



RETHINKING OVERTIME

HOW INCREASING OVERTIME EXEMPTION THRESHOLDS WILL AFFECT THE
RETAIL AND RESTAURANT INDUSTRIES

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OXFORD
ECONOMICS

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EXECUTIVE SUMMARY

An increase in the exemption threshold to \$808 per week would affect 1.7 million workers and would cost businesses \$5.2 billion a year, assuming, unrealistically, that they make no changes to offset their increased costs.

Today, some 3.3 million salaried workers across the retail and restaurant industries can be exempted from the right to receive overtime pay because they earn at least \$455 per week—the so-called overtime threshold.

The US Department of Labor is currently preparing a proposal that would change the rules that govern overtime payment. It will raise the threshold salaried employees must earn to be exempted from overtime pay, assuming they also meet certain duty requirements.¹ While the precise details of the new proposed regulations are not yet known, they are certain to have a significant impact on the food service and retail trades.

To better understand the effects of these changes, Oxford Economics conducted an analysis using three possible modifications of the overtime regulation. Our analysis found that:

- Raising the wage threshold from \$455 to \$984 per week, or more than \$51,000 per year, would mandate overtime pay for an additional 2.2 million workers in the retail and restaurant industries. Assuming, unrealistically, that employers do nothing to alter workers' hours, benefits, or hourly rate of pay to compensate for their increased costs, this would cost restaurant and retail employers \$9.5 billion per year.
- An increase in the exemption threshold to \$808 per week would affect 1.7 million workers and would cost businesses \$5.2 billion a year assuming, unrealistically, that they make no changes to offset their increased costs.

¹ i.e., the Executive, Administrative, and Professional exemption.

- Even an increase to a \$610 threshold, or \$31,720 in annual pay, would cost companies \$1.1 billion each year and affect 800,000 workers, or nearly a quarter of these employees, under the same assumptions.

On paper, the types of workers most affected by these regulations would be first-line salaried supervisors, such as assistant and department managers, store managers, office clerks, and administrative assistants. **In reality, however, it is unlikely that many of these workers would see their take-home pay improve simply because they gained the potential to earn overtime pay.** Instead, in the wake of changing regulations, employers would likely use a variety of strategies to reduce the additional labor costs in order to remain competitive.

Far more likely, employers who believe they cannot pass along higher labor costs to their customers will instead make significant adjustments in the structure of their workplaces to compensate for the billions of dollars of added wages the new regulations would impose. Indeed, an analysis of relevant academic research and interviews with retail and restaurant industry experts indicate that employers would adjust compensation schemes to ensure they do not absorb additional labor costs. To do this they could:

- Lower hourly rates of pay to leave total pay largely unchanged;
- Cut bonuses and benefits in order to increase base salaries above the new threshold;
- Reduce some workers' hours to fewer than 40 per week in order to avoid paying overtime, cutting compensation proportionally.

In this last case, employers would likely counteract the lost man-hours by hiring new, lower-wage and largely part-time hourly workers. In some areas, however, especially in jobs that carry out back-office activities, employers would likely turn to automation to increase efficiency. Thus, while the total number of workers employed by these industries would likely grow, the quality of these jobs would diminish: they would be low-paying and often part-time, and many workers currently in lower-level professional and managerial jobs would find their status jeopardized. Moreover, supervisors receiving more overtime and less incentivized bonus pay may prove less effective than more senior managers still motivated by large-incentive bonus pools.

The net results of these changes would be an accelerated “hollowing out” of low-level professional and administrative functions, as firms centralize their management structures to rely on a smaller number of genuine managers and professionals. Workplaces would become more hierarchical, and inequality

would increase. Lower-level employees, currently covered by overtime law, would find it harder to rise into the professional ranks as the number of mid-level salaried positions contract. Companies would encounter difficulties developing talent and promoting internally because of a narrower pipeline of talent.

In addition, while raising the threshold would appear to do little to actually boost worker compensation, new threshold rules would impose new costs on businesses, many of whom would have to update their payroll systems to convert salaried employees to an hourly rate, track time, field employee questions, and end incentive payments or bonus pools for many workers now eligible for such payments. The magnitude of these costs is not trivial: Oxford Economics estimates they would be as much as \$874 million if the threshold were raised to \$984 per week, \$648 million under the \$808 scenario, and about \$297 million under the \$610 scenario.

This report examines the implication of raising the threshold at each of these three levels. Examining the \$808 per week threshold, for example, we estimate that approximately 97,000 workers would likely see their wages increase, but their benefits cut to leave their total compensation unchanged. We also estimate that 351,000 salaried workers currently exempt from overtime would be made into hourly workers with their hourly pay rates reduced so they would earn the same amount they did when they were exempt from overtime. Finally, an additional roughly 175,000 would be converted to hourly status and see their work hours, and pay, reduced, so as to avoid paying overtime. As employers reduce work hours for some formerly salaried employees, we estimate that an additional 76,000 part-time workers will be hired to make up for some of the productivity lost due to reduced hours. On balance, the net result of all of these actions tend to offset each other—some employees gain additional overtime pay but many more will see hours or discretionary bonus awards reduced. This pattern repeats at all three levels—some employees may gain from this change, but an offsetting number will see compensation reduced.

INTRODUCTION:

HISTORICAL BACKGROUND

In 1938, during the depths of the Great Depression, Congress enacted the Fair Labor Standards Act (FLSA) as an incentive to create jobs and to put a floor on wages at a time of massive unemployment. It established three basic provisions in US labor law: a prohibition on child labor, a minimum wage, and a requirement that workers be paid time and a half for hours worked beyond 40 in a single week.² While the law can only be changed through Congressional action,³ the regulations related to the act, which are meant to enforce Congress's instructions and determine which workers should be exempt from overtime rules, may be revised periodically by the Department of Labor. The two most recent revisions occurred in 1975 and 2004.⁴

Following a presidential directive in March 2014,⁵ a proposal to revise the existing FLSA overtime regulations is expected early 2015. While details of the proposal are still uncertain, it is expected to significantly increase the pool of workers required to receive overtime pay, perhaps in unprecedented ways.

This report focuses on the potential impacts of a change in the overtime threshold on the retail and restaurant industries and estimates the number of workers who would be affected, the potential cost, and the likely effects on these industries.

² See <http://www.dol.gov/dol/aboutdol/history/flsa1938.htm>.

³ Which happened in 1961, 1966, and 1974; see William G. Whittaker, "The Fair Labor Standards Act: A Historical Sketch of the Overtime Pay Requirements of Section 13(a)(1)." Congressional Research Services report no. 5-9-2005.

⁴ These revisions increased the salary thresholds for overtime exemption. The 2004 revision also eliminated the alternative "short" duties test, and set the same threshold for executive, administrative, and professional workers. See Whittaker (2005).

⁵ "Presidential Memorandum of March 13, 2014; Updating and Modernizing Overtime Regulations." Notice in the April 3, 2014 *Federal Register* 79(64): 18737.

METHODOLOGY:

HOW WE CONDUCTED OUR RESEARCH

Oxford Economics was asked to calculate the real-world impacts of increasing the exemption threshold on the retail and restaurant industries. To complete this analysis, we undertook the following activities:

- **REVIEWED** the history of the FLSA and the proposals for amending the current rules.
- **DETERMINED** the number of workers affected in the retail and restaurant industry sectors, using government survey data to classify their occupational makeup.
- **CALCULATED** the cost of raising the threshold under three scenarios, assuming employers made no adjustment in hourly rates of pay or hours worked.
- **ANALYZED** the economic literature on the effects of overtime requirements.
- **CONDUCTED** interviews with retail and restaurant industry experts.
- **ASSESSED** the likely reaction of retail and restaurant employers, applying economic theory to information gathered through our interviews.

A full explanation of our methodology can be found in Appendix A.

UNDERSTANDING CURRENT OVERTIME RULES

Since the FLSA first became law, not all workers have been subject to mandatory overtime pay requirements. In fact, retail workers, a focus of this report along with restaurant workers, were not subject to the overtime provisions until 1963.⁶ Today, the vast majority of US workers are covered by the FLSA,⁷ but a significant fraction of the workforce remains exempt from overtime provisions.

Under the 2004 FLSA rules, there are seven common exemptions to overtime requirements.⁸ Of these, by far the most significant is the Executive,

⁶ Whittaker (2005).

⁷ But not those working for small companies not engaged in interstate commerce.

⁸ <http://www.dol.gov/elaws/esa/flsa/screen75.asp>. Three exemptions that directly affect retail

Administrative and Professional (EAP) exemption. To be exempt from overtime rules as an EAP employee, a worker must pass three tests:

- The **salary basis** test: The employee must be paid a weekly (or monthly) salary. The employee's base pay may not be reduced for working fewer than the usual number of hours in a day.
- The **salary level** test: The salary must be at least \$455 a week.
- The **duties test**: The employee must pass certain tests to demonstrate that his or her work is genuinely executive, administrative, or professional in nature.

The proposed changes to overtime rules could adjust both the salary level and duties tests that affect eligibility. For example, a stronger duties test might require a larger portion of an employee's time be spent on EAP activities.

The proposed changes to overtime rules could adjust both the salary level and duties tests that affect eligibility. For example, because many EAP workers spend some of their time on non-EAP activities (for instance, when a manager at a quick-service restaurant steps in behind the counter for short periods when lines get long), a stronger duties test might require a larger portion of an employee's time be spent on EAP activities.

Because the proposed changes to the duties tests have yet to be determined, this report only considers and calculates changes to the salary level test.

ESTIMATING POTENTIAL CHANGES BASED ON HISTORIC FLSA REVISIONS

Prior to 2004, a worker could qualify for an EAP exemption either under the combination of the standard duties test and salary level test (from 1975 on, a weekly wage of \$155 for executive and administrative employees or \$170 for professionals); or under the combination of a shorter, easier-to-demonstrate duties test along with a higher salary threshold test (\$250 weekly wage). The 2004 revision modernized this two-tiered structure and applied the same duties test to all workers.⁹ These two tiers serve as the basis for our analysis of possible rule changes. We have chosen to analyze three new thresholds:¹⁰

are those for outside sales employees, for highly commissioned sales employees, and for salesmen and mechanics at auto dealerships. Coverage under exemptions other than EAP is not estimated in this report.

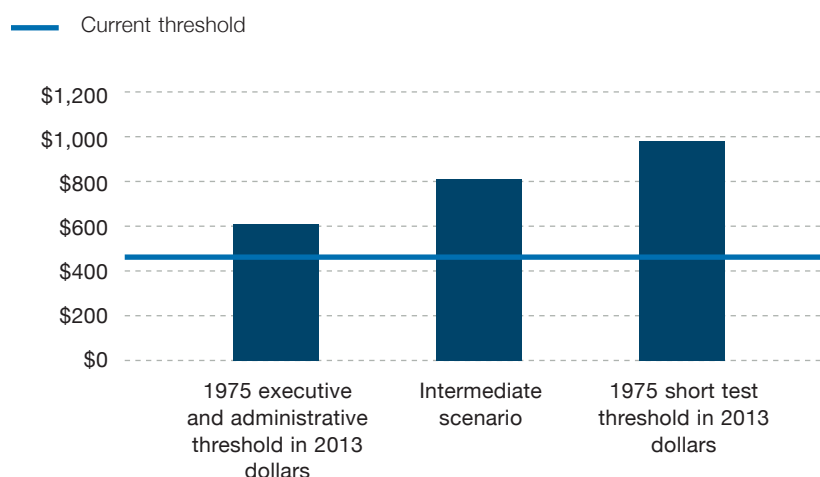
9 The 2004 revision also created a new high-paid exemption with no associated duties test at a salary of \$100,000 a year, or \$1,923 a week. The 1975 short test threshold level had been the equivalent \$798 per week in 2004 dollars, whereas the standard 1975 threshold for executive and administrative workers was \$495 in 2004 dollars, close to the \$455 single salary threshold set in 2004.

10 Congress and the Department of Labor did not intend to adjust salary thresholds based on inflation. To enable scenario comparisons for the purposes of this study, though, we used minimum salary thresholds from 1975 and adjusted the values to constant 2013 dollars. The

- \$984 a week (or \$51,168 per year),
- \$808 a week (or \$42,016 per year), and
- \$610 a week (or \$31,720 per year).

These values are displayed graphically in Figure 1. The bar represents the current weekly salary required for exempt employment. The first bar (\$610) indicates the weekly salary requirement for individuals classified as executive and administrative professionals back in 1975—shown in 2013 dollars. The second bar (\$984) indicates the weekly salary requirement for the short duties test back in 1975—shown in 2013 dollars. The last bar (\$808) indicates an intermediate value between the first two bars.

FIGURE 1: Scenario thresholds expressed in constant 2013 dollars



first scenario threshold, \$610 a week, represents the inflation-adjusted equivalent of the 1975 standard threshold for administrative and executive workers. The second, \$808 a week, is an intermediate value. The third scenario threshold, \$984 a week, represents the inflation-adjusted equivalent of the 1975 short duties test threshold. Inflation calculations use CPI-U-RS, from <https://www.census.gov/hhes/www/income/data/incpovhlth/2012/CPI-U-RS-Index-2012.pdf>; prior to 1947, they use regular CPI-U. All figures in 2013 dollars unless otherwise stated.

CHANGING OVERTIME RULES:

THE EFFECT ON EMPLOYEES

Remarkably, there is no current, official count of the number of workers covered by, or exempted from, the overtime provisions of the FLSA.

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The assessments presented in this report differ from those cited above because they focus solely on the retail and restaurant industry and use a different government survey¹⁵ to estimate the number of workers covered. Our methodology allows for a more specific occupational and sector breakdown of the number of workers affected, as well as a state-by-state breakdown.

11 <http://www.gpo.gov/fdsys/pkg/USCODE-2009-title29/html/USCODE-2009-title29-chap8.htm>.

12 Titled “Minimum Wage and Overtime Hours Under the Fair Labor Standards Act.”

13 “Defining and Delimiting the Exemptions for Executive, Administrative, Professional, Outside Sales and Computer Employees.” Friday, April 23, 2004 *Federal Register* 69(79): 22122–22274.

14 Heidi Shierholz, “Increasing the Overtime Salary Threshold is Family-Friendly Policy.” Economic Policy Institute Issue Brief #382 (August 20, 2014).

15 The Occupational Employment Statistics (OES) instead of the Current Population Survey (CPS); see Appendix A for more details. The primary advantage of the OES over the CPS is its superior occupational coding. Previous researchers have confronted the poor CPS coding. Shierholz (2014), for example, explains that for her CPS-based estimates, “observations are weighted by the share in each individual’s occupation that is exempt from the overtime protections of the Fair Labor Standards Act based on the duties of the occupation, according to U.S. Department of Labor codes,” but does not provide these weights or explain where they came from.

WHO'S EXEMPT?

IDENTIFYING AFFECTED WORKERS

To estimate the number of workers covered under current overtime law and thus those who would be covered if the threshold is changed, we first identified which occupations would likely pass the duties test.¹⁶ Then within each occupation, we determined how many workers would meet the salary threshold exemption. The list of occupations selected was based on data from O*NET,¹⁷ and was hand-checked; the full list is available in Appendix B.

We defined a worker as being affected by a threshold increase if the worker is currently exempt but being paid a salary below one of the new thresholds. Thus, these totals include workers who do not regularly work more than 40 hours a week and those whose salary is only slightly below the new threshold.

It's important to note, though, that workers currently working under 40 hours may be negatively impacted by these changes as well, as the rules will require them to begin formally tracking their time. While firms may continue to pay a fixed salary to nonexempt workers who typically work less than 40 hours a week—paying them more in weeks when they end up working over 40 hours in order to comply with overtime rules—in practice, firms are understandably reluctant to do this, and many labor lawyers discourage the practice.¹⁸

Our estimates show that if the current salary threshold were increased to \$984 a week, this new threshold would affect an estimated 2,242,000 retail and restaurant workers, or 67.4% of those now exempt. At \$808, the increased threshold would affect 1,689,000 of these workers, or 50.8% of those now exempt. At \$610 a week, the change would affect 796,000 workers, or 24.0% of those now exempt.

16 Of course, it is absolutely not the case that a particular title, or even occupational classification, implies that any given worker would pass the duties test. However, as the OES's primary purpose is the classification of a worker's occupation, we believe that relying on these classifications improves estimates of overtime coverage relative to more subjective CPS-based methods. Moreover, the requirements to be labeled a manager or supervisor in the OES suggest that the counts of exempt workers presented here are, if anything, conservative.

17 <http://www.onetonline.org/>.

18 See, e.g., <http://www.payrollexperts.net/why-i-dont-like-non-exempt-salaried-arrangements/>.

Although these new regulations would likely impose little net transfer of resources (wages/salary, bonuses and benefits) from companies to workers once companies adjust their labor structures to comply with revised standards, the imposition of these rules will impose transition and structural costs. The greatest cost is likely to result from the disruption all businesses face as they rearrange their employment pools and work schedules to control costs. It is likely that hundreds of thousands of workers currently paid a salary will become hourly workers, have their bonus compensation reduced, or some combination of the two. This will place an enormous strain on HR managers and small-business owners expected to communicate these changes to affected employees. In addition, some amount of new part-time positions would be created and filled and time-management computer systems modified, to track time for all of these newly converted (to hourly) employees.

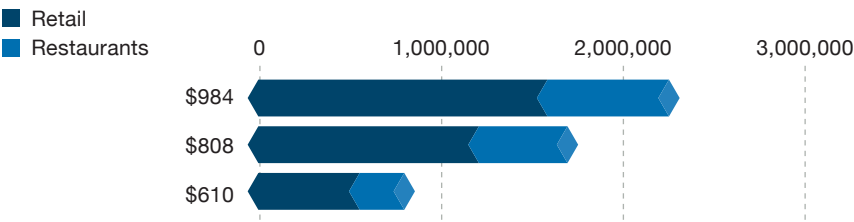
The majority of workers who would be affected by changing overtime thresholds are entry-level professionals who manage stores, chain restaurants, and back-office operations.

OCCUPATIONAL BREAKDOWN

The top 15 occupations, representing 88% of the exempt workforce in retail and restaurants, are shown in Figure 2. By far the largest groups of occupations are first-line supervisors, clerks¹⁹ and administrative assistants, and managers (see the box below for context). Other affected occupations include chefs and accountants.

The Bureau of Labor Statistics estimates that in 2013, approximately 25,432,000 workers were employed in the retail and restaurant industries.²¹ Of these, Oxford Economics estimates that 3,324,000 (13.1%) are currently exempt from overtime rules under the EAP exemption.

FIGURE 2: Retail and restaurant workers affected



19 The term “clerk” is widely used in the SOC system and roughly corresponds to job titles with terms like associate, assistant, specialist, coordinator; or function-specific titles like bookkeeper or shipper. See Appendix D.
20 See http://www.bls.gov/soc/soc_2010_user_guide.pdf p xii-xiii.
21 OES figures. The restaurant industry is identified as NAICS 722.

OCCUPATIONAL CATEGORIES:

HOW THE DOL CLASSIFIES WORKERS

The Department of Labor classifies workers according to Standard Occupational Codes, which do not always correspond to workers' formal job titles. While the DOL offers instructions on how workers should be classified, the occupational classifications of individual workers used in this report are ultimately made by the companies themselves.

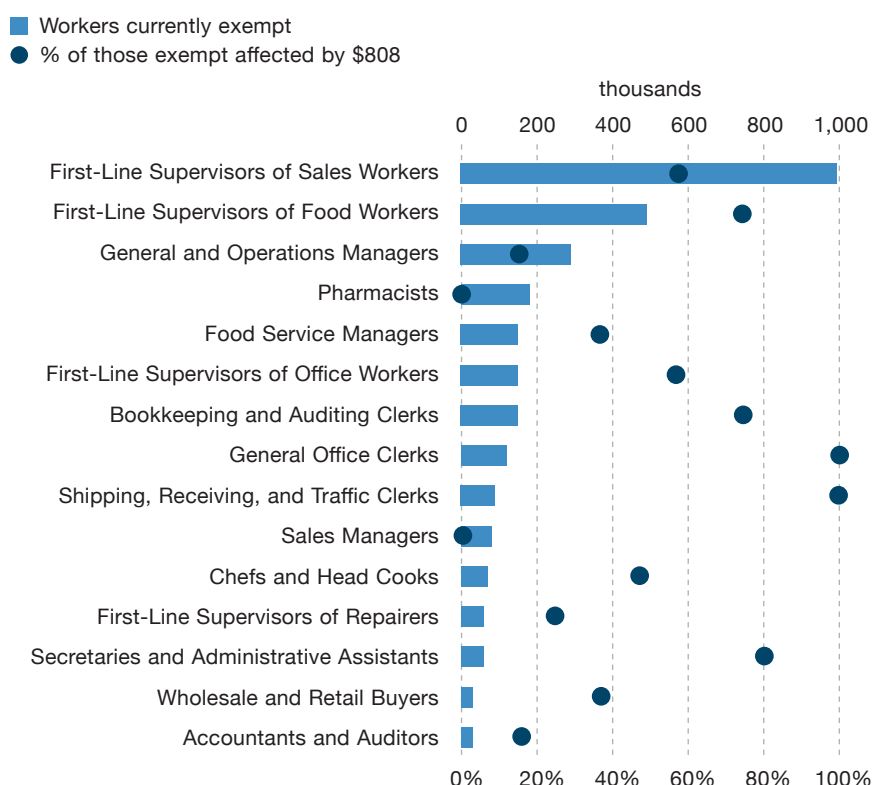
DOL offers some guidelines about how workers should be classified.²⁰ "Occupations are classified based on work performed and, in some cases, on the skills, education, and/or training needed to perform the work at a competent level. Workers primarily engaged in planning and directing are classified in management occupations. Supervisors usually have work experience and perform activities similar to those of the workers they supervise." Specifically, workers "who spend 80 percent or more of their time performing supervisory activities are coded in the appropriate first-line supervisor category... Persons with supervisory duties who spend less than 80 percent of their time supervising are coded with the workers they supervise."

A full list of common lay job titles for the 15 occupations discussed here is given in Appendix D.

Figure 3 on the next page shows the number of currently exempt employees by occupation and the percentage of workers potentially affected if the salary threshold were raised to an intermediate value of \$808 per week. Some occupations will be more dramatically affected than others. Approximately 57% of the 994,000 first-line supervisors of retail sales workers would be affected by an increase to \$808 a week. Likewise, 76% of first-line supervisors of food preparation and serving workers would also be affected.

A more detailed occupational breakdown for the top 15 occupations, showing the number of workers affected by all three salary thresholds, is presented in Appendix C.

FIGURE 3: Occupations most affected by a change in the OT threshold

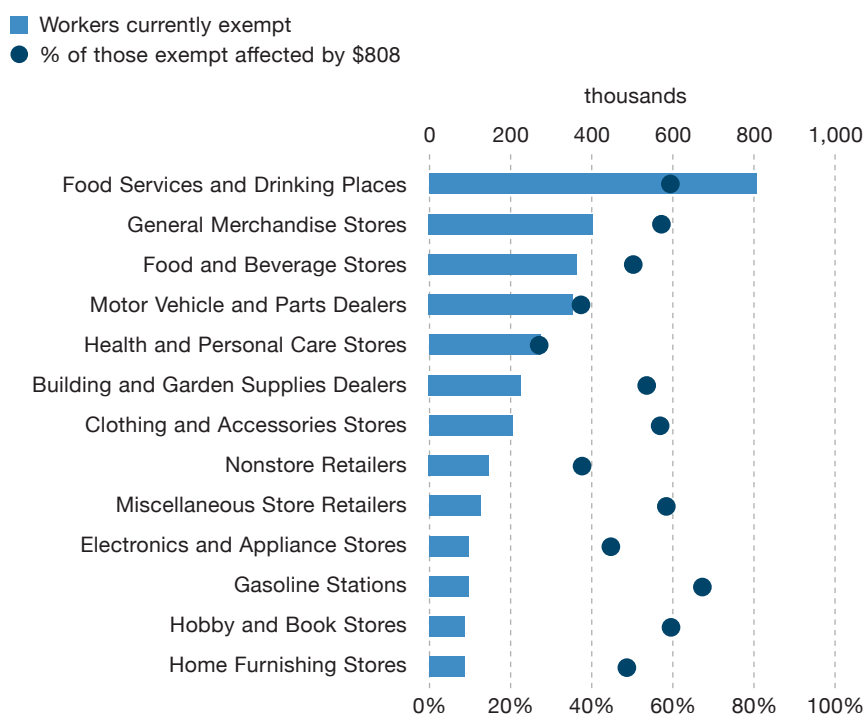


SECTOR BREAKDOWN

Figure 4 on the next page illustrates the size of the currently exempt workforce by industry sector, as well as the percentage of exempt workers that would be affected if the weekly threshold were raised to \$808. This gives an indication of which sectors would likely experience the most substantial disruptions in their employment ranks. For example, general merchandise stores employ roughly 414,000 exempt workers. If the salary threshold were raised to \$808 per week, approximately 57% of the exempt workers would be affected by this change. Health and personal-care stores would be the sector least disrupted, as only 27% of exempt employees would be affected by an increase to \$808 per week. This is likely because most pharmacists would remain exempt even under the higher threshold.

A more detailed sector breakdown for the top 15 occupations, showing the number of workers affected by all three salary thresholds, is presented in Appendix C.

FIGURE 4: Sectors most affected by OT threshold change



STATE-BY-STATE BREAKDOWN

The breakdown of currently exempt workers by state is shown in the map in Figure 5, while the share affected by an increase in the exemption threshold to \$808 is displayed in Figure 6.²²

As might be expected, high-wage states typically have a higher percentage of workers exempt from overtime (Figure 5). These usually include states where the legislature has approved a minimum wage that exceeds the federal standard even though exempt workers typically earn wages well above the higher state-mandated minimum wages. This would explain why the share of exempt workers is higher in the Northeast, as well as in Washington and Oregon. However, some states in which the percentage of exempt workers is high are not high-wage states and have not raised their minimum wages. Idaho and Wyoming are two examples. One explanation may be that the smaller size of the retail and restaurant sectors in these states, their relatively small populations, and the distance from larger markets means there is not as large

²² Some states, such as New York, California, and Alaska, have overtime rules that are more stringent than the federal rules. This analysis does not take into account these state differences.

FIGURE 5: Exempt workers by state

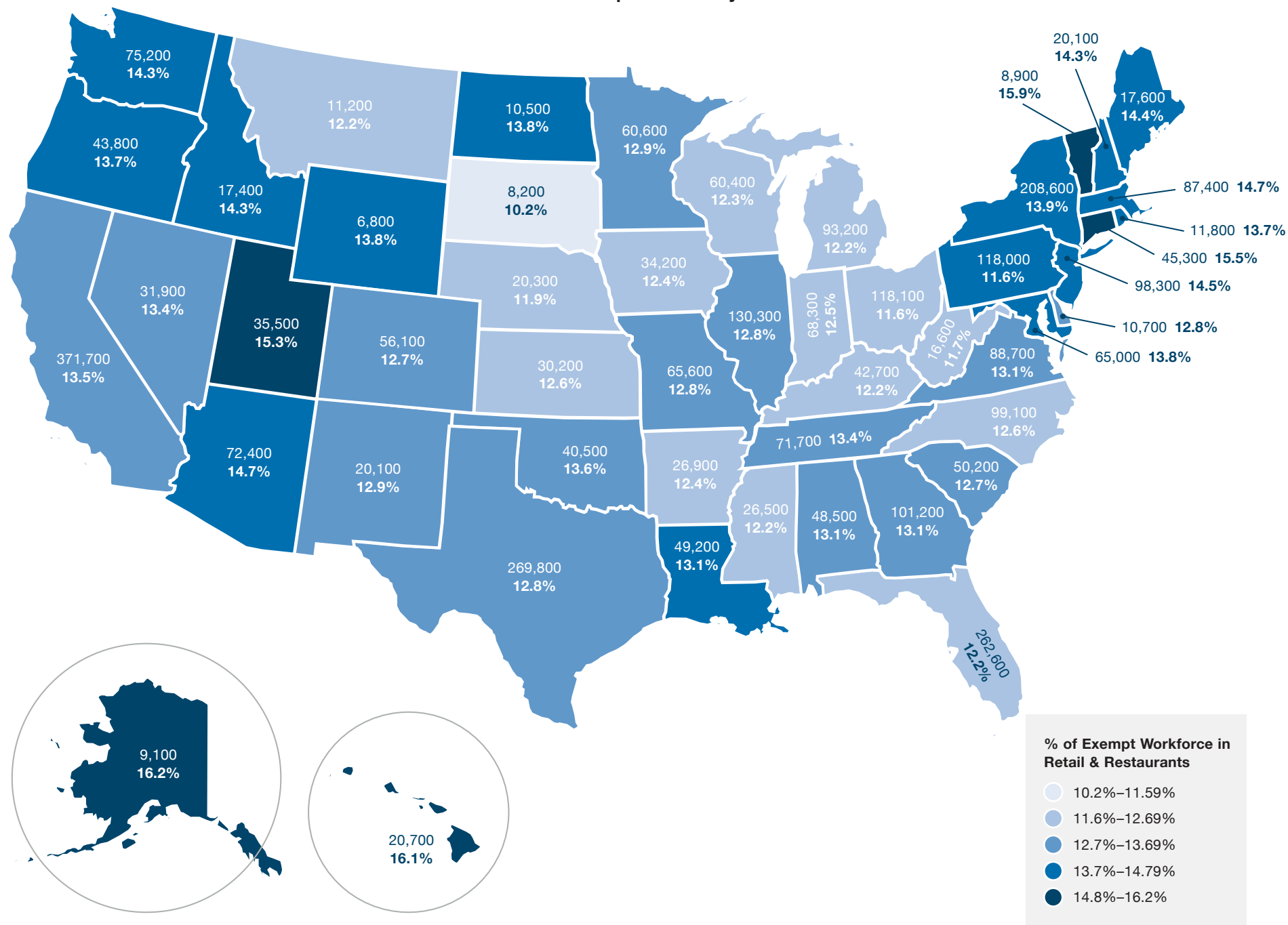
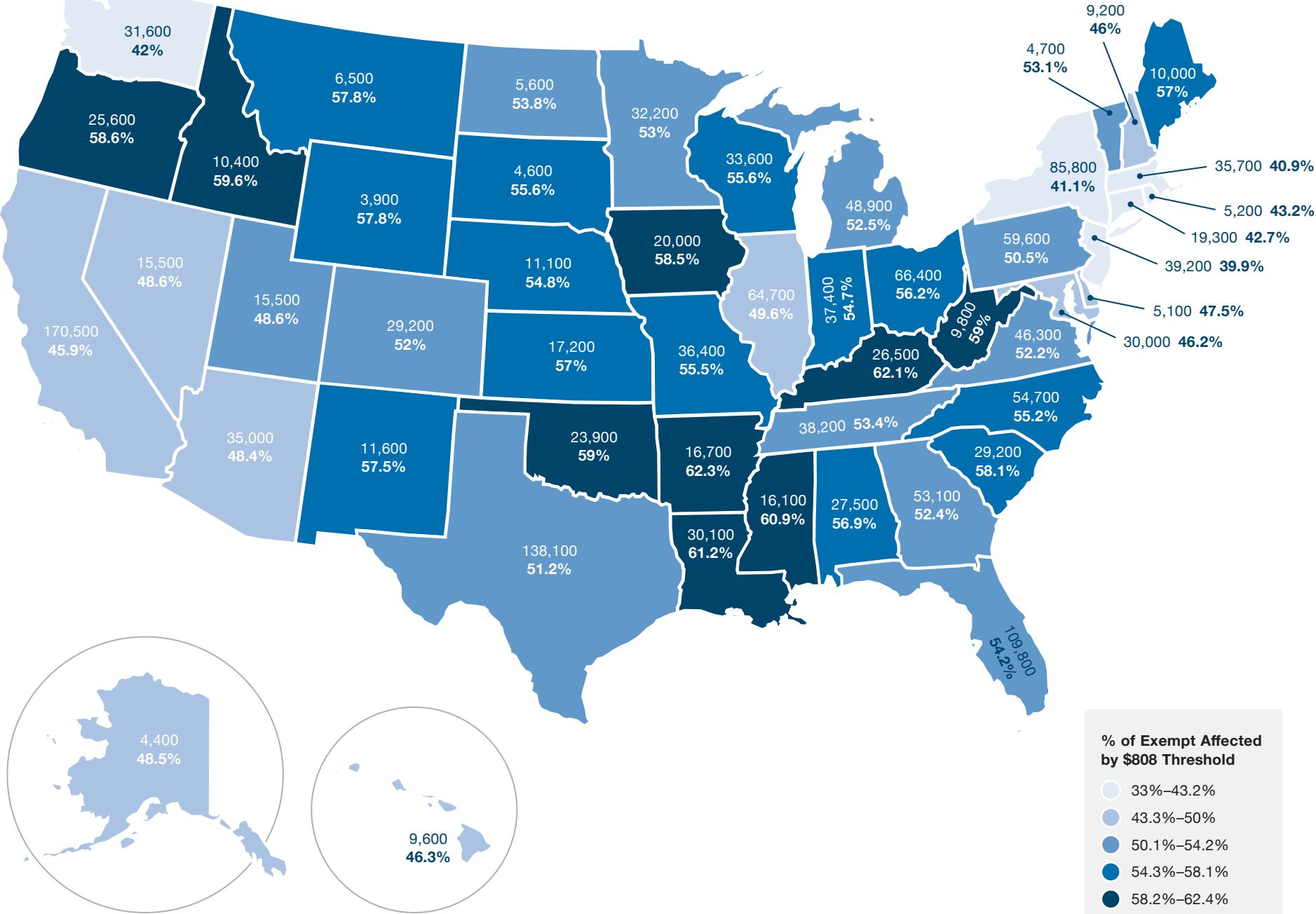


FIGURE 6: Number of workers affected by OT change by state



a market for national retail and chain restaurant establishments. While stores that service rural communities tend to have fewer employees, managers are still required, so the percentage of managers in these more rural states will tend to be higher than in states with fewer, bigger stores.

The distribution of workers affected by an increase in the threshold to \$808 (Figure 6) generally shows that high-wage states will see a smaller percentage of their exempt workforce affected by an increase in the exemption threshold. In states with lower labor costs, a larger share of the exempt workforce has salaries that are near the current threshold value. As such, an increase in the overtime exemption threshold could substantially affect retail and chain restaurants in a majority of the US; the smallest effects would be seen in the Northeast and in Washington.

DO OVERTIME RULES ULTIMATELY INCREASE EMPLOYEE PAY?

“The business model relies on managers operating stores efficiently. Changing compensation structure is risky because even small changes in manager behavior can adversely affect store performance.”

—industry expert

Much of the economic literature on overtime focuses on the question of whether overtime rules actually affect workers' total compensation at all. It might seem strange that they might not, but consider the following example of an exempt worker being paid a \$500-per-week salary. Her job description specifies that she's expected to work at least 40 hours per week, though in practice she works about 50. Now assume the exemption threshold is raised to \$600 a week. Her salary must now change, but how? If she becomes non-exempt, what should her hourly wage become, since she didn't even have an hourly rate of pay before? Consider these four options:

1. Her salary may be raised to **\$600 a week** to keep her exempt. In this case, her employer must either bear the extra \$100 in expense or recoup it through added work or reduced benefits and bonuses.
2. Her pay may be set at **\$12.50 an hour** (\$500/40 hours, as per her job description). If she continues to work 50 hours a week, she'll earn \$687.50 per week ($\$12.50 \times 40 + \$12.50 \times 1.5 \times 10$). While this represents the most literal reading of the contract, it is also a 38% pay increase for doing the same job.
3. Her pay may be set at **\$10 an hour** (\$500/50 hours, as per her usual weekly hours). If she continues to work 50 hours a week, she'll earn \$550 a week ($\$10 \times 40 + \$10 \times 1.5 \times 10$), a 10% pay raise for the same work.
4. Her pay may be set at **\$9.09 an hour**. If she continues to work 50 hours a week, she'll earn \$500 a week ($\$9.09 \times 40 + \$9.09 \times 1.5 \times 10$). In this case, assuming her hours of work don't change, she's receiving the same pay for the same work; the overtime rules simply changed the accounting for this pay.

Of course, the number of hours worked aren't necessarily fixed. If companies assume the hourly wage is fixed (as in example 2 or 3 above) and determine their labor needs accordingly, we would expect that the higher marginal hourly rate associated with FLSA-mandated overtime pay would lead companies to shift toward employing more workers for fewer hours each week. This is referred to as the **labor demand model**.²³ On the other hand, if workers have the ability to influence their own weekly hours, they may choose to work longer hours in response to overtime provisions, or to vary their hours from week to week to maximize overtime pay, the so-called **labor supply model**.

However, neither the hourly wage rate nor the number of hours worked represents a fixed external constraint imposed on companies. Both are jointly negotiated between companies and workers at the time of employment. While overtime rules may affect these negotiations, both by restricting potential outcomes and by altering workers' and companies' external options, they generally do not prevent workers and firms from arriving at the original outcome that they would have concluded in the absence of these rules, as shown in example 4 above. This is sometimes referred to as the **contractual model** of overtime pay.

At least two exceptions exist to the contractual model. First, in some cases companies will be unable to lower wages as much as necessary to completely offset the rule because of a binding minimum wage,²⁴ or because of internal salary constraints. Second, unpredictable work schedules may also be a factor. When workers and companies are uncertain of the number of hours expected, they may be unable to calculate an appropriate base wage rate. Overtime rules may also act as a commitment mechanism, and may help ensure that employment negotiations explicitly address the matter of expected weekly hours.

Despite these caveats, under the dominant contractual model, overtime rules are generally not expected to have a first-order effect of increasing workers' compensation or decreasing their hours of work. Rather, with effective wages determined in a (reasonably) competitive labor market, overtime rules tend to change only how compensation is accounted for.

Economists have empirically tested the effects of overtime regulation by comparing those workers covered by the FLSA with a control group not

23 See Robert Hart, *The Economics of Overtime Working* (Cambridge: Cambridge University Press, 2004). Where the intent of overtime rules is specifically to increase the number of people employed by reducing each one's hours, this goal is referred to as work sharing.

24 This is, of course, not a concern with the existing federal minimum wage, but could be more of an obstacle in states with stricter minimum wage standards.

THE EMPLOYER RESPONSE:

FEEDBACK FROM INDUSTRY EXPERTS

Oxford Economics conducted interviews with retail and restaurant industry experts. All insisted that companies lack the pricing power to absorb additional labor costs and suggested possible strategies to control costs if overtime rules were changed.

Consistent with the literature, all of the industry experts were exploring different strategies to minimize overtime payments whenever possible, or offset new overtime payments with reductions in other forms of discretionary compensation, such as bonuses.

These industry experts most often said salaried employees would likely be converted to hourly wages if salaries were close to the old threshold. This change is required if hours are to be carefully tracked and monitored.

Efforts would be made to avoid additional overtime costs by limiting the hours an employee could work to 40, even though supervisors and managers are currently expected to work at least 50-hour weeks, given the business hours their establishments typically maintain. As one strategy to avoid overtime, managerial positions might be split between two employees. Alternatively, hours could remain unchanged and overtime paid—but reductions in discretionary compensation (i.e., bonuses) would offset the amount of overtime pay gained.

Experience with past personnel actions strongly

suggests that transitioning workers to hourly status while maintaining total compensation will be expensive and require significant time commitment to customize and communicate the conversion process. Each supervisor's compensation package will need to be adjusted so that he or she works the same hours as before, is paid overtime, but receives the same total compensation as before

the change; and this will need to be communicated, likely in one-on-one meetings with HR representatives.

Under such a scenario, senior and general managers would likely absorb some of the responsibilities currently assigned to first-line supervisors and might receive increased bonuses or other compensation. As a result, the gap between senior managers (those paid salaries and eligible for bonuses) and

entry-level supervisors (paid hourly, with little likelihood of receiving bonuses) would widen. This "hollowing out" of the workforce can have serious repercussions. Most importantly, there is a widespread perception in the workplace that "hourly" means clerical work and "salaried" means professional labor. Changing this could undermine the current career progression in retail and restaurant industries. Aspiring retail professionals will not be attracted to an hourly position. As several interviewees put it, the "farm team" from which new executive talent is recruited could be severely disrupted.

Based on interviews with industry experts and a review of the relevant economic literature, it is quite likely that employers will adopt compensatory strategies to keep from having to accept the additional burden of high labor costs.

covered, in order to see whether those covered work shorter hours and/or earn higher hourly salaries. The classic work of this type was Trejo (1991),²⁵ who compared those covered in the mid-1970s with those not covered. Barkume (2010)²⁶ repeated this exercise using more detailed 2004 data, while Costa (2000)²⁷ explored the change in overtime rules associated with the adoption of the FLSA in 1938. While results were somewhat mixed, the authors generally found support for the contractual view, in which total compensation does not change significantly in response to overtime rules.²⁸

25 Stephen J. Trejo, "The Effects of Overtime Pay Regulation on Worker Compensation," *The American Economic Review* 81(4) (1991): 719–740.

26 Anthony J. Barkume, "The Structure of Labor Costs with Overtime Work in U.S. Jobs," *Industrial and Labor Relations Review* 64(1) (2010): 128–142.

27 Dora L. Costa, "Hours of Work and the Fair Labor Standards Act: A Study of Retail and Wholesale Trade, 1938–1950," (2000). Working paper.

28 Costa found a larger reduction in hours in the South than in the North following the adoption of the FLSA, which she attributes to a more binding minimum wage, which kept hourly wage rates from falling.

ASSUMING

A PASSIVE, UNLIKELY, RESPONSE

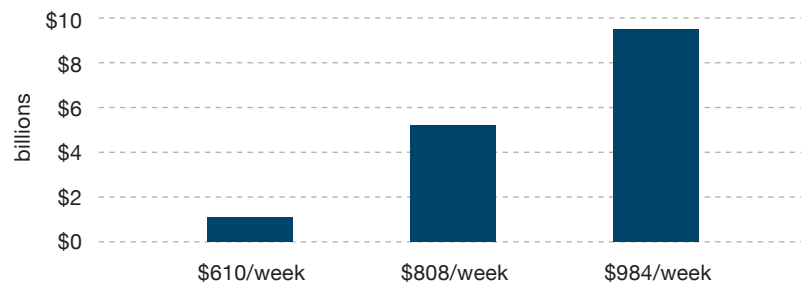
Any estimate measuring the costs of changing overtime regulations must consider how employers will actually respond. Increased costs are not simply absorbed in a vacuum. Under the passive model, however, it is assumed that businesses do not change behavior in response to higher costs – see the box below for more details on the passive assumptions. More realistic models, discussed later, anticipate how businesses will likely respond.

Under the passive model, the cost to businesses of the new rules would be enormous:

- \$9.5 billion annually under a plan to raise the threshold to \$984 per week;
- \$5.2 billion under the intermediate scenario, which boosts the threshold to \$808 per week; and
- \$1.1 billion under a \$610 per week wage threshold.

Figure 7 presents these total costs of the passive response model for the three scenarios. For context, total payroll expenses for all 25 million workers in the retail and restaurant industries were \$545 billion in 2012.²⁹

FIGURE 7: The impact of changing thresholds, assuming employers respond passively



²⁹ See Census's 2012 Annual Trade Report <http://www.census.gov/retail/>.

THE PASSIVE RESPONSE:

AN UNLIKELY OUTCOME

A first estimate of the costs of imposing a new threshold on retail and restaurant workers might assume that businesses will not change their policies or behaviors in response to new rules imposing higher costs.

But this assessment is not realistic, since employers must find a way to pay for their added costs.

The following (unrealistic) assumptions are used to calculate what is referred to as the “passive” model. (Additional details are available in Appendix A.)

- Employers set a new hourly wage equivalent to the old weekly salary divided by a 40-hour work week.
- Workers continue to work the same number of hours as before.
- No additional cost (or cost savings) is assumed for workers currently working 40 hours a week or less.
- When these calculations would result in a worker being paid more than the new threshold, we assume employers will instead keep the employee exempt and pay the new threshold.

Ultimately, the amounts estimated within the passive model represent the level of business adjustments that must be made in order to offset increased costs and remain competitive within the retail and restaurant industry.

MODELING THE LIKELY RESPONSES

TO CHANGES IN OVERTIME THRESHOLDS

Companies are likely to use a variety of methods to adjust to a higher overtime threshold. Some workers will see their base rate of pay reduced to maintain their overall compensation, while others will see their hours, along with their overall compensation, reduced. Consistent with economic theory and the interviews with industry experts, each of the adjustment measures considered in this study assumes that workers do not receive added pay for performing identical work.

Businesses that lack pricing power will not simply absorb new costs that cannot be passed along to customers. Instead, they will modify behavior to reduce costs. To adjust to changes in the threshold wage, employers are likely to adopt one or more of the following measures:³⁰

- **Measure 1 (trade-off):** Workers who are near the new exemption threshold³¹ will have their salaries increased in order to remain exempt, with bonuses and benefits reduced to maintain overall levels of compensation.
- **Measure 2 (bookkeeping adjustment):** Most³² workers furthest from the new cutoff will have their hourly rate of pay reduced so that their weekly compensation remains unchanged.

³⁰ It is assumed that workers working no more than 40 hours per week will see their hours and total weekly pay remain unchanged. See appendix A for a more detailed methodology.

³¹ Specifically, those for whom the new threshold is less than 107.5% of their current pay.

³² We assume two-thirds.

- **Measure 3 (reduced hours):** Finally, the remainder of workers will see their weekly hours cut³³ to avoid overtime expenses, with total compensation falling proportionally. To make up for the lost hours, companies will hire additional part-time (30 hours per week) workers.

This list is not intended to be a comprehensive description of all changes that would likely result from the new regulations, but a description of the core impact on workers. One major effect of these adjustments, strongly reinforced by interviews with industry experts, is that many retail and restaurant companies will shift their management structure in response to more stringent overtime rules. **Companies will become more hierarchical and rely less on mid-level managers and instead increase their reliance on technology**, which allows fewer managers to exert greater control. **This will likely result in a hollowing out of the mid-level professional ranks and an increase in inequality within companies**—a significant if unintended consequence of a possible change in the overtime threshold. Industry experts also expressed real concern that this would make it harder for them to develop and promote talent internally, because the “pipeline” of early-career professionals will be narrowed.

Despite the effort to control costs, we do not expect the new rules to trigger job losses. In fact, as some workers see their hours reduced (Measure 3); some companies will likely need to hire new, part-time workers. Industry experts indicate that one area where employment cutbacks might likely occur will be in back-office and secretarial functions. These are areas where software and centralized management can make up for lost hours.

ESTIMATE OF DIRECT COSTS TO EMPLOYERS & EMPLOYEES

As noted, our research has focused on three potential salary thresholds for the proposed change in overtime eligibility—\$984, \$808, and \$610. We have also determined three possible responses (Measures 1–3) employers are likely to take as a result of such changes.

If the threshold is raised to \$984, the high-end scenario, approximately 2,242,000 workers will be affected, of whom 857,000 work more than 40 hours per week.

- An estimated 52,000 workers who are closest to this high-threshold salary would likely see an increase in their base salaries by a total of

33 We assume hours are cut to 38 per week to avoid accidental overtime.

nearly \$95 million, or \$1,800 per worker. This group, however, would also suffer an equivalent decrease in their benefits and bonuses. (Measure 1)

- A disproportionate number of workers, about 537,000, will likely be converted to hourly non-exempt status from exempt salaried status and become eligible for approximately \$6.3 billion in overtime earnings, about \$11,700 per worker. However, this group will also see their hourly rates decreased by an equal amount, leaving their total annual earnings unchanged. (Measure 2)
- Approximately 269,000 workers would be converted from exempt salary to non-exempt hourly and have their hours reduced to 38 hours per week. This change will cost these workers about \$2.73 billion in earnings, but will permit employers to hire an estimated 117,500 part-time workers to fill their labor needs. (Measure 3)

Should the threshold be raised to \$808, 1,689,000 retail & restaurant workers will be affected.

- 97,000 workers will have their salaries raised by an estimated \$1,700 per worker - however, this same group will see an equal reduction in their bonuses and benefits.
- About 351,000 workers will be converted from exempt salary to non-exempt hourly and earn nearly \$3.6 billion (about \$10,200 per worker) more in overtime pay. However, employers will modify their base wage so each worker will not see any real income gain. (Measure 2)
- About 175,000 workers will be converted to hourly from exempt salaried positions and also have their hours reduced to about 38 hours per week—a loss of \$1.55 billion to management/supervisory workers, but a cost savings to employers. Employers will likely use the cost savings from this reduction to hire an estimated 76,000 part-time workers to fill additional labor needs. (Measure 3)

If the threshold is raised to \$610, an estimated 796,000 workers will be affected, of whom 282,000 work more than 40 hours per week.

- About 81,000 workers will have their base salaries raised, at a cost totaling almost \$95 million. But this group will also see cuts to their benefits and bonuses by \$95 million, \$1,200 per worker on average. (Measure 1)
- Meanwhile, 134,000 workers will be converted to non-exempt hourly employment from exempt salaried positions. The estimated amount of

If the threshold rises to \$808, some 97,000 workers will have their salaries raised by an estimated \$161 million, or \$1,700 per worker. However, this same group will see an equal reduction in their bonuses and benefits.

overtime earned will exceed \$1.14 billion (about \$8,600 per worker). However, this group of workers will also see their base wages reduced by \$1.14 billion, which will offset any real overtime earnings. (Measure 2)

- About 67,000 workers will be transferred from salaried to hourly positions and can expect their hours to be reduced to about 38 per week, effectively reducing their compensation by about \$497 million. This money will be used, in turn, to hire approximately 28,000 part-time workers to fill additional labor needs. (Measure 3)

ADDITIONAL TRANSACTIONAL COSTS TO EMPLOYERS

No matter the level of a new threshold, regulatory changes will trigger employers to modify their existing business operations, and these will generate additional costs. The “transactional costs” associated with converting a salaried employee to an hourly rate will be significant. Determining which employees should have salary adjustments to remain qualified for exempt status will also incur costs. More significantly, “operational costs” will likely result from the disruption in traditional staffing patterns as workers are shifted from salaried to hourly status.

Transitional costs: Measure 1 carries the relatively low transitional cost of identifying which employees ought to have salaries adjusted and then making and communicating that adjustment. Measures 2 and 3 each involve the cost of converting a salaried employee to an hourly rate and then adding that employee to the time tracking system (already in use for existing hourly employees). Converting managers from salaried to hourly will likely cause significant disruption to normal business operations as HR personnel communicate and implement the change. As more people are tracked, the more IT support is required for the time-tracking system. In addition, the added complexity of managing and scheduling people’s time will add to supervisory costs. In the case of Measure 3, considerable HR cost will be required to consult with each employee in establishing an hourly rate (lower than existing base salary) that is calculated so that overall compensation (including new overtime payments) will leave current total compensation unchanged.

We estimate that these expenses could equal an additional \$874 million in employer costs if the threshold were raised to \$984; \$648 million under the \$808 per week scenario; and about \$297 million under the \$610 scenario.³⁴

Significant “operational costs” will likely result from the disruption in traditional staffing patterns as workers are shifted from salaried to hourly status.

³⁴ These estimates are based on expected staff costs to process transitions; see Appendix A for details.

“More complexity in rules will inevitably lead to more disputes in how the rules are enforced.”
—industry expert

Operational costs: Converting professional salaried positions to an hourly rate is expected to increase certain operational costs. For example, recruitment costs may increase as young professionals become hesitant to accept an hourly position. First-line supervisors who find incentive bonuses reduced to fund their overtime pay might lose the motivation to innovate and excel. At the same time, there might be more motivation to inflate hours spent on tasks. Essentially, employers are concerned that the professionalism of the junior managers and supervisors who manage store, restaurant, and back-office operations would be greatly diminished if these positions were converted to hourly status. For example, simple generally accepted business practices—such as managers occasionally checking emails after hours—may become problematic when managers are converted to an hourly pay structure. As one industry expert put it, “more complexity in the rules will inevitably lead to more disputes in how the rules are enforced.” These views were consistently expressed during the interviews.

CONCLUSION

The overtime threshold, currently set at \$455 per week, today exempts an estimated 3.3 million retail and restaurant workers from overtime pay. Middle managers in these occupations often work 50-hour weeks and receive bonuses and other incentive pay. Many employers have created their current business and employment strategies based on the current threshold regulation.

While it remains uncertain what sort of regulatory changes the Department of Labor may propose, an increase of the overtime threshold is likely to cause significant complications for business owners and create a series of unintended consequences, both legal and regulatory, that are likely to cost workers. In theory, raising the overtime threshold to \$984 per week would make as many as 2.2 million workers—or some two-thirds of the total current workforce in retail and restaurant trades—eligible for overtime pay (and boost employers' labor expenses by an estimated \$9.5 billion annually). But it is highly unlikely that employers would simply pay the additional wages without making significant adjustments in the structure of their workplaces.

These adjustments would potentially lead to a “hollowing out” of the employment structure, creating a more hierarchical workplace; a rise in the use of part-time, entry-level workers as the hours of full-time workers are cut; a reduction in job-advancement opportunities for hourly workers who aspire to management ranks; and a fundamental increase in inequality within the labor force. They are also likely to boost the overall costs of doing business.