The Cost of Worker Misclassification In New York State

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Executive Summary

- Misclassification occurs when an employer, at hiring, improperly classifies a worker as an independent contractor rather than an employee.
- Responsible employers may misclassify workers because they are unclear or confused about how to apply complex, inconsistent and varying standards.
- Other employers intentionally misclassify workers, assuming the risk of incurring penalties, as a strategy to significantly cut labor costs, limit their liability and gain an unfair competitive advantage.
- The results of this study are based on audits performed by the NYS Department of Labor Unemployment Insurance Division during the four-year period 2002-05. Audits were performed on firms in certain industries, and data was extrapolated statewide for these industries only, based on given employment information.
- Based on general and specific audits, an estimated 39,587 New York employers within the audited industries misclassified workers as independent contractors each year.
- Of these, approximately 5,880 per year, or 14.9%, were construction industry employers.
- Approximately 704,785 workers — or 10.3% of the state's private sector workforce in these audited industries — are misclassified each year.
- Approximately 45,474 construction workers or 14.8% of the construction workforce in New York State are misclassified in a given year.
- Misclassification's impact can be severe (1) for workers, (2) for employers in those industries where the practice is prevalent, and (3) for government and taxpayers.
  - Workers
    - Misclassification denies many workers protections and benefits that they are entitled to.
    - Worker misclassification disrupts labor markets by enabling unscrupulous employers to ignore labor standards.
  - Employers
    - Misclassification destabilizes the business climate, creating an un-level playing field and causing law-abiding businesses to suffer unfair competition.
    - Responsible employers who properly classify their workers as employees have higher costs and are underbid by competitors who intentionally misclassify their workers.
      - The construction industry is prone to classification abuse by unscrupulous contractors.
  - Government and taxpayers
    - For the industries covered in the audits, average unemployment insurance taxable wages underreported due to misclassification each year during the four-year period 2002-2005 is $4,283,663,772.
    - Unemployment insurance tax underreported for the same period in these industries is $175,674,161.
    - Misclassification costs government — at all levels — substantial, uncollected revenues, resources that are needed for vital government programs and services and for the maintenance of a productive workforce and economy.
- Among items for policymakers' consideration are the following:
  - Conduct high profile enforcement in those industries, such as construction, where misclassification is widespread
  - Clarify guidelines so that state agency determinations are uniform and consistently applied
  - Presume employee status
  - Extend employee protections to independent contractors
  - Provide more resources for enforcement
  - Promote more information-sharing among agencies
  - Extend current outreach and education efforts

Any reform measures would, of course, require further study to determine their impact on public policy and agency practices.

I. What Is Worker Misclassification?

Misclassification occurs when an employer, at hiring, improperly classifies a worker as an independent contractor rather than an employee.

The distinction between "employee" and "independent contractor" relates to the right of control. Employers have the right to direct the means, methods and outcome of their employees' work. Independent contractors, properly classified, are not employees but are in business for themselves.[1] They are hired to accomplish a task or tasks determined by the employer but retain the right to control how they will accomplish it.

Responsible employers may misclassify workers because they are unclear or confused about how to apply complex, inconsistent and varying standards.[2] Well-intentioned employers may have difficulty determining whether a worker is an employee or can properly be classified as an independent contractor.[3]

Other employers intentionally misclassify workers, assuming the risk of incurring penalties, as a strategy to significantly cut labor costs, limit their liability and gain an unfair competitive advantage.

[1] For a thorough discussion of federal IRS standards, see *IRS Publication 15-A, Employer's Supplemental Tax Guide,* hereinafter IRS 15-A, available online at www.irs.gov. For NYS DOL standards, see *Covered and Excluded Employment under the UI Law* at www.labor.state.ny.us/ui.

[2] *The Governor's Task Force on Independent Contractors: A Report to Governor George E. Pataki,* 1999. [hereinafter *Task Force Report*] Recognizing the need for "a State system in which determinations…are made simply, consistently, and fairly," the *Governor's Task Force on Independent Contractors* was convened, pursuant to Executive Order 78.1, to hear extensive testimony from business and labor. The Task Force issued a report in 1999 providing clarifying guidelines for proper classification and with specific recommendations to achieve uniform determinations. Their recommendations have not been implemented.

[3] For a review of various tests applied by courts and federal and state agencies, see *Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification, Report to the Ranking Member, Committee on Health, Education, Labor, and Pensions, U.S. Senate,* United States Government Accounting Office, July 2006, hereinafter GAO 2006, at 51-55; also see *Task Force Report* at 8-11.

II. What Is the Extent of Worker Misclassification in New York State?

This study uses data based on audits performed by the NYS Department of Labor Unemployment Insurance Division during the four-year period 2002-2005. Audits were performed on firms in certain industries,[4] and data was extrapolated statewide for these industries only, based on given employment information. Using general and specific audits conducted during the four year period 2002-2005, it is estimated that 39,587 New York employers (of about 400,732) in audited industries misclassified workers each year as independent contractors. Of these, approximately 5,880 employers, or 14.9%, were in the construction industry.[5]

NYS Employers with Workers Misclassified as Independent Contractors

Table 1: **Audited Industries**

Year	Statewide Approximation
2002	34,253
2003	37,608
2004	43,282
2005	43,206
Average	39,587

Table 2: **Construction Industry**

Year	Statewide Approximation
2002	4,740
2003	5,230
2004	6,057
2005	7,493
Average	**5,880**

Table 3: **Construction Employers as a Percent of Audited Misclassifying Firms**

Year	Construction Share
2002	13.8%
2003	13.9%
2004	14.0%
2005	17.3%
Average	**14.9%**

[4] For a list of the industries audited, see infra, *V.: Methodology* (footnote 40).

[5] The New York State DOL runs two types of audits on employers: general and specific. General audits are conducted on employers who are not suspected violators of state laws but may reflect regulators' concerns about industries with higher rates of noncompliance. Specific audits are conducted on employers who, for various reasons, are suspected violators of state laws. For more information on data collection and DOL audits, see infra, *V.: Methodology.*

Approximately 704,785 workers—or 10.3% of the state's private sector workforce (comprising approximately 6,858,266)—are misclassified each year in audited industries, and approximately 45,474 construction workers or 14.8% of the construction workforce (comprising approximately 307,257) in New York State are misclassified:

Number of Workers Misclassified as Independent Contractors

Table 4:
Audited Industries

Year	Statewide Approximation
2002	691,744
2003	680,113
2004	713,103
2005	734,180
Average	**704,785**

Table 5:
Construction Industry

Year	Statewide Approximation
2002	48,842
2003	52,847
2004	37,037
2005	43,173
Average	**45,474**

Percent of Workers Misclassified as Independent Contractors

Table 6:
Audited Industries

Year Audits	General Audits	Specific Audits	All
2002	8.9%	56.8%	10.1%
2003	8.7%	61.0%	10.0%
2004	9.6%	16.2%	10.4%
2005	9.2%	19.5%	10.6%
Average	**9.1%**	**22.3%**	**10.3%**

Table 7:
Construction Industry

Year Audits	General Audits	Specific Audits	All
2002	14.2%	63.0%	15.1%
2003	16.4%	22.0%	16.5%
2004	12.6%	10.0%	11.7%
2005	14.2%	12.3%	13.5%
Average	**14.8%**	**14.5%**	**14.8%**

III. What Is the Impact of Worker Misclassification?

Misclassification's impact can be severe (1) for workers, (2) for employers in those industries where the practice is prevalent, and (3) for government and taxpayers.

Workers

- Misclassification denies many workers protections and benefits they are entitled to.
- Worker misclassification disrupts labor markets by enabling unscrupulous employers to ignore labor standards.

In an employer-employee relationship, the employer must withhold income taxes, withhold and pay Social Security and Medicare taxes, pay unemployment tax on wages paid, provide workers' compensation insurance, pay minimum wage and overtime wages, and include employees in employee benefit plans.[6] Employers are not generally obligated to make these payments to, or on behalf of, independent contractors.

"Employees" receive unemployment and workers' compensation benefits and are typically protected by a broad spectrum of federal and state legislation affecting wages, health and safety, the right to organize, family and medical leave, and pension security.[7]

Independent contractors are generally excluded from the coverage of protective legislation. Misclassified workers must first realize that they are misclassified, understand what that means, and then successfully challenge their misclassification through administrative or court action to confirm their eligibility for and receive these statutory protections[8] — an impractical remedy for many because of the time, expense, and risk involved.

Misclassified workers — as putative independent contractors — are directly and immediately burdened in several ways. They generally do not file for unemployment insurance benefits even though they may be eligible[9] and do not receive appropriate levels of workers' compensation insurance. If they are unemployed or injured on the job, the economic consequences can be devastating. They are solely responsible for withholding and reporting taxes at the substantially higher self-employed tax rate. Their employers might provide them with the required IRS Form 1099-MISC showing gross wages paid [Schedule C — self-employment] or simply pay cash "under the table" — without regard to tax laws, statutory wage standards and "below the radar screen" of state regulators. Some may never benefit from Social Security. They are on their own for any health care or retirement savings. These workers may also be required, as a condition of employment, to purchase their own workers' compensation and liability insurance coverage, and to sign waivers releasing employers from liability and other obligations inherent in a typical employer-employee relationship.[10]

Some workers choose independent contractor status. Others are compelled to accept it. Facilitated by recent changes in the workplace, in technology and communications, many higher-paid, high-skilled workers choose to be independent contractors, contracting for particular projects for particular employers, because independent contractor status carries desirable tax advantages, such as the range of available deductions, increased flexibility over time, and greater control over work.[11]

[6] IRS 15-A at 6; *GAO 2006,* at 25.

[7] Misclassification can impact workers' rights and protections pursant to these federal and state statutes: U.S. Department of Labor [Fair Labor Standards Act, Family and Medical Leave Act, OSHA]; Internal Revenue Service [FICA, Federal Unemployment Tax Act, Self-Employment Contributions Act]; U.S. Department of Health and Human Services [Medicare]; Pension Benefit Guarantee Corporation [ERISA]; Equal Employment Opportunities Commission [Title VII of the Civil Rights Act, Americans with Disabilities Act, Age Discrimination in Employment Act]; National Labor Relations Board; Social Security Administration; NYS Department of Labor [unemployment insurance]; Workers Compensation Board; NYS Department of Taxation and Finance. *GAO 2006,* at 8.

[8] *GAO 2006,* at 21.

[9] *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs,* Planmatics, Inc., for the U.S. Department of Labor Employment and Training Administration, hereinafter *Planmatics,* February 2000, at 91- 92.

[10] For a useful overview, see *The Social and Economic Costs of Employee Misclassification in Construction,* Françoise Carré, et al, Construction Policy Research Center, Labor and Worklife Program, Harvard Law School, Harvard School of Public Health, hereinafter *Massachusetts Study,* December 2004, at 8-9.

[11] *Planmatics,* at 3.

Other workers may not have a choice. Without the same levels of skill, education and training associated with higher-paid workers, without the benefit of collective bargaining and with little or no individual bargaining power, these workers are often compelled by employers to accept independent contractor status, at low pay with no health, pension, or retirement benefits,[12] and without the protection of laws covering "employees" such as wage and hour standards. These workers cannot afford to make contributions into retirement accounts and generally will not file for and collect unemployment insurance when needed. Undocumented workers, whose status makes them even less likely to challenge the employer's designation, are among the most vulnerable.

Employers

- Misclassification destabilizes the business climate, creating an un-level playing field and causing law-abiding businesses to suffer unfair competition.
- Responsible employers who properly classify their workers as employees have higher costs and are underbid by competitors who intentionally misclassify their workers.
- The construction industry is prone to classification abuse by unscrupulous contractors.

Employers have powerful economic incentives to limit or cut labor costs, particularly in those industries, such as construction, that are sharply competitive. The immediate advantages of misclassifying a worker are, for many employers, worth the more remote risk of being caught and penalized. To the extent that there is insufficient monitoring, oversight and regulation by policymakers and affected state and federal agencies, misclassification will continue to destabilize the business climate in certain industries.

Misclassifying employers reap substantial savings and enjoy an unfair competitive advantage by not making those payments and incurring those costs required of a typical employer-employee relationship: the administrative costs for withholding taxes and making payments for Social Security, Medicare, unemployment insurance, providing the proper level of workers' compensation insurance, paying overtime and minimum wages, and including workers in employee benefit programs.[13]

Social Security and Medicare taxes — paid by employers who properly classify their workers as employees — amount to 7.65 percent of wages paid. Unemployment taxes paid to the federal government are at 0.8% of the first $7,000 of remuneration. Combined federal and state unemployment insurance taxes are higher.[14] Federal and state unemployment taxes are estimated to be an average of 0.8 percent of wages, which could be a substantial cost.[15] Steadily rising medical costs and workers' compensation premiums represent a significant cost factor in certain, more injury-prone industries such as construction.

Responsible employers carry an undue burden: to the extent that misclassifying employers are not paying into insurance funds, responsible employers make up the difference in higher premiums.[16]

Avoiding workers' compensation payments is the leading reason that employers intentionally misclassify workers, a larger factor than non-payment of unemployment insurance contributions. A study of several states' insurance funds conducted for the

[12] The 2000 *Planmatics* study for the US DOL found that the majority of independent contractors, without making a distinction between those properly classified and those misclassified, has no health insurance or retirement benefits and earns middle to low-level wages. *Planmatics*, at 3, 91-92.

[13] *GAO 2006* at 25; *Planmatics* at 25-27.

[14] In New York State, the unemployment insurance tax rate is based on an employer's experience with the system and its account balance. See NYS Unemployment Insurance Law Article 18 §581et. seq.

[15] Commerce Clearing House, *Business Owner's Toolkit* at www.toolkit.cch.com.

[16] Another problem for the business community concerns mistaken, but not intentional, misclassification due to inconsistent standards and the inconsistent or conflicting application of standards among various federal and state agencies. For example, under §530 of IRS regulations, an employer may appropriately classify individuals as independent contractors while the states might hold them to be employees. See http://www.unclefed.com/Tax-News/1996/Nr96-44.html. Employees' wages may be taxable for state purposes and would not be taxable for FICA, FUTA, or Federal withholding. Also see *Planmatics* at 3 and *GAO 2006* at 25.

U.S. Department of Labor concluded that employers will take the risks associated with misclassification to gain a competitive advantage by not paying workers' compensation premiums — risks they would not likely take for unemployment insurance cost savings alone.

> The number one reason why employers use independent contractors and/or misclassify employees is the savings in not paying workers' compensation premiums and not being subject to workplace injury and disability-related disputes. Another reason is the avoidance of costs associated with employee lawsuits against employers alleging discrimination…[17]

Direct and immediate cost savings are an obvious incentive but so are potential cost savings from limiting or eliminating employer liability. In an employer-employee relationship, employers are liable for the torts committed by their employees within the scope of their employment. Employers are *not* liable for the torts of independent contractors. According to one advisor, "the tax savings [from hiring independent contractors] pale in comparison to the elimination of tort liability." [18]

The construction industry is particularly prone to worker abuse through misclassification. Studies conducted by the U.S. General Accounting Office and for the U.S. Department of Labor underscore that the *construction industry stands out both as the industry with the highest percentage of independent contractors [22%] but also as the industry with the "highest incidence of misclassification"* [emphasis added].[19]

This finding should come as no surprise. Construction is an expanding but fiercely competitive contract industry, characterized by slim profit margins, high injury and comp rates, comprised largely of numerous small to medium-sized companies whose numbers and size may make them more likely to operate beyond the view of state regulators. It is labor intensive, its jobs are temporary, and many jobs, particularly in unlicensed trades, can be broken down into piece work. It is a lucrative employment source for immigrant, often undocumented, workers and unscrupulous employers use their workers' alleged independent contractor status to circumvent employer obligations under federal immigration laws. And the construction workforce is mobile — making it difficult for regulators to track down particular employers. All the elements are present throughout the industry, but misclassification and "under the table" practices operate with particular impunity in the large and expanding residential and commercial sectors.[20]

Government and taxpayers

- Impact on New York State's unemployment insurance fund
- Broader implications of worker misclassification

[17] *Planmatics*, at iii. States providing data: California, New Jersey, Maryland, Florida, New Jersey, Washington, Indiana, Minnesota, Ohio, Wisconsin, Colorado, Connecticut, Nebraska, New Mexico, Oregon, Pennsylvania, and Texas.

[18] A later comment in the same study: "In high risk industries, workers' compensation was the single most dominant reason for misclassification. Many employers believe the risk of being caught is acceptable if it means the survival of their business." *Planmatics*, at 92.

[19] Commerce Clearing House, *Business Owner's Toolkit,* at www.toolkit.cch.com.

[20] *GAO 2006,* at 49; *Planmatics*, at 41. Other industries with disproportionately high numbers of independent contractors — and high rates of misclassification — include trucking, home health care, and retail services, at 91.

The average annual underreported wages subject to unemployment insurance taxes in audited industries during 2002-2005 were $4,283,663,771.79[21]*. Here it is important to note that unemployment insurance taxable wages are limited to the first $8,500 earned per employee during a single calendar year.*

UI Taxable Wages Underreported for Workers Misclassified As Independent Contractors

Table 8: **Audited Industries**

Year	Statewide Approximation
2002	$4,343,411,205.80
2003	$3,783,602,972.84
2004	$4,217,935,631.89
2005	$4,789,705,276.84
Average	**$4,283,663,771.79**

UI Taxable Wages Underreported Per Worker[22]

The average annual underreported UI taxable wages per employee is just over $6,000:

Table 9: **Audited Industries**

Year	General Audits	Specific Audits	All Audits
2002	$6,158.72	$7,004.09	$6,278.93
2003	$5,726.70	$4,644.21	$5,563.20
2004	$5,421.17	$8,098.07	$5,914.90
2005	$6,345.76	$7,069.67	$6,527.33
Average	**$5,913.09**	**$6,704.01**	**$6,071.09**

Figures for the construction industry are generally higher:

Table 10: **Construction Industry**

Year	General Audits	Specific Audits	All Audits
2002	$6,797.21	$5,074.83	$6,658.11
2003	$7,016.77	$11,669.80	$7,165.45
2004	$11,065.27	$3,241.98	$8,597.14
2005	$6,988.95	$6,557.50	$6,837.44
Average	**$7,967.05**	**$6,636.03**	**$7,314.54**

[21] While misclassification may not be the only cause of underreported wages and tax, it has been considered acceptable to use these figures as economic effects of misclassification (see *Planmatics* 2000).

[22] *Article 18. NYS Unemployment Insurance Law. Sec. 518. Wages. 1. Limitation. (a) "Wages" means all remuneration paid, except that such term does not include remuneration paid to an employee by an employer after eight thousand five hundred dollars have been paid to such employee by such employer with respect to employment during any calendar year. The term "employment" includes for the purposes of this subdivision services constituting employment under any unemployment compensation law of another state or the United States.*

The average annual unemployment insurance tax underreported in audited industries for the same period is $175,674,161.45:

UI Tax Underreported for Workers Misclassified As Independent Contractors

Table 11: **Audited Industries**

Year	Statewide Approximation
2002	$168,764,746.84
2003	$133,132,061.03
2004	$194,919,698.66
2005	$205,880,139.28
Average	**$175,674,161.45**

The average UI tax underreported per worker per year is $227.63:

UI Tax Underreported Per Worker

Table 12: **Audited Industries**

Year	General Audits	Specific Audits	All Audits
2002	$231.69	$317.98	$243.97
2003	$196.62	$190.90	$195.75
2004	$172.22	$269.73	$190.21
2005	$261.75	$336.78	$280.57
Average	**$215.57**	**$278.85**	**$227.63**

Table 13: **Construction Industry**

Year	General Audits	Specific Audits	All Audits
2002	$262.34	$246.75	$261.08
2003	$268.65	$479.92	$275.40
2004	$352.69	$101.18	$273.34
2005	$362.17	$345.32	$356.26
Average	**$311.46**	**$293.29**	**$291.52**

The financial viability of the state unemployment insurance fund is at issue.[23] An economic downturn amplifies problems caused by misclassification as funds are drained of resources. According to the U.S. Department of Labor study,

> …this drain would most likely have to be offset by assigning higher contribution rates to those employers that correctly classify their workers and pay their taxes, placing them at a further economic disadvantage.[24]

Broader implications of worker misclassification

The costs of worker misclassification extend well beyond workers and employers in those industries where it is most widely practiced. Misclassification costs government — at all levels — substantial, uncollected revenues, resources that are needed for vital government programs and services and for the maintenance of a productive workforce and economy.

The Internal Revenue Service last estimated misclassification's cost to the nation in 1984. Their estimate in 2006 dollars for tax loss in Social Security tax, unemployment insurance tax, and income tax is $2.72 billion.[25] Given the substantial growth in the nation's economy, population, and workforce since 1984, as well as recent shifts toward contingent and casual labor, it is reasonable to assume that the true figure today would be much higher.

The implications for overall lost state revenues are severe. One recent estimate of the total tax loss due to misclassification in California is as high as $7 billion.[26] A 2004 study in Massachusetts estimates losses of $12.6 to $35 million to that state's unemployment insurance system, a loss of $91 million in state income tax revenue, and $91 million in unpaid workers' compensation premiums.[27]

Misclassification's impact on the state's workers' compensation system is beyond the scope of this study but deserves further attention. Some reasonable estimates of the costs in lost premiums should be calculated. An analysis involving five other states showed that misclassification penalized workers' compensation insurers through the "retroactive use" of the system — when independent contractors file claims as employees for injuries received on the job.

> The insurers have to pay benefits for workers they never received premiums for. Some workers, who have been independent contractors and therefore exempted from workers' compensation for many years, become employees and get covered under workers' compensation without having paid premiums for all of the previous years…[28]

Just as responsible employers bear the costs of unfair competition in higher insurance premiums and lost business opportunities, so the state's taxpayers are shortchanged in resources lost to government and have to make up the difference.

Significant revenue shortfalls translate into broad social costs — less money available for communities, for school districts, hospitals, law enforcement, and the various other vital services of state, county, and municipal governments. To the extent that employer-based plans do not provide for health care or retirement, additional costs are borne by government-run or sponsored programs.

[23] *Planmatics,* at 91

[24] Ibid. at 93.

[25] *GAO 2006,* at 1-2.

[26] Jerome Horton, California State Assembly Member, 51st Assembly District, recorded interview within "1099 Misclassification: It's Time to Play by the Rules," video stream currently available at http://www.mosaicprint.com/client_preview/1099/index.html#.

[27] *Massachusetts Study,* at 2. Estimates noted here are for all industries.

[28] *Planmatics,* at 75-76.

IV. Items for Policymakers' Consideration

When workers are misclassified as independent contractors, they are denied fundamental legal protections, responsible employers face unfair and potentially disabling competition, and state government loses substantial revenue essential for the maintenance of vital public services.

Policymakers can now choose how best to address this problem. While any reform measures would obviously have to be examined for their impact on public policy and practices, we believe the following merit policymakers' consideration:

- **Clarify Guidelines So That State Agencies' Determinations Are Uniform and Consistently Applied**

Pursuant to Executive Order #78.1, the Governor's Task Force on Independent Contractors [1999] examined then current, and to date unchanged, standards and procedures among various state agencies and the courts for making proper classifications.[29] Although the NYS Department of Labor provides general classification guidelines, in print and on their website, which apply to most industries in New York State, the Task Force concluded in its Final Report that:

> First, there is no uniform guideline, rule or regulation that sets out the criteria to be used in determining an employment or independent contractor relationship. Second, there is often no effort among State regulators to reach consistent determinations. Third, State agencies do *not* recognize each other's determinations.[30]

- **Presume Employee Status**

Recently enacted legislation in Massachusetts [2004] seeks to clarify and streamline the determination process by presuming employee status so that independent contractor classification is recognized only if all three elements of a three-part test are met:

(1) the individual is free from control and direction in connection with the performance of the service, both under his contract for the performance of service and in fact;

(2) the service is performed outside the usual course of the business of the employer; and,

(3) the individual is customarily engaged in an independently established trade, occupation, profession or business of the same nature as that involved in the service performed.[31]

Similarly, New Mexico presumes an employee/employer relationship for all workers in the construction industry.[32]

- **Extend Employee Protections to Independent Contractors**

Some observers have noted that one approach to mitigating the misclassification problem is to extend protections now afforded employees to independent contractors. Recognizing that workforce changes that have left many workers, both properly classified and misclassified independent contractors, beyond the protections and benefits of more traditional employer-employee relations, the *Planmatics* report for the US DOL recommends a "multi-agency dialogue" to study these questions:

› Should ICs [independent contractors] participate in unemployment insurance, including payment of contributions?

[29] The Task Force's charge was to: (1) identify and recommend guidelines to provide clarity concerning the proper classification of workers; (2) propose recommendations to achieve uniform determinations of independent contractor or employee status among the various State agencies; (3) ensure that any recommendations are designed to continue the protections afforded to legitimate employees; (4) receive and evaluate information from labor unions, business groups and all other interested parties. At 1.

[30] *Task Force Report,* at 7.

[31] M.G.L. Chapter 149, Section 148b [http://www.mass.gov/legis/laws/mgl/149-148b.htm.].

[32] http://legis.state.nm.us/sessions/05%20Regular/bills/senate/SB0657CTS.pdf.

- Should workers' compensation be mandatory for them?
- Should IC agreements be subject to requirements such as the payment of a minimum wage?[33]

If state labor laws were extended to all workers, whether employees or independent contractors, the classification of these workers would no longer be an issue. We note that Colorado requires that workers' compensation coverage be extended to all construction workers.[34]

- **Provide More Resources for Enforcement, Promote More Information-Sharing Among Agencies**

State agencies need the tools to motivate employers or compel compliance with classification guidelines. As noted in the *Planmatics* report, "State and federal agencies have insufficient staff to crack down on employers who misclassify workers."[35]

Currently the New York State Department of Labor (DOL) Unemployment Insurance Division identifies cases of misclassification in several ways, among which are:

- Unemployment insurance (UI) benefit applications —i.e., when DOL finds that an applicant's previous employer classified him/her as an independent contractor, they investigate on behalf of that worker as well as others similarly employed by that entity.
- Audits, both general and specific
- Tips from the public
- Data sharing with the Internal Revenue Service
- Employer inquiries

Employers in violation who refuse to cooperate with DOL investigators are subject to failure-to-file penalties, the assessment of fraud penalties, higher tax assessments and tax rates, and periodic audits. The normal procedure in regard to audits is to educate employers on proper compliance and to bring those employers into compliance. Similarly, when employers contact DOL with questions about worker classification, they are met with information designed to educate and achieve compliance.

Non-compliant employers are subject to the collection of back UI taxes plus interest. Follow-up audits on three-year cycles are conducted on certain violators.

Issuing stiff penalties for violating classification rules would likely encourage greater attention to those rules by employers. Under Massachusetts law, for example, employers that violate classification rules are subject to both criminal and civil penalties involving fines of up to $50,000, imprisonment of up to two years, and debarment up to five years.[36] Well-publicized convictions of willful violators could go a long way toward motivating other employers to properly classify workers in their firms, particularly if enforcement mechanisms were stepped up as outlined below.

Permitting aggrieved workers private rights of action would further motivate compliance. The Massachusetts law cited above allows workers to file a civil action seeking treble damages and attorneys' fees. Illinois' day labor law provides for private right of action and "any party" may seek penalties.[37]

Enhancement of the data collection and audit capabilities of state agencies and requiring a collaborative approach to misclassification identification and enforcement would likely make a dramatic difference. For example,

[33] *Planmatics*, at 95. See also "Lone Rangers: Are those in the free-agent economy just getting to the future ahead of everyone else?" *Common Wealth,* Winter 2005, available on line at www.hidden-tech.net/articles/CommonWealth-Summer-2005.htm.

[34] htttp://www.leg.state.co.us/CLICS2004A/csl.nsf/fsbillcont3/7F2516C7B4E9B70087256D790073B01D?Open&file=1090_enr.pdf].

[35] *Planmatics* at 43.

[36] http://www.mass.gov/legis/laws/mgl/149-148b.htm.

[37] 820 ILCS 175/95.

see California's provision to create an Enforcement Strike Force on the Underground Economy.[38] Similarly, the (NYS) Governor's Task Force Report on Independent Contractors encourages cross-agency participation on a Certification Board that would certify the nature of employment relationships for businesses and workers, and their ruling would be binding upon all State agencies.

- **Conduct High Profile Enforcement**

High visibility enforcement directed against targeted employers who intentionally misclassify workers, particularly in industries — such as construction — where the practice is widespread, will send a powerful message to those who now abuse the system or are tempted to do so.

- **Extend Current Outreach and Education Efforts**

To increase compliance, provide all workers and employers with information about how "employees" and "independent contractors" are distinguishable (e.g., workplace posters similar to minimum wage postings). While this information is available at the NYS DOL website, misclassified workers may not question their status until after a situation (layoff, on-the-job illness or injury, etc.) has occurred.

Include a 1-800 number and/or a website address on required workplace posters for those with questions or complaints. (This action was similarly recommended to the U.S. Senate Committee on Health, Education, Labor, and Pensions in GAO Report 06-656, July 2006.)

Ensure that workers feel able to report classification errors/abuses by affording them whistleblower-type protection. For example, the National Employment Law Project (NELP) references the San Francisco Minimum Wage Ordinance, which presumes that any adverse action taken against a complaining worker is retaliatory if it occurs within 90 days of a worker's complaint.

Information-sharing currently occurs between the NYS DOL and the Internal Revenue Service. However, every state agency should consistently alert other affected agencies, both state and federal, when misclassification is identified. (This action was also suggested in GAO Report 06-656, July 2006.) The point of such notification would not be disciplinary (although violators would be subject to appropriate penalties) but to ensure compliance at every level so that workers, employers, government agencies and taxpayers receive their due.

[38] See CA UI Code section 329, http://caselaw.lp.findlaw.com/cacodes/uic/301-335.html.

V. Methodology

Defining the Data

The data for our studies come from audits provided by the New York State Department of Labor, Unemployment Insurance Division.[39] The NYS DOL runs two types of audits on employers statewide: general and specific. General audits are conducted on employers who are not suspected violators of state laws. It is important to note that these audits are not statistically random; that is, the DOL uses a complex method to determine which industries should be more heavily scrutinized in general. Industries are selected, among other reasons, on a cyclical basis: it is not the case that all employers are drawn arbitrarily in the "general" sample. For this reason, all statewide extrapolations have been performed using data for only audited industries.[40] However, it is significant that each of the employers has no reason to be a likely violator and should thus not be considered a specifically targeted entity.

On the other hand, the "specific" group consists of employers who, for one reason or another, are suspected to be violators of state laws. They are targeted based on multiple factors, including prior violations and other variables that increase their likelihood of noncompliance. They are not drawn at random in any way; their inclusion in the audit group is subjective.

The data give both general and specific employer information over a four-year period, from 2002 to 2005. This period was chosen because it gives the most recent data available and because it can be used to show current trends in the data. Rather than simply including a snapshot of worker misclassification, we are analyzing patterns, both in the types of audits performed and in the scope of noncompliance.

In our analysis, we look at the general and specific data separately to show individual trends. Additionally, we combine the two groups into a third category, which we call all audits. These aggregate data give a broader picture, which can be used to approximate what is happening across all those industries included in NYS DOL audits.

What the Data Show

Audit Counts

Table A provides audit counts for the audited industries. The table shows an upward trend in both the numbers of general selection audits and the total number of audits, though the rate of increase is declining. According to NYS DOL, this is due to limited staff and resources. Specific audits appear to remain relatively unchanged for the first two years of analysis but shoot upward in 2004 and almost double in 2005; this reflects a shift in NYS DOL's focus.

Clearly, across the audited industries, the number of specific audits is increasing quickly. In all, there were 38,280 audits performed over the four-year period. The vast majority of those were general selection.

Table A: **Audit Counts (Audited Industries)**

Year	General Audits	Specific Audits	All Audits
2002	7,057	203	7,260
2003	9,202	197	9,399
2004	10,102	476	10,578
2005	10,109	934	11,043
Total	**36,470**	**1,810**	**38,280**

[39] In the audit data, some firms are identified to have "alleged independent contractors," which can be considered misclassified employees. However, these workers may not necessarily all be misclassified. It has been generally acceptable to use a form of "independent contractor" allegations to measure misclassification.

[40] Industries covered by DOL audits for the years 2002-2005 include: construction; manufacturing; wholesale and retail trade; transportation and warehousing; information; finance and insurance; real estate; professional, scientific, and technical services; administrative and support and waste management and remediation services; health care and social assistance; arts, entertainment, and recreation; other industries.

Table B gives the audit counts for only the construction industry. In direct contrast to the counts in audited industries, the general audits and total numbers of audits have plummeted in the past four years. Specific audits have been on the rise, especially in 2005, where there were almost three times as many specific firms as in the year prior. Thus, the driving force behind the large drop in construction audits comes from the general selected firms, specifically between 2003 and 2004. Between these two years, general construction audits fell from 2,053 to 520, a drop of 74.7 percent. Between 2004 and 2005, general audits dropped another 27.5 percent, to 377. In all, over the period studied, general construction audits fell from 2,309 to 377, a four-year decrease of 83.7 percent.

Table B: **Audit Counts (Construction Industry)**

Year	General Audits	Specific Audits	All Audits
2002	2,309	28	2,337
2003	2,053	34	2,087
2004	520	79	599
2005	377	206	583
Total	**5,259**	**347**	**5,606**

This change is explained by the New York State Department of Labor, Unemployment Insurance Division, as due to adjustments in the general selection criteria to provide the best return on investment; that general audits conducted in industries other than construction were yielding considerably greater evidence of non-compliance as measured in additional taxable wages and/or taxes.

Looking at data over a longer period of time might offer additional insight into what is occurring among construction firms; however, the massive decrease in audit counts is extremely significant in terms of analysis of non-compliance in the construction industry. The sample of firms audited has become quite small; if these downward trends continue, it will be hard to gather information about noncompliance trends.

Of further interest, when one compares the trends in these data to those in Table A, the results are even more marked. Overall, the number of general audits has increased over the four years, yet, as Table C shows, the construction industry's share of the total number of audits has fallen at a rapid rate over the past four years. The intense decline of construction's share of general audits is slightly buoyed by a larger portion of specific audits dedicated to construction firms. While there has been a 29 percent decrease in construction's share of all general audits, construction's share of specific audits has increased 8.3 percent over the period analyzed. However, when all audits are grouped, construction has lost 26.9 percent of its share in audit counts, having comprised 32.2 percent in 2002. As noted above, DOL suggests this is due to adjustments in the selection criteria used by the DOL in order to identify the greatest number of firms out of compliance.

Table C:
Construction as a Percent of Audited Industries

Year	General Audits	Specific Audits	All Audits
2002	32.7%	13.8%	32.2%
2003	22.3%	17.3%	22.2%
2004	5.2%	16.6%	5.7%
2005	3.7%	22.1%	5.3%
Average	**14.4%**	**19.2%**	**14.6%**

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