Overtime Pay Mandates Are No Boon for Employees

Lower Wages and Less Business Expansions Are the Likely Results

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INTRODUCTION

The Fair Labor Standards Act of 1938 (FLSA) is best known for setting a federal minimum wage, but the Act also established the 40-hour workweek and overtime pay provisions. The Labor Department implements the Act, and most recently in 2004, set a weekly threshold of $455, below which employers must pay employees time-and-a-half for hours worked exceeding the 40-hour workweek, subject to certain exclusions and exemptions. Above the threshold, employees are exempt from the overtime pay requirement. The Obama administration wants to more than double the threshold to $970 for 2016,[1] thus changing the status of millions more employees from “exempt” to “non-exempt,” making them eligible for time-and-a-half overtime pay.

The minimum wage has been much analyzed and is conceptually straightforward, the main effect being fewer jobs if set above the market rate. Federal wage structure mandates receive less attention, but also have negative effects.

The government cannot force wage increases by giving employees so-called non-exempt (from overtime) status.

In response, employers can:

- ***Lower base wage rates;***
- ***Use more part-time staff;***
- ***Juggle work schedules;***
- ***Reduce benefits;***
- ***Reassign functions to remaining exempt staff;***
- ***Automate more functions.***

Employees may end up worse off as a result.

Federal intervention in wage and employment structures:

- ***Harms productivity;***
- ***Gives rise to avoidance costs that are a deadweight loss to society;***
- ***Truncates profitable business expansion and earnings opportunities for workers.***

MANDATED WAGE STRUCTURE

FLSA wage formula sets hours, *not* wages. Becoming eligible for overtime pay sounds like a boon for employees, assuming their base pay does not go down. That is a big assumption because the law does not mandate regular wage rates above the current minimum of $7.25 per hour. As long as it does not fall below the minimum, an employer can simply reduce the regular wage rate to make up for the higher mandated overtime pay rate.

Assume an employee works 50 hours and receives $600 per week. The Administration is suggesting that it can require the employer to give the employee a raise by increasing the FLSA eligibility threshold and causing the 10 hours worked that exceed the 40-hour workweek to receive remuneration at time-and-a-half, i.e., $18 per hour rather than $12 per hour.[2] But that suggestion is wrong.

[1] Along with other changes; see http://www.dol.gov/whd/overtime/NPRM2015/.
[2] $600/50 hrs. = $12. $12*1.5 = $18.

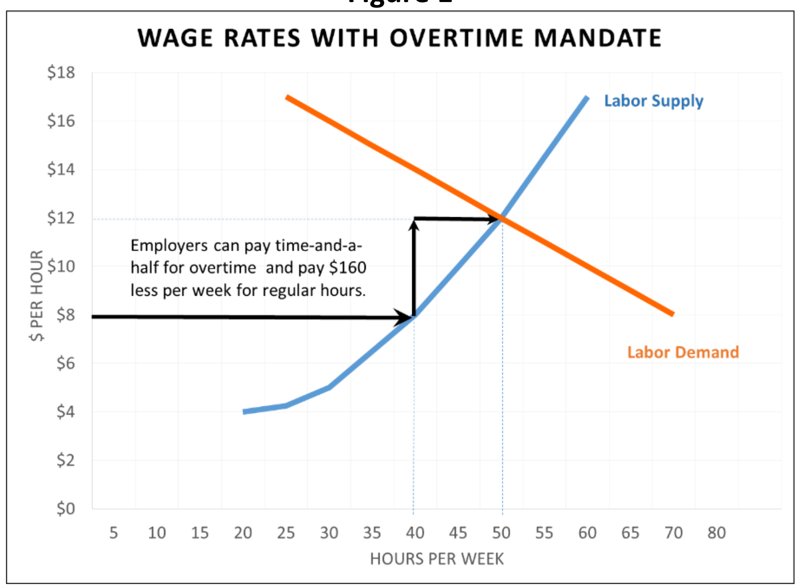
Employers can offset a higher overtime wage rate with a reduced regular wage rate.

The FLSA pay formula is: "40 hrs. * wage rate + 10 hrs. *1.5 * wage rate," whereby the employer can choose the wage rate so long as it is above the federal minimum wage. A wage rate of $10.91 per hour will result in total pay of $600 per week for 50 hours including overtime pay, the same as when the employer was paying a single hourly rate of $12 ($10.91*40 + 10*1.5*$10.91 = $600). Hence, the employer can negate the overtime mandate.

Segmenting the labor supply. One might conclude that the Administration's action, while conveying no benefit, at least will cause no harm either, but that would also be wrong for several reasons. First and foremost, those harmed directly could be the very employees the Administration is ostensibly trying to help. Consider the supply of labor, the two wage rates, and the total wage bill in the graph below.

Employers may even lower the regular wage rate more than to offset the overtime wage rate and pay workers less in total than before.

Figure 1



At a single wage rate of $12 per hour, workers will supply 50 hours of labor and the employer will pay $600 ($12*50) per week in the illustration, but if the employer can pay them $8 per hour for 40 hours and $12 for the next ten, the total wage payment will be less, namely $440 ($8*40+$12*10). Workers receive time-and-a-half for ten hours of overtime per week but not from an hourly base of $12, only of $8. They receive nowhere near $18 per hour for overtime and take home $160 *less* per week than before.

The federal wage mandate effectively segments the labor supply, which enables employers to pay lower wages.

A single employer cannot effectively segment the labor market into separate work periods with different wage rates, and it is illegal for employers to set wages collaboratively. However, if federal law defines a workweek as 40 hours for all employers and requires time-and-a-half for anything more than that, then the labor supply will be segmented and employers can lower the wage rate for regular hours to $8, unless their employees have employment contracts.[3] Given that most employees do not belong to unions and do not

[3] In a free market, higher wage offers would induce workers receiving $8 per hour to switch employers. Competing employers will bid up the market wage rate to the

have individual employment contracts, the overtime pay requirement thus may cause a *cut in total pay*.

Business associations argue that the overtime mandate will increase administrative costs for no gain in total employee compensation,[4] but in fact total compensation may actually decrease, especially considering that employers also can trim benefits to save money in less visible ways. There is no assurance that employers will merely hold constant and not reduce employee compensation in response to overtime pay requirements.[5]

Most employees do not have employment contracts and employers can work around minimum wage laws if they want to reduce employee compensation.

In low-wage segments of the labor market, minimum wage laws may not allow a lowering of the wage rate, but employers have other means of avoiding higher employment costs that overtime mandates might impose, as enumerated below in the section on "Evasive Responses." Among the options, employers can hire more part-time in place of full-time workers; ask some workers to stay home when business is slow; and as just mentioned, alter their benefits. As a last resort, employers will turn away business if government rules force increased incremental costs on them that exceed incremental revenue. Employer responses will vary across the country as some state minimum wage rates exceed the federal rate.

Federal wage structure ill-suited to address specific problems. Labor market conditions may not be competitive everywhere and allow some employers to pay workers less than their marginal revenue product. But as an earlier Joint Economic Committee (JEC) report on the minimum wage pointed out, such conditions do not apply uniformly across the country and do not remain constant over time.[6] If government intervention is ever warranted, it is in local labor market segments and the province of state or local governments that can fit their rules to the circumstances and modify, relax, or rescind them when they no longer fit. Competition among different geographic and occupational segments within the national labor market will encourage regulatory adaptation. The federal government cannot improve the functioning of the labor market with a permanent wage formula and work rules nationwide. On the contrary, for the federal government to change prevailing market-generated employment and wage structures would harm productivity. A free, competitive marketplace will tend to generate efficient employment and compensation structures in the sense that production of goods and services is maximized for every dollar of

A permanent wage formula and work rules nationwide cannot improve specific, local market imperfections.

market equilibrium of $12 per hour. Under a federal overtime wage mandate, however, all employers have the same motivation and opportunity to lower the wage rate for the first 40 hours and are not allowed to pay less than 1.5 times that rate for additional hours. The government thus segments the workweek and creates the opportunity for employers to extract workers' surplus.

[4] See, "Rethinking Overtime—How Increasing Overtime Exemption Thresholds Will Affect the Retail and Restaurant Industries," Oxford Economics, commissioned by the National Retail Federation.

[5] Note that at a wage rate of $10.91 per hour the mandated overtime rate would be $16.37 at which rate there is no demand for additional hours of work in Figure 1.

[6] "Washington is the Worst Place to set a Minimum Wage," JEC, July 25, 2014.

expenditure, whereby the expenditure includes wages, benefits, and administrative, management, and training costs (leaving aside for now taxes and government mandates).

EFFICIENT EMPLOYMENT AND COMPENSATION STRUCTURES

Employment. Work shifts are not accidental, uniform, or fixed but reflect employee incentives, the nature of job functions, and their relation to cost and revenue. The number of workers and the hours they work to perform a given task are not random combinations. For example, if work functions are readily transferable and administrative costs do not negate wage savings, then hiring people who cannot or wish not to work full-time increases the available labor supply and may reduce employment costs. Employers experiment with flextime, comp-time, paid time off, shorter workweeks and longer work days, etc. to find the most efficient combinations.

Compensation. When a team of workers generates measurable output associated with incremental sales revenue, compensation likely is based on hours of work, such as on the assembly line in an automobile factory. Variability in the demand for the output may lead firms to offer higher overtime pay rates for existing employees if incremental labor cost is held to less than the cost of hiring and training more full- or part-time workers. When units of sale can be attributed to individual employees, compensation commonly takes the form of individual sales commissions, possibly with flexible work times and without overtime pay.[7]

Employers try to arrange employment and compensation structures efficiently, and the federal government does not know how to improve them.

Work functions that do not directly affect output volume and sales, such as administration and middle management, are salaried, i.e., paid in constant amounts for a given pay period. The salary level will tend to match responsibilities and effort required as more demanding jobs will not attract suitable candidates without commensurate compensation. In place of overtime pay, performance bonuses may be offered where better performance and its payoff can be gauged at a cost less than the payoff. Executive management compensation typically is linked to firm profitability, such as by award of stock options. When there are economies of scale to providing nonwage benefits, they may be included in the compensation packages of all employees or at least of those who work long enough to generate value sufficient to cover the cost of extending the benefits to them.

Employers calibrate work rules, work schedules, and compensation packages to maximize productivity and control employment costs. They make adjustments to improve the trade-off and experiment with different forms of compensation, such as free or subsidized parking, training, health club memberships, use of company cafeterias; the list is endless, all intended to give employees more value and thereby make them more productive per dollar spent on them.

[7] Real estate agents are an example.

Distorted structure. The requirement of 1938—that employers nationwide offer different wage rates up to and above 40 hours per week with a 150 percent differential—long ago detached from employee work-leisure preferences, labor productivity, or employer cost savings, if there ever was a connection. Extending the requirement to many more jobs now would only worsen the resulting distortions. Existing employment and compensation structures already reflect numerous government constraints, requirements, and taxes imposed on the employment relationship, and their manifestations most definitely are not efficient. A prominent, recent example is employers limiting their full-time-equivalent employee headcount to less than 50 and holding weekly hours per employee below 30 to avoid the cost of additional ObamaCare mandates.

EVASIVE RESPONSES

In addition to reducing the rate of pay, employers can use other methods to negate or minimize the wage impact of a new overtime mandate. Full-time employees who expect to receive time-and-a-half for some of their hours from the Administration's proposal may find instead that:

- Their hours are cut as employers hire part-time workers and spread workloads over a larger number of employees, none of whom will be assigned more than 40 hours of work in a week. Since part-time employees receive fewer benefits, an employer may be able to arrange work schedules to avoid paying overtime and keep total employment costs from rising despite the use of more staff and without cutting the wage rate.[8]
- Employers shift managerial functions from currently exempt employees who become nonexempt under a new salary threshold to those with higher salaries who remain exempt. In other words, the functions and associated hours of work that give rise to overtime pay at one salary grade will be shifted to higher grades where they will not, and learning opportunities for relatively less experienced employees will diminish.
- Employers may give some employees whose current salary is close to the new threshold a raise just sufficient to preserve their exempt status, if the raise is less than the cost of paying overtime or hiring part-time help. Hence, salary increases could actually result from the Administration's proposed overtime pay requirement, but the incremental pay will be less than time-and-a-half and apply only to a sliver of the employment population that becomes nominally eligible.
- The ultimate avoidance strategy is automation of work functions. If employment costs rise as a result of navigating the government's

Employers will reorganize employment and compensation structures to minimize the cost of an expanded government overtime wage mandate.

Changing shift lengths, fringe benefits, work assignments, and automating solely in response to federally imposed costs does not benefit employees.

Few employees would see larger paychecks, and those paychecks would be smaller than the Administration may be leading them to expect.

[8] Re-designating positions from full- to part-time, which the employer could blame on the government's mandate, would justify reducing benefits. The use of part-time labor by employers thus also lends itself to reducing, and not just holding constant, employment costs, while deflecting the blame from employees.

mandates, existing automated processes become relatively more cost-effective and successful technological innovations may even earn firms extra profit relative to their competitors.

CONCLUSION

A mandate to "hike overtime wages," as it is commonly characterized,[9] is merely a mandate to change the wage *structure*. The federal formula for overtime pay leaves employers room to adjust the base period wage rate and negate an increase in total wage payments. Worse, it supplies a legitimate context in which employers can set discriminatory wage rates that lower the total wages they pay employees. A proposed mandate to vastly expand overtime payment eligibility may sound good to employees whose present salary ostensibly would qualify them, but few might actually receive a raise. Many more employees could see their paychecks shrink.

Promising many more workers overtime pay sounds good, but will generate much disappointment.

The wage-work structure of the 1938 Fair Labor Standards Act does not fit the preferences of many people today and neither will many employers' nonwage responses to expanding it. Where minimum wage laws or other considerations limit downward adjustment to the regular wage rate, employers can manipulate work schedules, the use of part-time in place of full-time employees, and benefits to arrive at a similar outcome, either maintaining or reducing total compensation for the same amount of work.

Extending the FLSA's overtime pay requirement to millions more employees would be a further massive interference with efficient organization of employment and compensation structures. The costs to business of monitoring and adapting payroll systems to hours worked and other operational costs of employment and compensation structures—altered solely in response to an arbitrary government mandate—as well as the loss of associated employee options would represent a deadweight loss to society.

A widened overtime wage mandate, instead, will impose unnecessary costs, hinder economic expansion, and more likely limit workers' earnings potential than enhance it.

Perhaps worst of all, an expanded overtime pay mandate may discourage business expansion and economic growth. Dictates to businesses of when to pay overtime and how much, can raise incremental costs and truncate profitable expansion opportunities along with earnings opportunities for workers. Any gains from lowering the base period wage rate will not be relevant to decisions at the margin.

It appears that the business community views an expanded overtime mandate as yet another administrative albatross rather than as an opportunity to lower wage payments. The National Retail Federation has published a study on the costs in opposition to the initiative (see footnote 3). Yet, if implemented, a widened overtime pay requirement would open the door to reductions in compensation as well as impose another cost burden on the economy.

[9] A front-page headline in *Politico* states, "Obama poised to hike overtime wages for millions," June 8, 2015.