

## Independent Contractors: an attractive option?

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*This paper explores the reasons for and the basis upon which employers may choose to engage independent contractors as opposed to directly employing employees. It has been a significant and recent trend to opt for independent contracting arrangements, whether by contracting out to existing external providers, or by "converting" employees into independent contractors. Often this has been in response to environmental changes, but without adequate consideration for strategic implications. Contracting out involves loss of control and skills and has implications for quality and health and safety.*

*The use of previous employees or the "conversion" of employees to independent contractors is an attractive option for employers seeking to minimise employment cost and obligation. The advantages include the transfer of risk and liability and the avoidance of employment "problems" such as leave and (perceived) dismissal complexities. The disadvantages to employers of using independent contractors are a function of control.*

*Independent contractor status may be advantageous to workers for both intrinsic and extrinsic reasons. However, some contractors that are in a position of dependence may require some form of protection to ensure that there is some premium for the undertaking of risk and liability. The implications of the Employment Relations Bill are discussed in relation to dependent contractors.*

### Introduction

The *Employment Contracts Act* (ECA) was introduced by the National Government in 1991 "to promote an efficient labour market". Along with economic restructuring and recessionary conditions, this contributed to the development of an environment where the "balance of power" favoured employers. High unemployment and weakened trade unions were not only facilitating factors, but also outcomes of this interplay. Employee concessions and staff reductions have been widespread and not unexpected. Employers have been encouraged and more able to create flexible employment contracts that suit their individual needs.

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In spite of these factors, employers appear to be actively pursuing means to improve the cost effectiveness of their workforces that go beyond the ambit of employment legislation. The most extreme measure is to opt out of employment altogether: to contract out, sometimes appropriately termed "distancing" (Atkinson and Meager, 1986a, 1986b).

The new Labour-Alliance Government's *Employment Relations Bill*<sup>1</sup> aims to address the inequality of bargaining power between employer and employee. However, employers' drive for cost effectiveness and flexibility in employment is unlikely to diminish. This impending change may only provide further impetus to the trend to contract out.

Employment practices and labour utilisation have undergone review by many businesses and enterprises in order to become more competitive, efficient and flexible. This has been to meet the demands of the domestic and global business environments characterised by competitive pressure, technological advance and uncertainty.

These initiatives have led to a growth in the use of "flexible" workers<sup>2</sup> as opposed to full-time, permanent employees (Deeks, Parker and Ryan, 1994). Although many organisations have traditionally made some use of flexible labour, the incidence has increased. Flexible forms of labour such as casual, temporary or fixed-term employees expose the organisation to less risk, in that they do not represent a commitment to on-going employment and its attendant costs. Contracting out or using independent contractors transfers risk and uncertainty to the contractor(s) as well as disposing of employment related "problems".

The drive for what tends to be broadly described as "flexibility"<sup>3</sup> has resulted in four models that an organisation may adopt as a means to increasing the flexibility and productivity of workers performing a particular activity:

1. Retain the activity in-house and improve employee productivity by management techniques including retraining, multi-skilling, motivation and incentive schemes. Redundancies and use of flexible (such as part-time and temporary) workers may be involved;

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<sup>1</sup> At the time of writing, the *Employment Relations Act 2000* was expected to take effect from 1 August 2000.

<sup>2</sup> Flexible workers are most easily defined as those that are not full-time permanent employees, that is: part-time, casual, temporary and fixed-term employees, agency and leased employees, homeworkers, outworkers, contractors, subcontractors and the self-employed.

<sup>3</sup> Flexibility essentially refers to the ability to respond and adjust to environmental changes. Much of the literature that has developed under the "flexibility" umbrella however describes employer *response* to changing circumstances rather than initiatives to enhance *ability to respond*. That is, rather than describing proactive measures in anticipation of the need to respond to environmental changes, it describes measures in response to changes that have taken place.

2. Retain the activity in-house but as a separate "business unit" that must operate in a competitive manner. The same management techniques as in 1. (above) are used in conjunction with competitive pressure to provide impetus. Redundancies may also be a feature of this model;
3. "Convert" existing employees into independent contractors. The relevant workforce becomes "redundant" and some proportion are contracted back as independent contractors;
4. Contract the activity out to external suppliers/providers. Here, of course, the relevant workforce *is* redundant.

This paper is concerned with the latter two models, and is presented in four sections. The first will discuss the basis upon which an organisation may contract out or use independent contractors. The second will outline more specifically the relative advantages and disadvantages to an employer of engaging independent contractors as opposed to employing employees. The third section briefly outlines the advantages and disadvantages to workers, and specifically the position of "dependent contractors". The implications of the *Employment Relations Bill* are discussed throughout and as the final section.

### Why employers contract out

There are several reasons why organisations typically use independent contractors for the performance of work. Hunter, McGregor, MacInnes, and Sproull (1993) have developed a useful typology:

1. *Traditional* rationales such as the provision of specialist services/skills or coping with peaks in demand;
2. *Supply-side* rationales where workers have a preference for self-employed status; and
3. *New* rationales, those concerned with "responding to increased ... uncertainty" (p.389), include reduced wage, overhead and training costs, to avoid tax and insurance administration, and perceptions that independent contractors are more productive or more committed (McGregor and Sproull, 1991).

The particular rationale given for the use of independent contractors, however, does not go far enough in providing an understanding of an organisation's decision to contract out.

Lonsdale and Cox (1998), based on a study of sixty organisations over a range of industries, categorise the bases of the decision to contract out as:

1. *Iterative and Entrepreneurial*: this approach is based on a regular assessment of the activities that will be essential in the market in the future. This emphasises a frame of reference that encompasses activities both within and external to the organisation (this may result in contracting out and in<sup>4</sup>). This is the "appropriate" approach, adopted by just 19 percent of organisations;
2. *Core Competency*: the decision is based on the core/non-core dimension, however the definition of core is based on the present rather than the future. This is by far the most common approach (52 percent);
3. *Short term cost and headcount reduction*: this is similar to an approach categorised by Reilly and Tamkin (1996) as "ad hoc pragmatic", one in which decisions are made on a short-term reactive basis and not as "part of any coherent resourcing strategy" (p.18). The danger with this approach is that a (future) core or essential activity may be contracted out, a risk taken by 29 percent of organisations.

The "core competency" strategy has become popular in the past two decades; the identification of "core" being specific to the particular organisation and its strategy. Core activities are likely to be those which are a source of competitive advantage or critical to the production process. Non-core activities involve skills that are transferable and require little firm-specific training; these skills may be general, technical or specialised. Generally then, activities contracted out should be non-core and require skills that are readily available in the market. These services should be provided more efficiently by a contractor that enjoys economies of scale.

There are strong suggestions that organisations are making decisions to contract out in response to economic conditions, with a lack of consideration for potential long-term or strategic consequences (James, 1992; Reilly and Tamkin, 1996; Lonsdale and Cox 1998). To some extent this assumption cannot be made without information pertaining to the nature of the activity contracted out in relation to what an organisation considers to be its core business. This is not always clear to an outside observer. However, many studies have reinforced this suggestion<sup>5</sup>; illustrated by Atkinson:

... manpower policies are often the unplanned outcome of business initiatives which have been taken without serious consideration of their manpower implications ... such policies are subordinate to business needs and do not have any independent rationale ... responses to changing economic circumstances are likely to be empirical and pragmatic (1984:28).

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<sup>4</sup> Contracting in is where a service or function performed externally is bought in-house by the employment of persons with those skills (for example, legal or accounting services).

<sup>5</sup> Such as: Atkinson and Meager (1986a); McGregor and Sproull (1991); Hunter and McInnes (1991).

Atkinson and Meager conclude from their study of contracting out<sup>6</sup>:

Although the observed changes were quite widespread, they did not cut very deeply in most of the firms, and therefore the outcome was more likely to be marginal, *ad hoc* and tentative, rather than a purposeful and strategic thrust to achieve flexibility. Short-term cost saving, rather than long-term development, dominated management thinking... (1986b:26).

### *The New Zealand context*

New Zealand organisations seem to be making decisions to contract out as a reaction to recessionary conditions rather than as a strategic initiative (Perry, 1992). Anderson, Brosnan and Walsh (1994) and Ryan (1992) found that overall, New Zealand organisations appear to be responding to environmental changes with a short-term rather than strategic approach.

Contracting out of non-core and ancillary activities became relatively widespread, particularly in the public sector, in the late 1980s. This was often the result of legislative changes requiring State owned activities and services to make a "profit". As shown by Table 1, the private sector seems to have followed to some extent, in response to changes in the business environment.

**Table 1: Contracting out in the previous five years<sup>7</sup>**

Contracting Out	Public Sector	Private Sector
1991	33 percent	11 percent
1995	26 percent	17 percent

Ryan (1992) found that 48 percent of organisations used independent contractors. Anderson et al. (1994) found that the use of contractors increased significantly between 1985 and 1991, with one third of firms expecting their use of contractors to increase by 1996.

It is unclear the extent to which contracting out has gone beyond non-core and ancillary services, although some examples do exist<sup>8</sup>. This may become more common as

<sup>6</sup> A study into contracting out of activities of 72 large firms in four sectors: food and drink manufacture; engineering; retail; and financial services.

<sup>7</sup> Source: Brosnan and Walsh, 1996:164.

<sup>8</sup> For a case study of an organisation that "converted" employees performing a core and essential function into independent contractors, see Greene (1998).

employers continue to seek means to reduce costs and their exposure to risk and uncertainty.

The *Employment Relations Bill* provides that collective agreements will contain an implied term of continuity of employment for the period of the agreement (s.66). This is intended to provide job security from the contracting out or sale of a business or function. In practice however this may have little effect – collective agreements may alter or exclude this provision (s.66(3)).

The foregoing section suggests that the basis of the decision to contract out or use independent contractors is moving away from traditional reasons, to those based largely on cost reduction. Further, it appears that often this is not guided by an overall organisational strategy, but by short-term or ad hoc measures. Contracting out an activity involves loss of control and loss of skills to the organisation<sup>9</sup>. If the decision is not made on a strategic basis, the risk is that an activity that is contracted out is (or will become) core or critical or one where the skills required become less widely available. The most adverse potential consequence is the domination by one large contractor; the existence of a sustainable competitive market should be a major consideration when contracting out. The cost of bringing the activity back in-house if required may be significant. Some organisations appear to be taking that risk.

### Advantages and disadvantages of contracting

The use of independent contractors has been widely reported as a perceived lower cost and more efficient source of labour (Lonsdale and Cox, 1998; Brosnan and Walsh, 1996; Davis-Blake and Uzzi, 1993; James, 1992; Belous, 1989; Pfeffer and Baron, 1988). This is a result of several identifiable cost benefits compared with direct employment, and to other perceived advantages. Independent contractors provide a source of numerical and contractual flexibility and may absorb the risk and cost associated with changes and fluctuations in demand (Belous, 1989). Independent contractors are typically responsible for their own work organisation and training, providing a source of cost saving to the employer (Belous, 1989; Pfeffer and Baron, 1988).

It is reasonable to suggest that the major advantage in having employees rather than contractors is largely a function of control. Employees are subject to the direction and control of their employer and are obliged to carry out employer instructions. The “control test” was the original test for the distinction between employees and independent contractors<sup>10</sup>, and illustrates the extent to which the employer has the *right* to control the

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<sup>9</sup> This also has implications for product or service quality and for health and safety standards and procedures.

<sup>10</sup> Although the control test currently carries little weight, the *Employment Relations Bill* provides for its resurgence as a primary test.

performance of an employee's work. Availability is another advantage of employees, although this may also be discussed in terms of control; independent contractors often work for others. Employees have knowledge of the organisation's culture, policies, work practices and procedures on both formal and informal levels. Because employers and employees form on-going relationships, employees develop an attachment to the organisation that infers loyalty, commitment and confidentiality<sup>11</sup>.

Independent contractors may be paid at a higher rate than employees, but they do not represent an ongoing cost commitment. Independent contractors are typically paid a lump sum for the performance of a service, or payment is based on some quantifiable measurement of their work. Cost and administration involved in tax is no longer the responsibility of the employer. Independent contractors may not work at the employers' premises, and often provide their own tools, equipment and vehicles; the reduction of capital tied up in plant and equipment may be an advantage. Efficiency in the use of resources is also likely to be a perceived advantage<sup>12</sup>.

The use of independent contractors may be seen as a method for reducing organisational headcount (Pfeffer and Baron, 1988; Belous, 1989). An attraction seems to be in the replacement of "wages" with contractor "fees". In financial reporting contractor fees do not represent a fixed or ongoing cost and the wage bill appears to be reduced (Pfeffer and Baron, 1988; Probert and Wajcman, 1991; Fevre, 1986).

The avoidance of or resistance to unions is associated with the use of independent contractors<sup>13</sup> (Pfeffer and Baron, 1988; Reilly and Tamkin, 1996; ILO, 1997). Union response to the use of flexible workers varies, and although some may resist their use (Davis-Blake and Uzzi, 1993) others see it as a trade-off for the security of core employees<sup>14</sup>. The Transport Workers Union in New South Wales adopted an interesting and unique response to independent contractors in the industry, one that may be disadvantageous to employers. The union has recruited owner-drivers since the 1940's, and finally achieved coverage of owner-drivers by the industrial arbitration system in 1979 (Bray, 1984, 1991).

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<sup>11</sup> These advantages are likely to vary depending on the employees' status, flexible employees may be less likely to display commitment and loyalty to an employer, although use is theoretically limited to "peripheral" jobs (Atkinson, 1984) or those in the secondary labour market (Deoringer and Piore, 1971).

<sup>12</sup> For example, an independent contractor is likely to take more care of a vehicle he/she owns than an employee may of a vehicle owned by the employer (Bray, 1991).

<sup>13</sup> Employer use of independent contractors for the primary reason of union avoidance has been defined as an unfair labour practice in Canada (ILO, 1997).

<sup>14</sup> See Bray and Taylor (1991) or Thompson (1995) for further discussion of union response.

Independent contractors may be used to protect core employees (Belous, 1989). The Flexible Firm Model is based on the achievement of numerical flexibility by "peripheral" workers, while the core enjoy job security (Atkinson, 1984). Some companies have a culture or policy of job security, in which case flexible workers are utilised to absorb fluctuations in demand (Pfeffer and Baron, 1988). This is likened to the Japanese model.

Wage equity considerations among permanent employees are widely reported as an advantage of, or motivation to use independent contractors (Pfeffer and Baron, 1988; Hunter and McInnes, 1991; Reilly and Tamkin, 1996; Rubery, 1988). The "market rate" for a task or job may be lower than the in-house rate due to internal wage negotiations. Rather than negotiate reduced pay, organisations may consider it "easier" to contract out (Reilly and Tamkin, 1996).

Employee related costs or "problems" include employment legislation and rights, such as leave, dismissal complexities, and risk and liability. Special (sick and bereavement) leave, holidays, parental leave and work related injury leave all present difficulties to the employer. Paid leave may be seen as payment for no return plus additional employees are necessary to maintain workforce levels. Leave, particularly parental leave, may require the temporary replacement of the employee, involving administration and training costs of substitute employees. Apart from the leave entitlement itself the administration of leave involves cost and effort. Occupational injury (such as Occupational Overuse Syndrome and Repetitive Strain Injury) is another area of growing concern for employers (*Business Monthly*, 1999), with employees absent for long periods on compensation and requiring redeployment.

Employers are likely to perceive that the dismissal of an employee is becoming more difficult to achieve without facing a claim of unjustified dismissal. The New Zealand Business Roundtable and Employers Federation have published several documents that are critical of the emphasis placed on procedural fairness in dismissal<sup>15</sup>. A main contention is that the requirements of procedural fairness impede employment, and employers are put off hiring "high risk" workers (for example, the young or inexperienced), because of the difficulties associated with disciplining and dismissing them if need be (Baird, 1996). It is also argued that wages and conditions suffer as a result of costs associated with employment protection:

As the pattern of judicial rulings is factored into firms' decision making, any cost-increasing restrictions in the name of workers protection will be offset by lower wages and/or other employment conditions that are less favourable (Business Roundtable and Employers Federation, 1992:i).

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<sup>15</sup> Such as: Baird, 1996; Robertson, 1996; and Howard, 1996



Although a degree of ignorance of the principles of substantive and procedural justification exists, *perceptions* regarding unjustified dismissal are a major reason why employers may consider opting out by engaging independent contractors. A personal grievance involves time, money, stress and possibly adverse publicity.

The *Employment Relations Bill* which promotes collective bargaining, encourages union involvement and is generally "pro-worker", is only likely to contribute to and accelerate the trend to contract out.

It has been suggested that a main advantage to employers of employing employees is control; it follows that a lack of control is therefore a major disadvantage of using contractors. Management expertise becomes critical in terms of the specification of contracts in order to control service, quality standards and the skill levels required. Contract and tender management may involve considerable resources.

Although theoretically employers and independent contractors are on an equal footing, control is to a certain extent a function of relative bargaining power and dependence. Economic conditions and supply and demand will have an effect on the relative power of the parties. The employer is likely to be able to exert more control over an independent contractor when market forces are in the employer's favour, and/or the contractor is dependent on that employer (dependent contractors are discussed further below).

Other potential disadvantages of using independent contractors include their effect on existing employees, and the challenge to their status as independent contractors.

The effect that the use of independent contractors has on existing employees will vary in relation to factors such as the nature of work for which independent contractors are engaged, and their place of work. The use of independent contractors is more likely to have an effect on employees where the contractors are visible or the work performed is similar. Employees in core activities are less likely to be affected where independent contractors are used for the performance of ancillary services or do not work on the employer's premises.

Employers that use independent contractors may be aware of the effect this may have on existing employees, but view this as positive. Independent contractors may act as a disciplinary tool (Bray, 1991; Davis-Blake and Uzzi, 1993; Pfeffer and Baron, 1988), or be used as a direct threat to force cost reduction and productivity improvement (O'Connell Davidson, 1991). The risk is that, regardless of employer motives, insecurity may lead to lower motivation and productivity, and reduced commitment of core employees to the organisation (Belous, 1989; Davis-Blake and Uzzi, 1993).

The status of an independent contractor may be challenged. Independent contractor status has implications for income tax and employment protection. Currently, challenge may be initiated by:

1. the tax authorities based on a perception that the worker is an employee and income should be taxed at source<sup>16</sup>;
2. the worker in seeking some remedy for perceived disadvantage or unfairness via employment institutions, for example, upon contract termination<sup>17</sup>.

If the tax authorities determine that an employer is incorrectly treating an employee as an independent contractor, the employer will be liable for the tax that should have been deducted (plus interest and penalties), and may be prosecuted and fined (Inland Revenue, 1998).

The majority of claims heard by the Employment Institutions that have been initiated by an "independent contractor" are personal grievance claims for unjustified dismissal upon the termination of a contract. If the worker is found to be an "employee", then the personal grievance can be heard<sup>18</sup>. In addition to the time and cost involved in the process, the outcome in terms of remedies may be quite costly to the employer. This may also lead to reconsideration of the status of other workers that the employer is treating as independent contractors.

The *Employment Relations Bill* provides for a determination by the Court as to whether a group or class of workers are independent contractors or employees. The determination is to be based on control and/or the extent to which the work is integrated into the employer's business (s.6(2)). A union, Labour Inspector, or any person in that particular group/class may initiate this (s.154). This will have implications for employers and independent contractors where the arrangement is arguably an employment relationship (this is discussed more fully later).

### ***Engaging previous employees as independent contractors***

The advantages and disadvantages to employers of independent contractors were outlined above. The contracting of previous employees has additional advantages, or may mitigate some of the disadvantages. Presumably, previous employees would not be contracted unless the organisation was satisfied with their ability. The use of a previous employee has the advantage of continuing service by a worker who understands and knows both the formal and informal operations and practices of the organisation. This may relieve management of some burden in terms of contract specification and monitoring.

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<sup>16</sup> For example, *Challenge Realty v Commissioner of Inland Revenue* [1990] 3 NZLR 42.

<sup>17</sup> For example, *Cunningham v TNT Express Worldwide* [1993] 1 ERNZ 695.

<sup>18</sup> Status is determined by a number of common law tests. These tests have been discussed, debated and criticised numerous times. See, for example, Collins (1990) and Commons (1996a, 1996b) for relatively recent reviews.

Many commentators have referred to the practice of engaging previous employees as independent contractors<sup>19</sup>, however elaboration or indication as to its extent is often lacking. For example, Kühl (1990) claims that this is a trend in all European countries, but without evidence; and Kelsey states that companies have increasingly made use of independent contractors that were "frequently former employees", again without elaboration (1997:266).

Brosnan and Walsh also recognise this lack of authority, noting that "in some popular accounts ... it is claimed that this practice is extremely common" (1996:164). They found in their survey of New Zealand organisations that 19.5 percent of organisations that had contracted out in the five years to 1995 did so to previous employees. For the previous five years to 1991 the corresponding ratio was 14 percent.

The process by which an employee becomes an independent contractor engaged to do the same work for the same employer may be instigated by the employee (for example for financial or tax benefit) or by the employer. Workers made redundant may be "encouraged" by their employer to become self-employed, or the arrangement may be more explicit (where employees are "converted"), or may have evolved following redundancy as a result of growth in demand.

The arrangement may take a variety of forms depending on the nature of the work involved. The employee may become a home-based independent contractor, or may lease office space from the employer. The employer may continue to provide vehicles and equipment where they are necessary, or the independent contractor may purchase or lease them from the employer. The "conversion" of an employee to independent contractor will involve tax and legal issues that may have a bearing, for example, on whether the contractor will own or lease equipment. Consideration may also be required as to the extent to which the contractor can source work elsewhere. The change in emphasis of the *Employment Relations Bill* in determining status will make such considerations more significant – not necessarily a bad thing!

At least initially, a contractor that is a previous employee is likely to be dependent on the organisation due to an absence of other clients or customers. In some situations, for example, where the organisation is effectively a "middle man", it is important to safeguard against the contractor contracting directly with the organisation's customers. Subject to the nature of the work, however, the ability of the contractor to secure other sources of revenue could encourage growth of a more viable and competitive contractor for the organisation. On the other hand, if the independent contractor is "dependent", the employer is likely to have more power to control terms and conditions (this is discussed further later).

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<sup>19</sup> For example: Rubery (1989); British Institute of Management (1985).

There are many considerations and there are many implications for the workers involved. The ability of the independent contractor to manage a business is one such consideration; some assistance with, or training in, business management may be required. The process and the extent of assistance from the employer will vary.

There are few studies<sup>20</sup> that discuss in any depth the use of previous employees as contractors despite the fact that, as mentioned above, it is a widely recognised practice.

### *Advantages and disadvantages to workers*

Independent contractor or self-employed status appears to be one to which many workers aspire (Carr, 1996; Hornaday and Vesper, 1982). Running a business and being "your own boss" carries implications of status and the associated advantages of independence and flexibility (Underhill and Kelly, 1993; McGregor and Sproull, 1991). There is also the perception of an opportunity to earn more, and associated tax advantages (McGregor and Sproull, 1991).

Workers may enter self-employment following redundancy. This may be due to a desire to remain in the same occupation (either because they enjoy that work, or are not skilled in other areas), and an inability to gain direct employment. Workers may not want to return to direct employment following a redundancy and seek some independence. This may or may not be in the same job. Some occupations that traditionally use independent contractors may be attractive to older workers; for example taxi drivers.

The advantages to workers of being an independent contractor are both intrinsic and extrinsic. Disadvantages to a large part stem from their exposure to competitive forces of supply and demand. Job and income (in)security is the most obvious disadvantage where market conditions are unfavourable to the contractor.

The strongest benefits to workers of being an employee are job and income security, employment rights and benefits and the right to collectivise. These advantages are largely associated with "traditional" employment (full-time, permanent, unionised employees), and vary in relation to permanency of employment. Thus, "flexible" employees are likely to enjoy these advantages to lesser extents.

Independent contractors are not afforded employment protection such as that provided by the Minimum Code. In theory, arrangements between an independent contractor and an organisation or another individual are between two parties on an equal footing; independent contractors are independent, and do not need protection. However there has been growing recognition that many "independent contractors" are in a position

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For some illustration, see: Stanworth and Stanworth (1997) regarding the publishing sector; and for the conversion of employees to independent contractors by Rank Xerox: Handy (1985), Hakim (1987), and British Institute of Management (1985).

incongruous with this rationale. The International Labour Organisation (1997) has directed attention to such workers or "contract labour", which includes dependent contractors and other legally defined independent contractors such as labour-only subcontractors. Some forms of "contract labour" are clearly disadvantaged and their true status is likely to be an employee. Kuhl (1990) refers to these workers as "quasi" or "fake" self-employed, and gives the example of service workers, such as waiters or drivers, in poorer European countries who "rent the necessary equipment" (p.247).

### ***Dependent contractors***

The term "dependent contractor" originated in Sweden and a Canadian scholar, Arthurs (1965), developed the concept. A dependent contractor is, at present, legally defined as an independent contractor, but is dependent upon one source or employer for the majority or all of his/her income. The dependent contractor brings to the exchange labour and capital by way of equipment and tools and/or vehicles.

Dependent contractors are a category of workers that fall into the "grey" area between employees and independent contractors. Employees and "true" independent contractors may be considered as representing polar ends of a continuum with several categories of workers, such as homeworkers, labour only subcontractors and dependent contractors (while legally defined as "independent contractors"), falling somewhere in between. Many of these workers are dependent in the sense that the majority or all of their income is derived from one employer; many are also in a position that is perceived to be disadvantaged or unfair.

This article is concerned with dependent contractors as described above. For example, owner-drivers are commonly dependent contractors as they are usually tied to one organisation by a contractual restraint of trade. The *Cunningham* case provides an illustration of an owner-driver who was a dependent contractor<sup>21</sup>.

Dependence may arise as a result of commitment to an employer that leaves little scope for the contractor to develop alternative sources of income. This may be by choice; a particular employer may offer enough work for the contractor to maintain sufficient revenue. Dependence may be a function of market conditions if there is little other work available. In other cases, a dependent contractor may be explicitly tied to one employer by a contractual restraint of trade.

Dependence is therefore not necessarily a result of employer control. However, it is often dependence that provides the employer with the *ability* to exert control. Dependent contractors bear all the risks of a business, and must have the *opportunity* to profit from

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*Cunningham v TNT Express Worldwide (New Zealand) Ltd.* [1993] 1 ERNZ 695.

running the business in an effective manner. Where an employer exerts control to the extent that the contractor's opportunity to profit is eroded, the contractor is in a position of economic subordination and control; one that is fundamentally unfair.

Employees and independent contractors are distinguished by common law tests of status. The tests have been subject to much criticism and debate (see for example, Collins, 1990; Commons, 1996a, 1996b); a given worker may be an "employee" or an "independent contractor" depending on the test prevalent at the time and/or the relative weight accorded the different tests.

The Employment Court ruled in *Cunningham* that he was an employee, based largely on employer control and the limited extent to which it could be said that Cunningham was "in business on his own account"<sup>22</sup>. However the Court of Appeal, in ruling that Cunningham was an independent contractor, held that the contractual intention of the parties should be the factor given most weight; this decision also having the effect of rendering the control test all but extinct. As discussed below, the *Employment Relations Bill* favours the Employment Court approach.

Where a contractor is dependent but in a position, in terms of power and control, similar to that of an employee, it would appear that some protection is warranted. There are several avenues by which protection may be provided. Employees have traditionally collectivised in order to increase their relative strength. Therefore one option is to provide for collective bargaining of dependent contractors. This is the approach taken by Canadian legislation that recognises dependent contractors for the purposes of collective bargaining. The Australian *Workplace Relations Act 1997* provides for independent contractors to form unions and if a contract is considered unfair the court may intervene. Consideration will be given to earnings (compared to that which an employee would earn) and bargaining power (Anderson, 1997).

Some argue that the tests should be revised so that dependent contractors more easily fall into the category of employees. Commons (1996a, 1996b) provides a comprehensive recent argument. The *Employment Relations Bill* provides that in determining status the Court give primary consideration to control and/or the extent to which the work is integrated into the employer's business, giving least weight to the "label" describing the relationship or contract (s.6(2)). This is a significant change from the Court of Appeal ruling in *Cunningham*.

However, arguments that dependent contractors should be classified as employees are based on the premise that these individuals would be "better off". This does not necessarily take into account the broader issue of *whether the individuals themselves would want or welcome the change*. The advantages to a worker of being an independent contractor revolve primarily around the independence, flexibility and intrinsic satisfaction

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<sup>22</sup> The "Fundamental" or "Economic Reality" test (*Market Investigations Ltd v Minister of Social Security* [1969] 2 QB 17).

that is associated with being "your own boss", and the opportunity to profit. While employee status does have advantages, studies have found that the majority of contractors prefer their status (Nisbet, 1997; Rainbird, 1991) and that the desire to be an independent contractor may persist regardless of financial benefits (Bray, 1991; Rainbird, 1991).

The question is raised as to the point at which a contractor would seek to be held to be an employee. Contractors may seek remedy for perceived unfairness even though their contractual terms and conditions as independent contractors have not been breached. Often this is upon contract termination but could be when a contractor's ability to profit has been eroded to a point where he/she perceives he/she would be just as well or even better off on wages - especially considering the other rights and benefits associated with employee status.

There should be some forum to examine the position of a contractor. Dependent contractors are in business, with an investment that carries risk and requires a return above "wages" levels. Contractual terms and conditions that effectively erode the contractor's opportunity to profit should be deemed unfair and thus set aside or modified. Control and economic reality are the important considerations when assessing the extent to which a contractor has the opportunity to profit from his/her business. The provision of protection in this form would serve to preserve a contractor's independence, while retaining or protecting the advantages of an independent contracting arrangement for both contractor and employer. Where practicable, allowing a contractor to source work elsewhere can be of benefit to both parties; the contractor should become more competitive and sustainable.

### ***The Employment Relations Bill***

The potential impact of the *Employment Relations Bill* in this area is significant. The relevant clauses are the definition of "employee" (s.6), and the provision for the Court to make a determination of status (s.154). The definition of employee specifies the tests or primary considerations in determining whether a worker is an employee or an independent contractor.

The explanatory note that accompanies the Bill discusses these sections under the heading "Dependent contractors". In the first instance, it is noteworthy that "dependent contractors" are not defined. However, the explanatory note refers to:

those persons who are currently classified as "independent contractors", but are in reality working in situations that are identical to an employment relationship (p.3).

As a definition, this is problematic. If it were that clear cut, there would be no difficulty in identifying such workers. It would seem that the intention is to broadly encompass any so-called independent contractors that are perceived to be in an unfair position, but this description has the effect of narrowing the scope.

This article is primarily concerned with dependent contractors as described above – those bringing to the exchange both labour and capital but being dependent on one employer for the majority or all of his/her income. Obviously, there are other classes or categories of “independent contractors” that are clearly disadvantaged and who the Bill is designed to address. It is likely that once implemented the intention and effect will extend to dependent contractors.

In determining status primary consideration is to be given to:

... the extent to which the work that [the worker] does ... and how and when [the worker] does the work is-

- (i) subject to the control and direction of [the employer];  
or
- (ii) integrated into [the employer's] business or affairs; or
- (iii) both...

The section further provides that least weight should be given to the label or description of the worker, contract or relationship (s.6(2)).

Control was the original test for the distinction between employee and independent contractor, and remained an important consideration up until the Court of Appeal ruling in *Cunningham*. It is suggested that control is the appropriate test, in terms of economic reality or the extent to which a contractor has the opportunity to profit. The emphasis placed on control in the Bill is positive as it may prompt employers of independent contractors to review contractual terms and conditions. Similarly, where employees are “converted” to independent contractors this will invoke greater attention to contractual terms and conditions.

The other primary consideration specified in the Bill is the integration or organisation test. According to this test, a worker is an employee when the work performed is integral to the employer's business, as opposed to being only accessory to it<sup>23</sup>. This test is problematic, involving in the first instance a distinction between “integral” and “accessory”<sup>24</sup>.

The power of the Court to declare status will be in relation to a “group or class of persons”. A determination could then be potentially far-reaching, whether in terms of one employer's workforce or an occupational group. A determination regarding a particular “group” or “class” is likely to lead to further applications and challenges concerning its parameters or definition.

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<sup>23</sup> *Stevenson Jordan and Harrison Ltd v MacDonald and Evans* [1952] TRL 101.

<sup>24</sup> For further discussion see Collins, 1990.



A union, Labour Inspector or member of a particular group or class of persons can make an application for determination of status. The Bill's explanatory note gives the rationale as providing "better access to employment rights for often poorly resourced people" (p.3). However, this also raises some concern that the wishes of the contractors themselves may not be taken into account.

As with all pending and new legislation, the operation of the Bill's provisions will not be clarified until there is the opportunity to test them. The Employment Relations Bill is, however, much more prescriptive than the ECA, the intention obviously being to leave less need for judicial interpretation.

## Conclusion

Organisations operating in a deregulated, competitive environment face the difficulty of trying to balance the objectives of gaining a competitive advantage through growth and development strategies with labour cost reduction and efficiency improvement. In the past decade, many New Zealand organisations appear to have been chasing the latter, to the possible long-term detriment of the former.

An outcome of organisational restructuring and consolidation has been to contract out of activities and functions that are perceived to be able to be provided more efficiently and at less risk by independent contractors. Often this is associated with the desire to concentrate organisational resources on the core function. However, it appears to have evolved into being more associated with (short-term) cost reduction without consideration for long-term strategic implications.

The use of independent contractors as opposed to employees is attractive in that risk and liability is transferred. This may be where "it is easier in management terms, or more cost-effective, to make the achievements of that flexibility 'somebody else's problem' ", or to "shift the burden and risk of uncertainty elsewhere" (Atkinson and Meager, 1986a:54, 9).

The disadvantages of employees for employers are the cost, risk and liability associated with workload fluctuations, health and safety, leave, employee injury and illness and personal grievances. Although some of these may be based on perception and could be mitigated by more effective management, they do have an impact on employer decision making. It appears that employers have been most interested in those options more likely to provide immediate benefits and/or those perceived to involve the least effort, resources and risk. The introduction of employment legislation more favourable to employees and unions is likely to only contribute to the trend of employers seeking to opt out.

The Employment Relations Bill specifies tests for the distinction between employees and independent contractors based on control and integration. An application for a determination of status by the Court can be made by an involved worker, a union or a

Labour Inspector; such a determination will apply to a "group" or "class" of workers. Although there appears to be potentially significant implications, these will not be clear until such time as the provisions are applied (and challenged).

Independent contractor status is attractive to many individuals, the reasons both intrinsic and extrinsic. However, where a contractor is in a position of economic subordination and control some form of protection is required. The most appropriate solution is a forum in which the opportunity for a contractor to profit is preserved by setting aside or modifying contractual terms and conditions that erode this opportunity. It is suggested that reclassification as employees is unattractive to those whose contract represents a business, an investment and "independence".

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