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PUBLIC INTEREST COMMENT

EXPLORING THE CONSEQUENCES OF WORKER RECLASSIFICATION PROPOSALS

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Independent Contractor Status under the Fair Labor Standards Act
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We appreciate the opportunity to submit a comment to the Department of Labor (the Department) in response to its proposed rulemaking regarding independent contractor status under the Fair Labor Standards Act (FLSA). The Mercatus Center at George Mason University is dedicated to bridging the gap between academic ideas and real-world problems and to advancing knowledge about the effects of regulation on society. This comment, therefore, does not represent the views of any particular affected party or special interest group. Rather, our intent is to provide an economic analysis of the Department's proposed rule and to highlight where it could be improved.

EXECUTIVE SUMMARY

The Department's proposed rulemaking about independent contractors is a much-welcomed development. The Department's historical analysis is impressive, and the conclusion that the primary determinants of being in business for oneself—the clearest definition of an independent contractor—are (a) the ability to control the work process and (b) the opportunity to profit as the result of individual initiative has a number of benefits. Although we find that the proposed secondary factors are unnecessary, we understand that adherence to precedent may compel the Department to maintain them for now.

In fact, we argue that if the Department were not so constrained, a better approach would be to stipulate that the explicit declaration of intent in the contract between the worker and the employer should serve as the sole determinant as to whether a worker is an employee or an

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independent contractor under the FLSA. Doing so would provide even greater clarity to the Department, courts, and affected parties.

In addition, we contrast the Department's proposed rule with California's recent changes to employment classification contained in Assembly Bill (AB) 5. Although we recommend some improvements to the Department's proposed rule, we are relieved that the efforts do not follow in California's footsteps by choosing rules that encourage cronyism and hurt the workers whom the rules are intended to help.[1]

We remind the Department (and other readers) that labor regulations are generally paid for by reductions in workers' total compensation and that economic regulations in general tend to result in both increases in price and reductions in quality, innovation, and future economic development. The ideal reform would be to shift from employment-based labor regulations, which are aimed at improving social welfare, to individual-focused and market-oriented programs, thereby eliminating the use of employment classifications altogether. This change would reduce waste, increase economic development, and improve workers' compensation simultaneously.

We suggest three reforms that would serve as a further improvement to labor regulation, in addition to the Department's proposed independent contractor rule:

1. Remove the secondary factors from consideration of whether a worker is an employee or independent contractor. They are unhelpful in determining a worker's classification, and their inclusion increases the potential for ambiguous interpretation of the rule, which is the exact problem the Department is attempting to resolve.
2. Remove the Department from determining a worker's classification entirely by basing the determination on an explicit statement of worker status in the employment contract. If no such contract exists, then the Department can fall back to using the primary factors it has identified.
3. End worker classification altogether, and replace the current social programs that depend on a worker's employment classification so they become market-oriented, individual-focused social programs. This change, however, is a task for Congress, not the Department.

THE DEPARTMENT'S RULEMAKING PROVIDES MUCH-NEEDED CLARITY

One of the main virtues of the Department's proposed rule for independent contractors is that it synthesizes previous understandings of the independent contractor rule and, thus, is only a modification of the status quo. This synthesis resulted from the Department's comprehensive examination of the existing body of precedent from both the Supreme Court and the federal courts of appeals. Even if a radical redesign of the rule may be beneficial (as discussed later), the Department's actions are constrained by the authorizing legislation from Congress and by prior legal decisions. As such, the approach is appropriate.

The Department finds that existing worker classification paradigms use some form of an "economic reality" test when determining whether a worker is properly classified as an independent contractor or as an employee under the FLSA.[2] The Department explains that the heart of this inquiry is whether "'as a matter of economic reality' the workers are 'dependent upon

1. Michael D. Farren and Trace Mitchell, "California Is Making Hiring More Expensive during a Recession. That's Crazy," *Orange County Register*, October 13, 2020.
2. Independent Contractor Status under the Fair Labor Standards Act, 85 Fed. Reg. 60600, 60601–4 (proposed September 25, 2020) (to be codified at 29 C.F.R. pt. 780, 788, 795).

the business to which they render service.'"[3] To assess the "economic reality" underlying a specific relationship between a worker and a hiring entity, the courts have relied on several factors first articulated in *United States v. Silk*.[4] Those factors include "degrees of control, opportunities for profit or loss, investment in facilities, permanency of relation[,] and skill required in the claimed independent operation."[5] However, the Court's ruling in *Silk* was careful to note that "[n]o one [factor] is controlling nor is the list complete."[6]

Lower courts have largely adopted those factors when conducting their own economic reality tests in the context of the FLSA, although some courts have added other factors or reinterpreted the understanding and relative importance of the factors. For example, in *Real v. Driscoll Strawberry Associates, Inc.*, the Ninth Circuit Court of Appeals applied a six-factor economic reality test that included the following:

1. The degree of the alleged employer's right to control the manner in which the work is to be performed
2. The alleged employee's opportunity for profit or loss depending on the person's managerial skills
3. The alleged employee's investment in equipment or materials required for the task or for employment of helpers
4. The concept of whether the service rendered requires a special skill
5. The degree of permanency of the working relationship
6. The concept of whether the service rendered is an integral part of the alleged employer's business[7]

Those factors closely reflect the factors that the Supreme Court articulated in *Silk*, with the addition of whether the service rendered is an integral part of the alleged employer's business.

However, the various economic reality tests are by no means identical, and the application of such tests can vary greatly. Some courts have made significant modifications that substantively change how the economic reality test is applied.[8] Furthermore, the current tests do not clearly delineate between each of the relevant factors. There is significant overlap between several of the factors, and there is no clarification as to how the factors are weighted, thus making the application somewhat amorphous and unpredictable.[9] Even the Department has struggled to apply its own version of the economic reality test in a way that is clear and consistent.[10] This ambivalence is why the Department's proposed independent contractor rule is so important: it provides greater clarity to workers and employers alike by identifying, defining, and clearly delineating between each of the relevant factors. Moreover, it specifies how the factors will be weighed by the Department.

3. Independent Contractor Status, 85 Fed. Reg. 60600, 60603 (citing Usery v. Pilgrim Equipment Co., Inc., 527 F. 2d 1308, 1311 (5th Cir. 1976) (quoting Bartels v. Birmingham, 332 U.S. at 130).
4. United States v. Silk, 331 U.S. 704 (1947).
5. 331 U.S. at 716.
6. 331 U.S. at 716.
7. Real v. Driscoll Strawberry Associates, Inc., 603 F. 2d 748, 754 (9th Cir. 1979).
8. Independent Contractor Status, 85 Fed. Reg. 60600, 60603–4.
9. Independent Contractor Status, 85 Fed. Reg. 60600, 60606–8.
10. Independent Contractor Status, 85 Fed. Reg. 60600, 60605.

DESCRIPTION OF THE DEPARTMENT'S PROPOSED RULE

The Department's proposed rule adopts and clearly defines two primary factors that will serve as the core of the economic reality test:

1. The nature and degree of individuals' control over their work
2. The individuals' opportunities for profit or loss as a result of their initiative[11]

The Department also proposes three secondary factors that it will consider when analyzing labor market relationships:

1. The amount of skill required for the work
2. The degree of permanence of the working relationship between the individual and the potential employer
3. The extent to which services rendered are an integral part of the potential employer's business[12]

The Department states that although the two primary factors are not dispositive, they are given greater weight. Therefore, a finding that both of those factors point toward a particular classification will be difficult to overcome.[13]

BENEFITS

Clarity. The Department's proposed rule builds on existing precedent and serves largely as a synthesis and clarification of previous economic reality tests, rather than implementing any sort of radical change. It is therefore unlikely to create substantial adjustment costs for the affected parties. Most affected industries and contractors will be able to continue business as usual, and they will likely have greater freedom to develop more productive economic relationships.

Lower Compliance Cost. The proposed rule will likely reduce the cost of complying with the relevant federal regulations. The subjective, case-by-case nature in which a worker's independent contractor status is challenged and determined motivates employers to limit their exposure to risk by unnecessarily constraining their production process. By contrast, a more objective standard that provides greater legal clarity to employers and workers will allow for more efficient production processes and will reduce the resources wasted on determining a worker's employment classification through the legal process. By clearly delineating between each of the relevant factors, identifying which factors are given primacy, and explaining how each of the factors will be interpreted, employers will be provided with a far more coherent framework for predicting how the Department will assess worker classification issues under the FLSA.

Neutrality. The rule does not bias the worker classification analysis in favor of an employee designation. Indeed, the Department could have followed California's recent shift toward a presumption that workers are employees unless strict conditions are met—doing so would certainly provide predictability for employers and workers.[14] But that approach increases economic costs in a different way by forcing a one-size-fits-all employment model on workers and employers. Inability to adapt to changing conditions causes economic losses, and recent history has

11. Independent Contractor Status, 85 Fed. Reg. 60600, 60612–15.
12. Independent Contractor Status, 85 Fed. Reg. 60600, 60615–18.
13. Independent Contractor Status, 85 Fed. Reg. 60600, 60618.
14. See discussion of the California Supreme Court's *Dynamex* decision and the California legislature's AB 5 worker reclassification law (an explanation of which follows).

shown how the flexibility of service created by freelance workers has improved the price and availability of goods and services, while providing job opportunities for workers who would not have been able to take a standard job.

Freelance work is an important aspect of the modern economy and appears to be increasing in importance over time. Many of the recent innovative products and services to emerge from the technology sector rely on a platform business model that is predicated on connecting independent service providers with consumers.[15] By starting the analysis from a neutral position, the Department's rule therefore allows for the dynamic experimentation that has resulted in this recent wave of technological and social innovation.

THE DEPARTMENT COULD CHART A CLEARER PATH FORWARD

Although the Department's proposed independent contractor rule is an improvement over the status quo and is preferable to other recent worker classification proposals, it is still less than ideal. The Department has made explicit its preference to "sharpen the existing test, rather than to create a new test out of whole cloth."[16] That approach may be the Department's best course of action considering the constraints it faces; however, there are reasons to think that the current paradigm could be further improved.

The proposed rule, despite its increased clarity and precision over the current economic reality tests, is still inherently subjective and allows the Department and courts to reclassify worker relationships on the basis of vague, qualitative standards. In particular, the three secondary factors of the Department's proposed test seem unnecessary.

The two primary factors—the degree of workers' control over their activities and the degree to which workers can profit by exercising initiative—strike at the core of the degree of workers' independence from their employers. In contrast, the secondary factors—the skill needed for the work, the permanence of the economic relationship, and the importance or integral nature of the work in relation to the employer's production—seem arbitrary and unnecessarily constraining in a modern, rapidly transforming economy.

There are situations in which workers with advanced skills need to be incorporated into a larger production team to ensure success. For example, the National Aeronautics and Space Administration (NASA) probably does not want a temp agency supplying aerospace engineers for the day of a rocket launch. But even in that same context, there are likely some tasks that can be broken out of the larger production process and that can be performed by outside agents—such as hiring atmospheric scientists to evaluate the minute-to-minute changes in the local weather that affect launch windows.

Similarly, a lesser-skilled worker might be hired as an employee to be a seat usher at a sports stadium, but that same worker could work as an independent contractor after the event to clean the facility. This duality could occur because the manner and time spent cleaning does not matter as much as the final product, but an usher's manner of interacting with sports fans is an important part of their experience and would be required to conform to particular standards.

15. Well known "gig economy" firms such as Uber, Lyft, and Postmates have built their entire platforms around the use of freelance, nonemployee workers.
16. Independent Contractor Status, 85 Fed. Reg. 60600, 60612.

The permanence (or long-running nature) of the economic relationship is an unhelpful basis for determining worker classification. Once a business finds a worker who provides satisfactory service, it is often not economically efficient to restart the search and selection process to find a replacement every time the task needs to be done; after all, search and selection are costly. The economic relationship would naturally continue—whether it is an employment or contracting arrangement—until there is a specific reason for it to stop. An independent contractor who cleans the stadium after each game might have been doing so for the past decade and might still be investing in new products or technologies to lower the personal cost of doing so (applying initiative to increase profits and self-managing the production process). Conversely, the ushers might be hired from week to week, might be given a brief training on how to interact with customers before each sporting event, and might then asked to turn in their name badges afterward.[17]

Finally, the integral nature of a worker's activities to the production of the final good or service is another poor gauge of whether someone is considered to be independent. The services provided by the atmospheric scientist are critical to a successful rocket launch, but that does not prevent the scientist from providing the same service the following day for a different employer. Similarly, although clean (or at least nonsticky) bleachers are an important part of a sports fan's experience, the cleaning crew working after the game might also be hired to clean up the bars around the stadium after the fans finish celebrating their big win.

Our suggestion is that Congress should direct the Department to adopt a different test that is clear, consistent, and deeply ingrained in America's system of law. Namely, Congress should allow the parties themselves to explicitly define the nature of their labor relationship. Doing so would then allow the Department to look at the underlying contract as the exclusive source for determining the nature of the worker–employer relationship.

This approach offers multiple benefits. It provides the Department and judges with a clear and consistent standard for assessing worker classifications (indeed, it would likely end most worker classification challenges). It also gives labor market participants greater autonomy over their decisions and near certainty when it comes to the legal status of their economic relationships. It allows both workers and employers to make investments in their production processes without fear of having their business model called into question by a court down the line.

Enshrining the right of workers and employers to declare the nature of their relationship contractually would also provide greater flexibility in employment relationships. Employers would be able to offer worker-specific compensation packages that include benefits such as health insurance or retirement programs to their independent contractors without fear that providing the specific types of compensation and work environment that their workers want could force a costly reclassification that would throw a wrench into their overall production process. Greater flexibility would also tend to lower the total cost of production, thereby leading to the creation of new jobs as employers use the savings to find innovative ways to serve new customers. And better tailoring of the compensation package would promote greater alignment of worker and employer objectives, making the economy less wasteful, more efficient, and increasingly productive.

17. Note that the practice of hiring and firing ushers on a weekly basis likely does not make sense under the current economic paradigm (although that is mostly because it is more costly to hire a worker as an employee; as we argue later, such a finding is simply a symptom of the dysfunction of the current system). However, there is no reason hiring should not be an option. It is costly, yes, but it should not be illegal.

Under this new paradigm, employee status—and the benefits or legal requirements that come along with it—would become a sort of bargaining chip to be negotiated between the worker and the employer. Workers who desire to have the security of social safety net programs, such as unemployment insurance, or who want a more dependable work schedule would include employee status in their compensation requirements. A worker who has a full-time job that already provides many of the benefits associated with an employee designation may desire to bargain for a higher wage or more flexibility by shifting to independent contractor status, but the current inability to do so may very well be making such workers unnecessarily worse off.

Although we understand that the Department is somewhat bound by existing precedent and legislative authority, a rule that looks exclusively to the underlying contract as the source for determining worker classification would go even further in providing the beneficial outcomes that the Department seeks.

AB 5 ILLUSTRATES THE COSTLIER PATH FORWARD

The Department's proposed rule about independent contractors is in sharp contrast with the recent worker classification reforms taking place in California. In 2018, the California Supreme Court issued a decision in *Dynamex Operations West, Inc. v. Superior Court*, thereby providing an interpretation for how worker classifications should be analyzed under California's wage order protections.[18] The decision highlighted the similarities between California's wage order protections and the FLSA—specifically the "suffer or permit" definition—and found that this protection was meant to extend employee status and the benefits that come along with it to the "widest class of workers that reasonably fall within reach of a social welfare statute."[19] However, the court also went on to consider the economic reality tests applied under the FLSA; it explicitly rejected them as a basis for determining worker classification under California's wage order protections.[20] It found that "the California wage orders are intended to provide broader protection than that accorded workers under the federal standard."[21]

According to this finding, the court held that the appropriate California standard for determining independent worker classifications was more stringent than the economic reality tests under the FLSA. The court argued that the California standard necessitated "placing the burden on the hiring entity to establish that the worker is an independent contractor who was not intended [by the legislature] to be included within the wage order's coverage."[22] To meet that burden, the hiring entity must "establish each of the three factors embodied in the ABC test."[23] Those factors are as follows:

A. "that the worker is free from the control and direction of the hirer in connection with the performance of the work, both under the contract for the performance of the work and in fact,

18. Dynamex Operations West, Inc. v. Superior Court, 4 Cal. 5th 903 (Cal. 2018).
19. Dynamex, 4 Cal. 5th at 951.
20. 4 Cal. 5th at 953–57.
21. 4 Cal. 5th at 956.
22. 4 Cal. 5th at 957.
23. 4 Cal. 5th at 957.

B. that the worker performs work that is outside the usual course of the hiring entity's business; and
C. that the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the hiring entity."[24]

This approach was expanded and codified into law by the California legislature in 2019 through AB 5.[25] The standard in AB 5 differs sharply from the one proposed by the Department in that it places on the hiring entity the burden of proof that the worker is properly classified as an independent contractor, and it imposes stringent standards for meeting that burden. As we discuss later, we believe that the Department's proposed rule has a number of benefits over a *Dynamex* or an AB 5 type of worker classification standard.

From its inception, AB 5 was intended to inhibit the freelance economy's use of independent contractors. In support of the bill, California Governor Gavin Newsom lamented that "[t]he federal government will be no help here" because "[t]he Trump administration has declared that workers in the gig economy are independent contractors and therefore not covered by federal labor laws."[26] Furthermore, the text of the bill was written by representatives of the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), and the bill seems designed to pursue that organization's well-known goal of organizing freelance economy workers.[27] This sort of legislative solution was necessary because although the FLSA enables employees to organize, such organization does not apply to independent contractors.[28]

California Representative Lorena Gonzalez-Fletcher, who introduced the AB 5 legislation, argued that the law was necessary because highly valued platform firms such as Uber and Lyft were contributing to income inequality by not paying their workers enough. Furthermore, workers who are classified as employees receive a variety of employment benefits by mandate. Thus, she argued that without those regulations, platform firms were delinquent in their responsibilities to their workers.[29]

If such arguments are accurate and worthwhile, however, there is little reason to create exemptions for specific industries, because the carve-outs would simply allow those industries to get away with the same objectionable conduct. However, AB 5 did exactly that by exempting 57 industries from compliance, including the following:[30]

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24. 4 Cal. 5th at 957.
25. John Myers, Johana Bhuiyan, and Margot Roosevelt, "Newsom Signs Bill Rewriting California Employment Law, Limiting Use of Independent Contractors," *Los Angeles Times*, September 18, 2019.
26. Gavin Newsom, "On Labor Day, Let's Pledge to Protect Workers and Create Paths to Union Membership," *Sacramento Bee*, September 2, 2019.
27. Katy Grimes, "CA Senate Passes AB 5 Despite Pleas from Independent Businesses," *California Globe*, September 10, 2019; "Full and Fair Employment," AFL-CIO, accessed October 18, 2020, https://aflcio.org/what-unions-do/empower-workers/1099-economy.
28. This approach should be understood as a failure of current union labor laws. With smarter, less restrictive regulations, unions would not be motivated to pursue widespread labor reform—thereby causing substantial collateral damage to workers and the businesses they work for—to serve their own needs. And under a better paradigm, freelance workers could benefit from the advantages offered by labor organizations. See John Wilcox, "NLRB Ruling Limits Independent Contractors' Right to Form or Join a Labor Union," *Business Management Daily*, January 28, 2019. See also "Employee Rights," National Labor Relations Board, accessed October 18, 2020, https://www.nlrb.gov/about-nlrb/rights-we-protect/your-rights/employee-rights.
29. "AB5 Interview with Lorena Gonzalez (California State Assemblywoman)," video, August 1, 2019, https://www.youtube.com/watch?v=HrHyOcGePS4.
30. Trace Mitchell and Michael D. Farren, "New California Ballot Initiative Is Just More Favoritism," *Foundation for Economic Education*, December 1, 2019; Chris Micheli, "AB 5 'Fix:' New Exemptions Added to California's Independent Contractor Law," *California Globe*, September 14, 2020.

- Physicians
- Lawyers
- Dentists
- Securities brokers
- Psychologists
- Investment advisers
- Veterinarians
- Private investigators
- Architects
- Direct salespersons
- Engineers
- Licensed insurance agents
- Accountants
- Commercial fishermen

After AB 5 was enacted into law in January 2020, protests by affected freelancers and their employers pressured the California legislature to pass follow-on legislation, AB 2257, which added another 55 exemptions to the law for the following (and other) workers:[31]

- People who provide underwriting inspections and other services for the insurance industry
- Manufactured housing salespersons
- People engaged by an international exchange visitor program
- Consulting services
- Animal services
- Competition judges with specialized skills
- Licensed landscape architects
- Specialized performers teaching master classes
- Registered professional foresters
- Real estate appraisers and home inspectors

Furthermore, the argument that companies that employ independent contractors are failing to live up to their responsibilities rests on several questionable assumptions. First, the argument implicitly assumes that workers cannot negotiate with employers to receive the benefits they want—that employers would provide only cash-based compensation unless forced to do otherwise. There are certainly situations in which employers have more bargaining power than workers have, but employers might well want to provide certain benefits in lieu of cash compensation because of the ancillary benefits they offer to the company.

First, giving a worker paid time off for illness or contributing to a medical insurance program is a way to prevent broader workplace disruption caused by many workers falling ill at once.[32]

31. Micheli, "AB 5 'Fix.'"
32. For more on the problem of offering benefits to independent contractors, see the section titled "The Problem of 'Employee Benefits' in Employee vs. Contractor Tests" in the public interest comment by our colleague, Liya Palagashvili. Liya Palagashvili, "Four Recommendations for Analyzing the DOL's Proposed Rule on Employees vs. Independent Contractors" (Public Interest Comment, Mercatus Center at George Mason University, Arlington, VA, October 26, 2020).

Second, the argument assumes that all workers want the same compensation package—an unrealistic assumption. Allowing workers and employers to craft their own tailor-made compensation packages is likely to result in increases in well-being for both parties.

Finally, the idea that somehow the companies that use independent contractors or that fail to pay their employees "a living wage" are free riding on government-provided social safety nets is a commonly held myth.[33] In some limited cases, such as the Earned Income Tax Credit, it is true that employers likely capture some of the value of the tax credit by being able to offer lower wages.[34] But most other social safety net programs, such as food assistance programs, actually *increase* a worker's bargaining power—and therefore the compensation—by shrinking the relative harm experienced by the worker from not having a job. In economic parlance, such programs raise the worker's reservation wage.[35]

DISCUSSION: AB 5 VS. THE DEPARTMENT'S PROPOSED RULE

The regulatory paradigms underlying California's AB 5 and the Department's proposed independent contractor rule chart substantially different paths forward. AB 5 severely biases most workers' classification away from independent contracting (ignoring the abundant exemptions granted to favored industries), which raises labor costs, reduces employee compensation, and restricts the economic organization of the firm. By comparison, the Department's proposed rule identifies independent contractors as those workers who can exert control over their production process and whose opportunity for profit or loss depends on their own individual initiative, thus allowing contractors and employers greater flexibility to develop their own nuanced tailored arrangements.

WORKERS OVERWHELMINGLY BEAR THE COST OF LABOR REGULATIONS

It is important for government officials to recognize that the regulations they promulgate create new costs that companies and workers must then incorporate into their economic activities. In particular, policymakers should be cognizant that such costs may not be borne by the party they anticipate or intend. Extensive empirical academic research has found that the cost of labor regulations, such as specific benefit mandates or employment taxes (both those paid by the employer and by the worker) to fund government-provided benefits, tends to reduce the worker's

33. See the discussion of policy-induced externalities in Michael D. Farren, "The 'Independent Worker' Proposal: A Step Sideways Rather than Forward," *Concentrated Benefits*, *Medium*, December 10, 2015.
34. Andrew Leigh, "Who Benefits from the Earned Income Tax Credit? Incidence among Recipients, Coworkers and Firms" (IZA DP No. 4960, Institute of Labor Economics, Bonn, Germany, May 2010); Austin Nichols and Jesse Rothstein, "The Earned Income Tax Credit (EITC)" (NBER Working Paper No. 21211, National Bureau of Economic Research, Cambridge, MA, May 2015).
35. "A worker's *reservation* wage is the minimum wage that the worker requires in order to participate in the labor market. It represents the monetary value of an hour of leisure (broadly defined as any non-labor-market activity) to the worker. If the wage offer does not meet or exceed the worker's reservation wage, then the worker's utility is maximized by remaining unemployed." Megan M. Way, "Reservation Wage," in *Wiley Encyclopedia of Management*, vol. 8 (Hoboken, NJ: Wiley, 2015).

total compensation.[36] In fact, workers generally bear the majority of the costs of such benefits.[37] In at least one case, the research suggests that there may even be a *net negative* effect on workers' total compensation.[38]

The findings suggest that labor markets do indeed work in a similar fashion to that suggested by basic economic theory: the total compensation offered by employers is largely determined by market forces and therefore is somewhat insensitive to many government proscriptions that attempt to change a worker's total compensation.

This finding is not set in stone, and there are exceptions of course. However, in cases where a regulation *does* change a worker's total compensation, the costs and effects of the regulation must then be incorporated elsewhere—this is the fundamental nature of opportunity costs and spillover effects. The minimum wage and the Earned Income Tax Credit are good examples of this exception. The case of a recent Ontario minimum wage increase offers an illustration of how a binding minimum wage can change the compensation structure that employers offer.

After Ontario's 2018 minimum wage increase, franchise owners of Tim Horton's restaurants were not allowed by their corporate parent to increase menu prices to accommodate the higher wages, nor would the corporate parent reduce the prices of Tim Horton's branded supplies that franchisees needed to purchase.[39] The result was that franchise owners were forced to create cost savings in other areas by reducing contributions to employees' health plans; reducing ancillary employment benefits (such as extra breaks, free meals, and free employee uniforms); and reducing staffing. This situation is unusual, because most minimum wage increases are accommodated by noncompensation channels of adjustment, such as price increases, service quality decreases, and staffing reductions.[40]

In conclusion, the costs of regulations that mandate particular employment benefits or changes to cash compensation, such as AB 5, are generally borne by the employee. Employers are likely to bear some of the costs, but they generally have greater ability to adapt their production process either to accommodate the cost or to shift it onto customers (as is customary in the fast food industry following minimum wage increases).[41] The Department's proposed rule, by

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36. Jonathan Gruber and Alan B. Krueger, "The Incidence of Mandated Employer-Provided Insurance: Lessons from Workers' Compensation Insurance," in *Tax Policy and the Economy*, ed. Jeffrey R. Brown, vol. 5 (Cambridge, MA: National Bureau of Economic Research, 1991), 111–44; Jonathan Gruber, "The Incidence of Payroll Taxation: Evidence from Chile" (NBER Working Paper No. 5053, National Bureau of Economic Research, Cambridge, MA, March 1995); Patricia M. Anderson and Bruce D. Meyer, "The Incidence of a Firm-Varying Payroll Tax: The Case of Unemployment Insurance" (NBER Working Paper No. 5201, National Bureau of Economic Research, Cambridge, MA, August 1995); José González-Páramo and Ángel Melguizo, "Who Really Pays Social Security Contributions and Labour Taxes?" *VoxEU.Org*, February 6, 2013; Gopi Shah Goda, Monica Farid, and Jay Bhattacharya, "The Incidence of Mandated Health Insurance: Evidence from the Affordable Care Act Dependent Care Mandate" (NBER Working Paper No. 21846, National Bureau of Economic Research, Cambridge, MA, January 2016); Jonathan Deslauriers et al., "Estimating the Impacts of Payroll Taxes: Evidence from Canadian Employer-Employee Tax Data" (IZA DP No. 11598, Institute of Labor Economics, Bonn, Germany, June 2018), 39; Martha Bailey et al., "The Long-Term Effects of California's 2004 Paid Family Leave Act on Women's Careers: Evidence from U.S. Tax Data" (NBER Working Paper No. 26416, National Bureau of Economic Research, Cambridge, MA, October 2019).
37. Michael D. Farren and Trace Mitchell, "Assembly Bill 5 Is Bad for Uber and Lyft, but It Will Be Worse for Workers," *Orange County Register*, September 30, 2019.
38. Alan B. Krueger and John F. Burton Jr., "The Employers' Cost of Workers' Compensation Insurance: Magnitudes, Determinants, and Public Policy" (NBER Working Paper No. 3029, National Bureau of Economic Research, Cambridge, MA, July 1989).
39. Michael D. Farren, "How Economic Theory Explains the Tim Hortons Wage Debate," *Globe and Mail*, January 10, 2018.
40. Barry T. Hirsch, Bruce E. Kaufman, and Tetyana Zelenska, "Minimum Wage Channels of Adjustment," *Industrial Relations: A Journal of Economy and Society* 54, no. 2 (2015): 199–239.
41. Sara Lemos, "A Survey of the Effects of the Minimum Wage on Prices," *Journal of Economic Surveys* 22, no. 1 (2008): 187–212.

comparison, will likely reduce costs (and therefore likely raise wages) by giving labor market participants greater clarity and marginally reducing the restrictiveness of the old rule.

LABOR REGULATIONS HARM BROAD ECONOMIC GROWTH

We note with pleasure that—in the proposed rulemaking—the Department cited Ronald Coase's Nobel Prize–winning research about the nature of a firm's institutional structure.[42] Employment classification regulations by their nature limit the ability of firms and workers to restructure their economic relationships to improve economic efficiency. This finding means that the labor restrictions also reduce long-run economic development by forestalling innovation into new production processes.[43] The Department's proposed rule would therefore provide greater opportunity for economic growth than would a rule similar to California's AB 5.

Recent research conducted by Cornell University's faculty using Seattle-specific worker data from the platform firms Uber and Lyft provides the best insight currently available into the habits and earnings of workers in the freelance economy.[44] Perhaps the researchers' most important finding was the expansive distribution of freelance worker activities and outcomes. For example, barely 15 percent of Seattle freelance drivers chose full-time work, with the median driver working only about 10 hours per week. Earnings, after accounting for expenses, showed a similar range of outcomes, with some drivers earning $40 per hour (before bonuses) while others made less than $10 per hour (the median worker earned $23.25 per hour).

Such findings are clear evidence of a heterogenous ecosystem of service providers, some of whom used freelancing as a full-time job (at least during the observation period) while most others dedicated the majority of their time to other pursuits. Similarly, some drivers were impressively effective while others were less so. In essence, the Seattle data show that the market for transportation services seems to be a microcosm of the broader market economy, where the wide range of economic outcomes are attributable to the specific initiative and production process selected by each entrepreneur.

The wide distribution of time investment and earnings found by the Cornell University study is relevant to the issue of worker classification because—under a more restrictive paradigm such as that created by AB 5—such variation would likely be greatly reduced when workers are required to conform to their employer's policies. In general, the increased regulatory costs and reduced institutional flexibility created by a mandatory employee classification would do the following:

A. Decrease workers' take-home pay
B. Decrease platform firms' demand for workers
C. Raise prices for consumers and reduce the quality and provision of services
D. Reduce innovation by replacing the efforts of many nimble freelancer entrepreneurs with a limited number of supervisors who attempt to coordinate employees' efforts through generalizable policies

42. Ronald H. Coase, "The Nature of the Firm," *Economica* 4, no. 16 (1937): 386–405.
43. Michael D. Farren and Trace Mitchell, "California's Assembly Bill 5 Shows How Good Intentions Can Lead to Bad Consequences," *The Bridge*, October 8, 2019.
44. Louis Hyman et al., *Platform Driving in Seattle* (Ithaca, NY: Cornell University, 2020).

For example, research by analysts at Barclays estimates that AB 5's reclassification of Uber and Lyft drivers would cost the companies an additional $3,625 per driver each year.[45] As we have described earlier, much of those costs would likely be borne by drivers in the form of reduced wages (or delayed wage increases) and to customers in the form of higher prices or reduced service quality. But to the degree that platform firms cannot pass the cost on to others, the firms will find ways to mitigate the effect of higher costs. Uber has already stated that one means of doing so would be to reduce the workforce by 75 percent and to require employees to work many more hours than their independent contractors typically do—as well as increasing prices.[46]

AN ALTERNATE IDEA: GET RID OF WORKER CLASSIFICATIONS ENTIRELY

Our analysis suggests an outside-the-box solution: If the costs of governmental attempts to improve workers' welfare through labor regulations are largely borne by the workers themselves and if such regulations generally reduce economic development by inhibiting innovation, then perhaps the best option is simply to get rid of worker classifications altogether.

It is clear that advocates of new labor regulations are generally trying to improve workers' welfare rather than trying to fix some abstract economic problem. That is, labor regulations are not attempting to solve a market failure but rather are attempting to create some desirable social outcome. The problem with using labor regulations to solve social problems is that such regulations almost inevitably carry the unintended consequence of slowing the economic growth that would help those individuals who are the intended beneficiaries of the regulation.

A better approach would be to create market-oriented programs that empower low-income individuals to achieve their own desired outcome. For example, a wage subsidy is preferable to a minimum wage because it increases both the supply and demand for workers, whereas the minimum wage increases the supply but decreases the demand, thus reducing the opportunities for employment. Similarly, if ensuring that workers (or all residents) have some minimum standard of healthcare access is deemed to be an important role of government, a good way to accomplish the standard would be to provide workers with dedicated healthcare financial accounts that empower them to pursue their own, individually appropriate healthcare needs in a marketplace that is designed to cater to customers.

In this new paradigm, where desired social outcomes are supported through market-oriented government programs rather than by labor regulations, employment classifications would likely seem superfluous. After all, the status of "employee" has been primarily used to mandate that employers provide some social service that policymakers determined to be valuable. Replacing the middleman with market-oriented programs would allow workers and employers to create context-specific employment contracts, rather than trying to slip each economic relationship into the same

45. Those estimated costs seem to be within the average 25–35 percent higher cost of employees compared with independent contractors. Alison Griswold, "How Much It Would Cost Uber and Lyft If Drivers Were Employees," *Quartz*, June 14, 2019; Bureau of Labor Statistics, "Benefits in Businesses with 500 or More Workers Were 35 Percent of Total Compensation in June 2019," *TED: The Economics Daily*, September 20, 2019.

46. Although it is difficult to predict the future (especially the economic future), the estimate of a 75 percent workforce reduction seems reasonable, given the Cornell University study that showed (a) that the median driver in Seattle worked around 10 hours each week, (b) that Uber would likely want to maximize the hours worked by employees to spread the fixed cost of their employment over as many work hours as possible, and (c) that Uber would avoid scheduling employees for more than 40 hours per week to avoid increased overtime costs. See Hyman et al., *Platform Driving in Seattle*; Dara Kerr, "Uber Says 158,000 Drivers Will Lose Work If They're Reclassified as Employees," *CNET*, May 28, 2020.

ill-fitting shoe. In fact, by increasing the status of low-income workers, the market-oriented solutions would likely improve workers' compensation potential by increasing their reservation wage (which would strengthen their relative bargaining power).

The Department could still have a role in developing and promulgating best-practice guidance for the individual contracts. For example, there should probably be a requirement that such contracts use clear language to ensure that one party's lack of legal knowledge is not weaponized against the worker. All told, this approach would

1. likely improve attainment of the desired social outcomes,
2. reduce the economic loss caused by previous labor regulations,
3. allow workers and employers to create economic relationships that are better tailored to each party's specific wants, and
4. unleash the economic development–creating innovation that has been held back by prior regulations.

CONCLUSION

The current paradigm of employment classification and labor regulations is failing American workers and businesses. The Department's proposed rule is a step in the right direction, and the Department should be commended for providing what amounts to a counterpoint to California's ruinous path. However, the Department should consider advising Congress that a better route forward would be to restructure social safety net programs and labor regulations from the ground up. Doing so would likely improve workers' compensation, enable businesses to better innovate, and set the stage for a new wave of economic development.