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US Daily: The New Federal Overtime Rules: Little Effect on Pay, Potential Boost to Payrolls (Phillips)

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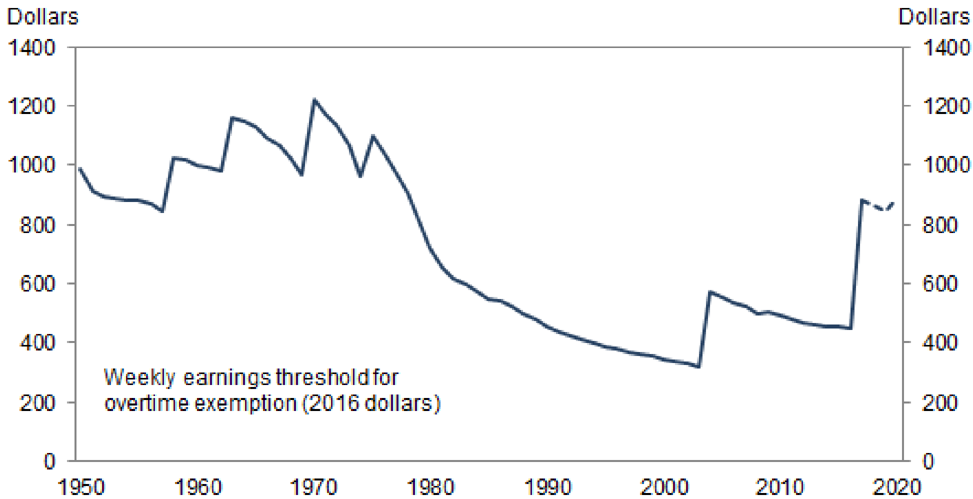
- The Department of Labor has released the final version of its proposed expansion of overtime rules. While the changes look unlikely to noticeably affect average hourly earnings when they take effect in December 2016, they could provide a modest lift to payrolls if employers cut overtime hours and hire new workers to make up the difference. Employer behavior following the last increase in 2004 suggests that this effect could boost payrolls by about 100k this time around, or around 10k a month if spread over several months to a year following implementation in December.

The Department of Labor (DOL) today (May 18) finalized the expansion of federal overtime rules that it proposed last year. Under current rules, employers must pay workers 150% of their normal hourly pay for each hour worked in excess of 40 hours per week. However, the rules have several exemptions, the most important of which is the exemption of "executive, administrative, and professional" workers. Currently, workers must satisfy three criteria to be exempt: (1) the employee is paid a fixed salary (not an hourly wage); (2) the worker's salary is greater than $455 per week ($23,660 annually), and (3) the job consists primarily of "executive, administrative, or professional" duties. Certain jobs (e.g., doctors, teachers, lawyers, and "computer-related" professions) are automatically exempt. Workers below the earnings threshold are automatically covered by overtime rules, subject to certain exceptions. Workers above the income threshold may still qualify if their "duties" do not qualify them for exemption.

DOL is making two important changes. First, the salary threshold for exemption would more than double, to $913/week, which we estimate will cover 36% of full time salaried workers when it takes effect in December. This is slightly lower than the $970/week threshold that DOL proposed last year. Second, DOL proposes to index the salary thresholds once every three years to the 40th percentile of full-time salaried workers in the lowest-wage census region. Notably, the DOL did not change the "duties test", which had appeared to be a possibility when the proposed rule was issued and which would have increased the number of workers affected by these changes.

This increase restores the threshold to around the level (in real terms) that prevailed from the 1950s through the 1970s. However, since the threshold has been updated only once since the 1970s, the upcoming hike in the salary threshold is far larger than any prior increase (Exhibit 1).

Exhibit 1: A large increase in the salary threshold



Source: Department of Labor, Goldman Sachs Global Investment Research

To estimate the effect of the new rules on the labor market, we first estimate the share of workers they affect. Using data from the Current Population Survey (CPS), we segment workers into hourly or salaried, by income and by hours worked. We find that as of April 2016, there were 2.3 million non-hourly workers who "usually" worked more than 40 hours and had a weekly income higher than the current threshold but lower than the new threshold, and another 800k in that weekly salary range who happened to work overtime last month.

However, this should be the upper bound on the number of potentially affected workers. As noted earlier, workers in certain jobs are automatically exempt from the overtime rules, as are workers who satisfy the "duties test". DOL estimates that of roughly 29.9 million salaried white collar workers not already covered by overtime rules, 4.2 million would be covered by the new rules and, of these, only about 1 million of them actually work overtime in a given week. This is slightly less than DOL estimated last year, presumably because the weekly salary threshold is slightly lower than previously proposed.

The effect of the new rules on the labor market will depend largely on employers, who could respond in several ways depending on how much overtime an employee is expected to work and how close an employee is to the new threshold. We would not expect many employers to make significant adjustments for employees who only occasionally work more than 40 hours per week, at least initially. These workers account for about ¼ of the affected overtime hours we calculate from the CPS data.

However, employers are likely to adapt their compensation practices to the new rules for employees who usually work overtime. They are likely to consider three general options, in our view. First, they could reduce these employees' regular weekly salary or convert them to an hourly wage, so that their total compensation, including overtime, remains roughly constant. Employers seem most likely to follow this strategy for employees who "usually" work more than 40 hours per week for a fixed salary. However, in some cases this would be difficult, particularly if employees do not work a consistent amount of overtime.

A second approach would be to raise workers' weekly salaries to just above the threshold to exempt them from the new rules. This seems likely only for employees whose salary is very close to the new threshold, since in most cases employers would be likely to choose a less costly option.

As a third option, some employers may limit newly affected workers to 40 hours per week and hire new employees to work the remaining hours at a normal (i.e., non-overtime) rate. This appears to have occurred to a degree following the last increase in the salary threshold in 2004. We can estimate the employer response by studying changes in the share of employees who worked overtime in the 12 months before and after those prior changes took effect, based on whether they were under the old threshold, above the new threshold, or in between the two and therefore affected by the change. The results suggest that the higher threshold led to a roughly 10-15% reduction in the share of employees who worked overtime in the newly affected group. This probably represents the low end of the potential effect, because the 2004 policy changes simultaneously raised the earnings threshold, which made more salaried workers potentially eligible for overtime, but loosened the duties test, which reduced overtime eligibility.

Our analysis of CPS microdata suggests that if a similar share of employers cut back overtime hours as did in 2004, it would take approximately 100k new full-time workers to make up the reduction in hours worked, though DOL's estimates of affected workers and average overtime hours suggests that the effect could be as small as 40k. However, since the latest policy change does not loosen the rules in certain respects the way the 2004 changes did, we would expect that the share of employers that cut back overtime hours would be greater than in 2004. The upshot is that a central estimate of around 100k full-time workers looks reasonable. We assume this effect would take place over several months or up to a year, potentially adding around 10k or more to monthly payroll growth in 2017.

By contrast, the new rules should have little effect on wages in the aggregate. If employers chose to pay all affected overtime workers 150% of their regular hourly-equivalent wage on overtime hours, this would boost the level of average hourly earnings by about 0.1%; however, since most employers are likely to reduce base pay or hire new workers to replace overtime hours, the effect would be even smaller. For example, DOL estimates the new rules will increase aggregate pay by $1.2 billion per year; it would take an increase several times this large to raise AHE by even 0.1%.

We would expect the employment effects to appear over several months following implementation in December 2016 as employers adjust to the new rules, though it is conceivable that the effect on hourly earnings could be slightly more concentrated if some employers pay the additional overtime costs while they adjust their employment policies.

Alec Phillips

Data Notes: We forecast that initial jobless claims declined to 270k in the week ending May 14.

Disclosure Appendix

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We, Jan Hatzius, Zach Pandl, Alec Phillips, David Mericle, Elad Pashtan and Daan Struyven, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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