

Hiring Contractors Vs. Employees: the Real Cost Difference

By Christian Knott

*Hiring a contractor
may be more
cost effective
than you think*

The misconception that contractors are more expensive than regular employees is common. Technical managers are not always aware of the true cost of hiring new employees. However when considering the extra, sometimes hidden, resources expended in making a permanent hire outsourcing often makes sense. In these turbulent times even the most stable companies are tightening their belts. Outsourcing provides them with a low-risk, commitment-free means of accomplishing technical goals without the hassle or overhead typically associated with a new hire.



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Recruiting

Hiring Managers often overlook many of the costs of recruiting regular employees. Expenses run deeper than just advertising costs. **Advertising** in newspapers, magazines, internet, billboards, and radio *does* cost money but in addition, considerable time is spent writing and placing these ads. Because time is money, as the saying goes, this gets expensive. **Sourcing** takes time too and includes searching at job fairs, screening resumes, appraising employment agencies of the job's requirements, posting jobs internally, networking, etc.

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Once resumes are sourced and narrowed down to the most qualified, **Interviewing** must take place. Potential employees interview with an average of three company representatives prior to accepting a job offer. As it can be difficult to terminate an employee once hired, quality time is spent up front sizing up technical ability and assessing the potential employee's ability to fit into the company environment. Keep in mind that a number of candidates will be interviewed prior to making a hiring decision. This translates to many hours of interviewing time. On the contrary, contractors typically need only to meet the hiring manager due to the commitment-free nature of their employment status and far less "comparison candidates" are required. Employers of regular employees are not afforded the same opportunity to "try before they buy", so to speak, as they are with contractors. So as part of the interviewing process significant time is also spent on thorough **reference checking**.

Recruiting fees can also be considerable when hiring regular employees but they are not an issue with independent contractors. When hiring regular employees through an agency, companies will generally be charged a fee equal to 15 – 35% of the new hire's annual salary (often this includes bonuses and stock grants). Internal Employee Referral Bonuses are generally a set figure, usually between \$500 and \$5,000. If you hire a regular employee through an internet site you may be charged a placement fee in addition to the cost of posting the job. In addition, unemployment is low; job candidates know this and often expect incentives to accept an employment offer. **Sign-on bonus** and **stock grants** are increasingly common even at the individual contributor level. Contractors, who typically expect only an hourly rate, do not require offer-acceptance bonuses.

Finally don't forget to factor in the time it takes for **Offer Negotiation**. Today this is more complex than ever as competition for quality job candidates rises. It is not uncommon for the negotiation process to take days while such details as stock allocation, vacation time, annual salary, annual bonus scheme, job expectations, and title are ironed out. Once an offer is accepted the new employee will usually require a minimum two-week lead-time before officially joining your company in order to provide sufficient **termination notice** to their existing company. Employers who hire independent contractors are not faced with painful stints of waiting to begin critical projects. Since they are self employed, contractors can usually begin work with little notice and because the offer negotiation process involves little more than settling on an hourly rate, it happens fast.

Orientation

Full days are often allocated for new employees to attend formal company and/or benefits orientations. Again this translates to additional non-productive time. To make matters worse, most hiring managers will have to live with some form of initial learning curve while the new employee gets up to speed. When contractors are hired, they are usually selected because they have the required skill set to hit the ground running. With a regular employee many other considerations go into the hiring decision. Knowing there is a longer-term commitment being made hiring managers will often hire employees who lack a little technical experience but may be "manageable" or have "potential", or "leadership ability", preferring to trade off technical skills that can be learned for personality traits that will be easy to live with.

Overhead

Overhead entails more than paying the electric bill. Other expenses will directly affect your bottom line. For example, there has been a huge shift in attitude towards company benefits during the past 50 years. **Benefits and benefits administration** are now extensions of annual salary. "Benefits" are no longer just that; rather, most prospective employees consider them an entitlement. Employees expect benefits such as 401(k) plans with company matching contributions, stock grants, discounted stock purchase plans, paid vacations and sick days, and medical, dental, life, long term disability, worker's compensation, and other insurances. When hiring a new employee, not only are you faced with the direct cost of providing these "benefits", you must also pay for additional employees to administer them. Contractors are more like vendors who work closely with you and as such, are not qualified to participate in company benefits programs.

Other costs related to overhead include **Taxes** (which are not an issue with contractors because they are paid on a 1099 or business-to-business basis). Depending on state laws most companies are responsible for withholding and submitting federal and state employment taxes, paying unemployment and FICA taxes, and preparing, distributing, and filing necessary tax forms.

Formal and informal technical training also gets expensive. Technology companies must have a thorough grasp of the latest technologies if they are to survive their competition. On-going training is time consuming and costly. Contractors, on the other hand, know that they are only hired if they have the skills their clients need. This means they stay up to date with emerging technologies and better still, client companies do not have to pay for their training

Office Space & equipment such as cubicles or offices, furniture, telephones, business machines, and office supplies must be provided in addition to **Technical Resources** like computers, additional licensed copies of software, and other technical equipment. True, some space will also need to be set aside when bringing in an in-house contractor however this is usually a less formal situation given the short-term nature of most contracts. New cubicles are not specifically constructed and furniture and machines are not specifically purchased solely with the contractor in mind. Usually a contractor will carve out a small corner somewhere or share an office or cubicle in addition to and software or other technical resources. Of special note, more contractors choose to work offsite and in our technologically advanced age of email, teleconferencing, videoconferencing, and instant messaging, this often works well. Offsite consultants are especially cost effective for employers who may be short on office space or other resources, provided that the nature of the work lends itself to such an arrangement. Also, it is generally agreed that offsite workers are more productive which again amounts to cost-savings for the client company.

Incentives

Incentives are also common in today's workplace where employees expect more than just benefits and salary in exchange for hard work. Employees want to feel appreciated. As such, companies are rewarding them with company-performance-based and guaranteed bonuses. Often companies also spend additional time and dollars in an effort to maintain high morale and a sense of employee satisfaction with

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scheduled company events, outings, lunches, and pep rallies, as well as face time with CEOs or other busy executives. Seeking to maintain a professional reputation, repeat business, and possibly referrals, contractors motivate themselves. They do not expect additional incentives and, if they are professional, will continue to do quality work indefinitely.

As an annual incentive, regular employees also receive **Formal Performance Assessments**. Written performance evaluations are a necessary tool to incent employees and increase their productivity while also mitigating the risk of wrongful termination claims. Performance evaluations take considerable time to write and deliver and involve some risk of internal conflict. In addition, they are usually tied to a performance-based **annual salary increase**. Plus, to effectively evaluate an employee's performance, a written set of the job's responsibilities is necessary. **Job Descriptions** cover this and are a valuable tool in many ways but they involve maintaining a formal pay structure and annual salary surveys. Keeping them updated as employee's job responsibilities change and shift requires effort as well. Independent consultants usually write their own job descriptions (referred to as an initial Proposal) and do not expect formal, written evaluations of their performance. If their client is unhappy with them, they are fired almost immediately. Weeks or months are not wasted on **coaching and counseling** (another time zapper with regular employees) or carefully constructing written evaluations hoping for performance improvement.

If Things Go Wrong

Hiring regular employees carries **Risks** that are not present with contractors. Discrimination claims in the increasingly litigious work environment are real. With each new hire comes an increased risk of being sued. In addition to threat of litigation, companies who make an effort to curtail these risks with sensitivity programs and other protective measures will incur direct training expenses. Contractors are not eligible for company benefits, job promotions, pay raises, or other rewards and as such they bring less risk. A contractor who is ineligible for company rewards cannot claim that they were passed over for benefits, promotions, or pay increases in an effort to give more perks to another employee of a different race, religion, gender, etc.

There is no such thing as a perfect employee and even with precautions and planning mishaps will happen. If your new hire isn't up to the task technically or if they turn out to be uncooperative or worse, you can count on losing money & productivity in a number of ways. **Lost Time & Energy** is a huge factor that is not always fully appreciated. If you hire what turns out to be a problem employee, Human Resources professionals and Hiring Managers will spend considerable time devising and delivering informal and written "performance improvement plans". Obviously the intention in these instances would be to assist the employee in improving their weaknesses; this does not always work though and it can take months to properly "transition" the employee out of your company. In almost all cases, **transition time** is in essence, down time.

In the meantime you can almost bet that the employee will have a damaging affect on co-workers' morale and in turn, co-workers' productivity can suffer. Further, whether the problem employee is unhappy, unwilling, or just under

qualified, the results amount to the same thing: **lost productivity** on their part.

Termination Pay can be costly too. Some companies spend tens of thousands of dollars fulfilling severance obligations or hedging against discrimination suits. As part of your termination budget you may need to set aside some money for **Outsourcing** services. If your company has a policy of assisting "downsized" employees with future employment prospects this will come directly out of your budget. At the very least you will most likely be asked to provide references and this gets tricky as ex-employees become more and more quick to yell "slander, liable, or defamation".

Litigation of wrongful termination cases is costly too. Worse, if damages are awarded, companies can be faced with losses large enough to put them out of business. Few, if any, termination expenses are present when outsourcing work to contractors. If things go wrong you have no long-term ties. Often the relationship can be terminated with little or no notice; and non-employees are in effect ineligible to pursue wrongful termination and other litigious routes.

Conclusion

No lengthy or costly recruiting process, no benefits or incentives to pay or administer, no initial or on-going training, no performance evaluations to write and administer, and no severance pay or litigation risks if things don't work out. What could be better?

Some employers mistakenly feel that all the extra effort involved in hiring and maintaining a regular employee is an insurance of sorts – that because the relationship is more "permanent" there is less risk of losing the employee. Surprisingly, all the incentives, benefits, and extra nurturing do not necessarily guarantee anything. Employees are very quick to consider other employment offers if they think they'll receive more stock, a more challenging position, or a more impressive title.

Contractors, although technically they do have more freedom to roam from contract to contract, usually do just the opposite. Because of the less secure nature of contracting, most contractors are happy to stay on indefinitely if they are treated well. They won't be tempted by headhunters calling them at your place of business whispering to them about the better deal they could get at your competition. Yes, the hourly rate for contractors is higher than that of a regular employee but as outlined here, cost effectiveness can't be measured on hourly rates alone.