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## ECONOMIC COSTS AND POLICY ALTERNATIVES TO CALIFORNIA'S DYNAMEX DECISION

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### INTRODUCTION

The nature of work is changing, but the ways in which it is classified and understood are not. The consequences of this growing discord between how we work and how the law categorizes that work are profound and are highlighted by the California Supreme Court's recent ruling in *Dynamex v. Superior Court of Los Angeles*.<sup>1</sup>

In addition to altering the terms upon which worker classification occurs in the nation's largest and most economically important state, in its decision, the Court expressed a normative preference for full-time employment arrangements:

Although in some circumstances classification as an independent contractor may be advantageous to workers as well as to businesses, the risk that workers who should be treated as employees may be improperly misclassified as independent contractors is signif-

1. *Dynamex v. Superior Court of Los Angeles*, S222732 (April 30, 2018). <http://s3.amazonaws.com/cdn.orrick.com/files/S222732.PDF>.

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icant in light of the potentially substantial economic incentives that a business may have in mischaracterizing some workers as independent contractors.<sup>2</sup>

Moreover, it does so in spite of clear evidence that the vast majority of workers in alternative arrangements (part-time or contract) value the flexibility afforded to them precisely by those arrangements.

Accordingly, the present study examines the statistical complexion of the U.S. workforce in light of new data from the Bureau of Labor Statistics, provides a legal overview of what new burdens the *Dynamex* decision requires, and then conducts an abbreviated economic analysis of the potential annual costs associated with the California Supreme Court's newly embraced standard.

In so doing, it concludes that the *Dynamex* decision is a judicial policy response to a manufactured crisis that does not, as an empirical matter, exist. And further, the decision will—conservatively—cost California businesses anywhere from \$1,300,944,074 to \$6,504,720,371 annually.

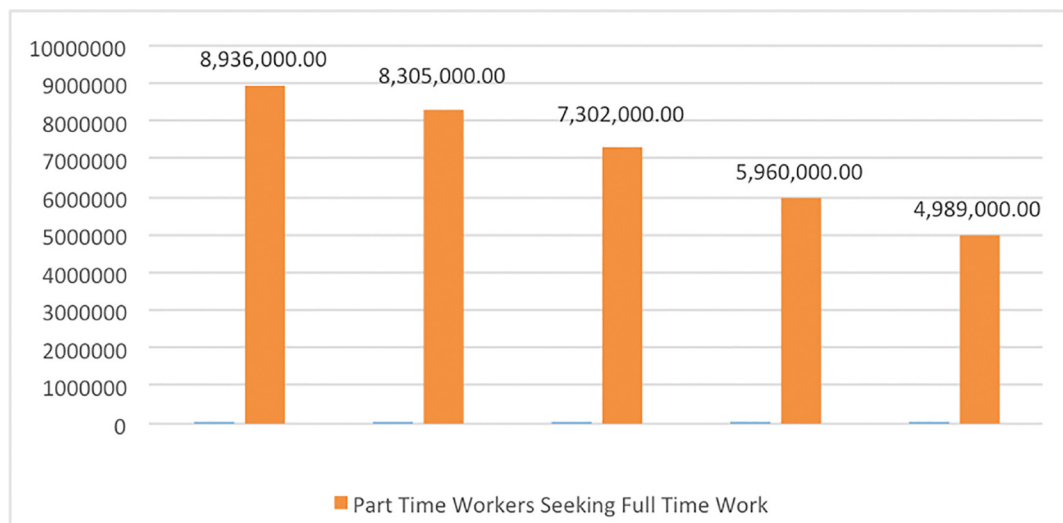
### POLICY BACKGROUND

The arrival of the “gig economy,” in which temporary assignments are readily available to workers with relatively low barriers to entry, has brought new economic opportunity to workers across the United States. These arrangements, however, have also drawn criticism that largely has focused on how “gig” positions do not offer the same protections as full-time ones.

Yet, to frame alternative work arrangements as deficient for what they lack in terms of security misunderstands the role that such work plays in the nation's economy. To do so also relies on an increasingly stale binary conception of labor that

2. *Ibid.*, p. 2.

**FIGURE I: WORKERS IN ALTERNATIVE ARRANGEMENTS**



SOURCE: Bureau of Labor Statistics, “Employment Level: Part-Time for Economic Reasons,” U.S. Dept. of Labor, June 10, 2018.

functionally restricts the availability of valuable non-cash benefits by associating their presence with control.

First, as to the value of alternative arrangements, it is vital to note that independent contractors are not bound by the demands of their employers in the same way that employees are. They are free to dictate their own schedules and to seek arrangements for work with multiple firms and thus have a terrific amount of flexibility.

On that basis, alternative and contingent positions have proven to be remarkably popular among those who fill them.<sup>3</sup> One survey found that 88 percent of those in freelance positions would not trade their current arrangements for traditional full-time work.<sup>4</sup> Another recent survey by the federal government confirmed this finding and concluded that “fewer than 1 in 10 independent contractors would prefer a traditional work arrangement.”<sup>5</sup>

Second, as to the limits imposed by the current binary conception of worker classification, there is no doubt that compensation for alternative work arrangements—particularly contingent work arrangements—could be improved. But a persistent challenge to improvement stems from the relative unavailability of competitive non-cash benefits like, for instance,

large group health plans, which are oftentimes better deals than individual market ones. Presently, the system of worker classification bars individuals from accessing better benefit options at great cost and with no obvious gain for workers.

In spite of these legally enforced shortcomings, alternative work arrangements are both popular with workers and vital to businesses. Yet, such arrangements are often vilified simply by virtue of the fact that they are not full-time positions. That vilification has been fueled by the proliferation of technology that has allowed easy access to alternative work, which has, in turn, created the impression that “gig work” is on a rapid and inexorable rise. Flatly, such claims are untrue.

In fact, in a recently released study from the Bureau of Labor Statistics, the common narrative that easy access to gig work is leading to an explosion in the number of workers in alternative arrangements was debunked. On the contrary, the study found that between 2005 and 2017, the number of workers in both alternative and contingent positions in the U.S. economy actually decreased from 7.5 percent of total employment to 6.9 percent.<sup>6</sup> There is also no evidence that people are working more “on the side.” The number of workers who work part-time and, for economic reasons, want full-time work has declined steadily. By May 2018, that number was the lowest in a decade.<sup>7</sup>

It is against this policy background that the California Supreme Court turned its attention to *Dynamex v. Superior Court of Los Angeles*.

3. Note that “alternative” and “contingent” arrangements are not the same but are not mutually exclusive. The former refers to statuses other than employment (e.g., independent contractor status), while the latter refers to the temporary nature of an arrangement.

4. “How to Live the Freelance Life: Lessons from 1,000 Independents,” Emergent Research, May 28, 2014. [https://fu-web-storage-prod.s3.amazonaws.com/content/filer\\_public/8f/d7/8fd7d4ce-f714-486e-b2d5-80e190b0ce70/fu\\_surveyinfographics\\_workandlife\\_v3.pdf](https://fu-web-storage-prod.s3.amazonaws.com/content/filer_public/8f/d7/8fd7d4ce-f714-486e-b2d5-80e190b0ce70/fu_surveyinfographics_workandlife_v3.pdf).

5. Bureau of Labor Statistics, “Contingent and Alternative Employment Arrangements Summary,” U.S. Dept. of Labor, June 7, 2018. <https://www.bls.gov/news.release/conemp.nr0.htm>.

6. Ibid.

7. Bureau of Labor Statistics, “Employment Level: Part-Time for Economic Reasons,” U.S. Dept. of Labor, June 10, 2018. <https://data.bls.gov/timeseries/LNS12032194>.

## LEGAL ANALYSIS OF THE *DYNAMEX* DECISION

Dynamex is a courier service that, for years, classified its workers as employees for wage-and-hour purposes. That is, until 2004, when the firm reclassified its drivers as independent contractors. On that basis, the drivers undertook a class action complaint against Dynamex, alleging that they were still employees on the basis of the state’s labor and unfair competition codes and various wage orders. On appeal, the Supreme Court ruled unanimously against Dynamex.

The cornerstone of the Court’s ruling is a new presumption that workers are employees and *not* independent contractors. Now, under *Dynamex*, to demonstrate otherwise, the firm classifying workers as independent contractors must establish that its workers satisfy each element of the so-called “ABC test.” Stated in the affirmative, this three-factor test defines an independent contractor as someone who:

- A. is not being directed by the hirer in the performance of their job;
- B. is doing work outside the scope of the company’s typical business and;
- C. has made the affirmative decision to go into business for themselves.

If a firm is unable to demonstrate any one of the “ABC” elements, the worker in question is deemed an employee and not an independent contractor. This development is a notable departure from the wage- and-hour classification regime it replaces, known as the “*Borello* standard.”<sup>8</sup>

For years, California applied *Borello* as the state’s common law standard. Under it, the most important factor in establishing the classification of a worker involved the “means and manner” of control asserted by a firm. Ancillary factors also played a role, but the focus of classification analysis revolved around the extent to which an independent contractor was able to direct their own behavior. In practice, the standard was flexible precisely because it took a relatively holistic approach.

The scope of the ABC test’s applicability to different types of alternative work arrangements has yet to be determined. Some fields—like, for example, motor carriers and delivery drivers—will almost certainly see massive shifts in their status simply because they are analogically similar to the *Dynamex* plaintiffs. Other alternative workers—like those providing professional services—are less likely to face reclassification. Still, employment experts agree that “given the allocation of the burden of proof, the number of individuals

who are considered employees in California for purposes of the applicable wage orders will almost certainly increase.”<sup>9</sup>

## ECONOMIC IMPACT ANALYSIS

When a worker is classified as an employee, the employer is saddled with a battery of onerous legislative and regulatory requirements. Additionally, they also face taxes on payroll, Social Security and unemployment insurance, and must make contributions to workers’ compensation insurance. All of these burdens mean that independent contractors cost only 66 cents on the dollar for every hour worked by a full-time employee.<sup>10</sup> On that basis, even a small shift in the number of independent contractors currently in California’s economy will have a massive effect on the cost of doing business in the state.

### Methodology

In light of the uncertainty associated with the manner and scope of how *Dynamex*’s “ABC test” will be interpreted and applied, the present study sets forth a range of scenarios to assess the economic cost of the decision on California’s employers. We assessed a range of reclassification scenarios for California as a whole, and then used the average cost difference between independent contractors and employees to gain a general sense of how much reclassification will cost—in total—based on the number of workers reclassified.

The most recent data from the Bureau of Labor Statistics (BLS) reports that independent contractors are 6.9 percent of the nation’s workforce.<sup>11</sup> The California Employment Development Department (EDD) offers statistics about the size of California’s workforce. Using their data from February 2018, we found that the state’s total labor force stands at 19,392,800.<sup>12</sup>

The principal shortcoming of the EDD data is that it does not break out independent contractors from other employment numbers overall. Thus, our analysis extrapolated a very conservative estimate of the proportion of California workers in alternative arrangements, at 6.9 percent, from the latest BLS

8. *Borello & Sons Inc. v. Dept. of Industrial Relations*, 48 Cal.3d 341 (1989). <https://law.justia.com/cases/california/supreme-court/3d/48/341.html>.

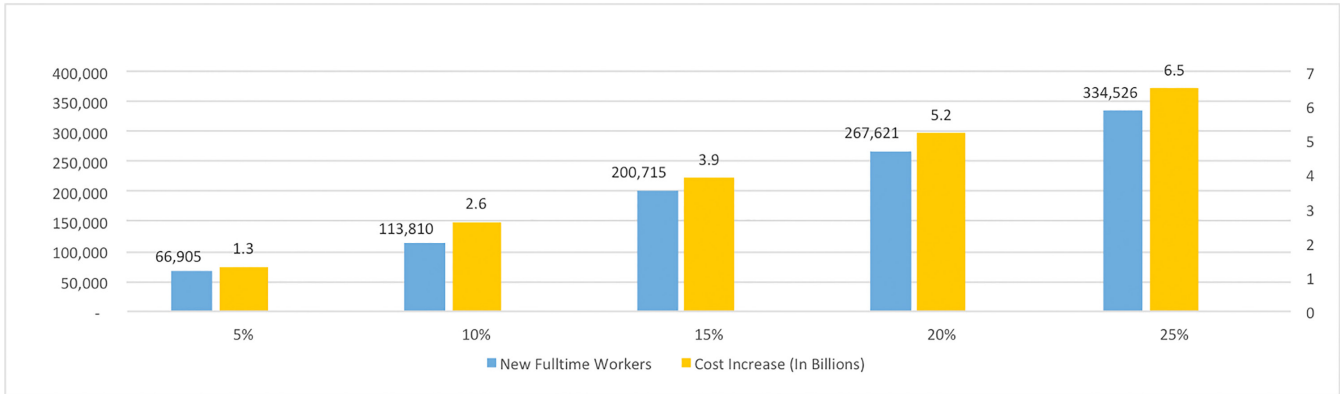
9. “Easy-Or Challenging-As ABC?,” *Orrick Employment Law and Litigation Blog*, May 9, 2018. <https://blogs.orrick.com/employment/2018/05/09/easy-or-challenging-as-abc-california-supreme-court-rewrites-independent-contractor-test-for-wage-order-claims>.

10. Institute for Research on Labor and Employment, “Exploring the Costs of Classifying Workers as Independent Contractors,” University of California-Los Angeles, December 2015. [http://irle.ucla.edu/wp-content/uploads/2016/03/IndependentContractorCost\\_20151209-1-2.pdf](http://irle.ucla.edu/wp-content/uploads/2016/03/IndependentContractorCost_20151209-1-2.pdf).

11. Bureau of Labor Statistics, “Contingent and Alternative Employment Arrangements Summary,” U.S. Dept. of Labor, June 7, 2018. <https://www.bls.gov/news.release/conemp.nr0.htm>.

12. Employment Development Department, “Monthly Labor Force Data For Counties, February 2018,” State of California, April 20, 2018. <http://www.labormarketinfo.edd.ca.gov/file/lfmonth/1802rcou.pdf>.

**FIGURE 2: DYNAMEX CALCULATIONS**



SOURCE: Chart compiled by authors using data from the California Employment Development Department, the Bureau of Labor Statistics and the UCLA Institute for Research on Labor and Employment study.

report.<sup>13</sup> It likewise estimated the median wage of the workers in alternative arrangements, which was determined to be \$37,745 or 66 percent of the statewide full-time-worker median wage.<sup>14</sup>

We then ran five different scenarios for independent contractor reclassification: assuming 5, 10, 15, 20 or 25 percent were eligible for reclassification under the “ABC test” and created a new “full-time workforce” in each of these scenarios by relying on an assumption by UCLA researchers that an independent contractor costs 66 cents for every dollar a full-time employee costs.<sup>15</sup>

Depending on what reclassification eligibility is used, there will be anywhere from **66,905 to 334,526** independent contractors reclassified as full-time workers in California. This shift will cost Golden State businesses anywhere from an additional \$1,300,944,000 to \$6,504,720,371 in payroll expenses annually.

What’s more, the distribution of these costs will not fall evenly across every sector of California’s economy, but will reach far beyond the “gig” firms upon which much of the coverage of the decision has focused. Accordingly, in the near term, the real cost of *Dynamex* may be greater than the estimates provided above. This is also because, functionally speaking, the Court’s decision makes the application of the standard retroactive. Thus, the plaintiff, and other plaintiffs, may be able to seek recompense for misclassification that pre-dates

the decision.

The effects of the cost increases triggered by *Dynamex* are at once predictable and lamentable. Some business models will be rendered unviable outright. As a result, many will be pushed out of the work upon which they rely. In other instances, where contractors are retained, employers will reduce pay for existing full-time workers to cover increased outlays for converted contractors. Overall, the *Dynamex* decision will likely lead to fewer and lower paying jobs in California.

Ironically, although the California Supreme Court is seeking to bolster worker protections through its decision, the hardest hit population will be those who are marginally attached to the labor force or have challenges such as a physical disability, a mental challenge or substance abuse problem that impacts their ability to work. Eliminating positions with enhanced flexibility will exacerbate their marginalization and likely will result in second-order costs associated with their increased reliance on public assistance.<sup>16</sup>

## ALTERNATIVES AND POLICY OPPORTUNITIES

The misclassification of wage-and-hour workers that the California Supreme Court seeks to address in *Dynamex* can be better remedied through policy innovation than blanket reclassification. In particular, the following three alternatives stand out.

### Better Portable Benefits

One of the most compelling steps that could be taken to reduce the qualitative security distinction between full-time employees and independent contractors would be to enhance and improve existing systems that disconnect health, retirement and other benefits from the workplace.

13. We did this even though there is evidence that suggests that the number of alternative workers in California is actually higher than the national average (nearly 8.5 percent of the state’s workforce). See Center for Labor Research and Education, “What do we know about Gig Economy Work in California,” University of California-Berkeley, June 2017. <http://laborcenter.berkeley.edu/pdf/2017/What-Do-We-Know-About-Gig-Work-in-California.pdf>.

14. Bureau of Labor Statistics, “State Occupational Employment and Wage Estimates California,” U.S. Dept. of Labor, May 2017. [https://www.bls.gov/oes/current/oes\\_ca.htm](https://www.bls.gov/oes/current/oes_ca.htm).

15. Institute for Research on Labor and Employment. [http://irle.ucla.edu/wp-content/uploads/2016/03/IndependentContractorCost\\_20151209-1-2.pdf](http://irle.ucla.edu/wp-content/uploads/2016/03/IndependentContractorCost_20151209-1-2.pdf).

16. Our cost projections do not account for this additional expense to the state.

While some version of most workplace benefits is available in the individual market, the terms are rarely as favorable.

For instance, health insurance prices for those in the small- and large-group markets can often be more favorable than those in the individual “Obamacare” market. Likewise, people with full-time jobs can purchase certain benefits like dental and vision insurance with pre-tax dollars, while the self-employed worker must both pay more for these benefits *and* cannot use pre-tax dollars to buy them.

The solution, then, would be to create entities that would make it easier for individuals to access the types of benefits ordinarily purchased at the workplace. Workers would benefit because it would provide them with access to the more affordably priced suite of non-cash benefits that are a hallmark of full-time status. Firms would benefit because it would give them new tools to compete for the best workers. This would expand opportunities for both.

To date, this proposal has attracted diverse supporters, including the online marketplace Etsy, philanthropist Nick Hanauer and labor leader David Rolf, and R Street Institute President Eli Lehrer. Each have outlined various mechanisms for funding and managing flexible benefits, as well as differing cases for their adoption.<sup>17</sup>

### Third-Way

An additional and complementary proposal would involve the creation of another worker status that would lie somewhere between that of a full-time worker and a contractor.<sup>18</sup> The specifics of what any U.S. “third-way” would look like vary dramatically between proposals. Some, like the one offered by Sen. Mark Warner (D-Va.), would simply codify a current standard that happens to also embrace the use of a portable benefits system.<sup>19</sup> Others are drawn from examples set elsewhere in the world, and would evaluate the extent of connectedness between a contractor and a single firm to determine the level of obligation owed by that firm to the “dependent contractor.”<sup>20</sup>

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17. See Nick Hanauer and David Rolf, “Shared Security, Shared Growth,” *Journal of Democracy* 37 (Summer 2015). <https://democracyjournal.org/magazine/37/shared-security-shared-growth>; “Economic Security for the Gig Economy,” Etsy, Fall 2016. [https://extfiles.etsy.com/advocacy/Etsy\\_EconomicSecurity\\_2016.pdf](https://extfiles.etsy.com/advocacy/Etsy_EconomicSecurity_2016.pdf); Eli Lehrer, “The Future of Work,” *National Affairs* (Summer 2016). <https://www.nationalaffairs.com/publications/detail/the-future-of-work>.

18. Such a status is an explicit part of Lehrer’s proposal and is implied in the Hanauer-Rolf proposal.

19. S. 1251 (2017), Sen. Mark Warner (D-Va.). <https://www.congress.gov/bill/115th-congress/senate-bill/1251>.

20. Heather Hettiarachchi, “Understanding Dependent Contractors,” *Small Business BC Blog*, Oct. 27, 2016. <https://smallbusinessbc.ca/blog/understanding-dependent-contractors-and-how-to-avoid-legal-action>.

Regardless of the course pursued, escaping the constraints of a 1930s binary understanding of labor relationships would almost certainly create new work opportunities.

### Safe Harbor

Greater certainty in the context of worker classification is desirable, even if it is not the good in itself that the California Supreme Court describes in *Dynamex*.<sup>21</sup> To that end, establishing a safe harbor concerning classification of independent contractors based on objective criteria would ultimately work to the benefit of both workers and employers. Furthermore, such a safe harbor might be directly linked to a firm’s participation in a flexible benefits system or its adaptation of a “third-way” worker status. In any event, if properly executed, it would allow firms to innovate without fear of inadvertently accruing the potentially ruinous liabilities associated with misclassification.

Introduced in 2017, S. 1549 by Senator John Thune (R-S.D.) would have provided just such a system for the purposes of income and taxes, though its approach could also be applied in the context of wage-and-hour determinations.<sup>22</sup> Under Thune’s proposal, which would supplement instead of replace the common law standard, a classification safe harbor would be created if three factors could be established:

1. That the independent party is not tied to a single job provider;
2. That the location at which work takes place is not exclusive;
3. That a written agreement exists expressing the intent of the parties that the relationship is based on an independent contract.

What’s more, if a firm were found not to have qualified for safe harbor status, it would only face reclassification on a prospective basis.

To be sure, Thune’s proposal is not the only way in which a safe harbor might be created, and different priorities will lead to different boundaries and standards. But, the flexibility afforded by this sort of arrangement would likely result in the proliferation of new work arrangements that, at present, represent too great a risk of misclassification liability.

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21. *Dynamex*, p. 67. <http://s3.amazonaws.com/cdn.orricks.com/files/S222732.PDF>.

22. S. 1549 (2017), Sen. Thune (R-S.D.). [https://www.thune.senate.gov/public/\\_cache/files/c9e8dda1-dbb6-4a78-8f2a-88f39c14be1e/D975731B1FE56963DD1D09F2CB-8D78CC.ott17387.pdf](https://www.thune.senate.gov/public/_cache/files/c9e8dda1-dbb6-4a78-8f2a-88f39c14be1e/D975731B1FE56963DD1D09F2CB-8D78CC.ott17387.pdf).

## CONCLUSION

Bad facts make bad law, and the *Dynamex* decision offers a solution in search of a problem. While it is unclear exactly how much it will cost California businesses that rely upon workers in alternative arrangements, expenses will increase and opportunities for work will decrease. In light of this, the political branches of the state's government should seek to provide rapid relief to workers and firms alike by pursuing innovative new policies that would afford, at once, new protections and new opportunities.

### ABOUT THE AUTHORS

**Ian Adams** is associate vice president of state affairs with the R Street Institute, where he is responsible for coordinating R Street's outreach and engagement at the state and local level. He is also involved in the institute's insurance research, matters related to next-generation transportation and is a frequent commentator on the disruptive impact burgeoning technologies have on law and regulation.

Ian is also a public policy attorney at the international law firm of Orrick, Herrington & Sutcliffe LLP, where he advises clients on matters at the intersection of law, business and public policy, with a focus on highly-automated vehicle technologies and insurance.

Earlier in his career, Ian was a Jesse M. Unruh Assembly Fellow with the office of California state Assemblyman Curt Hagman (R-Chino Hills), while Hagman served as vice chairman of the California Assembly Insurance Committee. He also served as a legal extern with the office of Oregon state Rep. Bruce Hanna (R-Roseburg), who was then co-speaker of the Oregon House of Representatives. Ian also worked as a law clerk for California's largest insurance trade association.

Ian is a graduate of Seattle University, with bachelor's degrees in history and philosophy. He received his law degree from the University of Oregon and is a member of the California and Illinois bars.

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Brian joined R Street in March 2018. Prior to that, he worked as a consultant for Gray Media Group, a Boston-based public affairs firm that represents corporate and political clients. Additionally, as a professional political strategist, he has provided strategic planning and media consulting for a wide array of municipal, state legislative and ballot initiative campaigns.

In 2014, Brian served as the communications director for Vincent "Buddy" Cianci's campaign for Providence mayor.

He graduated with honors from Wheaton College in Massachusetts, where he wrote an honors thesis on the enduring political legacy of the Reagan Administration.