

# **The Social and Economic Costs of Employee Misclassification in the Michigan Construction Industry**

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A report of the

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## The Issue of Misclassification

The unemployment insurance system was established to provide income security to employees when they lost employment through no fault of their own. It serves both to improve employee income security in the transition between jobs and labor market efficiency through improved matches between employee skills and employer needs.

While the administrative costs of state unemployment insurance systems are paid through a federal program, the costs of providing income to qualified unemployed are paid through a tax on employer payrolls. The first \$9,000 of each employee's payroll is subject to a tax that in 2004 was, on average, 3.4 percent of taxable payroll and 0.80 percent of gross payroll.<sup>1</sup>

Although important to the efficient and equitable operation of Michigan labor markets, the cost of the unemployment insurance program provides incentives to employers and employees to conceal employment and payments so as to avoid paying this tax. This can be accomplished by classifying statutory employees as self-employed independent contractors, by not reporting wage payments to employees, or by classifying payments as non-taxable income such as reimbursements. Such actions are often referred to as misclassification; they unlawfully reduce employer payments to the unemployment insurance trust fund.

Misclassification can result in even larger employer savings when employers, by classifying

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<sup>1</sup> Actual taxes paid vary with employers industry and experience rating – their prior record of layoffs. From , Average Contribution Rate Based on Total and Taxable Payrolls, 1936-2004, Unemployment Insurance Agency, Department of Labor and Economic Growth web site <http://www.michigan.gov/uia/0,1607,7-118-1328-78733--,00.html>

employees as self-employed independent contractors, avoid paying not only unemployment insurance taxes but also for workers compensation and the employer share of Social Security (FICA) and Medicare. In the latter two cases, the employees who are classified as independent contractors must assume the full burden of the Social Security and Medicare taxes. Employers may also avoid paying for employee health care and retirement savings by classifying employees as self-employed workers.

Although advantageous to employers who misclassify, employee misclassification is disadvantageous to honest employers, the misclassified employees, and to the citizens of the state of Michigan. It disadvantages honest employers by forcing them to compete against employers with lower labor costs. This increases competitive pressures on honest employers, prevents them from growing as much as they would if they competed on a level playing field, and provides incentives for otherwise law abiding employers to misclassify. Even if some employees cooperate in misclassification, it works to the disadvantage of employees by depriving them of some or all unemployment insurance benefits.<sup>2</sup> If the employer not only misclassifies employees for the purposes of unemployment insurance, but also for workers compensation, employee benefit programs and taxes, the employee will not have income or medical support if a work-related injury or illness is incurred and may experience reduced disability and retirement income. Misclassification also injures the citizenry and state of Michigan because it reduces the revenues of the unemployment insurance system, the income of the residents of Michigan during periods of unemployment, and likely state tax revenues.

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<sup>2</sup> Employees can benefit in the short term from misclassification if they receive income in forms that allow them to underpay social security and state and federal income taxes on their pay. Underreporting of income by the self-employed is fairly common but has been reduced by the requirement by the U.S. Internal Revenue Service that the payer file a 1099-Misc form for payments to the self-employed that total \$500 or more in a tax year.

This report, which was derived from a sample of the random audits of employers covered by the unemployment insurance system of the state of Michigan, finds that, on average, 30 percent of Michigan employers misclassify employees as self-employed workers or underreport employee payroll. One fifth of the employees of employers who misclassify are either erroneously classified as self-employed or receive payments that are not reported as part of payroll. In all, eight percent of all Michigan employees are misclassified as self-employed or receive undeclared income from their employer.

Although Michigan has a lower proportion of its labor force misclassified than several other states, considerable payroll is not reported and the state loses revenues to the unemployment insurance trust fund and general revenue funds as a result of misclassification. On average, almost \$1.5 billion in payroll is not reported to the Unemployment Insurance Agency annually because of misclassification. This costs the unemployment insurance trust fund \$17 million in revenue each year. Reasonable projections of the underpayment of state income tax by the self-employed suggest an additional \$20 to \$33 million lost every year through misclassification.

A key finding from this study is that additional efforts to improve employer compliance with the unemployment insurance system would produce benefits for Michigan and its citizenry. First, it would improve income security for employees when they are laid off. This benefits not only the employee, but also the state as unemployment does not have as dire consequences for the individual, their family, and the businesses they patronize as it would otherwise have. A second benefit is the increase in funds flowing to the state to support the

unemployment insurance system and the general revenues. Third, because misclassification under the unemployment insurance system is likely associated with similar misclassification under other income security programs the state loses additional revenue in those programs. Moreover, as health insurance coverage is associated with employee status, misclassification may also result in a shift of the medical costs of these uninsured from the employer to others, including the state (through Medicaid), medical care providers, and insurance companies and employees who may pay higher rates than otherwise because medical providers must increase their costs to account for nonpayment by the uninsured. Finally, by compelling employers who misclassify to treat employees lawfully, law abiding employers will face less unfair competition and will find additional opportunities to profit and expand their business.

#### What Is An Employee?

For the purposes of the Michigan Unemployment Insurance Agency, the statutory test for employer-employee relationship is whether a person performs services under the direction and control of another person.<sup>3</sup> Otherwise, the employee is considered an independent contractor. An individual's status as an employee or an independent contractor is not determined by a shared understanding between the parties or by the presence of a written contract. Rather, case law has established a seven part *economic reality* test. Under this test, the criteria used to determine the status of a worker are:

1. Whether the employer will incur liability if the relationship terminates at will,
2. Whether the work performed is an integral part of the employer's business,

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<sup>3</sup> See Unemployment Insurance Agency publication 1982-L, *Independent Contractors* 2004.

3. Whether the employee depends on the wages for living expenses,
4. Whether the employee furnishes equipment and materials,
5. Whether the employee holds himself out to the public as able to perform the same tasks,
6. Whether the work involved is customarily performed by an independent contractor,
7. The factors of control, payment of wages, maintenance of discipline, and the right to hire and fire employees,

These factors are weighted in a way that will most favorably effectuate the purposes of the Michigan Employment Security Act. An individual's status as an employee or independent contractor is determined by the preponderance of evidence.

Although this economic reality test is well established in law, the determination of whether a person is an employee or self-employed is complicated by differences in the definition of employee under other federal and state programs. For example, the U.S. Internal Revenue Service uses "right to control" (Muhl, 2002). If an employer is uncertain about whether an individual providing services is an employee or an independent contractor, the Michigan Unemployment Insurance Agency provides advice to employers on the classification of workers.

#### Methodology:

This research used the administrative records of the Unemployment Insurance Agency of the Michigan Department of Energy, Labor and Economic Growth. The Unemployment Insurance Agency conducts two types of audits of employer records - targeted and random.<sup>4</sup>

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<sup>4</sup> The discussion of audits is derived from *Regarding Tax Audits/Investigations*, form UIA 1039, Revision 8-07.

Targeted audits occur if there is an employer account referral – if there is preliminary evidence that the employer has not met the requirements of the Michigan Employment Security Act. Random audits are determined by computer based sampling. The U.S. Department of Labor (USDOL) suggests that State Unemployment Security Agencies (SESAs) audit 2 percent of employers each year. The USDOL requires that at least 10% of all audits conducted be selected on a random basis. The Unemployment Insurance Agency conducts audits of approximately 1 percent of employers every year. The random audits provide a representative sample of the employers required to participate in the Michigan unemployment insurance system and an accurate portrait of the form and extent of employer misclassification of employees.

After several meetings with this staff, we decided to use the records from the random audits of employers audited for the years 2003 and 2004 to determine the extent of misclassification. Although the random audits cover only one percent of the employers in the U.I. system, almost 1,500 employers participate in random audits annually. As the burden of collecting the data needed from 3,000 administrative records for the two year period in which we were interested would be large, we chose to collect data for every audited firm in the three industries of interest: construction, trucking and security guards, and from 10 percent of the firms in the balance of the Michigan economy. In order to assure that the 10 percent sample of audits of firms in the balance of the economy was representative, we constructed a random sample of these firms.

For purposes of this study, the Unemployment Insurance Agency assigned an identification number to each audit. The Agency provided a listing of the identification



numbers for audits of firms in the balance of the Michigan economy to the researchers. No additional identifying information was included with these identifiers. The identifiers were sorted from smallest to largest. We used a random number chart to choose the first audit to be reviewed among the initial ten audits and then selected every tenth audit after that. The identifiers for the audits to be reviewed were then sent to the Unemployment Insurance Agency staff.

Eight Hundred ninety four audits were reviewed for this study. Of these, 523 audits were for construction firms, 41 were for trucking firms, nine firms providing security guards and 321 audits of other firms were included in this study. With the exception of the small number of observations for security guards, the number of audits in the sample for each industry was sufficient to be confident that they are broadly representative of the population of firms in those industries. The spreadsheets provided by the Unemployment Insurance Agency include information on the number of employees misclassified, pre and post audit payroll, and the change in unemployment insurance tax payments associated with misclassification. This information was used to determine whether an employer misclassified employees, the number of employees who were misclassified, the change in payroll associated with misclassification, and the change in revenue going to the unemployment insurance fund.

#### Results: Proportion of the Michigan Labor Force That Was Misclassified

Almost one-third, 30.1 percent, of Michigan employers covered by the unemployment insurance system misclassified employees or failed to report payments to employees covered by the unemployment insurance system (Table 1 & Figure 1). The proportion of employers with

misclassified employees varied considerably by sector. In construction, 26.4 percent of employers misclassified employees or employee payments; in trucking, 24.4 percent of employers misclassified employees or employee payments. Although the number of firms providing security guards is small, 9, and the estimates are not as reliable for those for other industries, 55.6% of employers engaged in misclassification.

What proportion of Michigan employees are misclassified? Slightly more than one in twelve, 8.4 percent, of Michigan employees is misclassified, either by being classified as self-employed or by receiving payments that were improperly recorded.<sup>5</sup> The rate of misclassification in construction industry and trucking was somewhat lower than the average across Michigan, at 6.2 and 5.3 percent respectively while security guards were somewhat above average, at 8.6 percent.

Given that a minority of employers engaged in misclassification, how does this minority behave with respect to its employees? Across all industries, misclassifying employers misclassified 23.5 percent of their employees. In the construction industry, misclassifying employers who engaged in misclassification misclassified 18.9 percent of their employees; in trucking, misclassifying employers misclassified 20.1. percent of their employees. Among firms providing security guards, 24.0 percent of the employees of misclassifying employers were misclassified. The rate of misclassification, between one in five and one in four employees, suggests that firms which engaged in misclassification misclassified substantial numbers of employees.

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<sup>5</sup> We distinguish between the two forms of misclassification later in this study.

## Results: Proportion of Payroll Under-Reported Due to Misclassification

In Michigan, unemployment insurance is only paid on the first \$9,000 of an individual's payroll. However, audits by the Unemployment Insurance Agency collect data on both under reported taxable income and under reported gross income. For U.I. purposes, taxable income is limited to the first \$9,000 of payroll, gross income includes all payroll.<sup>6</sup>

Turning to taxable income first, 1.88 percent of all Michigan post-audit taxable payrolls was underreported; firms that misclassified underreported 4.6 percent of post audit payroll (Table 3). Construction and trucking firms underreported 1.0 percent and 1.2 percent of taxable income respectively. Employers in these industries who misclassified under reported 2.4 and 6.0 percent of taxable income respectively. On average, firms in the security industry under reported 2.3 percent of taxable income, misclassifying employers in the security industry under reported 2.4 percent of taxable income.

The proportion of gross income that is under reported is somewhat lower than the proportion of taxable income (Table 3). On average, 1 percent of the post audit gross payroll of Michigan employees is under reported. This varies from 0.8 percent for the construction industry to 2.5 percent for trucking. Employers who engage in misclassification of employees or underreporting income underreported 2.3 percent of gross post audit payroll. This varies from 1.8 percent for construction to 11.6 percent for trucking.

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<sup>6</sup> One of the complexities of the period under consideration is that the income subject to tax under the Michigan Unemployment Insurance system was reduced from \$9,500 to \$9,000. This change caused a divergence between the amount subjected to tax by the federal system, \$9,500, and the Michigan system. As a result, significant numbers of employers over paid their taxes and, when audited, received tax refunds. We have not included these refunds in our calculations because, as employers learn about the change in maximum income, the number of employers overpaying their taxes should decline substantially.

## Distinguishing Types of Misclassification

To this point, this report has treated the misclassification of employees as self-employed and the under reporting of payroll as essentially identical. From the point of view of lost revenue, the distinctions between these two forms of misclassification are not dissimilar. However, from the point of view of the employee, the differences are substantial. While a employee who is classified as self employed forgoes unemployment insurance coverage, may forgo coverage by workers compensation, may not be subject to payroll deduction of taxes and has to pay both the employer and employee share of social security; employees who receive unreported payments will likely be covered by all of these systems as well as by protective labor legislation.

Distinguishing these forms of misclassification is burdensome as it requires detailed review of each audit in which it was determined there was misclassification. In order to reduce this burden and minimize the diversion of resources in the unemployment insurance agency, we asked the Unemployment Insurance Agency personnel to randomly select 40 audits from construction and 40 audits from all other industries and collect information on the number of employees subject to each form of misclassification and the amounts of payroll going to each form of misclassification.

For all Michigan industries, 66 percent of employees who were misclassified were treated as self-employed, the balance, 34 percent, received unreported payments (Table 4 & Figure 4). This varied considerably by industry. In construction, 38 percent of misclassified

employees were treated as self-employed, while in trucking all misclassified employees were treated as self-employed.

With respect to improperly classified payments, 74 percent of unreported taxable income and 54 percent of gross income is paid to workers improperly classified as self employed. The remainder, 26 percent of taxable income and 46 percent of gross income, is paid in undeclared payments to employees. In construction, 79 percent of taxable income, and 58 percent of gross income, goes to employees improperly classified as self-employed; in trucking 100 percent goes to those improperly classified as self-employed.

#### Projections of Under Reported Income and Lost Revenues for the State of Michigan

On average, \$1.5 billion in payroll was under reported to the State of Michigan annually in 2003 and 2004 (Table 2 & Figure 2). Slightly more than half this amount, \$826 million, was underreported income subject to unemployment insurance taxation. As a result, \$16.8 million in unemployment insurance payments were not collected in each of 2003 and 2004. In construction, \$169 million dollars of payroll was under reported, of this \$52 million was subject to unemployment tax and \$2.5 million in unemployment insurance taxes were not paid to the state of Michigan. The trucking industry had \$38.6 million in under reported income, \$5.8 million in under reported taxable income, and under paid unemployment insurance taxes by \$48,000. Remarkably, the security industry, with relatively few employees, had \$9 million in unreported gross income, \$5.8 million in unreported taxable income, and should have paid an additional \$154,000 in unemployment insurance taxes.

Under reporting affects programs beyond the unemployment insurance fund. A number of studies have established that the self-employed are less likely to pay income taxes on all of their income. The amount underpaid varies considerably between studies, but it is reasonable to believe that the self-employed fail to pay taxes on between 30 and 50 percent of their income.

Using these figures as the minimum and maximum for under reporting of income by those misclassified as self-employed, and assuming that employed individuals similarly underpay on undeclared income, the state of Michigan loses between \$19.5 and \$32.5 million dollars in state tax revenue to underreporting and misclassification (Table 5 & Figure 3). In combination with forgone unemployment insurance revenues of \$16.8 million, Michigan annually forgoes between \$36.3 and \$49.3 million in revenues. Under reporting and misclassification may also affect the revenues of the workers compensation system of Michigan, but calculation of this amount is difficult because of the complexity of the formulas required to calculate workers compensation payments.

Substantially larger amounts are likely lost by the Social Security Administration and the Internal Revenue Service of the United States as the average rate for income tax and the social security tax are considerably larger than the rate for either the Michigan unemployment or state income tax. Considering only the employer portion of the social security tax, and not allowing for the cap on social security, the Social Security Administration loses between \$34 and \$57 million a year in Michigan due to misclassification. Using the average tax rate of 12.9 percent of adjusted gross income found in the Statistics of Income for 2005, the federal

government annually lost between \$57.9 and \$96.5 million in forgone income tax revenue due to misclassification in Michigan.<sup>7</sup>

The construction industry underreported \$168 million in income annually in 2003 and 2004. Under the assumption of 30% under reporting of self-employment income, the state of Michigan lost \$2.2 in income tax revenue, under the assumption of 50% under reporting, the state of Michigan lost 3.7 million in income taxes (in addition to the \$2.5 million in unemployment insurance payments). In trucking, the state lost between \$503 and \$840,000 in income tax revenue due to under reporting in addition to the \$48,000 in lost unemployment insurance revenue.

#### Comparison to Other States:

There have been studies of misclassification for Massachusetts, Maine, New York and Illinois. The current study was somewhat broader than prior studies in including not only the self-employed but cases in which employee income was underreported. Adjusting the Michigan data to exclude this latter category, Michigan has as good or better misclassification performance than these states (Table 6). For example, 5.5 percent of Michigan employees are misclassified as self-employed workers. Although this is one percentage point above the rate of misclassification in Massachusetts, it is well below the rate of misclassification in New York, Maine and Illinois. Similarly, while misclassifying Michigan firms which misclassified 15.4 percent of their employees, the proportion of misclassified employees is substantially higher in Massachusetts, Maine and Illinois.

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<sup>7</sup> See <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=133521,00.html>

## Suggestions to Prevent Misclassification and Improve the Financial Base of the Unemployment System

The misclassification of employees as self-employed, and the under reporting of payroll of employees, imposes a burden on employees, honest employers and the state of Michigan. Employees lose because they do not receive the benefits of unemployment insurance coverage and likely of workers compensation payments. They are almost certainly excluded from pension and medical benefits by their employer. They are also likely placed in the situation of either having to pay both the employers and employee share of social security on their full income, or of under reporting their income and later not receiving full social security pensions.

Honest employers are placed in a very difficult position because they are at a competitive disadvantage relative to employers who engage in misclassification and under reporting. An employer who avoids unemployment insurance payments reduces its labor costs by at least two percent. If, as is likely, they are also not paying workers compensation, the employer share of social security, and pension or medical insurance, they are reducing their labor costs by at least 20 percent and possibly as much as 40 percent. Just as bad money drives out good money, misclassifying employers make it more difficult than otherwise for non-misclassifying employers to operate profitably. Non-misclassifying employers are faced with a situation in which they either need to leave a market, or emulate the practices of employers who engage in misclassification and under reporting.

The state of Michigan suffers because of the substantial loss of revenue to support its unemployment system and other tax revenues. The state forgoes significant amounts of



revenue, between \$36.3 and \$49.3 million, each year because of misclassification of employees and under reporting of payroll. Given Michigan's striated economic circumstances, this is a significant loss of revenue to the state treasury. But misclassification imposes other costs on the state and its citizens. Employees who are classified as self-employed are less likely than regular employees to have health insurance and retirement savings plans. As a result, the self-employed are more likely to use public medical services, imposing costs on medical providers and the state. Similarly, the limited retirement savings are likely to create costs for public programs for the elderly when these workers retire.

A first suggestion would be to increase the number of firms subject to random audits by the unemployment insurance administration. Currently, an employer can reasonably count on being audited once every one hundred years. It is in part because of the low likelihood of being audited that almost one third of all audited employers are found to be misclassifying employees.

Although the return to audits is currently unlikely to be very large, substantial efficiencies can be realized by coordination of audits across Michigan agencies. As indicated by our work, firms that misclassify employees not only underreport taxable income, but also gross income. There are, as a result, likely substantial losses of state income tax revenues in cases in which firms misclassify employees for unemployment insurance purposes. If the Unemployment Insurance Agency were able to communicate the results of its audits to the Department of Revenue, this might improve the targeting of that Department's audits. Similarly, if the Department of Revenue could share information with the Unemployment

Insurance Agency, the agency could better target its audit resources. This should produce greater revenue per audit. The UIA does routinely share its audit results with both the Internal Revenue Service and the Michigan Workers' Compensation Agency.

Although the Unemployment Insurance Agency already has a very good employer information program, this program is likely to come under stress if there is an increase in the number of audits. Increased resources for employers, and aid in helping employers classify employees properly, will be needed to meet employers who are trying to adhere to the requirements of the Unemployment Insurance law.

A challenge for the Unemployment Insurance system is the disjuncture in the definitions of employee and self-employed between the federal and state systems. Such differences increase the probability of good faith, inadvertent misclassification. If such intentional misclassification imposes a cost on the state, the state may wish to consider changing its definitions of employee and independent contractor to conform to the federal system.

Overall, the result of this study suggest that employee misclassification, whether intentional or inadvertent, results in substantial lost revenue for the State of Michigan and imposes cost burdens on employers who do not misclassify. Taking action to address misclassification could have substantial benefits for the State relative to the costs of such action.

## Bibliography

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	Percent of Employers Misclassifying	% of Workers Misclassified by Misclassifying Firms	% of Workers Misclassified Among All Employers		
All Industries	30.1%	23.5%	8.4%		
Construction	26.4%	18.9%	6.2%		
Trucking	24.4%	20.1%	5.3%		
Security Guards	55.6%	24.0%	8.6%		

	Under Reported Gross Wages	Under Reported Taxable Wages	Additional Payment of U.I. Taxes	Under Reported Taxable as % of Total Taxable (Firms)	Under Reported Gross as % of Total Gross (All Firms)
All Industries	\$1,496,667,933	\$826,181,034	\$16,826,044	1.88%	0.98%
Construction	\$168,706,387	\$51,851,890	\$2,536,065	0.96%	0.80%
Trucking	\$38,610,722	\$5,766,099	\$47,907	1.22%	2.54%
Security Guards	\$8,992,460	\$5,816,346	\$153,945	2.32%	1.12%

	Under Reported Taxable as % of	Under Reported Gross as % of	Misclassifying Firms: Percent of Taxable	Misclassifying Firms: Percent of Taxable	

	Total Taxable (Firms)	Total Gross (All Firms)	Under Reported	Under Reported	
All Industries	1.88%	0.98%	4.57%	2.31%	
Construction	0.96%	0.80%	2.38%	1.79%	
Trucking	1.22%	2.54%	5.94%	11.62%	
Security Guards	2.32%	1.12%	2.36%	2.32%	

	% of Misclassified Reported as Self-Employed	% of Misclassified Reported as Employees	% of Unreported Taxable Income Going to "Self-Employed"		% of Unreported Gross Income Going to "Self-Employed"	
			"Self-Employed"	Employees	"Self-Employed"	Employees
All Industries	65.7%	34.3%	73.6%	26.4%	53.9%	46.1%
Construction	38.0%	62%	79.0%	21.0%	57.6%	42.4%
Trucking	100.0%	0%	100%	0%	100%	0%
Security Guards						

	Under Reported Gross Income	30% Under Reporting	50% Under Reporting
All Industries	\$1,496,667,933	\$19,531,517	\$32,552,528
Construction	\$168,706,387	\$2,201,618	\$3,669,364
Trucking	\$38,610,722	\$503,870	\$839,783
Security	\$8,992,460	\$117,352	\$195,586

	Percent of Employers Misclassifying	% of Workers Misclassified by Misclassifying Firms	% of Workers Misclassified Among All Employers

Michigan		<b>15.4%</b>	<b>5.5%</b>
Massachusetts	13%	25%	4.5%
Maine	11%	44.6%	11.0%
New York			9.1%
Illinois	17.8%	28.8%	7.5%

Figure 1

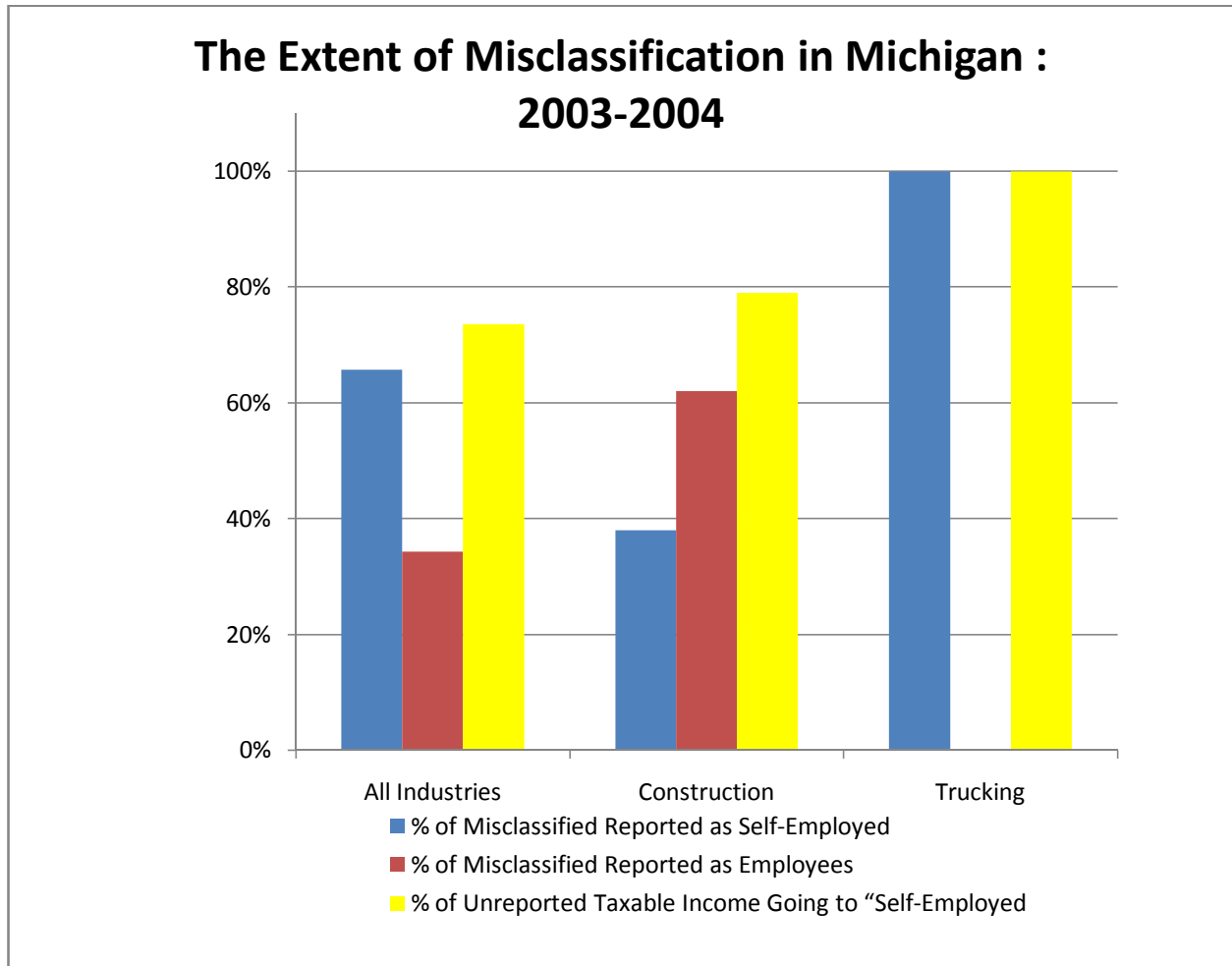


Figure 3

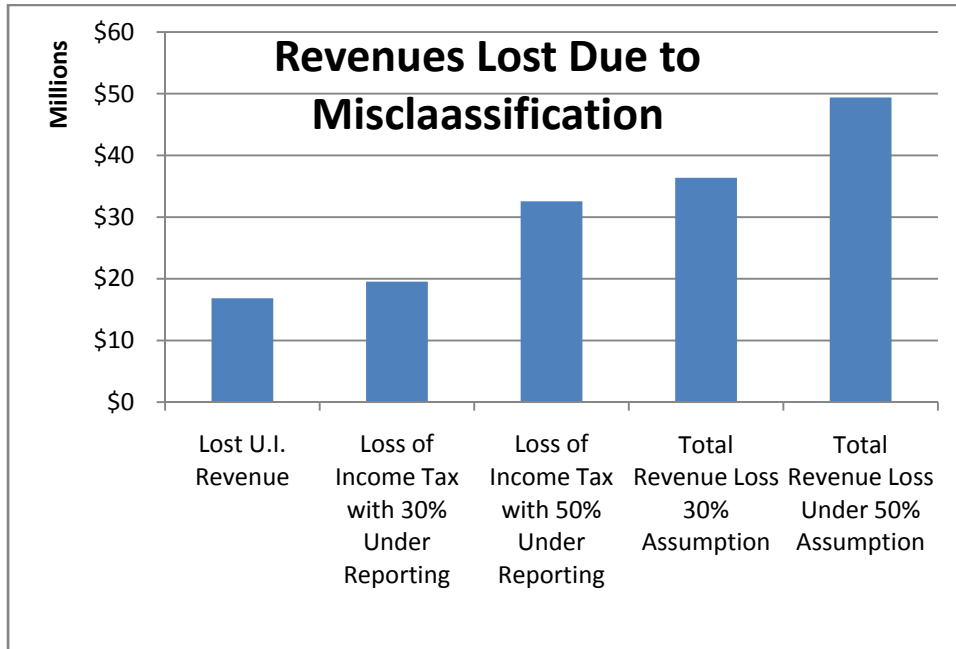


Figure 2

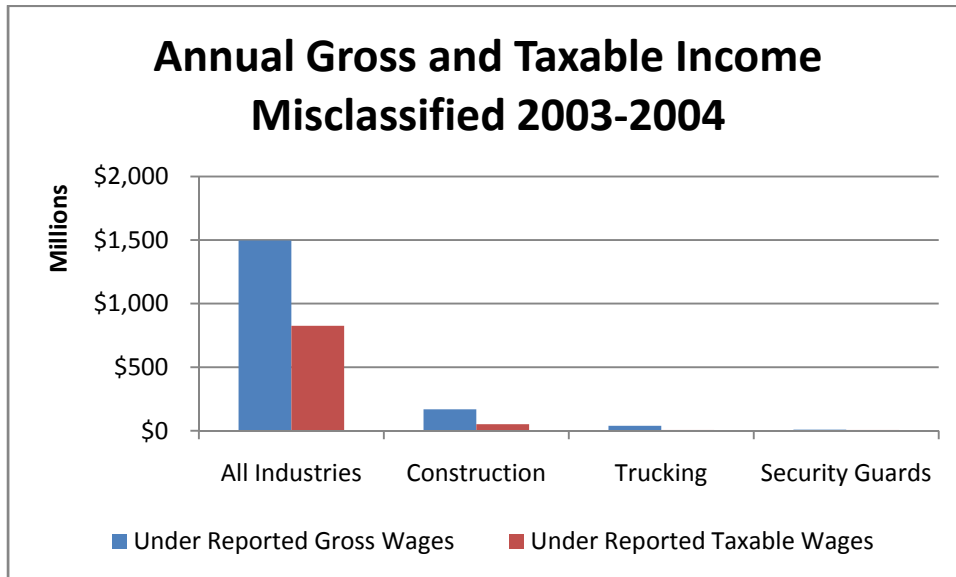




Figure 4

