



Bulletin:
Inefficiency and Greed

By James R. Ziegler, Ph.D.

Published by
P.A.C.E.

Professional Association of Contract Employees
<http://www.pacepros.com>

The Contract Employee's Handbook is online at
<http://www.cehandbook.com>

Bulletin: Inefficiency and Greed

What Do The Agencies Make?

The Ties That Bind

Recruiting firms can easily hide what they make because they practice *tying*. Recruiting firms tie the job matching function to the employer of record function. The up side of this arrangement is that recruiting firms help you locate contract assignments. The down side is that in order to take an assignment you must become their employee.

Even if you succeed in retaining your status as an independent contractor, the recruiting firm still holds you captive by keeping you from signing a direct contract with the end user and by refusing to disclose what they are billing the client for your consulting services.

In most industries tying is an illegal restraint of trade – an anti-competitive practice. Unfortunately, tying is still tolerated in the technical and professional contracting industry. Staffing firms can get away with tying because, while the contractor is indeed a *customer* of the staffing firm, the contractor is also the firm's *employee*. Laws against tying are written to protect customers and clients, not employees.

Tying Stifles Career Advancement

Staffing agencies use tying to isolate contractors from the very information they need to assess their careers. For example, staffing agencies invariably bar contractors from

active participation in contract negotiations with the client. Most contractors never see the contract that defines the very conditions under which they must work.

Staffing agencies also use tying to keep contractors ignorant of their value on the open market. They don't want contractors to know how *much* they could be billing as independent contractors, and they certainly don't want contractors to know how *little* they are being paid in comparison with their actual worth.

Staffing agencies view contract employees as their *competitors*, and they view contract details and billing rates as *competitive information* to be protected at all costs. Staffing agencies use tying as a strategic tool to protect their "competitive information."

If contract professionals are to regain their independence they must split the entirely separate functions of job matching and employer of record. They must break the ties (pun intended) that bind them to traditional recruiting firms.

Only then will contractors be able to make reasoned decisions based on the quality of service and on price. They will be able to work with an agency based on value delivered rather than on who controls the information.

What Is A Fair Margin?

It is easy to determine if a recruiting firm is charging a fair margin or if it is gouging both the client and the contractor. You begin by examining what stand-alone job-matching services and stand-alone employers of record charge for their separate services. Competition and full disclosure ensure that these stand-alone services are priced fairly.

A recruiting firm that matches you with a contract assignment and then forces you to become the recruiting firm's employee in order to take that assignment should surely charge no more than the combined charges for a stand-alone job-matching service and a stand-alone employer of record. In fact, the recruiting firm should be able to charge *less* owing to economies of scale and elimination of duplicate costs.

So let's review what stand-alone job-matching services and stand-alone employer of record services actually charge. If a so-called "full service" recruiting firm charges more than the combined charges of the separate stand-alone services it can only be attributable to *inefficiency and greed*.

The Cost of Stand-alone Job-matching Services

Savvy contractors develop and nurture a powerful, professional network of colleagues, clients, and coworkers. They search the contractor-friendly job boards and corporate career pages for contracting opportunities, and they contact prospective clients directly.

Savvy contractors negotiate their own contract terms and billing rates, and they do a better job of marketing their consulting services to prospective clients than any hack recruiter at a third-party recruiting firm.

Nevertheless, there are contractors who prefer to have someone else market their services.

Talented professionals in other industries employ talent agents to market their services. Examples of talent agents are actors' agents, sports agents, literary agents, and musicians' managers. Typically, talent agents earn 10% to 15% of the talent's gross revenues.

Talent agents work for the talented professionals they represent. Talent agents do not work for the production company, team owner, book publisher, or record label. That would be a conflict of interest.

Given that talent agents charge 10% to 15% we can assess the same value to the job matching service provided by third-party recruiting firms.

The Cost of Stand-alone Employer Of Record Services

The umbrella service business model offers contractors a far more comprehensive employer of record service than is available through any third-party recruiting firm. As the Executive Director of P.A.C.E., Professional Association of Contract Employees, I am very familiar with the services and costs of umbrella services.

Let's review the formidable benefits of P.A.C.E., <http://www.pacepros.com>, for contract professionals.

P.A.C.E. provides a "virtual back office" for contract professionals. P.A.C.E. processes time sheets, invoices the client, collects receivables, processes payroll, administers benefits, pays withholding and payroll taxes, and issues an IRS Form W-2 at the end of the year.

P.A.C.E. contractors enjoy continuity of employment with an established corporation, making it relatively easy to qualify for big-ticket credit items such as a home loan or auto lease.

P.A.C.E. contractors enjoy health and dental benefits that are far superior to those offered by traditional recruiting firms and placement agencies. Contractors qualify for group health and dental insurance after their first full month on the job. P.A.C.E. also reimburses its contractors with tax-free dollars for out-of-pocket medical expenses, including private insurance premiums, co-pays, and deductibles up to 10% of gross wages.

The P.A.C.E. 401(k) Retirement Savings Plan is an extremely aggressive, 100% self-directed, retirement savings program designed for highly compensated employees. It is unexcelled by any employer of record service in the country, and is vastly superior to any retirement plan

offered by any third-party recruiting firm. P.A.C.E. contractors may contribute pre-tax dollars equal to 25% of gross earnings up to \$30,000 per year into a Charles Schwab Personal Choice Retirement Savings account. There is no waiting period to qualify, and contributions are immediately vested.

P.A.C.E. reimburses its contractors with tax-free dollars for a wide range of out-of-pocket expenses. Qualified expenses include travel, business promotion, cell phone, modem lines, ISP, phone calls, training, personal health and disability insurance payments, dependent child care, home office supplies, computer equipment and expensive software (through our leaseback program), per diem and auto allowance while on temporary, remote assignments, and virtually any other work-related expense that an independent contractor would otherwise claim on IRS 1040 Schedule C.

And finally, P.A.C.E. contractors enjoy the same professional freedom experienced by self-employed, independent contractors. P.A.C.E. contractors choose when, where, and for whom they will work. They set their own billing rates, and they negotiate their own contract terms.

P.A.C.E. provides all of the above, yet P.A.C.E.'s margin is never greater than 15%. P.A.C.E.'s contractors still earn at least 85% of the billing rate after P.A.C.E. deducts its standard 5% service fee plus the employer's share of payroll taxes.

Combined Costs

Talent agents who work *for* the talented professionals they represent charge 10% to 15% of the talented professional's revenues. Thus, the benchmark for the job-matching function of a full-service recruiting firm must be no greater than 15% of the billing rate.

The P.A.C.E. umbrella service business model provides the industry's most comprehensive employer of record service, yet P.A.C.E.'s overall margin is less than 15% of revenues. Thus, the benchmark for the employer of record function of a full-service recruiting firm must be no greater than 15% of the billing rate.

It is clear that any so-called full-service recruiting firm with a margin greater than 30% is padding the bill. They are gouging either the client company or the contractor, or both.

I attribute any excess in a recruiting firm's margin over 30% to *inefficiency and greed*.

Calculating Inefficiency and Greed

What is the real cost of using a full-service agency that takes more than 30% of the billing rate? Table 1 shows the cost of inefficiency and greed for billing rates of \$100 and \$50 per hour when the agency margin is 35%, 40%, 50%, and 60% of the billing rate.

Even at a relatively low agency margin of 35% the annual cost of inefficiency and greed is several thousand dollars. At higher agency margins the cost is higher yet.

I have calculated the cost of inefficiency and greed based on the assumption that a typical contractor will only work a total of ten months out of the year, the remainder being vacation, sick days, national holidays, bench time between assignments, and time off for training. It is clear, however, that the more hours a contractor works the more he or she will loose to inefficiency and greed.

How do you know how much your agency is taking off the top? Ask them! If they won't tell you their margin then you know they are taking too much, and they don't deserve

your business. Call around until you find an honest agency that will work on *your* terms. You should not have to pay for someone else's inefficiency and greed.

Better yet, don't even use a third-party recruiting firm. The analysis in this paper shows that you will do much better financially if you split the job matching function and the employer of record function. Use a talent agent if you must, or use your own wits to locate your next assignment. Then, if the client wants you to be someone else's employee, use an umbrella service as your employer of record.

Table 1: Calculating The Cost Of Inefficiency and Greed.

Billing Rate Per Hour	Gross Wage Per Hour	Cost Per Hour	Cost Per 1600 Hours
35% Gross Margin: includes 5% inefficiency and greed			
\$100	\$65.00	\$5.00	\$8,000
\$50	\$32.50	\$2.50	\$4,000
40% Gross Margin: includes 10% inefficiency and greed			
\$100	\$60.00	\$10.00	\$16,000
\$50	\$30.00	\$5.00	\$8,000
50% Gross Margin: includes 20% inefficiency and greed			
\$100	\$50.00	\$20.00	\$32,000
\$50	\$25.00	\$10.00	\$16,000
60% Gross Margin: includes 30% inefficiency and greed			
\$100	\$40.00	\$30.00	\$48,000
\$50	\$20.00	\$15.00	\$24,000

The Greed In Independent Contractor Subcontracts

Consider this scenario. You ask a third-party recruiting firm to introduce you to prospective clients. You interview with one or more companies, you select a client, and the agency quotes a W-2 wage as the amount they will pay you.

You would like to sign directly with the client as an independent contractor but the agency explains in no uncertain terms that because the agency found the contract assignment they “own” the contract.

Agencies seek control of the contract because they perceive themselves as working *for* the client, and because they perceive you as their *direct competitor* (which, of course, you are).

Either you must work as the agency's employee or you must work as the agency's subcontractor. But in either case it is the agency that will sign a contract with the client.

As a subcontractor you have two options:

- Sign a subcontractor agreement with the agency as an independent contractor.
- Select an employer of record that will sign a subcontractor agreement with the agency as an independent contractor.

You may not need an employer of record if you qualify as a “1099-compliant” independent contractor. 1099-compliant means that you satisfy the common law factors that define an independent contractor relationship. In other words, you are able to satisfy the powers that be that there is little chance that the IRS or another government agency might reclassify you as an employee of the client.

Of course, you may not qualify as a 1099-compliant independent contractor, or the agency may have a blanket fear of reclassification, or you simply don't want the hassle

of running your own consulting business. In these cases you will have to become the employee of a third-party employer of record.

If you convert to independent contractor status the agency will save on payroll taxes, payroll processing costs, insurance costs, and the cost of money for payrolling you before they receive payment from the client. Instead, these costs will be passed on to you or your employer of record.

How much will the agency save because they are now paying you or your employer of record as an independent contractor?

If the agency does not pass the entire savings on in their pay rate they will realize a significant windfall, and you will end up earning significantly less than if you had agreed to be the agency's employee.

Assume for the sake of argument that the agency had originally offered you a W-2 wage of \$100 per hour. What must the agency pay to you as an independent contractor so that both the agency and you break even on the deal?

Below is a brief discussion of the payroll-related costs that *no longer apply* when the agency contracts with an independent contractor.

■ **Employer's share of payroll taxes – 12.45% of Gross Wage**

Companies pay out-of-pocket for payroll taxes on employee's wages. They do not pay taxes on what they pay to independent contractors. Payroll taxes include:

- **Workers Compensation – 0.5%**
Rates vary by region, industry, and experience level, but they average about 0.5% of GW for white collar professions.
- **FICA Social Security – 6.2%**
Employer pays 6.2% of GW out of pocket (and employee pays 6.2% of GW out of payroll). In 2001 the wage cap for FICA SS, above which neither employer nor employee pays, is \$80,400.

- **FICA Medicare – 1.45%**
Employer pays 1.45% of GW out of pocket (and employee pays 1.45% of GW out of payroll). There is no wage cap for FICA Medicare.
 - **FUTA Federal Unemployment Insurance– 0.8%**
The wage cap for FUTA is \$7000.
 - **State Unemployment Insurance – 3.5%**
Rates vary among states and with the company's experience level. The UI wage cap also varies among states. Owing to their high number of UI claims temp agencies and contractor recruiting firms have relatively high UI rates.
- **Additional costs associated with payrolling an employee – 2.35% of Gross Wage**
Agencies incur additional costs associated with computing, processing, and paying regular payrolls that they do not incur when paying independent contractors.
- **Cost of processing payroll – 0.5%**
This item includes the cost of a payroll service such as ADP, plus associated administrative labor costs to compute and process payroll.
 - **Cost for General liability and errors & omissions insurance – 0.15%**
Agencies pay for GL and E&O insurance to cover their own employees. They do not provide these insurance coverages for independent contractors. Independent contractors must pay for their own insurance coverage.
 - **Cost of benefits administration – 0.55%**
This item includes the set-up and maintenance costs for retirement plan and health insurance, plus associated administrative labor costs.
 - **Cost to pay wages in advance of client's payment – Minimum of 1.00%**
Temp agencies and recruiting firms must pay their contract employees on regular paydays. The cost of

money to advance payroll on regular paydays is about 1% of wages, assuming an average float of 30 days. Small firms that cannot qualify for a sufficiently high line of credit must sell their receivables to a factoring company. Factoring companies charge between 3% and 7% depending on volume.

- **Bad debt – 0.15%**

The cost of bad debt can vary widely depending on the state of the economy and on how well the agency qualifies its clients. Agencies must pay their hourly-paid temporary employees regardless of whether the client ever pays the agency. On the other hand, agencies pay their subcontractors only if and when the client pays the agency. When you operate as an independent contractor your agency passes on the risk of bad debt to you or to your employer of record.

Naturally, the overhead costs associated with payrolling agency employees will vary from agency to agency. However, these figures show that on average an agency will save about 15% of gross wage when it converts from an employer-employee relationship to a client-vendor relationship.

If you change your status from W-2 employee to independent contractor your agency should increase your wage by at least 15%. Anything less and the agency makes a windfall profit on the difference ... at your expense.

Most agencies will adjust up their W-2 pay rate by 5% or 10% at the most. Don't let them get away with it. Use this analysis to negotiate an independent contractor pay rate that is at least 15% higher than the agency's previously quoted W-2 rate.

Table 2 shows some equivalent independent contractor pay rates based on a payroll overhead cost of 15%

Table 2: W-2 Wage and Equivalent IC Pay Rate.

Agency's Offer of W-2 Wage	Equivalent IC Pay Rate
\$35.00 per hour	\$40.25 per hour
\$50.00 per hour	\$57.50 per hour
\$75.00 per hour	\$86.25 per hour
\$100.00 per hour	\$115.00 per hour

The Greed In Payroll Taxes

Contract employment agencies, like all other employers, must pay the employer's share of payroll taxes. The previous section shows that the employer's share of payroll taxes is about 12.5% of gross wage, although the exact percentage will vary from state to state and with the employer's experience rating for unemployment claims and workers compensation claims.

The employer's share of payroll taxes contributes significantly to the overall margin that an agency must charge to payroll a W-2 employee.

Agencies gain a huge windfall when highly paid contractors on long assignments exceed the annual wage caps for Federal unemployment taxes (\$7000), State unemployment taxes (wage cap varies by state), and Social Security taxes (\$80,400 in the year 2001). Once the wage caps for these taxes are exceeded, the employer's share of payroll taxes drops by approximately 10.5% of gross wage, and the agency gets a big raise. Temp agencies love highly compensated contractors on long assignments.

Independent contractors can look forward to significant savings in the employer's share of payroll taxes during the third and fourth quarters of each year, but contract employment agencies invariably keep the savings for themselves.

True umbrella services pass the savings in payroll taxes on to their contract employees. Agencies with fixed margins do not. Nevertheless, there is still hope.

As an agency contractor you may be able to use this information to your advantage during initial contract negotiations with your agency. Insert language in your employment agreement specifying that (1) the agency will increase your pay rate by an amount equal to the agency's unemployment tax rate upon reaching the Federal and State wage caps for unemployment insurance, and (2) the agency will increase your pay rate by an additional 6.2% upon reaching the Social Security wage cap.

Of course, the ultimate solution to the problem of greed in payroll taxes is not to use a fixed-margin agency as your employer of record. Instead, locate your contract assignments without the assistance of greedy recruiting firms and use an umbrella service as your employer of record.

* * * * *

About the author – James R. Ziegler, Ph.D. writes extensively on issues affecting contract professionals. He directs the **Contract Employee's Project** consisting of The Contract Employee's Handbook, The Contract Employee's Newsletter, The Contract Employee's Workshop, and P.A.C.E. Send e-mail to ziegler@pacepros.com.

About P.A.C.E. – P.A.C.E. offers its employer of record service nationwide. The P.A.C.E. website is at <http://www.pacepros.com/>. The Contract Employee's Handbook is at <http://www.cehandbook.com/>.

Contact P.A.C.E. -

Professional Association of Contract Employees
367 Civic Drive, Suite 15
Pleasant Hill, CA 94523

E-mail: admin@pacepros.com

Tel: (925) 680-0200.