



AN ECONOMIC ANALYSIS OF OVERTIME PAY REGULATIONS

Under the Fair Labor Standards Act, employers must pay workers who work more than 40 hours in a week time-and-a-half for every hour worked over 40. Numerous exemptions to this requirement exist, including for salaried workers who have “executive, administrative, or professional” (EAP) duties and have an annual base salary of more than \$23,660. The Department of Labor recently proposed removing the exemption for EAP workers earning an annual base salary of between \$23,660 and \$50,440, which would extend mandatory overtime pay to an additional 5 million workers. While the Department of Labor claims that this change will encourage additional hiring, improve the well-being of employees, and lead to higher paychecks, economic theory and empirical evidence suggest otherwise.

A new study for the Mercatus Center at George Mason University provides a thorough analysis of the Department of Labor’s proposed overtime rules, finding that the rules will fail to achieve their objectives and will reduce the diversity of labor contracts used across different industries in the United States. Research indicates that the rules will increase compliance costs for firms, and that employers will respond to the new requirements in unintended ways. In particular, employers will be forced to move some employees from salaries to hourly pay or find other ways to clock their work.

To read the study in its entirety and learn more about its authors, Donald J. Boudreaux and Liya Palagashvili, see [“An Economic Analysis of Overtime Pay Regulations.”](#)

KEY FINDINGS

US Labor Markets Are Competitive

While the proposed overtime rules presume a systemic problem of overwork and underpayment among EAP workers, the Department of Labor does not provide any evidence supporting this presumption.

- *Employers must compete for employees.* Economists generally agree that US labor markets are quite competitive, particularly for the low- and medium-skilled workers who would be

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most affected by the rule change. The few studies that find employers with some market power over their employees focus on highly specialized markets.

- *Wages are competitive.* Several studies have found evidence that, in the United States, wages move in tandem with labor productivity. This suggests that employers must pay competitive wages to workers in order to keep them.
- *Employment arrangements are competitive.* While not all employment arrangements may be ideal at any given time, the competitive process provides sufficient incentive to spur workers and employers to find the most mutually beneficial employment arrangements. The Department of Labor does not provide any evidence that EAP workers making between \$23,660 and \$50,440 are systematically underpaid or overworked.

Employers Will Respond to New Rules in Unintended Ways

Because the workers affected by the proposed rules will have to be paid more when they work overtime, the marginal cost of employing them will increase while their marginal output will not be directly affected. Employers will respond to these increased costs by reducing compensation or by reducing the number of employees.

- *They may reduce base salaries.* Because the imposition of time-and-a-half pay for affected EAP workers who work overtime will increase their average hourly wage, employers may respond by cutting a worker's base salary to compensate for this increased cost of employment.
- *They may reduce overall compensation.* Rather than cutting base salaries, employers may instead choose to cut other compensation, such as fringe benefits (e.g., health insurance, pensions, and office perks) or performance bonuses.
- *They may replace current workers with capital or with higher-skilled workers.* Employers may find it cheaper to replace some workers with automated processes or with a smaller number of higher-skilled workers who earn salaries above the new threshold for overtime pay.

Proposed Overtime Rules Won't Achieve the Department of Labor's Objectives

The empirical literature on overtime rules does not supply any strong evidence that the proposed overtime rules will improve health or increase income for affected workers, or increase employment in EAP jobs.

- *Overtime rules decrease employment and increase moonlighting.* Several studies have found that employers react to overtime rules by cutting back on overtime hours. Other studies show an increase in "moonlighting," or taking a second job, as workers seek to compensate for a decline in income from their first job.
- *There is no evidence that overtime causes health problems.* While several studies show that overtime is associated with increased incidence of cardiovascular disease, none of the studies establish a causal link between the two.
- *Employers react to overtime rules by cutting compensation.* Studies in the United States have found that employers reacted to the introduction of overtime payment rules by decreasing

the base salaries of affected workers. In Japan, researchers have found that workers who were not exempt from overtime payment rules earned on average a lower base salary than their exempt counterparts, and often also worked shorter hours.

Proposed Overtime Rules Will Increase Compliance Costs

In order to comply with overtime rules, the Department of Labor requires that employers “make, keep, and preserve records of the persons employed by the employer and of the wages, hours, and other conditions and practices of employment.” This compliance requirement introduces several economic costs that the department did not consider, particularly for start-up companies.

- *Firms may disallow telecommuting.* The easiest way to keep track of hours worked for the purposes of compliance with overtime rules is to have employees maintain timesheets. To ensure workers don't claim overtime hours they didn't actually work, employers may cut back on allowing their workers to telecommute.
- *Legal costs will increase.* Reclassifying employees as hourly workers entails considerable legal costs for employers. The tech start-up industry alone might pay between \$317 million and \$4.5 billion in legal fees to comply with the proposed rules.
- *The diversity of labor contracts will decline.* Paying employees an hourly wage is convenient in some industries, but isn't the most efficient compensation mechanism for all workers or employers. Compensation tied to output, such as profit sharing, bonuses, and commissions, is more efficient for some employers and employees. The proposed rules will make it more difficult for companies to use these forms of compensation.

CONCLUSION

The Department of Labor's analysis of its proposed overtime rules is flawed and incomplete. Economic theory and empirical evidence strongly suggest that, over time, employers will react to these new rules by cutting base salaries or laying off workers covered by the rules. The proposed rules may force newly underemployed employees to instead choose to take a second job. Increased compliance costs will force employers and employees into hourly wage contracts that are ill suited to many jobs, and will lead to greater compliance costs for many employers.