



Insight

# The Economic Cost of Worker Reclassification

ISABEL SOTO | SEPTEMBER 27, 2019

## Executive Summary

- California's Governor Gavin Newsom recently signed into law Assembly Bill 5 (AB5), which severely restricts how many workers can be classified as contract workers instead of employees, and some policymakers are interested in applying this law nationwide.
- AB5's method for classifying workers, the ABC test, is much less nuanced than the method it replaces and, most notably, presumes that workers are employees unless they fit several criteria.
- If implemented nationwide, the ABC test would implicate over 13 million workers who produce over \$1.6 trillion in economic output, about 8.5 percent of gross domestic product.

## Introduction

California recently enacted the highly anticipated Assembly Bill 5 (AB5). The bill restricts when a worker may be classified as an employee rather than a contract worker, with workers assumed to be employees unless they fit a specific three-pronged test called the ABC test.

The argument in favor of AB5 and the ABC test is that employers are intentionally classifying swaths of their labor force as contract workers instead of employees in order to cut costs. When they are no longer classified as employees, "Workers lose basic protections like the minimum wage, paid sick days and health insurance benefits," as California Governor Gavin Newsom [argued](#) in an op-ed. Restricting the conditions under which workers may be classified as contract workers provides greater wage and work security, the argument goes.

While currently limited to California, the ABC test has caught the attention of national legislators such as Senator Patty Murray, who this year incorporated the ABC test into the Protecting the Right to Organize Act (PRO Act). Several presidential candidates, including Senators Bernie Sanders, Elizabeth Warren, Cory Booker, and Kamala Harris, have co-sponsored the bill.

The challenge with applying the ABC test to the entire economy, however, is that it upends the business model of a number of companies, including Uber, Etsy, and countless other gig economy companies. Given the importance of the bill to both California and, potentially, to the nation as a whole, it's important to understand the effect this rule would have on the economy. Using data from the [2017 Contingent Worker Survey \(CWS\)](#), this piece estimates the proportion of the economy that this kind of proposal, if implemented nationally, could implicate. Such an estimate gives a sense of scale for the disruption that this rule could bring.

## The Bill

AB5 expands the applicability of the California Supreme Court's 2018 ruling in *Dynamex v. Superior Court of Los Angeles* to the entire state economy. The plaintiff in the *Dynamex* case, delivery driver Charles Lee, filed

a suit alleging a violation of California’s Industrial Welfare Commission Wage Order Number 9. The various California wage orders—there are 17—essentially regulate wages, hours, and working conditions for specific industries, and Wage Order Number 9 applies to the transportation industry.[1] *Dynamex* narrowed the definition of what makes an independent contractor in all 17 wage orders by replacing the former “Borello standard” with the ABC test.

Under Borello, in order to determine whether a worker is an employee or contract worker, a multi-factor test explores questions such as method of payment, investment in equipment, length of time that duties are performed, and, most important, whether or not the employer has the right to control the worker or how the work is to be done.[2] The Borello standard allows for a nuanced approach to worker classification, with the multi-factor method leading to a variety of combinations that address a range of situations.

The ABC test could encourage a more mechanical and blunt approach. It assumes workers are employees unless the following three elements hold true:

1. The worker is free from the control and direction of the hirer in connection with the performance of the work, both under the contract and for the performance of such work;
2. The worker performs work that is outside the usual course of the hiring entity’s business; and
3. 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.

After *Dynamex*, the ABC test applied only to the 17 wage orders, not more broadly to the entire state economy. AB5 expands the test beyond the wage orders to the entire state labor code as well as unemployment claims.

### Affected Industries

The buzz surrounding this new change in California has focused primarily on tech companies, specifically Lyft and Uber, with Uber declaring that it would not be reclassifying its workers as employees. They, along with DoorDash and Lyft, have pledged \$90 million to fight this new legislation.[3] But the impact is far broader than these companies, and as a result, several industry groups opposed the California bill, notably including the California Trucking Association and the California Hospital Association.[4]

While the tech companies are grabbing the headlines, they represent only a small portion of those companies that would be affected by reclassification. According to the Bureau of Labor Statistics (BLS), jobs enabled by online platforms made up only 1 percent of all jobs in 2017, but 10.1 percent of all workers are in alternative work arrangements.[5] Of those alternative workers, nearly 70 percent are independent contractors.[6] Industries that stand to witness the most significant impact from a nationwide reclassification of workers include construction (23 percent), professional and business services (18 percent), and financial activities (11 percent), as the table below indicates.

Industry	Total alternative workers	Total workers	Percent of workers in alternative arrangements
Agriculture and related industries	264,126	2,469,774	11
Mining, quarrying, and oil and gas extraction	39,382	728,647	5
Construction	2,391,324	10,386,798	23

Manufacturing	765,563	16,067,246	5
Wholesale trade	236,395	3,407,014	7
Retail trade	850,308	16,151,991	5
Transportation and utilities	867,472	7,760,122	11
Information	318,589	2,937,796	11
Financial activities	1,163,582	10,675,439	11
Professional and business services	3,197,736	17,948,007	18
Education and health services	2,132,731	35,217,451	6
Leisure and hospitality	986,719	14,220,610	7
Other services	1,190,228	7,531,466	16
Public administration	304,197	7,196,847	4

*\*The BLS estimates that 10.1 percent of all employed are in alternative employment arrangements. Other estimates including Gallup data show that 36 percent of U.S. workers participate in the gig economy.*

## The Economic Cost of Worker Reclassification

The impact of the ABC test nationally can be estimated by examining the percentage of each industry contributed by non-traditional workers. This calculation takes three steps: First, determine the percentage of national gross domestic product (GDP) that each industry produces; next, divide the total output of the industry by the number of workers to find the average output per worker; and finally, multiply the average output per worker by the number of alternative workers in the industry.

Using the [broadest measure of gig economy workers](#) – total number of alternative workers (independent contractors, temp agency workers, on-call workers, and contract company workers) – the estimated scale of potential economic disruption totals over \$1.6 trillion, or 8.5 percent of GDP. The table below breaks out the cost by industry. In the agriculture industry, for example, we can see that the industry adds \$169.2 billion to national GDP, and with 2.4 million total workers, the value added per worker to the economy is just over \$68,500.

Industry	Value add to GDP	Gig and traditional workers	Value add per worker	Total gig workers	Total share of GDP
Agriculture and related industries	\$169.2 billion	2,469,774	\$68,518	264,126	\$18.1 billion
Mining, quarrying, and oil and gas extraction	\$268.6 billion	728,647	\$368,653	39,382	\$14.5 billion
Construction	\$781.4 billion	10,386,798	\$75,231	2,391,324	\$179.9 billion
Manufacturing	\$2.18 trillion	16,067,246	\$135,657	765,563	\$103.9 billion
Wholesale trade	\$1.17 trillion	3,407,014	\$344,619	236,395	\$81.5 billion
Retail trade	\$1.09 trillion	16,151,991	\$67,305	850,308	\$57.2 billion

Transportation and utilities	\$307.5 billion	7,760,122	\$39,625	867,472	\$34.4 billion
Information	\$1.05 trillion	2,937,796	\$357,672	318,589	\$113.9 billion
Financial activities	\$4.06 trillion	10,675,439	\$380,043	1,163,582	\$442.2 billion
Professional and business services	\$2.43 trillion	17,948,007	\$135,188	3,197,736	\$432.3 billion
Education and health services	\$1.7 trillion	35,217,451	\$48,279	2,132,731	\$102.9 billion
Other services	\$416.1 billion	7,531,466	\$55,246	1,190,228	\$65.7 billion
<b>TOTAL</b>				<b>13,417,436</b>	<b>\$1.65 trillion</b>

*\*While the CWS included industries leisure, and public administration there were not equivalent measures for value added to GDP.*

These estimates show the breadth of the national economy implicated by the ABC rule. They do not represent either its direct impact or its cost – or, for instance, the amount of GDP that would be foregone by implementing the ABC rule. Nevertheless, these figures indicate that the impact would be substantial in both its aggregate as well as the wide distribution of workers across the economy. Few industries would be untouched by the rule.

### **The Impact of a Nationwide Rollout**

A [UCLA](#) study found that “contractors cost only 66 cents on the dollar for every hour worked by a full-time employee.” This finding is not surprising, as employers typically give benefit packages to employees that they do not give to contract workers – the very reason why California enacted AB5. Many workers appear to prefer contract work, however, because of the greater flexibility it affords. Fewer than one in 10 independent contractors reported that they prefer a traditional job over their alternative arrangement.<sup>[7]</sup> The contract model allows for individuals to set their own schedules, invest in themselves, and take ownership of their work in a way that is often impossible in a traditional working arrangement.

AB5 and the ABC rule threaten the flexibility that comes from working outside of a traditional arrangement. Not only would the number of these flexible jobs decrease, but the employer’s cost per worker would increase. Therefore the number of jobs would be expected to decline. Reclassifying gig economy workers as employees will certainly help some workers, but the resulting economic disruption promises to hurt many others.

[1] Industrial Welfare Commission <https://www.dir.ca.gov/iwc/wageorderindustries.htm>

[2] California Department of Industrial Relations [https://www.dir.ca.gov/dlse/FAQ\\_IndependentContractor.htm](https://www.dir.ca.gov/dlse/FAQ_IndependentContractor.htm)

[3] Kate Conger, The New York Times <https://www.nytimes.com/2019/08/29/technology/uber-lyft-ballot-initiative.html>

[4] Judy Lin, Cal Matters <https://calmatters.org/economy/2019/09/whos-in-whos-out-of-ab-5/>

[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.html>

[6] Ibid.

[7] Ibid.