



## **Independent Contractor Misclassification Imposes Huge Costs on Workers and Federal and State Treasuries**

### Introduction and Background

Employers increasingly misclassify their employees as independent contractors, denying them the protection of workplace laws, robbing unemployment insurance and workers compensation funds of billions of much-needed dollars, and reducing federal, state and local tax withholding and revenues. State-level task forces, commissions, and research teams are using agency audits along with unemployment insurance and workers compensation data to document the scope of independent contractor misclassification. Confirming the findings of earlier national studies, these state reports show that 10 to 30% of employers, or even more, misclassify workers, and several million workers may be misclassified. State and federal governments lose billions in revenues annually.

#### 1. National studies and reports

Several government studies document the extent to which misclassification drains federal revenues. The data is limited, however, and should be updated to give a more accurate assessment of the economic impact.

A 1994 study by Coopers and Lybrand estimated the federal government would lose \$3.3 billion in revenues in 1996 due to independent contractor misclassification, and \$34.7 billion in the period from 1996 to 2004.<sup>1</sup>

A 2000 study commissioned by the U.S. Department of Labor (DOL) – the “Planmatics” study – found that between 10% and 30% of audited employers misclassified workers.<sup>2</sup> Misclassification of this magnitude exacts an enormous toll: researchers found that misclassifying just one percent of workers as independent contractors would cost unemployment insurance (UI) trust funds \$198 million annually. This report also shows that workers would benefit tremendously from increased scrutiny; up to 95% of workers who claimed they were misclassified as independent contractors were reclassified as employees following review.

A 2009 report by the Government Accountability Office (GAO) estimated independent contractor misclassification cost federal revenues \$2.72 billion in 2006.<sup>3</sup> The GAO’s estimate was derived from data reported by the IRS in 1984, finding that 15% of employers misclassified 3.4 million workers at a cost of \$1.6 billion (in 1984 dollars). From 2000 to 2007, the number of misclassified workers identified by state audits increased from approximately 106,000 workers to over 150,000 workers. These counts likely undercount the overall number of misclassified employees because states generally audit less than 2% of employers each year.

According to a 2009 report by the Treasury Inspector General for Tax Administration,<sup>4</sup> the IRS's most recent estimates of the cost of misclassification are a \$54 billion underreporting of employment tax, and losses of \$15 billion in unpaid FICA taxes and UI taxes. The \$15 billion estimate is based on 1984 data that has not been updated. The report explained, "Preliminary analysis of Fiscal Year 2006 operational and program data found that underreporting attributable to misclassified workers is likely to be markedly higher than the \$1.6 billion estimate from 1984."

## 2. Findings from State Studies and Reports

A growing number of states have been calling attention to independent contractor abuses by creating inter-agency task forces and committees to study the magnitude of the problem. Along with academic studies and other policy research, the reports document the prevalence of the problem and the attendant losses of millions of dollars to state workers' compensation, unemployment insurance, and income tax revenues.

The following chart summarizes the findings from 20 state-level studies. The studies rely on a range of data: most use UI and/or Workers Compensation audits; some draw on the records of multi-level government agencies, and a few used interviews with workers. Some studies examine the workforce as a whole, while others focus on industries where misclassification is rampant – namely, construction.

### Independent Contractor Misclassification Costs: Summary of Leading State Studies

\* Indicates figures for the construction industry.

State	% Employers who misclassify	Loss to UI	Loss to Wkrs Comp	Unpaid state income taxes
CA <sup>5</sup>				\$112 million (collected)
CO <sup>6</sup>	33.9%			
CT <sup>7</sup>		\$17 million	\$57 million	\$65 million
IL <sup>8</sup>	17.8% 19.5% ('05)	\$39.2 million \$53.7 million ('05) \$8.9 million*	\$97.9 million \$23.2 million*	\$124.7 - \$207.8 million \$14.8 million*
ME <sup>9</sup>	11% 14% *	\$314,000*	6.5 million*	\$2.6 – 4.3 million*
MA <sup>10</sup>	12% 14% *	\$35 million \$3.9 million*	\$91 million \$7 million*	\$91 -152 million \$6.9 million*
MD <sup>11</sup>	20%	\$15-25 million		
MI <sup>12</sup>	30%	\$17 million		\$20-33 million
MN <sup>13</sup>	14% 15% *			
NJ <sup>14</sup>	38-42% of audited cases	\$15 million (UI and disability)		\$5 million
NY <sup>15</sup>	10.3% 14.9%*	\$175.6 million	\$1.1million (incl. penalties)	\$170 million
OH <sup>16</sup>		\$12 - \$100 million	\$60-510 million	\$21-\$248 million
PA <sup>17</sup>	9%	\$200 million	\$81 million	
TN <sup>18</sup>		\$8.4 - \$15 million*	\$52 - 91.6 million*	
Austin, TX <sup>19</sup>				\$8,618,869 (state and federal combined)
WA <sup>20</sup>		\$14.8 million	\$34.5 million	\$225 million
WI <sup>21</sup>	44% of audited employers			

### 3. Trends in the Findings From State Studies

The findings from the state studies demonstrate the staggering scope of misclassification, the difficulties in reaching precise counts of workers affected and funds lost, and the potential for enforcement initiatives to return much-needed funds to state coffers.

- **A staggering number of workers are misclassified.** Audits generally uncover numerous cases of misclassification at an individual workplace or employer, resulting in large numbers of workers who are reclassified as employees following review. For example, targeted audits conducted by the Ohio 1099 Task Force resulted in the reclassification of almost 47% of the workers interviewed.<sup>22</sup> In 2007, California's Employment Development Department identified 36,536 workers who had been misclassified. According to their latest Taskforce reports, the Connecticut DOL identified close to 8,000 misclassified workers and the NY DOL identified 12,300. Studies that extrapolate from audit data put the actual numbers of misclassified workers at much higher levels: an estimated 368,685 workers in Illinois; 4,792 in Maine; between 125,725 and 248,206 in Massachusetts; 704,785 in New York; between 54,000 and 459,000 in Ohio; and 580,000 in Pennsylvania.
- **Studies most likely underestimate the true scope of misclassification.** Many of the studies are based on unemployment insurance tax audits of employers registered with the state's UI program. The audits seek to identify employers who misclassify workers, workers who are misclassified, and the resulting shortfall to the UI program. Researchers extrapolate from UI audit data to estimate the incidence of misclassification in the workforce and its impact on other social insurance programs and taxes. UI audits rarely identify employers who fail to report any worker payments to state authorities and workers paid completely off-the-books – the “underground economy” – where misclassification is generally understood to be even more prevalent.
- **Billions of dollars of payroll are never reported to state governments.** As explained above, many employers underreport their payroll, or pay workers off-the-books and do not report any wages. In California<sup>23</sup> and New York alone, employers fail to report billions of dollars to state agencies. Reliance on random audits as the sole investigatory may result in an undercount of violations and unpaid taxes.
- **Misclassification also results in lost income tax revenue to local governments.** Municipal governments supported by payroll taxes are also hit hard by misclassification. This includes some of the nation's largest and most important economic centers.
- **Independent contractor misclassification rates are rising.** In California, for example, the number of unreported employees increased by an impressive 54% from 2005 to 2007. In Illinois, the rate of misclassification by violating employers increased by 21% from 2001 to 2005. A recent report by the Ohio Attorney General reported a 53.5% increase in the number of workers reclassified from 2008 to 2009.<sup>24</sup> A study of misclassification in Massachusetts's construction industry from 2001 to 2003 noted that both the prevalence of misclassification and the severity of the impact have worsened over the years.

- **Misclassification rates are disproportionately high in certain industries, such as construction, real estate, home care, trucking, janitorial and hi-tech jobs.** Some of the studies focused on construction because the industry has been so plagued by independent contractor misclassification. The Maine, Massachusetts, Minnesota and New York studies found rates of misclassification up to several points higher in construction as compared with the workforce as a whole. Delivery drivers and truckers have also experienced widespread abuse. Sixteen states are currently involved in negotiations with FedEx to end the delivery company's practice of misclassifying its drivers as independent contractors. Reports indicate that employers in several other key sectors routinely misclassify workers.
- **Targeted audits have the potential of returning hundreds of millions of dollars to state coffers.** Audits conducted by California's Employment Development Department between 2005 and 2007 recovered a total of \$111,956,556 in payroll tax assessments, \$18,537,894 in labor code citations, and \$ 40,348,667 in assessments on employment tax fraud cases.

Misclassification of employees as independent contractors exacts an enormous toll on workers and our economy. Accurate information on the prevalence of the problem, and on patterns of violations, can help state officials to direct their efforts at the worst violators and most problematic industries. The growing body of research summarized here has been vital to recent efforts in the states to combat misclassification; new research will further facilitate enforcement.

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<sup>1</sup> Coopers & Lybrand, *Projection of the Loss in Federal Tax Revenues Due to Misclassification of Workers*, Prepared for the Coalition for Fair Worker Classification (1994).

<sup>2</sup> Lalith De Silva, et al., *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs*, Planmatics, Inc., Prepared for the US Department of Labor Employment and Training Administration (2000), available at <http://wdr.doleta.gov/owsdrr/00-5/00-5.pdf>.

<sup>3</sup> U.S. General Accounting Office, *Employee Misclassification: Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention* (August 2009), available at <http://www.gao.gov/products/GAO-09-717>.

<sup>4</sup> Treasury Inspector General for Tax Administration, *While Actions Have Been Taken to Address Worker Misclassification, and Agency-Wide Employment Tax Program and Better Data Are Needed* (February 4, 2009), available at <http://www.treas.gov/tigta/auditreports/2009reports/200930035fr.pdf>.

<sup>5</sup> Tax audits conducted by California's Employment Development Department (EDD) from 2005 to 2007 identified 36,536 previously unreported employees. The number of unreported employees increased 54% from 2005 to 2007, reaching 15,751 workers in 2007. During this 3-year period, the EDD recovered a total of \$111,956,556 in payroll tax assessments, \$18,537,894 in labor code citations, and \$ 40,348,667 in assessments on employment tax fraud cases. California Employment Development Department, *Annual Report: Fraud Deterrence and Detection Activities*, report to the California Legislature (June 2008), available at [http://www.edd.ca.gov/pdf\\_pub\\_ctr/report2008.pdf](http://www.edd.ca.gov/pdf_pub_ctr/report2008.pdf)

<sup>6</sup> A recent report found that 33.9% of audited employers misclassified employees as independent contractors; 41,915 employers in the state had misclassified new workers as independent contractors; 8.5% of workers at audited employers were found to have been misclassified; 172,609 workers statewide misclassified; total taxable wages underreported statewide for new workers misclassified as independent contractors: \$36,291,042; tax underreported statewide for new workers misclassified as ICs: \$6,429,685; average UI tax rate: 17.7%; percent of state UI taxes underreported due to workers misclassified as ICs: 3.6%. Data on file with author.

<sup>7</sup> A 1992 study estimated that the State and the Federal governments were losing \$500 million annually as a result of worker misclassification. Each year, state income tax receipts were reduced by \$65 million; the workers' compensation system lost \$57 million in unpaid premiums; and the unemployment insurance fund lost \$17 million. William T. Alpert, *Estimated 1992 Costs in Connecticut of the Misclassification of Employees*, Department of

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Economics, University of Connecticut (1992). The first annual report from the Joint Enforcement Commission on Worker Classification reported that the Labor Department reclassified 7,900 workers as employees, uncovered more than \$53 million in wages and additional unemployment tax of \$750,000, assessed over \$2 million in additional tax, and collected \$90,000 in civil penalties against violating employers. *State of Connecticut Joint Enforcement Commission on Worker Misclassification, Annual Report*, Prepared for the Honorable M. Jodi Rell, Governor, and the Labor and Public Employees Committee of the General Assembly (February 2010), available at <http://www.ctdol.state.ct.us/wgwkstnd/JEC/JEC.pdf>

<sup>8</sup>A 2006 study estimated that independent contractor misclassification resulted in a loss of \$39.2 million in unemployment insurance taxes, and between \$124.7 million and \$207.8 million in state incomes taxes each year from 2001 to 2005. 17.8% of audited employers, about 56,650, misclassified employees as independent contractors. The study estimated that an average 368,685 employees were misclassified each year. The rate of misclassification by violating employers increased 21% from 2001 to 2005. Michael P. Kelsay, *et al.*, *The Economic Costs of Employee Misclassification in the State of Illinois*, Department of Economics, University of Missouri-Kansas City. (2006), available at [http://www.carpenters.org/EmployerPayrollFraud/studies\\_reports.aspx](http://www.carpenters.org/EmployerPayrollFraud/studies_reports.aspx). Other state reports for which there is no other website listed can be found on the United Brotherhood of Carpenters website.

<sup>9</sup>From 1999 to 2002, 11% of all Maine employers and 14% of construction employers misclassified their workers, totaling 4,792 misclassified workers across all industries. Misclassification of construction workers resulted in an annual average loss of \$314,000 in unemployment compensation taxes, \$6.5 million in workers compensation premiums, between \$2.6 million and \$4.3 million in state income taxes, and \$10.3 million in FICA taxes. Françoise Carré and Randall Wilson, *The Social and Economic Costs of Employee Misclassification in the Maine Construction Industry*, Construction Policy Research Center, Labor and Worklife Program, Harvard Law School and Harvard School of Public Health (2005), available at <http://www.law.harvard.edu/programs/lwp/Maine%20Misclassification%20Maine.pdf>

<sup>10</sup>A study of misclassification in the state's construction industry from 2001-2003 found that at least 14% of Massachusetts construction employers and 13% of all Massachusetts employers misclassified workers. Less conservative methods suggest that construction misclassification could run higher and range up to one in four (24%) of MA construction employers. An estimated 7,478 to 15,790 of construction employees were misclassified. In the workforce as a whole, an estimated 125,725 to 248,206 workers were misclassified. The state lost an estimated \$91 million to \$152 million in income tax revenue and up to \$91 million of worker compensation premiums. The study noted that both the prevalence of misclassification and the severity of the impact have worsened over the years. Françoise Carré and Randall Wilson, *The Social and Economic Costs of Employee Misclassification in the Construction Industry*, Construction Policy Research Center, Labor and Worklife Program, Harvard Law School and Harvard School of Public Health (2004), available at <http://www.law.harvard.edu/programs/lwp/Misclassification%20Report%20Mass.pdf>.

<sup>11</sup>Audits conducted by Maryland's Unemployment Insurance Division found an average of 20% of employers misclassify workers. The report estimated that misclassification accounts for an annual loss of between \$15 million and \$25 million to the Unemployment Trust Fund. The Secretary of the Department of Labor noted that the estimate is likely conservative, because audits are random, do not target industries where misclassification is most prevalent, and do not capture the underground economy. Testimony of Thomas E. Perez, Secretary of the Department of Labor, Licensing and Regulation, on HB 1590, before the House Economic Matters Committee (March 20, 2008), available at <http://www.dllr.state.md.us/whatsnews/testimonymisclass.shtml>.

<sup>12</sup>A 2008 study of the state's unemployment insurance system found that an average of 30% of employers misclassify employees or underreport employee payroll, and that 8% of all MI construction workers are misclassified or receive income that is not reported by their employer. Each year, about \$1.5 billion in payroll is not reported to the UI Agency. Misclassification costs the state's unemployment insurance trust fund \$17 million each year, and results in an estimated loss of \$20 to 33 million in state income taxes. Dale Belman and Richard Block, *Informing the Debate: The Social and Economic Costs of Employee Misclassification in Michigan*, Michigan State University (2009), available at <http://www.ippsr.msu.edu/Publications/BEBelman.pdf>.

<sup>13</sup>The Office of the Legislative Auditor used UI audit data to estimate that 14% of employers misclassified workers in 2005 – about 17,500 employers. Misclassification rates in the construction industry were higher: 15% of construction employers and 31% of drywall employers misclassify their employees. The estimates are conservative because they exclude employers that operate in the “cash” economy or fail to register in the unemployment program. James Noble, *Misclassification of Employees as Independent Contractors*, Program Evaluation Division, Minnesota Office of the Legislative Auditor (2007), available at <http://www.auditor.leg.state.mn.us/ped/pedrep/missclass.pdf>.

<sup>14</sup>New Jersey Department of Labor and Workforce audits found that between 38% and 42% of employers either misclassified workers or paid in cash “off-the-books,” and between 25,000 and 28,286 workers were misclassified. *New Jersey State Agency Will Share Employment Tax Examination Results with the IRS*, State of New Jersey Department of Labor and Workforce Development (Nov. 8, 2007).

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<sup>15</sup> A 2007 study issued by the Cornell University School of Industrial and Labor Relations, based on audits by the NYS DOL UI Division of select industries from 2002-05, estimated annual misclassification rates of about 10.3% in the state's private sector and approximately 14.9% in the construction industry. Each year, an estimated 39,587 employers within those audited industries misclassified workers. Approximately 704,785 workers were misclassified. Average UI taxable wages underreported due to misclassification each year was \$4,238,663, and UI tax underreported was \$175,674,161. Linda H. Donahue, James Ryan Lamare, Fred B. Kotler, *The Cost of Worker Misclassification in New York State*. Cornell University School of Industrial Labor Relations (Feb. 2007), available at <http://digitalcommons.ilr.cornell.edu/reports/9/>.

A 2007 study estimated that between \$25 billion and \$50 billion in payroll – 20% of total payroll – was unreported for workers' compensation. The estimate may be conservative, because it was calculated by comparing payroll reported to the state for UI with payroll reported to the WC system, and did not account for payroll that was not reported to either system. Fiscal Policy Institute, *Building up New York, Tearing Down Job Quality: Taxpayer Impact of Worsening Employment Practices in New York City's Construction Industry* (December 2007), available at [http://www.fiscalspolicy.org/publications2007/FPI\\_BuildingUpNY\\_TearingDownJobQuality.pdf](http://www.fiscalspolicy.org/publications2007/FPI_BuildingUpNY_TearingDownJobQuality.pdf).

A 2009 report by the New York Joint Enforcement Task Force on Employee Misclassification identified 12,300 cases of misclassification and over \$157 million in unreported wages, resulting in an assessment of over \$4.8 million in unemployment taxes, over \$1 million in UI fraud penalties, over \$1.1 million in workers compensation fines and penalties, and over \$12 million in unpaid wages. New York State Dept. of Labor, *et. al.*, Annual Report of the Joint Enforcement Task Force on Employee Misclassification (Feb. 1, 2009), available at [http://www.labor.state.ny.us/agencyinfo/PDFs/Misclassification\\_TaskForce\\_AnnualRpt\\_2008.pdf](http://www.labor.state.ny.us/agencyinfo/PDFs/Misclassification_TaskForce_AnnualRpt_2008.pdf).

<sup>16</sup> A 2009 report by the Ohio Attorney General – extrapolating from UI audit data, and using findings from other state studies – estimated that between 54,000 and 459,000 workers were misclassified each year, and found that the state lost between \$12 million and \$100 million in unemployment compensation payments, between \$60 million and \$510 million in workers compensation premiums and between \$21 million and \$248 million in forgone state incomes tax revenues. Report of the Ohio Attorney General on the Economic Impact of Misclassified Workers for State and Local Governments in Ohio (Feb. 18, 2009), available at <http://www.ohioattorneygeneral.gov/getattachment/f2b2aa5b-de26-45a2-9631-2e0fd21cf9b5/Misclassification-Report.aspx>.

<sup>17</sup> A 2008 study found that 9% of the state's workforce, or 580,000 workers, are misclassified as independent subcontractors each year. Misclassification resulted in a loss of over \$200 million to the unemployment compensation trust fund and \$81 million to the workers compensation system. Testimony of Patrick T. Beaty, Deputy Secretary for Unemployment Compensation Programs, Pennsylvania Department of Labor and Industry, before the House of Representatives Commonwealth of Pennsylvania, Labor Relations Committee on HB 2400, The Employee Misclassification Prevention Act (April 23, 2008), available at [http://www.legis.state.pa.us/cfdocs/legis/TR/transcripts/2008\\_0091\\_0001\\_TSTMNY.pdf](http://www.legis.state.pa.us/cfdocs/legis/TR/transcripts/2008_0091_0001_TSTMNY.pdf).

<sup>18</sup> A 2010 study of Tennessee's construction industry estimated that between 21,990 and 38,680 construction workers were either misclassified or unreported in 2006. The study estimated losses of between \$8.4 million and almost \$15 million to the state's unemployment insurance program, between \$52 million and 91.6 million to the state's workers compensation program, between \$15.2 million and \$73.4 million in federal incomes taxes, and between \$7.8 million and \$42 million in Social-Security and Medicare taxes. William Canak & Randall Adams, *Misclassified Construction Employees in Tennessee* (January 15, 2010).

<sup>19</sup> A 2009 study found that 38% of the construction workers in the Austin area were misclassified. In "vertical construction" alone, this misclassification resulted in an estimated loss of at least \$8,618,869 in federal taxes and state unemployment taxes. *Building Austin, Building Injustice: Working Conditions in Austin's Construction Industry*, Workers Defense Project in collaboration with the Division of Diversity and Community Engagement at the University of Texas at Austin (June 2009), available at [http://www.buildaustin.org/Building%20Austin\\_Report.pdf](http://www.buildaustin.org/Building%20Austin_Report.pdf)

<sup>20</sup> The Washington Department of Revenue studied discrepancies in the number of businesses that had registered with the IRS but not with the State, finding that in-state and out-of-state businesses registered with the IRS in 2004 failed to pay \$274 million in state taxes: \$225 million in state income taxes, \$14.8 million in unemployment insurance taxes, and \$34.5 in workers compensation premiums. In-state construction employers failed to pay \$13.1 million in taxes: \$1 million in state income tax, \$3.4 in unemployment insurance taxes, and \$8.7 million in workers compensation. In 2001, the state lost \$183 million in taxes from employers registered with neither the IRS nor the state. Washington State Dept. of Labor and Industries and the Washington State Employment Security Dept., *Unregistered Business Study: Joint Report of the Washington State Dept. of Revenue* (November 2007), available at [http://dor.wa.gov/docs/reports/Unregistered\\_Business\\_Study\\_finalfinal.pdf](http://dor.wa.gov/docs/reports/Unregistered_Business_Study_finalfinal.pdf).

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<sup>21</sup> The Wisconsin Unemployment Insurance Division found that 44% of the workers investigated in the course of employer audits had been misclassified. *Report of the Worker Misclassification Task Force*, Submitted to Secretary Roberta Gassman, Wisconsin Department of Workforce Development (June 2009).

<sup>22</sup> Richard Cordray, Ohio Attorney General, *Misclassification of Employees as Independent Contractors* (May 11, 2010).

<sup>23</sup> A study on fraud in California's workers compensation system estimated that employers underreported between \$19 billion and \$106 billion in payroll for premium calculations. This accounted for 6% to 23% of total payroll for employers required to buy insurance. Frank Neuhauser and Colleen Donovan, *Fraud in Workers' Compensation Payroll Reporting: How Much Fraud Exists and How are Honest Employers Impacted* (University of California, Berkeley, 2007).

<sup>24</sup> Richard Cordray, Ohio Attorney General, *Misclassification of Employees as Independent Contractors* (May 11, 2010).