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How California's AB5 protects workers from misclassification

Fact Sheet • By Celine McNicholas and Margaret Poydock • November 14, 2019

In September, California adopted a new law aimed at combatting the misclassification of workers. The legislation, Assembly Bill (AB) 5, will take effect on January 1, 2020. AB5 adopts the "ABC" test that has been used by courts and government agencies to determine employee status. Under this test, workers can only be classified as independent contractors when a business demonstrates that the workers:

a. Are free from control and direction by the hiring company;

b. Perform work outside the usual course of business of the hiring entity; and

c. Are independently established in that trade, occupation, or business.

Workers who don't meet all three of these conditions must be classified as employees for purposes of state wage and hour protections. AB5 will help ensure that California's workers who perform core work under company control versus as independent businesses have access to basic labor and employment protections and benefits denied independent contractors, including minimum wage and overtime protections, paid sick days, workers' compensation benefits, and unemployment insurance benefits. Further, the legislation will protect law-abiding businesses that properly classify workers from unfair competition from companies that cut costs by misclassifying workers: AB5 will make it more difficult for companies to avoid paying their fair share of Social Security, Medicare, and unemployment insurance taxes and avoid providing state workers' compensation insurance. In contrast, employers would not be held accountable under a ballot initiative backed by digital platform companies.

Misclassification is widespread

The misclassification of workers as independent contractors is a serious and persistent problem nationwide. A 2000 study commissioned by the U.S. Department of Labor found that between 10% and 30% of audited employers misclassified workers and that up to 95% of workers who claimed they were misclassified as independent contractors were reclassified as employees following review.[1]

Table 1

Employee v. independent contractor coverage in California

Labor standard	Employee	Independent contractor
Minimum wage	√	X
Overtime pay	√	X
Unemployment insurance	√	X
Workers' compensation	√	X
Paid sick days	√	X
Paid family leave	√	X
Discrimination and sexual harassment protections	√	X

Source: EPI analysis of California labor laws

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Misclassification robs millions of workers of labor and employment law protections and deprives federal and state governments of billions in tax revenues

How a worker is classified has serious implications. For workers, the costs of misclassification are high. Most federal and state labor and employment protections are granted to employees only, not independent contractors. So, when an employer misclassifies a worker as an independent contractor, the employer robs that worker of the basic protections intended to serve as foundational standards for all workers. For example, a misclassified worker loses access to a minimum wage and overtime pay, and is no longer protected from discrimination and sexual harassment. Further, workers face additional financial responsibilities, including taxes and insurance obligations (see Table 2). For these reasons, independent contractor status should apply only to those workers who have made the decision to go into business for themselves and where the firms that they contract with do not control the way they get their job done.

State and federal governments also lose when workers are misclassified. As noted, companies that misclassify workers avoid paying their fair share of Social Security, Medicare, and unemployment insurance taxes and avoid providing state workers' compensation insurance. The state of California estimates that the annual state tax revenue loss due to misclassification is as high as $7 billion.[2]

Table 2

Independent contractors' "benefits" in California

Benefit	Eligibility
Workers' compensation	Independent contractors do not qualify for workers' compensation.
Unemployment insurance	Independent contractors are not eligible for unemployment insurance and thus do not get unemployment benefits when they are not working.
Disability insurance	Independent contractors can apply for Disability Insurance Elective Coverage (DIEC), but coverage is not guaranteed.
Social Security and Medicare	Payroll taxes are not withheld in payments independent contractors receive. As a result, independent contractors must pay the Self-Employment Tax to cover Social Security and Medicare.

Source: EPI analysis of California labor laws

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AB5's straightforward test protects against misclassification of a range of California workers, not just gig workers

In 2018, the California Supreme Court issued a unanimous decision, *Dynamex Operations West, Inc. v. Superior Court of Los Angeles*, which clarified that the "ABC" test should be used to determine whether a worker is an employee or independent contractor under California's wage orders.[3] The test is a straightforward analysis that presumes that a worker is an employee unless the employer can demonstrate that the three parts of the test do not apply to the work arrangement. AB5 codifies the *Dynamex* decision and adopts the "ABC" test, with some exceptions, including licensed insurance agents, commercial fishermen, and real estate licensees.[4] A study by the UC Berkeley Center for Labor and Education estimates that 64% of workers who currently do independent contracting as their main job would be categorized as an employee under the ABC test.[5]

While much of the debate around AB5 focused on its application to gig/digital platform companies, the standard applies across all sectors of work in California. This means that AB5 will make it harder for companies to misclassify janitors, construction workers, home health aides, and hotel and hospitality workers as independent contractors. AB5 applies for purposes of California's wage and hour laws.[6]

AB5 does not give workers' the right to join a union

AB5 helps to ensure that workers are correctly classified as employees for purposes of state wage and hour protections. However, the bill does not offer workers one of the most important labor and employment rights: the right to join a union. Federal law preempts states from legislating private-sector workers' union and collective bargaining rights. Specifically, the right of private-sector workers to join together in collective action through a union or other means is established by the federal National Labor Relations Act (NLRA),

which does not cover independent contractors. The National Labor Relations Board (NLRB), the agency tasked with administering and enforcing the NLRA, has systematically narrowed the scope of workers covered by the NLRA under the Trump administration. Further, the Trump board recently ruled that it was not a violation of federal labor law for an employer to misclassify its employees as independent contractors.[7] This leaves workers vulnerable to misclassification under the NLRA. Federal labor law reform must establish a similar test to the "ABC" test for workers to have meaningful access to union rights. This is especially true for gig/digital platform workers because the Trump NLRB's General Counsel, based on flawed logic, has already found them to be independent contractors under the NLRA.[8]

Gig companies' ballot initiative is a campaign to continue to misclassify workers

The passage of AB5 was met with intense opposition from gig/digital platform companies. Companies including Uber, Lyft, DoorDash, Postmates, and Instacart pledged to spend $110 million on a ballot initiative that would exempt them from AB5 regulations.[9] They filed the Protect App-Based Drivers and Services Act on October 29, 2019, hoping to qualify as a ballot initiative on the November 2020 ballot. In exchange for exempting gig workers from AB5, the proposal includes an earnings floor for drivers (set at 120% of the minimum wage), health subsidies consistent with employer contributions under the Affordable Care Act for drivers who work 15 hours or more per week, and auto-insurance coverage. While the ballot initiative would provide gig workers with some access to benefits and a wage floor, it denies these workers coverage under the most basic employment protections by continuing to allow companies to misclassify their workforces. These companies avoid meaningful responsibility under the law and instead invent standards for digital platform workers.

Much of the messaging opposing AB5 argues that it will cost workers flexibility. However, workers classified as employees enjoy flexibility under current law. For example, under current law, employers may choose to allow their workers to vary the start or end of their workdays, including on an ad-hoc basis.[10] Employers may also choose to permit employees to schedule four 10-hour days with one workday off, or arrange nine-hour workdays with a day off every other week. All of these arrangements are permissible for employees covered under existing wage and hour laws. Employees can enjoy flexible schedules without sacrificing basic workplace protections.

Conclusion

AB5 is an important step forward for workers in California. On January 1, 2020, when AB5 takes effect, employers across the state should comply with the law and ensure that workers are properly classified and receive the required protections.

Table 3

Comparing worker rights under AB5 and proposed gig worker ballot initiative

Labor standard	As employees under AB5	As exempted gig workers under ballot initiative (Protect App-Based Drivers and Services Act)
Minimum wage	√	X*
Overtime pay	√	X
Unemployment insurance	√	X
Workers' compensation	√	X
Paid sick days	√	X
Paid family leave	√	X
Discrimination and sexual harassment protections	√	√
Right to join a union	X	X

*The UC Berkeley Labor Center estimates that loopholes in the initiative leave Uber and Lyft drivers with a pay guarantee that is equivalent of a wage of $5.64 per hour, far less than the 120% earnings guarantee provided by the initiative. See Ken Jacobs and Michael Reich, "The Uber/Lyft Ballot Initiative Guarantees only $5.64 an Hour," UC Berkeley Labor Center blog, October 31, 2019.

Source: A.B. 5, 2019–20 Assemb., Reg. Sess. (Cal. 2019); Nielsen Merksamer LLP. 2019. Memorandum, Request for Title and Summary for Proposed Initiative Statute: Section 1, Chapter 10.5, App-Based Drivers and Services. Received by California Attorney General Xavier Becerra's Office, October 29, 2019.

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Endnotes

1. Planmatics, Inc., *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs*. Report prepared for the U.S. Department of Labor Employment and Training Administration, February 2000.

2. State of California Department of Industrial Relations, "Worker Misclassification" (web page), accessed November 2019.

3. *Dynamex Operations v. Superior Court* (2018) 4 Cal. 5th 903.

4. See AB5 text: "These exempt occupations would include, among others, licensed insurance agents, certain licensed health care professionals, registered securities broker-dealers or investment advisers, direct sales salespersons, real estate licensees, commercial fishermen, workers providing licensed barber or cosmetology services, and others performing work under a contract for professional services, with another business entity, or pursuant to a subcontract in the construction industry." A.B. 5, 2019–20 Assemb., Reg. Sess. (Cal. 2019).

5. Sarah Thomason, Ken Jacobs, and Sharon Jan, *Estimating the Coverage of California's New AB 5 Law*, UC Berkeley Center for Labor Research and Education, November 12, 2019.

6. While the Fair Labor Standards Act (FLSA) creates basic wage and hour protections for most employees in the U.S., states can pass laws with higher standards. For example, the federal minimum wage is $7.25 but California's is $12.00 and will be $15.00 an hour by 2022. In the

absence of higher state standards, federal law prevails.

7. Celine McNicholas, Margaret Poydock, and Lynn Rhinehart, *Unprecedented: The Trump NLRB's Attack on Workers' Rights*, Economic Policy Institute, October 16, 2019.

8. Lawrence Mishel and Celine McNicholas, *Uber Drivers Are Not Entrepreneurs: NLRB General Counsel Ignores the Realities of Driving for Uber*, Economic Policy Institute, September 20, 2019.

9. Michael Hiltzik, "Gig Firm Instacart, Facing Revolt by Its Workers, Joins Uber's Campaign to Reduce Pay," *Los Angeles Times*, November 4, 2019.

10. Ross Eisenbrey and Celine McNicholas, "Letter to the U.S. House Education and the Workforce Committee on The Working Families Flexibility Act (H.R. 1180)," May 2, 2017.