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NEW INFLATION-ADJUSTED SALARY TEST WOULD BRING NEEDED CLARITY TO FLSA OVERTIME RULES

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Introduction

Seventy-five years ago, the Fair Labor Standards Act (FLSA) of 1938 established the rules governing overtime pay. Workers covered by the FLSA overtime provisions must be paid at least "time-and-a-half," or 1.5 times their regular pay rate, for each hour of work per week beyond 40 hours.

These provisions are important for covered workers, including 75 million hourly-wage workers, who value having a 40-hour workweek and earning extra pay when they work overtime. The right to a limited workweek provides time for leisure, civic participation, commuting, self-improvement, and tending to family and friends. Preserving this right is just as important today as it was 75 years ago, and, when it comes to child-rearing, might be even more important. Between 1968 and 2008, the share of children living in households in which all parents work full time doubled from 24.6 percent to 48.3 percent.

The overtime (OT) provisions of the FLSA are also important for employers, who must factor in the added expense when considering their labor costs.

Though we reference these costs throughout our analysis, the focus of our paper is a fairly narrow but critical dimension of OT pay: the rules regarding the so-called "white collar exemption," which excludes from coverage executive, administrative, and professional employees. In particular, we are concerned that the breadth of the "duties tests" of today's OT rules exempts too many salaried white collar workers who, because of the routine nature of their work, their low pay, and the lack of control they have over their time and tasks, should be covered by the act and entitled to OT pay and other FLSA protections, such as the minimum wage. In addition, we suspect that millions of employees who are not exempt and who are entitled to overtime pay do not know it because the law and regulations are so opaque.

A simple way to address these problems is to raise the salary threshold under which all salaried workers, regardless of their work duties, are covered by the OT provisions. This key FLSA parameter has rarely been updated, nor is it indexed to inflation: The salary threshold has been changed only eight times in 75 years and only once since 1975. Simply adjusting the threshold for inflation since 1975—one of our key recommendations—would raise it to $970 per week, equivalent to an annual salary of about $50,440 today.[1]

In the interest of both clarity and meeting the goals of the FLSA to reduce unemployment by spreading work, prevent excessive overtime, and fairly compensate workers who do work overtime, we propose that the administration issue new regulations that establish the following:

1. An OT threshold salary level commensurate with the status, prestige, and value of executives, administrators, and professionals.

2. An inflation adjustment of the salary level tests going forward.

This change would entitle millions more workers—likely between five and 10 million—to the OT protections in the FLSA.

This coverage is consistent with the intentions of the law and it would correct for the falling real value of the salary threshold over many decades. The costs of increased coverage would ultimately be borne by workers as employers set base wages taking expected overtime pay into account. Thus, we do not expect this change to reduce employment or hours worked. To the extent that employers cannot pass higher OT costs on to workers, or if they have to pay for more overtime than expected, the changes would establish an incentive for employers to create new "straight-time" jobs, which would benefit the U.S. economy now and in years to come.

The paper begins with a brief history of the OT provisions and the white collar exemptions, followed by a discussion of the rationale for nonexemption of certain salaried workers. We then discuss our proposal and project its impact on workers and their employers.

Principles of OT coverage and how they have been operationalized

The fundamental idea behind overtime coverage, and the minimum wage, is to maintain a basic norm within our labor market. Under certain market conditions, for example when unemployment is high or workers hold especially low levels of bargaining power, employers might be able to require employees to labor long hours without receiving additional compensation. This was, in fact, the case prior to the passage of the FLSA. Congress decided that this was a market failure based on the asymmetrical bargaining positions of affected workers and employers, and thus enacted the OT rules to create a financial disincentive to subject employees to excessive work hours.

But who should be covered by such protections? President Franklin D. Roosevelt and key members of Congress began with an assumption that every worker falling within Congress's power to regulate interstate commerce should eventually have a workweek of 40 hours, with the exception of agricultural workers. Additionally, from the first draft of the bill that became the FLSA, the legislation exempted executives as a class that did not need protection, followed in subsequent drafts by administrative employees. They were, after all, the bosses, managers, and administrators who set the rules and policies that governed the workplace.

The FLSA OT regulations designate hourly workers as entitled to OT in virtually all cases because hourly pay is not associated with the prestige or security of the high-level employees Congress originally intended to exempt. In the Department of Labor's first report on the FLSA's overtime provisions in 1940, Presiding Officer Harold Stein wrote, "The shortest pay period which can properly be understood to be appropriate for a person employed in an executive capacity is obviously a weekly pay period and hourly paid employees should not be entitled to the exemption." Hourly-wage workers are also subject to having their wages reduced when they are absent from work for short periods, a condition that does not fit with the workplace reality of executives, administrative employees, and professionals.

The department recognized that rules were needed to prevent employers who sought to avoid time-and-a-half payments from simply designating every salaried employee as an executive or in another exempt category. Thus, the regulations laid out a set of tests intended to prevent such strategic exemptions.

Broadly speaking, there are two tests in these cases: a duties test and a salary test. The former has changed over time, as we explain below. The latter, with which we are most concerned, is straightforward and based on the notion that an employee's salary level is itself an indicator of status, and that workers paid below a threshold salary level should be paid overtime, regardless of their duties.

Brief history of white collar OT exemptions and their salary tests

Executive, administrative, and professional employees, along with "outside salesmen" (salespersons who work outside the office), have always been excluded from both the minimum-wage and overtime protections of the FLSA, but the definitions of each excluded group have always been left to the determination of the Secretary of Labor. Section 13(a)(1) of the FLSA states that "the provisions of sections 6 and 7 shall not apply with respect to (1) any employee employed in a bona fide executive, administrative, or professional capacity… ."

It is noteworthy that the exclusion is preceded by the modifier "bona fide," a signal that not just anyone with a corresponding title is to be excluded from the act's protections. Congress knew from experience with exemptions under the National Industrial Recovery Act's industrial codes and the President's Reemployment Agreement (which in 1933 began setting maximum work hours and minimum wages) that employers would try to avoid coverage by misclassifying ordinary workers as managers, executives, or other kinds of exempt "bosses." The National Recovery Administrator had felt compelled to declare that the exemption would be limited "to those who exercise real managerial or executive authority" and warned employers that paying anyone less than $35 per week created an irrebuttable presumption that the exemption did not apply. (Linder 2004, 268-269)

The 1940 amending regulations

Under the first FLSA regulations issued by the Department of Labor in 1938, the definition of exempt executive and administrative employees included duties tests and a salary test of only $30 a week, $5 less than the industrial codes had required several years earlier.

When the Roosevelt administration amended its overtime regulations in 1940 and kept the salary test for executives at $30 per week, it took pains to explain why it had adopted “such a low requirement”(U.S. DOL 1940, 21). According to DOL’s report that explained the regulatory changes, the low salary threshold was counterbalanced by the ease of determining the bona fides of executive function based on the fact of supervision and departmental authority, and by the compensating advantages that could be found in the nature of executive employment: the opportunities for promotion, and greater security of tenure. The FLSA’s goal of spreading employment was not especially well served by a narrow exemption because, by its very nature, “the executive’s work cannot be shared,” the report said. Finally, there was less need for a high executive salary threshold because, by denying the exemption to any employee who spent more than 20 percent of his time on nonexempt duties, the amended regulation made it easier to identify bona fide executives.

The 1940 regulations also separated the executive and administrative exemptions (which had been merged into a single exemption in the original implementing regulations), provided a less stringest duties test for administrative employees (no specific limit on time spent in nonexempt duties), and required a much higher salary level to satisfy the administrative exemption—$200 per month, the equivalent of about $40,000 a year today. The report stated, “It is believed that the employees in the administrative group are so heterogeneous in function that it would present a disproportionately weighty problem in administration to determine what constitutes nonexempt work. However, when this valuable guard against abuse [a strong duties test] is removed, it becomes all the more important to establish a salary requirement for the exemption of administrative employees, and to set the figure therein high enough to prevent abuse” (U.S. DOL 1940, 26). The new threshold of $200 a month was both 1.67 times higher than the $30 per week executive salary test and about 3.1 times the minimum wage.

The department further explained its salary level choice by examining the pay of a group of office employees whose duties consisted overwhelmingly of routine clerical work (stenographers, typists and secretaries) and who therefore clearly fell outside of the exemption. The correct salary level would act as a proxy for a more detailed duties test, disqualifying nonexecutive employees by disqualifying employees with lower pay. Because less than 1 percent of the nonexempt employees examined earned more than $2,400 a year, the department determined that the $200-per-month requirement was adequate to guard against abuse. A $35-per-week salary requirement could exempt almost 32 percent of bookkeepers and a $40-per-week salary requirement could exempt 20 percent; in contrast, a $50-per-week salary requirement could exempt only 8 percent of bookkeepers, an occupation that was undoubtedly nonexempt.

Most interesting, the department determined that a $50-per-week requirement would exclude about 50 percent of accountants and auditors, a group “whose work, while related to that of bookkeepers, requires in general far more training, discretion, and independent judgment.” The Roosevelt Labor Department found it appropriate and desirable to set the salary requirement at a level that would deny the exemption to more than half of accountants and auditors, presumably because their pay would reflect their employers’ understanding of their actual duties and responsibilities.

In 1940, the professional exemption's salary test was set at $200 a month as well, though the "traditional" professions of theology, law, and medicine had no salary test at all. The Department of Labor's 1940 report determined that $200 was the dividing line between subprofessional and fully professional employees, based largely on the federal government's pay schedules.

The report constituted the first full explanation of the thinking behind the department's regulatory choices in implementing the FLSA; it likely accurately reflects the understanding and goals of the Roosevelt administration, which proposed the FLSA, including section 13(a)(1), as well as those of Secretary of Labor Frances Perkins, who championed the act.

The 1950 regulations

The next major change in the regulations came in 1950, following an extensive set of hearings and another presiding officer's report and recommendations. (U.S. DOL 1949). The 1949 report outlining the regulations recommended a somewhat unfortunate innovation, the "special provisos for high salaried executive, administrative, or professional employees" (U.S. DOL 1949, 22). In essence, the regulations adopted two versions of the duties tests for each exemption category; the two versions became known as the long test (virtually identical to the 1940 regulations) and the short test (a new, simpler version with fewer elements to satisfy, accompanied by a much higher salary level requirement). The new short test of executive duties, for example, dropped requirements that the executive exercise hiring and firing authority over at least two employees and dropped the 20 percent limit on nonexempt duties. The salary level was set at $100 per week, as opposed to $55 for the long test. Thus, an employer willing to pay a high enough salary could meet the requirements for exemption without having to keep meticulous track of the employee's time to demonstrate that the 20 percent limit had not been surpassed.

The 1950 regulations made a major change in the duties test for administrative employees, adding a requirement (similar to the 1940 requirement for the executive exemption) to what would become known as the long test that no more than 20 percent of the exempt administrative employee's time could be spent on nonexempt duties. As the department's report explained, "An 'administrative' employee whose more important duties do not take up all his time may typically be assigned a routine function, such as keeping one of the ledgers or making up payrolls. While it is entirely reasonable to exempt an employee who performs a small amount of such unrelated clerical or other low-level work, it would be contrary to the purposes of section 7 and 13(a)(1) of the act to extend the exemption to such employees who spend a substantial amount of time in such activities" (U.S. DOL 1949, 59).

Nevertheless, despite an emphasis on limiting nonexempt duties to prevent undeserved exemptions, the regulations set up a higher salary threshold in the short test for the executive and administrative exemptions as a trade-off for eliminating the employer's obligation to enforce and document the time limitation on the exempt employee's performance of nonexempt duties.

Changes from 1959 through 2003

In 1959, DOL again amended the white collar regulations, following a report and recommendations by Presiding Officer Harry Kantor, written in March 1958. Kantor determined that the salary tests should be set "at about the levels at which no more than about 10 percent of those in the lowest-wage region, or in the smallest-size establishment group, or in the smallest-sized city group, or in the lowest-wage industry of each of the categories would fail to meet the tests." These levels worked out to $80 per week for executives and $95 per week for administrative and professional employees. To keep the previous ratio to the long test, Kantor recommended a short-test salary of $125 per week, or $862 in 2012 dollars.

The Ford administration updated the salary tests in 1975, choosing not to fully index them to changes in the consumer price index as a concession to concerns of the Council of Economic Advisers about inflation. The last increase until 2004, the 1975 update set the short-test level at $250 a week, the long-test level for executive and administrative employees at $155 a week, and the long-test level for professional employees at $170 a week.

In 1980, the outgoing Carter administration issued a final rule that would have raised the salary level thresholds substantially, but the rule never took effect and was withdrawn by the Reagan administration. No attempt to amend the regulations was made by the Reagan, Bush, or Clinton administrations. The passage of 29 years without an adjustment made the salary levels obsolete and irrational: By 2003, a full-time minimum-wage worker paid $5.15 an hour had weekly earnings above the white collar long-test salary thresholds. Annual inflation adjustments would have prevented this from happening.

The 2004 OT rules and their legacy of complications

When the George W. Bush administration finally amended the white collar overtime regulations in 2004, it eliminated the long tests and created tests with a uniformly low and wholly inadequate $455 a week salary test—barely more than the poverty threshold for a family of four. The 2004 rule also created a new, even more abbreviated version of the short tests with an annualized salary level of $100,000.

In addition, the 2004 rule made numerous changes to the duties tests for each exemption category. In our view, these changes have led to more confusion and ambiguity, and, even worse, to the unjustified exemption of salaried workers who, under the spirit of the law, should be covered, including, for example, an ill-defined class of "team leaders," certain embalmers and mortuary employees, and athletic trainers.

Under the current OT rules, salaried workers earning less than $455 per week automatically qualify for the OT wage premium. As noted throughout, this threshold is not automatically adjusted for inflation. Prior to 2004, the long-test weekly salary levels were $155 for executive and administrative employees and $170 for professional employees, and the short-test level was $250 for all three categories, where it had stood since 1975. Had the $250 weekly salary level simply kept pace with inflation since 1975, it would have been $970 in 2012; had the 1959 value of $125 for administrative or professional employees kept pace with inflation, it would have been $862 in 2012. Even the relatively low $455-per-week level set in 2004 would be $553 in 2012 dollars. In other words, simple inflation adjustments would mean many more workers would be automatically covered today.

We can think of no cogent economic reason not to adjust this salary cap for inflation. Certainly, the spirit of the law is vitiated if a covered worker becomes exempt simply because of nominal earnings gains that have no bearing on the actual purchasing power of her paycheck.

Today, employees earning between $455 and $1,923 in weekly salaries (or $23,660 and $100,000 in annual pay) are in a separate category under the FLSA OT rules. In order to avoid their being unjustly exempted from coverage, the law requires the application of a complicated duties test. Here, the law has traditionally conceptualized certain aspects of the employee/employer relationship as determining, together, whether the worker should be covered or exempted. For example, does the worker control her own schedule, something hourly workers typically do not? Does she manage others? If so, is that a small or a large part of her job? Does she control her work flow? Does she make important and independent decisions? What credentials must she have to perform the work?

Making these determinations has always been complicated, and the set of OT "reforms" in 2004 made them more so. One of the most exhaustive analyses of the problems with the duties tests as amended in 2004 is by Fraser et al. (2004). We summarize some of their findings here:

The rule creates an illusion of preserving the long test but in reality, it replaces it with the old short test while attaching a too-low version of the long test's salary level.

"In fact, however, the Department's new rule expands the classes of exempt employees by applying, for the vast majority of workers, a rule matching a variant of the old 'easy' duties with the new 'low amount' salary. And – presto! – the worker finds a walnut shell with no overtime under it, and the employer is now able to qualify many more employees as exempt than the existing regulatory structure ever contemplated." (Fraser et al. 2004, 14)

The abandonment of the 50 percent rule has the potential to exempt workers who perform even a tiny amount of exempt duties.

The original regulations issued within months of the FLSA's passage required that an employee, to be an exempt executive, could do "no substantial amount of work of the same nature as that performed by nonexempt employees of the employer." In its enforcement, the Department of Labor's Wage and Hour Division treated work in excess of 20 percent of an employee's time to be "substantial" enough to deny the exemption, and employers generally conceded the fairness of that threshold and the need for a sufficiently definite rule. Thus in 1940, when the Roosevelt administration amended the regulations for the first time, it added a fixed limit on nonexempt work of 20 percent.

A new, high-compensation proviso added to the regulations by the Truman administration in 1950 introduced a more expansive allowance for nonexempt duties, one that did not have an explicit time limit; however, this permissive treatment applied only to relatively highly paid employees, whose annual salaries, adjusted for inflation, would be above $43,000 today.

Over the years, that looser test became conflated with the determination of the employee's "primary duty," which was codified as a 50 percent "rule of thumb": "[i]n the ordinary case it may be taken as a good rule of thumb that primary duty means the major part, or over 50 percent, of the employee's time." In other words, while the 20 percent limit on nonexempt duties did not apply under the short test, it was effectively replaced by a rule that half of the exempt employee's time had to be spent performing an exempt primary duty.

The 2004 regulations went even further and abandoned any serious notion of time limitations on nonexempt duties, a change Fraser called "a grievous loss." (Fraser et al. 2004, 14) The new rules defined "primary duty" as the "principal, main, major or most important duty," thereby essentially eliminating the relatively more objective factor of how the employee actually spends his or her time. Instead of a rule that only exempts an employee if she spends at least half her time performing an exempt activity, the regulations now state that she may be exempted if the duty the employer considers most important is an exempt duty.

In contrast with an examination of what the worker actually does all day, what her employer deems "most important" is subjective. Imagine, for example, a salaried assistant manager at a clothing store who spends a few hours training new hires in the course of a week. If her employer considers that her most important duty, she could be an exempt executive even though a significant majority of her time is spent assisting customers and running a cash register. And as Fraser and his co-authors point out, the employer's choice will tend to be biased: "an employer, if called upon to state which of several duties of an employee is primary, will likely choose the one which results in the employee's exemption from the requirements of the law (thereby effectively reducing labor costs)." (Fraser et al. 2004, 14)

Administrative exemptions are too broad

Under the 2004 rules, office or nonmanual employees whose work is directly related to management policies or general business operations and who exercise any "discretion and independent judgment with respect to matters of significance" can be exempted. Fraser et al. found (and we agree) that this is an arbitrary classification that has lost all connection to the original administrative exemption, which required the employee to be responsible for a function of the organization, if not of subordinate employees, and required him to be engaged in the business operations as a staff person rather than as a production or line employee. When the administrative exemption was first conceived as separate from the executive, in 1940, the department's report stated, "The term 'administrative' can . . . be reserved for persons performing a variety of miscellaneous but important functions in business. This latter group is large in modern industrial practice, and includes typically, such persons as personnel managers, credit managers, buyers, supervisors of machine tools, safety directors, claim agents, auditors, wage-rate analysts, tax experts, and many others." The Roosevelt/Perkins DOL could not have envisaged automobile claims adjusters, for example, qualifying for the exemption, although employers routinely classify them as "administrative" for purposes of the OT provisions.

As with the executive exemption, the 2004 rules make no reference to the allocation of the exempt administrative worker's time. For example, an administrative assistant might have the authority to independently decide whether she should refer certain "cold calls" to her supervisor (as does the assistant of one of the authors of this paper). Though this happens only a few times a week, it could be considered grounds for exemption under the current rules. In contrast, the original administrative exemption contemplated exemption only of workers fully engaged in managing a function—personnel managers, credit managers, supervisors of machine tools—but not of someone only occasionally involved in a task deemed important in the sense of exemption from OT coverage.

Another problem with the current duties test is the risk of erroneous exemptions, as, for example, under the "team leader" provision, which assumes managerial responsibilities for team leaders on "major projects" and grants exemptions when those responsibilities are deemed sufficiently important to the employer—a completely subjective determination. Also, the 2004 duties tests allow exemptions for workers with various credentials or licenses, again with no reference to actual managerial, supervisory, or independent responsibilities.

The rationale behind our recommendations

Principles to apply

Several important principles emerge from our review of the regulatory history of the white collar exemptions.

Bright-line, objective tests regarding duties are preferable to the ambiguous and ill-defined subjective tests that have replaced them. Explicit limits on the time that exempt employees may spend performing nonexempt duties would provide far more guidance than vague tests based on the employer's subjective feelings about the importance of one duty compared with another. In the first years after passage of the FLSA, when the law and its purposes were freshest in the minds of the Department of Labor officials who had advocated for and helped draft the act, the regulations reflected an understanding that an exempt employee should do no substantial amount of nonexempt work, and should in no case devote more than 20 percent of her time to such duties.

Clarity and simplicity are aids to administration and to compliance by employers. For example, if employees cannot understand whether they exercise sufficient independence or judgment in their work, or make decisions about sufficiently important matters, to be exempt, they cannot demand their rights. The more employees and employers can rely on objective tests, the better.

Although it would be reasonable to restore the original requirement that an exempt executive may not perform a significant amount of work of the same nature as that performed by nonexempt employees, and in no case may such work involve more than 20 percent of an exempt employee's time, for simplicity's sake we instead recommend focusing on salary levels.

Updating the salary level: Why use 1975 updated to today?

As noted, we recommend an updated salary threshold of $250 per week (the 1975 level), adjusted for inflation since that year. Because inflation, as measured by the CPI-U-RS, has been almost 290 percent since 1975, the adjusted level is $970 per week. While we readily admit that any level will involve some arbitrariness, in this section we explain why we think the indexed 1975 level makes sense.

First, however, we stress that the salary level has become increasingly important over the years as a bright-line indicator of which employees are clearly exempt and which are not. However difficult it might be to judge whether an employee's primary duty is truly that of an executive or exempt administrative employee, an employee and her employer can easily determine the level of the employee's pay. The salary level is the clearest, most easily applied test of exemption.

It is also true, as the department declared in 1940, that "the final and most effective check on the validity of the claim for exemption is the payment of a salary commensurate with the importance supposedly accorded the duties in question." Or, as the department said in its 1958 hearing report and recommendations, "[i]t is an index of the status that sets off the bona fide executive from the working squad leader, and distinguishes the clerk or subprofessional from one who is performing administrative or professional work."

To be commensurate with the status and prestige expected of exempt managers and executives, the salary level should be well above the median wage, the wage paid to the typical production, nonsupervisory employee. When the Ford administration raised the salary threshold in 1975, it was 1.57 times the median wage. The median wage today is $16.70 per hour. Were we to update that same ratio—1.57 times the median wage—the short-test threshold would be $26.22 an hour, around $1,050 on a weekly basis and $54,536 on an annual basis, suggesting that our recommended $970 weekly threshold is on the low side.

The salary level for exemption must also be, according to the 1949 report, "considerably higher" than the level of newly hired "college graduates just starting on their working careers." As the report explained, "[t]hese are the persons taking subprofessional and training positions leading eventually to employment in a bona fide professional or administrative capacity." Entry level wages and salaries for college graduates in 2011 were $21.68 per hour for men and $18.80 per hour for women. Using the Department of Labor's reasoning in 1949, we determine that the salary level for exemption must be "considerably higher" than $800 a week or $41,600 a year, a view that is again consistent with our updated 1975 threshold. The 1950 rule set the level 25 percent above the college entry-level wage; applying that same ratio today would yield a salary of $1,000 a week.

The relationship between the original salary-level test threshold and the minimum wage was 2.73-to-1. When the administrative test was established as a separate category of exemption and given its own salary level, its ratio to the minimum wage was 3.1-to-1. And in 1975, before the 29-year period when the department failed to increase the salary levels, the short-test salary level was set at a ratio of approximately 3-to-1, close to our choice of the 1975 test adjusted for inflation.

CPS earnings data for 2012 show that only about 20 percent of full-time, salaried workers have weekly earnings below the current salary threshold of $455 per week, while just under two-thirds earn less than $970. Is the higher threshold, covering about 40 percent more of salaried workers, more consistent with the goals of the policy than the current threshold? Clearly this is a challenging question given both data limitations and the qualitative aspects of some of the duties tests. But the following evidence supports our choice:

- BLS publishes data (most recently from 2010) of supervisory workers by occupation and median weekly earnings (U.S. BLS National Compensation Survey). For management occupations, the BLS breaks out four levels of supervisory responsibilities, and the median weekly earnings range from $1,520 to $3,995. Thus, by this metric, our threshold is well below a level associated with supervisory, and presumably exempt, duties.
- Looking at the full list of median earnings for supervisory jobs in management, only "team leaders" who were preschool education administrators, food service managers, property managers, and lodging managers earned below our threshold (and note that for some of these occupations, the mean, as opposed to median, earnings were above $970 per week).
- BLS grading of occupations by leveling factors (scores given to each occupation based on its demands for skill, knowledge, and responsibilities) find the hourly wage of about $24 (970/40) to be consistently below level 7 (out of 15), also consistent with nonsupervisory responsibilities.

In light of these lessons, we recommend that the administration establish the following:

1. A salary test set at the inflation-adjusted level of the short test in 1975—$970 per week in 2012 dollars.

TABLE 1

Occupation	$455–$970	>$970
Bookkeeping, accounting, and auditing clerks	212,468	282,607
Secretaries and administrative assistants	570,180	838,246
Claims adjusters, appraisers, examiners, and investigator	90,308	172,870

Source: 2012 CPS Earnings Files

Below this level, salaried employees would not be exempt, whatever their duties might be, and would be guaranteed overtime pay for work in excess of 40 hours a week.

2. Inflation adjustment of the salary-level test going forward.

The impact of our recommendations to raise the salary threshold

This section briefly summarizes the likely job-market effects of extending OT coverage to all of the estimated 20 million salaried workers whose full-time weekly earnings are between $455 and $970. The two key points on which we focus are a) the number of affected workers, and b) the incidence of the OT time-and-a-half provision (who pays for the extra salary?).

First, not all of the workers in this range are currently exempt from OT; since some workers in this salary range are already covered, 20 million is an unrealistic upper bound on the number of salaried workers who would gain coverage under our proposed change. Unfortunately, there are no data sets that would allow us to determine how many nonexempt workers are in that range. However, since our data (CPS Earnings Files) do contain detailed occupation codes, we can derive a very rough estimate by excluding workers whose occupational tasks would give them nonexempt status under today's duties tests.

Table 1 shows our analysis of just a few occupations with duties characteristic of covered, nonexempt jobs. In each case, significant numbers and shares of workers earn between the current and proposed thresholds, meaning they are not automatically covered under current law but would be under our proposed salary-test level.

For example, there are approximately 212,000 salaried bookkeepers in this range. A look at their tasks, as offered by O-NET—the online site devoted to detailed enumeration of occupational tasks—suggests that many of these workers already are, or at least should be, nonexempt.

Still, even were we to net out the workers under our new, higher threshold such that the number newly covered would be well below 20 million, our reform would significantly increase the number of covered workers, and thus possibly increase labor costs. All else equal, would this lead to fewer hours of work demanded by employers?

Not necessarily. The determinant issue in cases of wage mandates (or taxes) is one of incidence. Who bears the cost of the mandate? In the case of OT regulations, labor economists employ two basic models with quite different incidence implications.

One model, which we call the base-wage-adjustment, or BWA, model, posits that the incidence falls on the workers. Since employers have a rough sense of how much they want to pay for a given worker, including any time-and-a-half overtime costs, they will adjust their "straight-time," or base wage, offer down to a level that will make the total hourly wage, including OT costs, equal to their intended rate of pay.[2]

Under this model, wage offers adjust to hold labor costs constant. Assuming the employer's estimate of the number of OT hours is roughly correct, the BWA model predicts little change to labor costs and thus employment. An exception would be for workers with earnings near the minimum wage, since employers cannot adjust wages below the minimum.[3]

The other model simply assumes no adjustment (NA), maintaining that OT rules increase the marginal cost of an hour of labor by covered workers beyond what employers planned when they hired them. This would lead to a decline in their OT hours, though it could also lead to an increase in hiring of additional workers to complete the necessary work without invoking the OT premium. In fact, one motive for the original rule was that by increasing the relative cost of OT labor, employers would have an incentive to increase hiring rather than pay time-and-a-half. To the extent that the BWA model holds, however, there is no increase in labor costs from OT (more precisely, from expected OT) and thus no impact on hours or hiring.

Barkume (2008) finds evidence for both effects, though consistent with the conventional assumption by labor economists about the incidence of mandates (or payroll taxes), his estimates suggest that the BWA model dominates the NA model.

Mapping these findings onto our suggested reform is tricky in at least one regard. Since lifting the salary threshold would presumably cover workers who are now exempt, employers would have to lower their base wages to make the adjustments suggested by the BWA model. That is much easier to do with new wage offers than with existing workers (nominal wages are rarely lowered), so perhaps the more standard NA would apply initially. Over time, BWA dynamics could take hold if employers provide fewer and smaller raises than they would otherwise provide.

Of course, we recognize that the BWA model works against some of the reform rationales we raised above. If OT is designed to provide a compensating wage differential to workers working more hours than what is generally considered as full-time work, then a downward adjustment that partially erases that differential is obviously less beneficial to workers. However, this is really only a problem in cases where employers use more OT hours than they expected when setting the base wage, since it is only in that case that the worker would earn more in total salary. If OT hours worked are roughly what was expected (or less than expected), the worker is better off by dint of the regulation.

Conclusion

Our review of the history of OT regulations dating back to their inception in the FLSA of 1938 leads us to conclude that confusing and ambiguous duties tests in tandem with the lack of proper adjustment of salary tests have left too many salaried workers uncovered by time-and-a-half regulations. We recommend raising the salary threshold to $970 per week, which is the 1975 threshold updated for price growth, and strongly urge that this salary be adjusted for inflation going forward.

Why the 1975 threshold? While any threshold will have an arbitrary element, the 1975 threshold is consistent with both the qualitative goals articulated by both the FLSA and officials of the DOL and the central goal of the salary test: to ensure that those whose pay did not reflect the status and prestige of exempt workers were covered by the OT protections.

This change would entitle millions more workers—likely between five and 10 million—to the OT protections in the FLSA. While opponents of such changes historically have argued that they distorts the labor market by increasing the marginal costs of labor, this line of argument erroneously assumes that the incidence falls on the employer, not the worker. Labor economists consistently assume otherwise—that the incidence falls on the worker—which in this case means that the wage offer reflects expected overtime hours, as shown in footnote two. As such, there is no change at the margin from expanding coverage, at least once the pay of newly covered, existing workers is allowed to adjust.

More comprehensive reforms of the OT regulations would improve or repeal most of the 2004 changes in the duties tests, including by, for example, removing language that exempts team leaders, removing athletic trainers from the exempt professional occupations, and restoring the primary duty test to measure the duty an employee performs during most of her work time, while eliminating the notion that one can be performing management duties while performing menial duties.

However, while we urge the Department of Labor to undertake such comprehensive reforms, we recognize that the reforms will be complex and time consuming. Raising and indexing the salary threshold is a simpler reform that could be accomplished in the very near term.

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Endnotes

1. All inflation adjustments in this study are made using the CPI-U-RS.

2. If w equals the hourly wage the employer plans to pay for a given worker and w_1 is the base wage offer, including OT costs, TOT equals total weekly hours, and OT equals overtime hours (so TOT=40+OT), then w=OT/TOT*1.5*w_1+40/TOT*w_1. So, an employer who views a new worker as worth $10/hr (so w=10), and expects her to work 10 hours of OT per week, would offer her a base wage (w_1) of $9.09.

3. While research by both Trejo (1991) and Barkume (2008) find some evidence that the probability of OT hours is lower at wage levels near the minimum, as predicted by the BWA model, the latter study finds the likelihood of overtime to be insignificant in states with higher minimum wages relative to the federal level, the opposite of the BWA prediction (because states with higher minimum wages have less room for downward wage adjustment than states with lower minimums).

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