment positions.

Further illustrating the point that assuming 100 percent of contracting jobs will become employment jobs is unreasonable is a report by the California Legislative Analyst's Office in response to California's AB 5, which is more restrictive than the DOL rule for independent contractors, but is nonetheless illustrative that zero contracting losses is an improper assumption. The DOL should examine this report. The report concludes that "we cannot predict the exact number of contractors who will become employees due to AB 5. Although we cannot predict the exact figure, it is probably much smaller than the roughly 1 million contractors that AB 5 applies to." One of the primary reasons the office expected this outcome is that "businesses will comply with the law in different ways. Some businesses may hire their contractors as employees, while others may hire some, but not all, of their contractors. Other businesses may decide to stop working with their California-based contractors."

There is some anecdotal evidence of these job losses in response to AB 5. For example, the *Los Angeles Times* reports job losses in the creative community of independent workers such as professional choral artists, classical performers and singers, dancers, actors, musicians, and other types of artists. Several other news articles report harm and job losses for translators and interpreters, court transcript editors, musical performers, writers, and truck drivers. In December 2019, the American Society of Journalists and Authors (the nation's largest professional organization of independent nonfiction writers) and the National Press Photographers Association

(a leading professional organization for visual journalists) filed a lawsuit on behalf of their members because of harm from AB 5—in particular, harm resulting from a significant loss of freelancing opportunities for their members. Indeed, the *New York Times* reports that Vox Media had to terminate 200 freelance writers in response to the law. Because of these challenges, after the passage of AB 5, California added 53 occupations to its list of occupations exempt from the law, bringing the total to 110.

The estimates and anecdotal evidence of job losses seem consistent with estimates of the cost of reclassifying independent workers as employees. One study finds that having an employee costs a business between 29 and 39 cents extra for every dollar of the employee's pay.

Owing to these substantial additional costs, organizations—especially small organizations—may not be able to hire all their independent contractors as employees. In fact, according to tax data, between 2000 and 2016, small firms (those with fewer than 20 employees) saw the greatest growth in the hiring of independent contractors, compared with medium-sized or large firms.

If a large number of contractors lose their jobs, the aggregate benefit of a reclassification of workers is not likely to offset its aggregate cost. There is a clear danger that the proposed classification reforms may not confer their intended benefits on many independent contractors, who would neither become employees nor be able to maintain their jobs as contracts. The loss of contractor jobs could further harm workers who may already be suffering from hiring freezes and layoffs as the United States enters potential recession territory.

New research providing an empirical assessment of reclassification policies:

My co-authors and I empirically examine the employment effects of California's AB5, focusing on overall employment, labor force participation, traditional employment, and self-employment. We use data from the Current Population Survey (CPS) to measure the employment, labor force participation, traditional employment, and self-employment levels for each state, occupation, and month in our period. Our analysis compares the labor market outcomes in California to all other states and also to a subset of states with less stringent and unchanged legal environments. We employ a simple difference-in-difference strategy to compare labor market outcomes in occupations within California to those outside California before and after AB5 was enacted.

Our preliminary evidence finds that AB5 is significantly associated with a decline in self-employment and overall employment. We do not find robust statistically significant evidence that AB5 increased traditional employment. Our findings suggest that AB5 did not merely induce employers to hire former independent contractors as traditional employees, and that the reduction

in self-employment was not accompanied by an equal increase in traditional employment. Thus, AB5 may have reduced overall employment and labor force participation.

Overall, this new research study provides the first empirical assessment of recent reclassification policy efforts in the United States by analyzing the effects of California's Assembly Bill 5, the country's strictest criteria for legally classifying a worker as an independent contractor rather than an employee. Our findings suggest that AB5 likely did not merely induce employers to reclassify some independent contractors as employees, and that it resulted in a significant decline in self-employment and overall employment. We find no robust evidence that AB5 increased traditional employment as intended.

This means that AB5 did not simply alter the composition of the workforce as intended, with more workers becoming employees and fewer workers as independent contractors. These findings have implications for the Department of Labor independent contractor rule, which assumes that the rule will have only a compositional effect—more independent contractors becoming employees. Our findings indicate that may not be the case, and instead we highlight the potential unintended consequences of the DOL rule on self-employment, overall employment, and labor force participation.