

## **Misclassification: The Illegal (and Hidden) Tax on our Communities**



### **What is "misclassification"?**

- Employers purposely misclassify employees as "independent contractors" to skirt payroll expenses and other worker-related expenses to the state and federal governments while retaining huge financial windfalls.

### **How does misclassification hurt employees?**

- Misclassified employees lose out on national labor laws that protect employees in the workplace, like worker's compensation, unemployment insurance, healthcare and retirement benefits.
- Misclassified workers are forced to pay for safety net benefits, like Social Security and Medicare, and other expenses in which employers should be responsible.
- Misclassified employees make **up to 20% less** than properly classified employees in the same position.

### **How does misclassification hurt employers who play by the rules?**

- While employers misclassifying employees retain huge financial windfalls, employers who properly classify employees face a **25% tax** to cover these tax cheats.

### **How does misclassification hurt states?**

- Misclassified employees only report 68% of annual income while properly classified employees report 99% of income.
- Misclassification costs states **more than \$200 million annually** in unemployment insurance funds.
- Misclassification ranges up to 19% in individual states across the country, costing states hundreds of millions of dollars each year in uncollected income taxes.

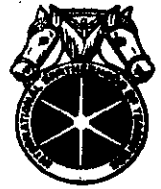
### **Misclassification: A growing problem?**

- More than **1.5 million employees are misclassified** in the United States – a 7% increase since 2004 - costing the federal government **\$4.7 billion annually**.
- Companies like Federal Express, Merrill Lynch, Time Warner and Sara Lee, have been cheating the system for years, illegally saving millions of dollars. FedEx is currently being investigated by the IRS which could end up costing the company **\$1 billion in taxes and penalties**.
- Misclassification crosses into all industries – parcel delivery services, construction, real estate, stock brokers, insurance agents, and the entertainment industry.

### **What are states doing to stop this illegal, hidden tax on our communities?**

- Six states established misclassification task forces to investigate the practice in their state through executive orders or legislation.
- Twelve states introduced legislation to investigate misclassification.
- More than thirty states are investigating FedEx Ground's misclassification of employees.

## **Fact vs. Fiction: Setting the Record Straight on Misclassification**



**Fiction:** As independent contractors, workers get to live the American dream by becoming small-business owners.

- **Fact:** In reality, misclassified workers lose basic job protections, health care and retirement benefits, and are paid up to 25% less than their properly-classified counterparts.

**Fiction:** The Worker Misclassification campaign will eliminate all independent contractors.

- **Fact:** The campaign is only targeting 1.5 million misclassified workers currently considered independent contractors, but recognizes that there are an additional 13.5 million legitimate independent contractors – more than 7% of the nation's total workforce.

**Fiction:** Worker misclassification only exists in the construction industry.

- **Fact:** Misclassification is used across all industries, including the construction, real estate, motion picture, and parcel delivery industries. In fact, many well-known Fortune 500 companies use this practice, such as FedEx Ground, Microsoft, and Sara Lee.

**Fiction:** The Worker Misclassification campaign will force small businesses to close, costing more workers to lose their jobs during the current recession.

- **Fact:** Cracking down on misclassification will ensure a level playing field among competitors. Employers who play by the rules are currently taxed up to 25% in additional worker-related expenses, like unemployment insurance taxes and workers' compensation premiums, because employers who misclassify employees avoid paying into these pools.

**Fiction:** The Worker Misclassification campaign is unnecessary because the practice is already illegal in many states.

- **Fact:** In some states, worker misclassification is illegal, but not everywhere. Also, states must make a commitment to use resources to enforce misclassification laws.

**Fiction:** Enforcing worker misclassification laws will be too costly for state governments, especially during tough economic times when those funds would be better used elsewhere.

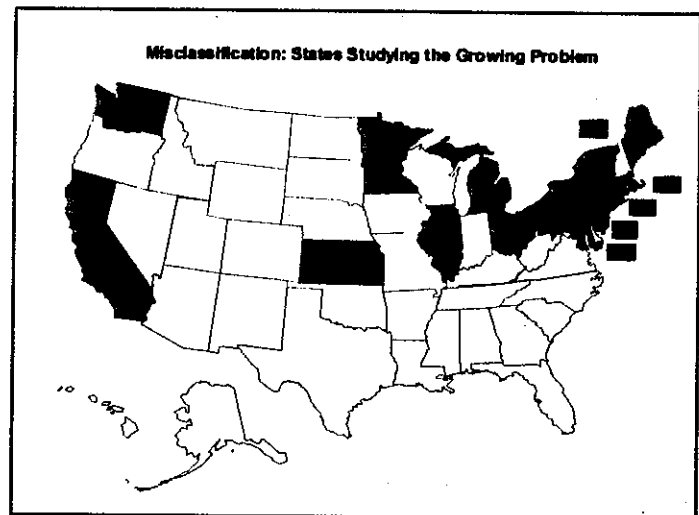
- **Fact:** A small state appropriation today will reap huge financial rewards in the future. In 15 states in which the issue has been studied, cracking down on misclassification would inject substantial future revenue into income and unemployment tax systems as well as in workers' compensation premiums. Additionally, misclassified workers will once again be protected by basic job protection rights.

## Misclassification: The Illegal (and Hidden) Tax on our States



### **Misclassification: A growing problem across the country?**

- Approximately 1.5 million employees are misclassified as independent contractors across the country, costing the United States more than \$4.7 billion each year in uncollected income taxes.
- Misclassification rates increased 7% nation-wide in just the last four years. Meanwhile, misclassification allows employers who misclassify employees to save up to 30% in worker-related expenses like unemployment insurance taxes. The practice also costs employers who play by the rules an additional 25% misclassification tax to cover lost revenues due to the practice.



### **Misclassification: A State-by-State cost estimate**

#### **California**

- A 2007 state study revealed that underreported income due to misclassification totaled \$100 billion – an increase of 400% in only five years.

#### **Connecticut**

- Misclassification costs the state an estimated \$65 million annually in uncollected income taxes and more than \$17 million in the state's Unemployment Insurance Fund.

#### **Illinois**

- Misclassification costs the state approximately \$250 million in uncollected income taxes and more than \$96 million in workers' compensation premiums each year.

#### **Kansas**

- In 2006 and 2007, the state's Department of Labor conducted an audit revealing more than 2,860 misclassified employees by less than 350 employers.

#### **Maine**

- In 2005, studies estimated that the state failed to collect \$4.3 million in uncollected income taxes in the construction industry alone.

#### **State Misclassification Rates:**

Illinois – 7.5%
Maine – 11%
Massachusetts – 19%
Minnesota – 17%
Pennsylvania – 9%

#### **Total Lost Revenue (in millions annually):**

Connecticut – \$82.0
Illinois – \$346.0
Maine – \$4.3
Massachusetts – \$275.0
New York – \$176.0
Pennsylvania – \$281.0
Ohio – \$159.0
Washington – \$274.0

### Massachusetts

- Misclassification costs the state more than \$275 million annually, including \$152 million in uncollected income taxes, \$35 million in uncollected unemployment insurance taxes, and \$91 million in uncollected workers' compensation premiums.

### Michigan

- Between 2003 and 2007, state audits revealed more than \$23 million in misclassified wages.

### Minnesota

- A 2006 state audit identified 65% of employers' misclassified employees resulting in \$10 million in new taxable wages.

### New Jersey

- Audits in 2005 and 2007 revealed more than 53,000 misclassified employees earning more than \$1.1 billion in taxable wages.

### New York

- A 2007 audit of only 15 employers revealed more than 2,000 misclassified employees earning more than \$19 million – resulting in more than \$1.2 million in uncollected income taxes and other worker-related expenses. The same audit revealed that the state loses more than \$176 million annually in uncollected income taxes due to misclassification.

### Ohio

- The State Treasurer's Office estimates more than 92,000 misclassified employees work in the state, costing Ohio more than \$36 million in uncollected income taxes, \$20 million lost in its unemployment insurance fund, and \$103 million lost in workers' compensation premiums.

### Pennsylvania

- A 2008 survey revealed that the state loses more than \$200 million in its unemployment insurance fund and \$81 million in lost workers' compensation premiums each year.

### Washington

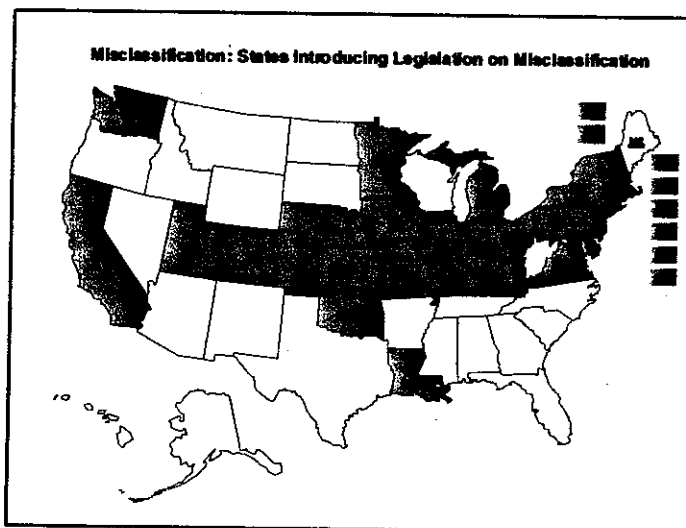
- A state study showed that misclassification cost the state \$274 million in unpaid income taxes, unpaid unemployment insurance, and unpaid workers' compensation premiums.

#### Lost State Income Taxes (in millions annually):

Connecticut – 65.0
Illinois – \$250.0
Maine – \$4.3
Massachusetts – \$152.0
New York – \$176.0
Ohio – \$36.0

#### Lost Unemployment Taxes (in millions annually):

Connecticut – \$17.0
Ohio – \$20.0
Pennsylvania – \$200.0



**The Economic Costs  
of  
Employee Misclassification in  
the State of Illinois**

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A Report by the

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## **I. Summary Findings**

This report is a first step toward analyzing the economic implications of employee misclassification for the public and private sectors in the State of Illinois. It is based upon aggregate audit data for the five-year period, 2001-2005, provided by the Illinois Department of Employment Security (IDES) and the results of similar studies on misclassification in other states. In this report, we analyze the scope and trends of misclassification in Illinois. We provide estimates of the impact of misclassification on Illinois state revenues, the unemployment insurance fund, and for workers' compensation in Illinois.

Employee misclassification is defined as the case where employers treat workers as independent contractors that should otherwise be wage or salaried employees. If an employee is classified as an independent contractor, the employers are not required to pay a variety of payroll-related taxes, fees and benefits (e.g. social security, unemployment insurance, income taxes, workers compensation, pension and health benefits, etc.). Not only are these costs illegally shifted to the individual worker, the "independent contractor" is also not fully protected by various employment laws (minimum wage and overtime requirements, workers compensation protection, the right to form a union and bargain collectively, etc.) and may, incorrectly, believe he or she is not protected by Illinois unemployment laws.

The issue of misclassifying employees as an independent contractor is a growing problem for the unemployment insurance system in Illinois and the nation since employers remit their unemployment taxes based upon their payroll. Recent studies have shown that misclassification by employers is increasing.<sup>1</sup> Note, the "underground economy" (workers paid in cash) is outside the scope of our study. Thus, the estimates we provide may underestimate the full extent of the problems associated with the employer practice of misclassification in Illinois.

Misclassification negatively impacts the citizens of Illinois in several ways. First, the conditions for a fair and competitive marketplace are sabotaged. Firms that misclassify can bid for work without having to account for many normal payroll-related costs. This illegal practice can decrease payroll costs by as much as 15 to

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<sup>1</sup> In a report by the National Employment Law Project, it was reported that US DOL quarterly audits found 30,135 employees misclassified in 2002. This was a 42% increase from the prior year.

30%. This places employers who correctly classify their employees at a distinct competitive disadvantage.

In Illinois, workers who have been misclassified, but who have been paid on a 1099-basis, may still receive unemployment insurance benefits if they complete an affidavit and file for benefits. When they do so, a benefit-related audit is triggered by the Audit Section of the Illinois Department of Employment Security (IDES) to determine the eligibility of the former employee. If the employer can be located and/or the former employee's eligibility can be confirmed, the employer will be subject to collection procedures to recover the unreported wages. Ultimately, in a legal sense, it is not the employer but state law that determines who is eligible for unemployment insurance benefits. Still, the violating employer will have been able to gain business illegally by exploiting their competitive advantage during the bidding process and they will have profited by avoiding other payroll related expenses.

Several studies have shown the problem of misclassification to be particularly acute in the construction sector. A U.S. Census Bureau analysis of projected employment by major industry division for the period 2004-2014 shows that the growth in overall employment is projected to increase 14.8%, or an annual rate of increase of 1.4%; in construction, the growth in employment is projected to increase 11.4%, or an annual rate of increase of 1.1%. Given the projected growth in the construction sector, the impacts of misclassification will get worse.

A number of studies have been conducted to assess the extent and impact of misclassification. For the 11 states studied, the moderate rate of misclassification was from 13-23%. In two states, Massachusetts and Maine, the incidence of misclassification in the construction industry is higher than all other industries in their states. For Massachusetts, the moderate statewide rate is 19%, while the rate of misclassification in the construction sector is 24%; for Maine, the low statewide estimate is 11%, while the incidence rate of misclassification in the construction sector is 14%. In a report by the General Accounting Office (1996), it was reported that the percentage of misclassified workers in all industries was 15%, while the percentage of misclassified workers in the construction sector was 20%.

In Illinois, since 2003, the Unemployment Insurance Trust Fund has been experiencing increasing deficits. While the key contributing factor to the growing deficit was the downturn in the overall economy during this period,

misclassification did partially contribute to the negative outcomes. A review of the Fund's year-end balances shows the trend. From 1987 through 2002, the Trust Fund ended each year with a positive balance. In 2000, the year-end trust fund balance was a positive \$2.051 billion. However, in 2003, the Fund ended the year with a \$511 million deficit which was projected to increase to a \$627 million deficit in 2004.<sup>2</sup>

States, including Illinois, perform unemployment insurance audits that are both random and non-random. The purpose of performing non-random audits is to search for incidents of misclassification where they are more likely to be discovered than with random audits alone. In Illinois, unlike some other states, nearly all the non-random audits were related to specific filings for unemployment benefits. Unlike Illinois, some other states also perform "targeted" audits that are based upon the conduct of employers. Examples of these situations would include the delinquent filing of reports, late registration, past violations of state law such as with misclassification of employees, etc. For the purposes of making informed projections for our study on Illinois, random audits will provide a lower bound estimate on the prevalence of misclassification while non-random audits will provide an upper bound estimate on the extent of misclassification.

Based upon data provided by the Illinois Department of Employment Security, the audit department conducted 23,587 audits for the five-year period, 2001-2005. Of these audits, 18,092 or 76.7% were random. Benefit related audits (e.g. non-random audits) were 5,106 or 21.6% of the total. These two audit types account for 98.3% of all unemployment insurance audits in Illinois for 2001-2005. The remaining 1.7% was comprised of six other audit types (see table, Page 23).

#### **Employee Misclassification in Illinois**

- For the years 2001-2005, state audits found that 17.8% of the audited Illinois employers had misclassified workers as independent contractors. This translates into approximately 56,650 total employers statewide of which 6,206 were in construction. In 2005, the rate of misclassification was higher, 19.5%. This translates into 63,666 employers statewide with 7,040 employers in

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<sup>2</sup> The Unemployment Insurance Trust Fund. Illinois Department of Employment Security. August 19, 2004.



construction.<sup>3</sup> Based upon the fact that 76.7% of these audits were random, the rate of misclassification in Illinois indicates that the rate of misclassification may be higher in Illinois than in other states that have been studied.

- **When an employer practices misclassification in Illinois, the results show that this behavior is pervasive.** An analysis of the percentage of employees that are misclassified indicates that it is a common occurrence rather than a random one in those companies that do misclassify. According to the data provided by the Illinois Department of Employment Security, 28.8% of workers were misclassified by employers that were found to be misclassifying for the period 2001-2005. The rate of misclassification showed an upward trend as well. In 2001, 22.8% of workers were misclassified by employers who were found to be misclassifying; this had increased to 33.0% in 2003, and had decreased somewhat to 27.6% in 2005. **The rate of misclassification by violating employers had increased 21% from 2001 to 2005.**

- **From our analysis of the labor force of all employers in Illinois (those that misclassify and those that don't), we estimate that 7.5% of employees in Illinois were misclassified as an independent contractor for the period 2001-2005. The audit results show that misclassification is a growing problem in Illinois.** While 5.5% of employees in Illinois were estimated to be misclassified in 2001, this increased to 8.5% in 2005. **This represents a 55% increase in the misclassification rate in Illinois from 2001 to 2005.**

- **The number of employees statewide that were affected by the improper misclassification is estimated to have averaged 368,685 annually for the 2001-2005 period. For 2005 alone, the estimated number of employees affected by misclassification had increased to 418,870. Within the construction sector for the period 2001-2005, the number of employees affected by misclassification is estimated to have averaged 20,202. In the year 2005, the estimated number of misclassified employees in the construction sector had increased to 22,371.**

- **Misclassification of employees has a negative financial impact on individual workers, the Illinois state government, and the private sector in**

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<sup>3</sup> According to the Illinois Department of Employment Security, the average number of employers over 2001-2005 was 34,954 in construction and 319,054 in all industries. In 2005, there were 36,154 construction employers and 326,945 in all industries. These numbers exclude local, state, and federal government.

**Illinois.** The workers are directly impacted by being denied the protection of various employment laws and by being forced to pay costs normally borne by employers. State income tax revenues and the unemployment insurance system in Illinois are adversely affected as well. Misclassification also imposes other costs on employers who play by the rules, the general health delivery system, taxpayers, and upon the public at large.

- **We estimate that the unemployment insurance system lost an average of \$39.2 million every year from 2001 to 2005 in unemployment insurance taxes that were not levied on the payroll of misclassified workers as they should have been. During 2005, we estimate that the unemployment insurance system in Illinois lost \$53.7 million in unemployment insurance taxes. A portion of this lost revenue may be recaptured when misclassified workers who received a 1099 apply for unemployment insurance benefits. In those cases, a benefit related audit is normally triggered and the IDES will seek to recover the unpaid unemployment insurance taxes involved. In 2005 for example, the amount of uncollected unemployment insurance tax that was recovered from these non-random audits, approximately \$1.1 million, equaled nearly 2% of the total amount that we project was not collected.**
- **For the construction sector, we estimate that the unemployment insurance system lost an average of \$2.0 million annually from 2001 through 2005 in unemployment insurance taxes that were not levied on the payroll of misclassified workers in construction as they should have been. For 2005 alone, we estimate that the unemployment insurance system in Illinois lost \$2.5 million in unemployment insurance taxes just in the construction sector.**
- **According to published data, workers misclassified as independent contractors are known to underreport their personal income as well; as a result Illinois suffers a loss of income tax revenue. According to the IRS reports, wage earners report 99% of their wages whereas non-wage earners (such as independent contractors) report approximately only 68% of their income. This represents a gap of 31%. Other studies estimate the gap to be as high as 50%.**
- **Based upon IRS estimates that 30% of the income of misclassified workers in Illinois is not reported, we estimate that, on average, \$124.7 million annually of income tax was lost in Illinois for 2001 through 2005. In just 2005, we estimate that \$149.0 million of income tax was not collected in Illinois. For the construction sector, we estimate that \$8.9 million annually of income tax was lost**

in Illinois from 2001-2005. For 2005, we estimate that \$10.4 million of income tax was lost in the construction sector in Illinois.

- Based upon the higher estimate that up to 50% of the income of misclassified workers is not reported, an estimated \$207.8 million annually of income tax was lost, on average, in Illinois for 2001 through 2005. For just 2005, we estimate that \$248.4 million of income tax was lost in Illinois. For the construction sector, we estimate that an average of \$14.8 million annually of income tax was lost in Illinois during 2001-2005. For 2005, we estimate that \$17.3 million of income tax was lost just in the construction sector.

- Misclassification also impacts worker's compensation insurance. Among other effects, costs are higher for employers that follow the rules placing them at a distinct competitive disadvantage. A large, national study reported that the cost of worker's compensation premiums is the single most dominant reason why employers misclassify (Planmatics, 2000). Employers who misclassify can underbid the legitimate employers who provide coverage for their employees. The practice of misclassification shifts the burden of paying workers' compensation insurance premiums onto those employers who properly classify their employees. It has the further effect of destroying the fairness and legitimacy of the bidding process. The same national study (Planmatics, 2000) reported that many previously misclassified workers were later added to their company's worker's compensation policy by their employer after they were injured, resulting in the payment of benefits even though premiums had not been collected.

- Based upon statewide average worker's compensation insurance premium rates published by the State of Illinois, we estimate that, on average, \$95.9 million annually of worker's compensation premiums were not properly paid for misclassified workers. For 2004, we estimate that \$97.9 million of worker's compensation premiums were not properly paid due to misclassification.

- Worker's compensation premiums are much higher in the construction industry. In Illinois the statewide rate for all industries is less than \$3.00 (per \$100 of payroll). However, within construction, rates can range from \$8.01 for electrical wiring to \$27.94 for concrete construction. Using an average premium rate of \$10 per \$100 of payroll, we estimate an annual average of \$23.2 million of worker's compensation premiums were not properly paid by construction

**employers in Illinois. Using a higher average premium rate of \$15 per \$100 of payroll, we estimate this average annual amount to be \$34.8 million.**

**Thus, we conclude that misclassification is an increasing problem in Illinois. The effects of increasing misclassification negatively impact workers, employers, small businesses, insurers, taxpayers and tax authorities. Furthermore, the operation of fair, competitive markets is compromised when the bidding process is undermined by the practice of misclassification. Illinois will stand to benefit from better documentation of misclassification, from adopting measures that help to improve compliance with state statutes and from targeting employers who intentionally and repeatedly misclassify their employees.**

### **Acknowledgements**

This project received funding from the National Alliance for Fair Contracting (NAFC). According to the NAFC website: "The National Alliance for Fair Contracting (NAFC) has been providing a forum in the construction industry for those interested in fair, competitive contracting. NAFC is a labor-management organization that promotes a 'level playing field' through compliance with all applicable laws in public construction." ([www.faircontracting.org](http://www.faircontracting.org))

The authors wish to especially thank the Illinois Department of Employment Security (IDES) for their assistance in providing summary-level data to us without which this study could not have been completed. Preferred de-identified, individual audit-level data, like that utilized for studies conducted in a few other states, could not be obtained due to proprietary software issues and other limitations. With enough time, funding and cooperation from numerous parties, an industry-specific analysis of misclassification could be done that would help the IDES more effectively target their resources toward those sectors with a higher rate of misclassification.

Note: Studies such as ours that project economic costs to a given state due to the employer practice of misclassification should not be taken as report cards, so to speak, on the departments in those states responsible for collecting various revenues. In fact, the Illinois Department of Employment Security (IDES) consistently ranks at or near the top for all states in the U.S. for identifying and recovering unreported wages and in other measures of performance.

## **II. The Problem of Misclassification – Detailed Findings**

Employee misclassification is defined as the case where employers treat workers as independent contractors that should otherwise be wage or salaried employees. If an employee is classified as an independent contractor, the employers are not required to pay a variety of payroll related expenses (e.g. social security, unemployment insurance) while the independent contractor loses the protections that go with being an employee and is forced to pay many of his or her own employment related costs (the employer's portion of social security insurance, workers compensation, health insurance premiums, etc).

Workers with alternative work arrangements are making up an increasing percentage of the workforce.<sup>4</sup> According to the United States Bureau of Labor Statistics, workers with alternative work arrangements accounted for 11.0% of the total workforce in February, 2005. Of the total amount of workers with alternative work arrangements, independent contractors accounted for 70% of workers with alternative work arrangements. An examination of independent contractors by industry showed that the construction sector accounted for 22.0% of all independent contractors, the highest level of concentration of independent contractors in all industries.

The problem of misclassifying employees as an independent contractor is a growing problem for the unemployment insurance system in Illinois and the nation, as employers remit their unemployment taxes based upon their payroll. Recent studies have shown that employee misclassification is a growing problem.<sup>5</sup>

There are a number of different practices whereby misclassification is accomplished. First, many employers may hire labor as self-employed independent contractors and provide them with a 1099-Miscellaneous Income for tax purposes. An emerging problem takes the form of simply paying labor with cash with no trail of the independent contractor agreement. State and federal revenue bases are significantly impacted when employees are improperly

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<sup>4</sup> The Bureau of Labor Statistics defines workers with alternative work arrangements as (1) independent contractors, (2) on-call workers, (3) temporary help agency workers, and (4) workers provided by contract firms. (<http://www.bls.gov/news.release/conemp.t08.htm>)

<sup>5</sup> In a report by the National Employment Law Project, it was reported that US DOL quarterly audits found 30,135 employees misclassified. This was a 42% increase from the prior year.

classified as independent contractors. The IRS reports that voluntary compliance in reporting income varies significantly across groups of individual taxpayers. Among those filing tax returns, wage earners report 99% of their wages; self-employed individuals who receive a 1099, report 68% of their business income; and "informal suppliers" - self-employed individuals who operate informally on a cash basis - report just 19% of such income on their tax returns. Informal suppliers accounted for almost 17% of all unpaid individual income and employment taxes in 1992.<sup>6</sup>

The issue of misclassification has implications for the unemployment insurance system in several ways. Firms that misclassify employees as independent contractors pay no employment insurance tax on those workers. A portion of this unpaid tax may be eventually recovered when audits are generated due to formerly misclassified workers applying for unemployment insurance benefits. In 2005, these audits recovered about 2% of the total amount of taxes we project were not collected in Illinois.

Employers who correctly classify their employees are at a distinct competitive disadvantage over those employers who misclassify their employees. This practice also has distinct budgetary implications for the unemployment insurance fund and state tax revenues in Illinois.<sup>7</sup> This may be particularly acute in the construction sector.<sup>8</sup> It was reported by Planmatics (2000) that the construction industry was the most frequently cited sector as the one most likely to use independent contractors, contain the highest incidence of misclassification, and the one that lures workers into becoming independent contractors.

There may be a number of reasons why a person, who would otherwise be legally authorized, would not file for unemployment insurance benefits. For one, filing will automatically trigger a benefit-related audit which will cause their former employer to be assessed back taxes that may also include penalties and interest. The worker may reasonably assume that such an outcome could jeopardize their future employment opportunities with that employer. In addition, violating employers require workers to sign various forms of

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<sup>6</sup> United States General Accounting Office. Taxpayer Compliance: Analyzing the Nature of the Income Tax Gap. GAO/T-GGD-97-35.

<sup>7</sup> Illinois Department of Employment Security. Office of Revenue. EA-2005.

<sup>8</sup> The General Accounting Office (1996) reported that the estimated percentage of employees with misclassified workers was 13.4%, while the estimated percentage in the construction sector was the highest of all industry groups at 19.8%.

paperwork that serves to provide legitimization to the whole disenfranchising process of misclassification. The worker may be understandably confused as to their full rights under the law. In particular, workers paid "off the books" (in cash) are highly unlikely to file. These are just a few reasons why benefit-triggered audits only get at a portion of the total uncollected unemployment insurance tax.

Misclassification also presents societal costs to workers and the private and public sectors in Illinois. Although these costs are not quantified in this report, the societal costs are substantial. For example, workers that are misclassified do not receive health insurance benefits. The lack of health insurance coverage exacts a large toll on the uninsured – avoidable deaths, poorly managed chronic conditions, and underutilizes life-savings medical procedures. In addition to the direct toll the lack of health insurance coverage takes on the uninsured, there are other substantial social and economic costs as well. The economic costs of being uninsured or under-insured are borne by workers, employers, the health system, taxpayers, and the public at large. The costs borne by the uninsured include a greater probability of death, reduced preventive care, and a smaller likelihood of early detection of medical problems.<sup>9</sup> The health system also bears an economic cost as well. It is reported that \$34.5 billion in uncompensated care was received by the uninsured in 2001. In addition to these direct costs to the health system, there are indirect costs through inefficient use of the health system (e.g. costs of emergency room visits that are not needed). One report stated that 33% of emergency room visits were for health reasons that did not require emergency room care and could have been avoided.

The taxpayers also bear economic costs of the uninsured and underinsured. Federal, state, and local governments support care of the uninsured through public clinics, and payments to certain care facilities that care for the poor and uninsured. The Commonwealth Fund reported that these intergovernmental expenditures were approximately \$30.6 billion annually. These conclusions show that the uninsured as a result of misclassification are exacting a high cost on those individuals as well as employers, the general health delivery system, taxpayers, and the public at large.

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<sup>9</sup> The Commonwealth Fund reports that the lack of health insurance leads to 18,000 deaths per year. The Commonwealth Fund. *The Costs and Consequences of Being Uninsured*. Commonwealth Fund Publication #663.

There are a number of reasons why employers engage in misclassification. It is reported that the cost of workers' compensation premiums is the single most dominant reason for misclassification (Planmatics, 2000). Employers also engage in misclassification in order to avoid the economic costs associated with litigation against employers alleging discrimination, sexual harassment, and putting in place the regulations and reporting procedures required for employees (Planmatics, 2000). Additionally, if an employee is classified as an independent contractor, the employers are not required to pay a variety of payroll taxes (e.g. social security, unemployment insurance) and the independent contractor is not fully protected by employment laws. This allows employers to underbid the legitimate employers who provide coverage for their employees. In the construction sector, workers compensation misclassification penalizes legitimate contractors in the bidding process. It has been reported that many workers are added after an injury to a company's worker's compensation policy, resulting in payment of benefits even though premiums were not paid (Planmatics, 2000).

From 1987 through 2002, the Illinois Unemployment Insurance Trust Fund ended each year with a positive balance. In 2000, the year-end trust fund balance was a positive \$2.051 billion. However, in 2003, the Fund ended the year with a \$511 million deficit which was projected to increase to a \$627 million deficit in 2004.<sup>10</sup> While the key contributing factor to the deficit was the downturn in the overall economy during this period in Illinois and the nation, misclassification in Illinois partially contributed to the negative outcomes experienced by the Trust Fund.

In the State of Illinois, the maximum unemployment insurance rate remained constant at 6.8% for the period 1996-2002. It has increased every year since 2002 with the maximum rate in 2005 at 9.8%, an increase of 44.1% since 2002. The wage base had remained constant at \$9,000 for the period 1996-2003. It increased in 2004 and 2005 to a level of \$10,500, which is an increase of 16.7% since 2003.

Table 1 provides estimates from a number of studies undertaken to determine the extent of employee misclassification in a number of states. For the 11 states where studies have been conducted, the moderate rate of misclassification was from 13-23%. In two state-level studies (Massachusetts and Maine), the incidence of misclassification in the construction industry is higher than all industries in their states. For Massachusetts, the moderate statewide rate is 19%,

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<sup>10</sup> The Unemployment Insurance Trust Fund. Illinois Department of Employment Security. August 19, 2004.



while the rate of misclassification in the construction sector is 24%; for Maine, the low statewide estimate is 11% while the incidence rate of misclassification in the construction sector is 14%. In a report by the General Accounting Office (1996), they reported that the percentage of misclassified workers in all industries was 15%, while the percentage of misclassified workers in the construction sector was 20%.

**TABLE 1**  
Prevalence of Misclassification in All Industries  
and the  
Construction Sector

	Low	Moderate	High
All Industries (9 States) <sup>1</sup>	5-10%	13-23%	29-42%
All Industries (United States) <sup>2</sup>		15%	
All Industries (Massachusetts <sup>3</sup> )	13%	19%	
All Industries (Maine <sup>4</sup> )	11%		
Construction Sector (Massachusetts <sup>5</sup> )	14%	24%	
Construction Sector (Maine <sup>6</sup> )	14%		
Construction Sector (United States <sup>7</sup> )		20%	

<sup>1</sup> Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs, February, 2000.

<sup>2</sup> United States General Accounting Office, 1996.

<sup>3</sup> The Social and Economic Costs of Employee Misclassification in Construction. December 17, 2004.

<sup>4</sup> The Social and Economic Costs of Employee Misclassification in the Maine Construction Industry, April 25, 2005.

<sup>5</sup> The Social and Economic Costs of Employee Misclassification in Construction. December 17, 2004.

<sup>6</sup> The Social and Economic Costs of Employee Misclassification in the Maine Construction Industry, April 25, 2005.

<sup>7</sup> United States General Accounting Office, 1996.

States perform unemployment insurance audits that both are random and non-random. The purpose of performing non-random and "targeted" audits is to locate audits where misclassification is more likely to occur than with random audits alone. For example, "targeted" audits will meet certain criteria such as delinquent filing of reports, late registration, and/or claims of determination with respect to an employer/employee relationship. Random audits provide a lower bound estimate on the prevalence of misclassification while, for Illinois, non-

random audits provide an upper bound estimate on the extent of misclassification. Illinois does not conduct "targeted" audits.

The Illinois Department of Employment Security (IDES) has 9 different types of unemployment insurance audits (see table on page 23). The IDES conducted 23,587 audits from 2001 through 2005. The largest category of audits was audit type 1, "random audits." The number of random audits from 2001-2005 was 18,092 or 76.7% of the total number of audits. The second largest category was audit type 6, "Referral for Benefit Related Audits." These represent an audit undertaken as a 'claim of determination' that has been made with respect to an employer/employee relationship. The number of benefit related audits conducted from 2001-2005 was 5,106 or 21.6% of the audits. These two categories of audits accounted for 98.3% of all audits conducted for 2001-2005.

Using aggregate level data on unemployment insurance tax audits provided by the Illinois Department of Employment Security, we have developed reliable estimates of statewide misclassification and misclassification in the construction sector in Illinois. Using methodologies developed in earlier studies, we present projections of the economic costs of misclassification for unemployment insurance, income tax, and the worker compensation system in Illinois.

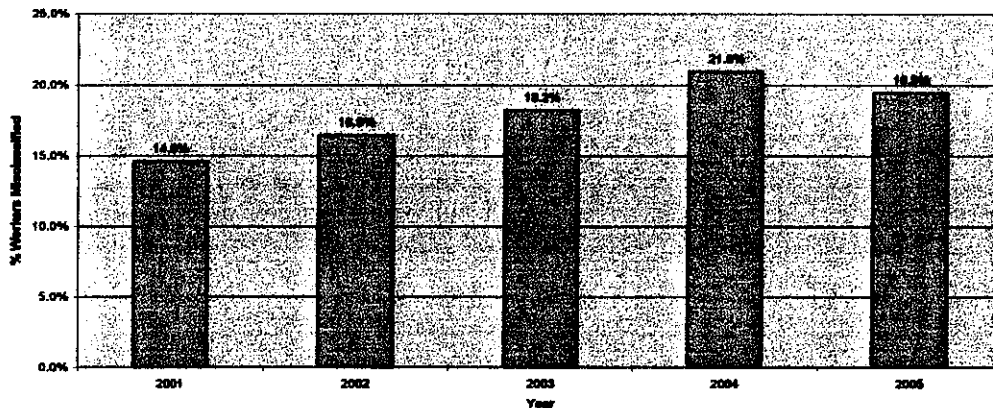
Some studies of misclassification in other states have been able to obtain de-identified data from unemployment insurance tax audits from which to derive estimates of misclassification. De-identified data is data that does not identify an individual or company and from which there is no reasonable basis to believe that the information provided can be used to identify an individual or a company. The use of micro-level, de-identified data would have allowed a detailed analysis of misclassification for multiple industry sectors. For example, previous research has shown that the rate of misclassification is higher in construction and home health care than in other sectors. Due to the proprietary nature of the IDES database, we were provided with aggregate level data for 2001-2005. From this data we have been able to estimate the overall rate of misclassification in Illinois, and for the construction sector, with statistical reliability.

### **III. Extent of Misclassification in Illinois**

## When Employers Engage in Misclassification

For the years 2001-2005, state audits found that 17.8% of Illinois employers that were audited were found to have misclassified workers as independent contractors (Chart 1). Because random audits (accounting for 76.7% of total audits in Illinois) provide a lower bound estimate for the rate of misclassification, this represents a conservative estimate of the overall rate of misclassification in Illinois. This estimate of misclassification in Illinois translates into an estimate of approximately 56,650 employers statewide annually for 2001 through 2005, of which 6,206 were estimated to be in the construction sector. The rate of misclassification had increased in 2004 and 2005 to 21.0% and 19.5%, respectively, compared to the rate of misclassification of 14.6% in 2001. For 2005, this translates into an estimate of approximately 63,666 employers statewide in 2005, of which 7,040 were estimated to be in the construction sector.

Chart 1  
Percentage of Employers  
Misclassifying Workers  
in Illinois  
(2001-2005)



## Workers Impacted by Misclassification

To assess the impact of workers impacted by misclassification, we use the methodology developed in earlier studies (See Carre and Wilson, 2004). First, in order to determine the *severity* of the impact of misclassification we determine the percent of workers misclassified *within employers found to have misclassified workers*. In order to estimate the *extent* of misclassification, we

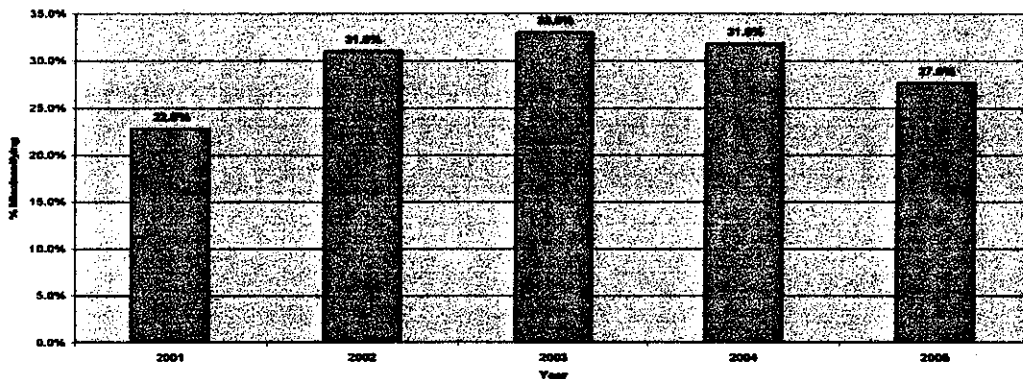
determine the percentage of workers misclassifying among *all workers in the state*.

### Severity of the Impact of Misclassification

When employers misclassify in Illinois, the results show that this behavior is pervasive. An analysis of the percentage of employees that are misclassified indicates that misclassification is a common occurrence rather than a random event in those companies that do misclassify. According to our estimates, 28.8% of workers are misclassified by employers that were found to be misclassifying for the period 2001-2005 (Chart 2).

This rate of misclassification by employers that are found to have misclassified employees shows an increasing trend as well. In 2001, 22.8% of workers were misclassified by employers who were found to be misclassifying. This increased to 33% in 2003 before falling to 27.6% in 2005.

Chart 2  
Percentage of Misclassified Workers  
as a Percentage of Workforce at Misclassifying Employers  
Illinois (2001-2005)

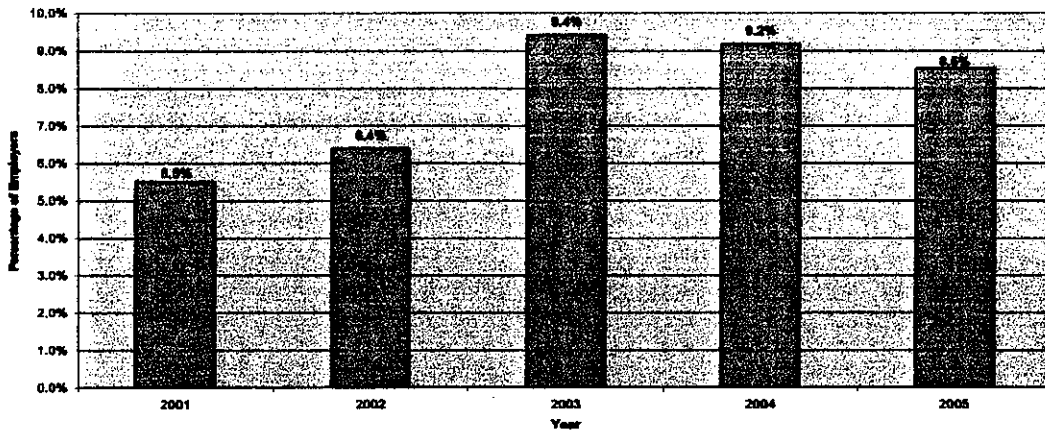


### Extent of Misclassification

An analysis of the labor force of all employers in Illinois (those that misclassify and those that do not), we estimate that 7.5% of employees in Illinois are misclassified as an independent contractors during the period 2001-2005 (Chart 3). The audit results show that the extent of misclassification is a growing problem in Illinois as well. In 2001, only 5.5% of employees in Illinois were

estimated to be misclassified. The rate of misclassification had increased to 8.5% in 2005. This represents a 55% increase in the misclassification rate in Illinois since 2001.

**Chart 3**  
**Percentage of Employers Misclassifying**  
**as Percentage of all Employers**  
**(Illinois 2001-2005)**



The estimated number of employees statewide that are affected by the improper misclassification is estimated at 368,685 annually for the period 2001-2005. For 2005, the estimated number of employees affected by misclassification was 418,870. For the construction sector, the estimated number of employees affected by misclassification was 20,202 annually for the period 2001-2005. The estimated number of employees in the construction sector affected by misclassification was 22,371 in 2005.

#### **IV. Implications of Employee Misclassification in Illinois**

Misclassification of employees has a negative financial impact on individual workers, the Illinois state government, and the private sector in Illinois. In addition, the integrity of the bidding process, upon which a merit-based free-market economy relies, is sabotaged by unscrupulous employers seeking an illegal competitive advantage. Here we estimate the economic implications of employee misclassification with respect to (1) the unemployment insurance tax revenues, (2) state income tax revenues, and (3) the amount of worker's compensation insurance premiums not properly paid due to misclassification.

## **Implications of Employee Misclassification for Unemployment Insurance Tax**

As stated earlier, the problem of misclassification has implications for the unemployment insurance system in several ways. Firms that misclassify employees as independent contractors pay no unemployment insurance on those workers. The violating employer saves additional money because the large majority of laid-off employees are never charged to their unemployment insurance account. This places those employers who are correctly classifying their employees at a distinct competitive disadvantage over those employers who are misclassifying their employees. This behavior has distinct budgetary implications for the unemployment insurance fund in Illinois.<sup>11</sup>

We estimate that the unemployment insurance system has lost an average of \$39.2 million annually from 2001-2005 in unemployment insurance taxes that are not levied on the payroll of misclassified workers as they should be. For 2005, we estimate that the unemployment insurance system in Illinois lost \$53.7 million in unemployment insurance taxes. A portion of this lost revenue may be recaptured when non-employees who receive a 1099 apply for unemployment insurance benefits. In those cases a benefit related audit is normally triggered and the IDES will seek to recover the unpaid unemployment insurance taxes involved. In 2005, these audits recovered approximately \$1.1 million equaling about 2% of the total amount we project was not collected.

For the construction sector, we estimate that the unemployment insurance system has lost an average of \$2.1 million annually from 2001-2005 in unemployment insurance taxes that were not levied on the payroll of misclassified workers in construction as they should have been. For 2005, we estimate that the unemployment insurance system in Illinois lost \$2.5 million in unemployment insurance taxes in the construction sector.

## **Implications of Employee Misclassification for State Income Tax Revenue**

According to published data, workers misclassified as independent contractors are known to under-report their personal income because they do not have their taxes withheld. Also employees misclassified as independent contractors can reduce their tax liability by deducting certain expenses that employees are not entitled to deduct. For example, independent contractors can deduct expenses

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<sup>11</sup> Illinois Department of Employment Security. Office of Revenue. EA-2005.

for automobiles, homes, medical insurance, retirement plans, and business trips. As a result, Illinois suffers a loss of state income tax revenue. According to published IRS figures, wage earners report 99% of their wages. Non-wage earners report approximately 68% of their income. This represents a gap of 31% in reported income. Other estimates report the gap as high as 50%. The IRS reports that when informational returns (e.g. 1099 Miscellaneous Income) are examined, misclassified workers reported 77% of that income on their tax returns, but reported only 29% of the income not covered by informational returns (e.g. wages paid in cash).<sup>12</sup>

The State of Illinois imposes a flat 3.0% income tax on income. We assume that personal exemptions and federal exemptions are fully incorporated into their reported tax returns and we do not apply these exemptions to unreported income. We also do not report the loss in federal tax revenue which would be even much more substantial as well. We present two estimates for lost income taxes. The first estimate is based upon the assumption that 30% of the income of misclassified workers is not reported; our second estimate is based upon the assumption that 50% of the income of misclassified workers is not reported. For our calculations with respect to lost state revenues, we estimated the annual earnings of all misclassified workers in the State of Illinois and the annual earnings of construction workers in the State of Illinois.<sup>13</sup>

Based upon an estimate that 30% of the income of misclassified workers is not reported, we estimate that an average of \$124.7 million of Illinois income tax was lost annually during the period of 2001 through 2005 due to unreported income. For 2005 itself, we estimate that \$149.0 million of Illinois income tax was lost. In the construction sector, we estimate that an average of \$8.9 million of Illinois income tax was lost annually for 2001-2005. For the year 2005, we estimate that \$10.4 million of Illinois income tax was lost from construction sector income.

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<sup>12</sup> Tax Administration. *Issues in Classifying Workers as Employees or Independent Contractors*. United States General Accounting Office. GAO/T-GGD-96-130.

<sup>13</sup> We obtained the average annual earnings for workers across all industries from the United States Department of Labor, Bureau of Labor Statistics. November 2004 State Occupational Employment and Wage Estimates. State of Illinois ([http://www.bls.gov/oes/current/eos\\_il.htm](http://www.bls.gov/oes/current/eos_il.htm).) The mean annual earnings in 2004 was \$38,580. We adjusted the earnings for other years using the Employment Cost Index from the Bureau of Labor Statistics. Series ID: ECS20002I. For the construction sector, the mean annual earnings in 2004 in Illinois was \$49,950. We adjusted the earning for other years using the Employment Cost Index from the Bureau of Labor Statistics: Series ID: ECS22302I.

Based upon an estimate that 50% of the income of misclassified workers is not reported, we estimate that an average of \$207.8 million of Illinois income tax was lost annually during the period of 2001 through 2005 due to unreported income. For 2005 itself, we estimate that \$248.4 million of Illinois income tax was lost. In the construction sector, we estimate that \$14.8 million of Illinois income tax was lost annually during 2001-2005. For 2005 itself, we estimate that \$17.3 million of Illinois income tax was lost from construction sector income.

### **Implications of Employee Misclassification for Worker Compensation**

Misclassification also impacts worker's compensation insurance. Among other effects, the costs are higher for employers that follow the rules, placing them at a distinct disadvantage. It has been reported (Planmatics, 2000) that the cost of worker's compensation insurance premiums is the primary reason why employers misclassify. Misclassification offers employers an opportunity to avoid paying the high cost of these insurance premiums. This allows those employers who misclassify employees as independent contractors the ability to underbid employers who correctly classify workers as employees. Therefore, in the construction sector, workers compensation premium costs have increasingly fallen on those contractors who classify their employees appropriately. It has also been reported that after an injury has occurred many independent contractors are simply converted to employee status in order to obtain coverage under the company's worker's compensation policy, resulting in payment of benefits even though premiums were not collected.<sup>14</sup>

According to the Fiscal Year 2004 Report of the Illinois Worker's Compensation Commission, the average worker's compensation statewide premium rate was \$2.65 per \$100 of payroll. Based upon published worker's compensation premium rates, we estimate that from 2001 through 2005, an annual average of \$95.9 million of premiums were not properly paid for misclassified workers. For the year 2005, we estimate this annual amount was \$97.9 million of worker's compensation insurance premiums that were not properly paid. When these annual premiums are not paid by those employers who misclassify, it results in raising the premiums that are charged to those employers who do correctly classify their employees.

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<sup>14</sup> "Reconversion from IC [Independent Contractor] to employee status also occurs in order to avoid paying high worker's compensation premiums...[in California]...This practice was prevalent in the other states also." (p. 30); and, "...the retroactive use of workers' compensation [when they are injured]...The insurers have to pay benefits for workers they never received premiums for." (p. 76). Planmatics (2000)



Worker's compensation premiums are much higher in the construction industry. As reported, the statewide rate for all industries is less than \$3.00 per \$100 of payroll. However, within the construction trades, the rates can range from \$8.01 per \$100 of payroll for electrical wiring to \$29.94 per \$100 of payroll for concrete construction in Illinois.<sup>15</sup>

We present two estimates for worker's compensation premiums in construction trades in Illinois based upon (1) a rate of \$10 per \$100 of payroll and (2) a rate of \$15 per \$100 of payroll. Based upon a rate of \$10 per \$100, we estimate the annual cost shift of premiums to be \$23.2 million. Based upon a rate of \$15 per \$100, we estimate the annual cost shift in premiums to be \$34.8 million. Again, annual premiums not paid by misclassifying employers may result in an increase of premiums paid by employers who classify their employees correctly.

## **V. Comparison of Illinois Estimates with Other States.**

The low estimates presented in Table 1 are generally based upon random audits, where the rate of misclassification is lowest. With high levels of random audits, it is reported that from 90%-100% of the audit group was randomly sampled. This places the estimates of misclassification in this group in a range from 5-14%. The moderate estimates presented in Table 1 are based upon a range of audit types, ranging from random to non-random. With moderate levels of random audits, it was reported that from 50%-56% of the audit group was randomly audited. The estimates of misclassification in this group range from 12%-23%. The high estimates presented in Table 1 are based primarily upon non-random audits. With low levels of random audits, it was report than from 1%-18% of the audit group was randomly audited. For all industries reported in Illinois, the rate of misclassification was 17.4%, with 76.6% of those audited randomly selected.

## **VI. Conclusions**

Our study is a first step toward illustrating the dimensions of and the negative economic impacts associated with the problem of employer misclassification in the State of Illinois. Our study has confirmed the fact that misclassification is a severe and growing problem which impacts the public and private sectors in

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<sup>15</sup> Oregon Workers' Compensation Premium Rate Ranking - Calendar Year 2004. Appendix 4.

Illinois. We have shown that misclassification has direct and significant impacts on workers, employers, taxpayers and markets. By gaining access to de-identified individual tax audit files, future analysis would be able to project revenue losses by specific industry sectors which would allow the Illinois Department of Employment Security to target their resources effectively toward those sectors where the problem of misclassification is most acute.

One factor involved in calculating the extent of economic costs related to misclassification in Illinois concerns the three different definitions utilized for determining "independent contractor" status by the Illinois Department of Employment Security, the Illinois Department of Revenue and the Illinois Worker's Compensation Commission. In other states, this kind of discrepancy has been found to hinder efforts for reform. An attempt to bring these varying definitions into alignment would be preferred.

We believe we have shown that workers, businesses, revenue collection agencies, and policy analysts in Illinois will benefit from better documentation on misclassification in Illinois. Furthermore, it seems reasonable to suggest that public officials devote special attention to those employers who intentionally and/or repeatedly violate state statutes regarding misclassification.

As a beginning, we recommend the following steps for consideration by policy makers and public officials in Illinois: (1) the Legislature empower the IDES to perform "targeted" audits on problem employers like those done in other states,<sup>16</sup> (2) develop meaningful penalties to deter those employers who intentionally and/or repeatedly violate state laws on misclassification, (3) seek to align the three different definitions for what constitutes an "independent contractor" currently applied by the IDES, the Department of Revenue and the Worker's Compensation Commission, and (4) review current authorities and procedures for the sharing of information among state agencies so that violations of state statutes will receive a comprehensive and coordinated response with the intent of recovering all payroll-related funds that are due and of deterring future willful violations.

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<sup>16</sup> Targeted audits are those audits identified where a higher degree of misclassification may be observed. For example, targeted audits might be audits of employers with (1) delinquent filings or (2) multiple delinquent quarters of unemployment insurance due. Planmatics (2000) encouraged states to maintain audit selection criteria that reflect potential noncompliance (e.g. high employee turnover, type of industry, and prior reporting history).

## Unemployment Insurance Audit Statistics and Audit Definitions for Illinois

<u>Audit Activity</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
Total Audits	5,117	5,415	4,403	4,097	4,555
Total Employees	167,039	129,140	93,848	109,840	99,897
Gross Payroll (Post Audit)	\$3,022,659,809	\$2,609,285,180	\$1,834,363,529	\$1,930,488,572	\$1,930,379,539
<b><u>Audit Types:(1)</u></b>					
1. Random	3,847	4,221	3,472	3,026	3,526
2. Multi Non-Filers	4	71	12	0	0
3. New Employer	49	5	0	2	0
4. Employer Rep	0	2	5	1	2
5. External Info	9	5	5	10	8
6. Benefit Related	1,194	1,069	866	989	988
7. Bankruptcy	1	0	0	0	0
8. Combined Chargeability	12	35	43	69	31
9. Follow Up	0	0	0	0	0
<b><u>Audit Results</u></b>					
Total Employers Misclassifying Workers	748	891	803	859	887
Total Workers Employers Misclassified	9,201	8,258	8,844	10,087	8,520
Total Employees for Employers Misclassification	40,298	26,612	26,769	31,664	30,823
<b>Employers Misclassifying by Audit Section</b>					
Metro Misclassified	0	114	150	165	147
North Misclassified	376	366	288	303	356
South Section Misclassified	372	411	365	391	384
<b><u>Revenue Data from Audited Employers</u></b>					
Unreported Taxable Wages for Misclassified	\$31,677,187	\$30,390,832	\$29,751,925	\$36,854,257	\$33,091,112
UI Taxes (unreported contributions) for Misclassified	\$815,735	\$837,485	\$923,749	\$1,107,098	\$1,092,141

\* NOTE: Audit statistics in Illinois for the period 2001-2005 provided by the Illinois Department of Employment Security (IDES).

**(1) Audit definitions [per Illinois Department of Employment Security]:**

1. Random -- random selection of potential accounts for employer field audits.
2. Multi Non Filers -- Accounts that have multiple report delinquencies for over a year.
3. New Employer -- Resolve issues to have a correct liability.
4. Employer Rep -- Resolve issues raised by employer reports.
5. External Info -- Responding to information from outside sources.
6. Benefit Related -- Based on a claim for unemployment insurance
7. Bankruptcy -- Audits generated when aware of bankruptcy filing
8. Combined Chargeability -- Provide evidence for hearings dealing with employer chargeability and liability.
9. Follow Up -- Employers notified of prior audit discrepancies monitored for compliance.

## ESTIMATION METHODS

I. **Calculating the Extent of Employee Misclassification (Percentage of Workers with Misclassified Workers).**

We calculated the percentage of all audited employers who were found to be misclassifying, and applied that rate to the total number of UI-covered employees in Illinois. Thus, we assumed that the sample of employees selected for auditing was representative of all UI-covered employers in Illinois.

II. **Calculating the Severity of the Impact of Employee Misclassification (Percentage of Misclassified Workers within Employers Found to be Misclassifying workers as Independent Contractors).**

To estimate the severity of misclassification among employers who would otherwise be covered by unemployment insurance, we assume that the audited employers found to be misclassifying can represent all misclassifying employers in Illinois. We calculated the percentage of workers among those audited employers who were misclassifying workers and applied that result as an estimate of the severity of misclassification among all Illinois employers that misclassify workers.

III. **Calculating the Extent of Worker Misclassification (Percentage of all Workers Misclassified as Independent Contractors).**

We assumed that the total number of workers employed by audited firms can represent all UI-covered workers in Illinois. In order to estimate the extent of worker misclassification, we calculated the percentage of workers misclassified as a percentage of all workers at the audited firms. We applied this percentage to the total number of UI-covered workers in Illinois.

IV. **Calculating Economic Loss in Unemployment Insurance Taxes**

We calculated an estimated average tax loss per worker as a result of misclassification in the audit results and assumed that these workers could stand as a proxy for all workers in Illinois. This result was multiplied by the estimated number of workers misclassified in Illinois.

Most of these figures are taken from the information provided by the IDES shown on the table on page 23. For example, divide audited "Total Workers Employers Misclassified" in 2005 (8520) by "Total Employees" audited in 2005 (99,897) to obtain an 8.5% rate of misclassification. Then, multiply total Illinois non-government employment for 2005 (4,923,713) times the 8.5% misclassification rate to determine that 418,870 statewide non-government employees were misclassified in 2005. This figure will be multiplied by the average unpaid unemployment insurance tax per employee. To determine that figure, divide the 2005 "UI Taxes (unreported contributions) for Misclassified" (1,092,141) by "Total Workers Employers Misclassified" in 2005 (8520). This results in an average unpaid unemployment insurance tax per employee of \$128.19. Now multiply 418,870 times \$128.19 for the total estimated loss of uncollected unemployment insurance taxes for Illinois in 2005 of \$53,694,946.

#### V. Calculating the Loss in Illinois Income Tax

In order to calculate the loss in state income taxes for the construction sector and statewide, we multiplied the estimated number of statewide workers by an estimated average annual earnings for construction workers and workers statewide.

For the construction sector, we estimated the number of misclassified construction worker in Illinois annually for 2001-2005 (20,202 workers) and multiplied that by the estimated annual earnings of construction workers in Illinois from 2001-2005 (\$48,947). For workers statewide, we estimated the number of misclassified workers in Illinois annually for 2001-2005 (368,885) and multiplied that by the estimated annual earnings for worker in Illinois from 2001-2005 (\$37,583)

For the construction sector in 2005, we estimated the number of misclassified construction workers in Illinois in 2005 (22,371) and multiplied that by the estimated annual earnings of construction workers in Illinois in 2005 (\$51,506). For workers statewide in 2005, we estimated the number of misclassified in Illinois in 2005 (418,870) and multiplied that by the estimated annual earnings for workers in Illinois in 2005 (\$39,531).

We then provided two estimates of ("income not reported"), using alternative assumptions regarding the amount of income not reported (30% and 50%). Multiply these results by 3.0% (Illinois Income Tax Rate) yielded a range of two estimates for loss state income taxes for the construction sector and all workers in Illinois.

#### VI. Calculating the Revenue Losses on Workers' Compensation Premiums

We present two estimates for lost workers' compensation premiums. Our first estimate is for lost workers' compensation premiums statewide. Using the quarterly census of employment and wages for Illinois (EC 202), we calculated gross payroll reported in Illinois. We then calculated the unreported wages as percentage of gross payroll reported in the audit results and applied this percentage to total wages reported by Illinois EC202. We then multiplied this by the \$2.65 workers' compensation premium per \$100 of payroll. The Illinois Workers' Compensation Commission stated that the average workers' compensation premium per \$100 of payroll in Illinois was \$2.65 per \$100 of payroll.

For workers in the construction sector, we provided two estimates of lost workers compensation premiums. Workers' compensation premiums are substantially higher than in other sectors and we, therefore, present estimates based upon (1) \$10 per \$100 of payroll and (2) \$15 per \$100 of payroll.

We then calculated the unreported wages as percentage of gross payroll in construction reported in the audit results and applied this percentage to total construction wages reported by the Illinois EC202. We then multiplied this by workers' compensation premiums per \$100 of payroll of \$10 and \$15, respectively.

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**RICHARD CORDRAY**  
OHIO ATTORNEY GENERAL

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**Report of the Ohio Attorney General  
on the Economic Impact of Misclassified Workers  
for State and Local Governments in Ohio**

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*February 18th, 2009*

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## *Executive Summary*

The problem of worker misclassification has been extensively investigated and analyzed both at the federal level and in a number of other states. According to the best available estimates, it appears that at least five million (and perhaps as many more) workers across the United States are misclassified as independent contractors rather than as employees. This misclassification problem represents a kind of "black market" that operates, as it often is consciously intended, to defeat government regulation and taxation. The most obvious effect of this structured noncompliance with the law is that it costs federal, state, and local governments the revenues that are expected and needed to fund public services and programs. In addition to the revenue shortfalls that it generates, the worker misclassification problem also creates an uneven playing field within many industries, with all law-abiding businesses being left at a competitive disadvantage by their very compliance with the law. Not only does this lead to general disrespect for the law, but also it creates perverse incentives for businesses facing vigorous competition to cheat in order to meet the artificially low prices of their dishonest counterparts.

Until now, Ohio has not conducted any broad study of the extent of the worker misclassification problem to date. The Ohio Attorney General has prepared and is now issuing this report in an effort to gauge the likely extent of the problem in Ohio, based on extrapolations from studies that have recently been conducted elsewhere. The conclusion we reach is that worker misclassification very likely imposes direct costs to state and local governments in Ohio costing hundreds of millions of dollars in lost revenues annually to state and federal government.



## *Introduction*

Many Americans go to work each day and earn a paycheck. Part of their earnings they use at their discretion: to provide for their families, donate to a church or charity, or spend for leisure pursuits. Some of that money, as we are all well aware, is returned to the government for the public benefit, in the form of taxes and fees. But other workers and employers do not share the cost of public services maintained at the federal, state, and local government levels. These workers are members of what is sometimes referred to as the "underground economy." They might be engaged in illegal commerce, or they may be compensated for their legitimate work in cash and other benefits that elude detection by the Internal Revenue Service and by state and local tax officials.

Although much of the underground economy routinely falls under the radar screen, there are ways to identify when someone is being paid "off of the books," or when employers fail to pay their fair share of taxes. But the nature of the underground economy becomes murkier with the contemplation of worker misclassification. The practice of classifying employees as independent contractors to avoid payroll taxes and other charges is apparently widespread across the country. According to a U.S. General Accountability Office study conducted in 1989, worker misclassification costs the federal government at least \$4.7 billion in annual income tax revenues. Based on another federal estimate, approximately five million employees were misclassified in 2005, which means their employers failed to carry their share of the proper tax burden, while honest companies were left to shoulder more than their fair share of these financial responsibilities.

This problem is a concern not just for the federal government. In fact, state governments are disproportionately burdened when employers misclassify their workers. Several states have recognized this inequity and moved to remedy the problem. The first step taken by most states, as a precursor to legislative changes or the establishment of an enforcement strategy, is a broad study of the impact of worker misclassification on state and local government finances to determine what industries are most affected and how scofflaws can be best identified. Several states have moved beyond the research stage to combat



the situation with new laws and administrative initiatives that take aim at preventing and penalizing worker misclassification.

As other states have taken steps to provide for more evenhanded enforcement of their employment laws, Ohio can learn from their actions, especially as the state's budget condition has become more critical and state services such as unemployment compensation and workers' compensation are experiencing their own specific financial pressures. (Indeed, recent reports reveal that Ohio's unemployment insurance reserves are far below recommended levels, a problem that is doubtless exacerbated by shortfalls that result from misclassification.) In Ohio, some of our municipalities have considered ordinances that attempt to ensure fair economic competition and their ability to collect all proper tax revenues within their borders. Yet it is clear that smaller jurisdictions such as municipalities typically lack the power and the funding to act as effective law enforcers in this regard.

Beyond obvious concerns about lost revenues, worker misclassification broaches broader issues of compliance with applicable laws and regulations. Employers who misclassify their workers have a clear pricing edge over their honest counterparts, creating unfair competition in the same marketplace. Once a company realizes that it can get away with misclassifying its employees, it may chafe against other restrictions, leading to more lawless behavior. Watching their competitors profit from flouting the law, other companies may feel pressure to begin misclassifying their own employees, breeding a culture of disrespect for government and those laws and regulations that are meant to apply to all citizens equally. It also places economic burdens on the workers who are misclassified. These workers (if they are aware and respectful of their legal obligations) must pay their own and their employer's share of payroll taxes. Moreover, if they are injured on the job or laid off, they will have trouble obtaining worker's compensation or unemployment benefits to which they are supposed to be legally entitled, while their former employers profit by skirting the law.



Misclassifying workers also makes it easier for employers to get around all manner of workplace restrictions. For example, independent contractors are not subject to the time and wage restrictions that limit employees. They work more hours without commanding overtime pay. Occupational health and safety standards may also be more difficult to enforce, which could increase the likelihood of workplace injuries.

The Ohio Attorney General has a keen interest in ensuring that the state receives its fair portion of taxes and other revenues and that the laws of Ohio are enforced effectively and evenhandedly. Thus, we believe it is our duty to explore the scope of the problem here, and to share our suggestions for actions that the state could take to protect law-abiding employers by creating a stronger and more effective regulatory scheme.

We will begin by defining the worker misclassification problem, then canvass existing studies of the problem that have been undertaken by the federal government and other states. Extrapolating from their findings, we will then attempt to estimate the current financial scope of the problem that exists here in Ohio.

### *Defining the Problem of Worker Misclassification*

Worker misclassification is an issue that derives from the legal distinction between an employee and an independent contractor. Misclassification occurs when employees are wrongly designated as independent contractors. There are several standards for what is an "employee" as opposed to an "independent contractor," though the issue is not as simple or straightforward as anyone would like. In particular, the Internal Revenue Service has a twenty-point questionnaire that is designed to help employers determine if they are hiring employees or independent contractors. The difference lies mainly in how much authority and control an employer has and exerts over a worker. Independent contractors are hired for short terms and generally use their own materials and methods to create a work product by a scheduled deadline.



Employees are hired for a longer expected term, are typically subject to an established work schedule, and use the employer's materials to create outcomes in an employer-specified manner.

Worker misclassification adversely affects federal, state, and local income-tax revenues because employees receive W-2 tax forms while independent contractors receive 1099s. Each form has its own unique stipulations. When a company hires an employee, it is responsible for paying half of that employee's social security and Medicare taxes, as well as premiums for workers' compensation and unemployment insurance coverage. Employers also typically withhold federal, state, and local income taxes. An employee is responsible for half of his or her social security and Medicare taxes, as well as any state and federal income tax in excess of the amounts withheld by the employer. By contrast, an independent contractor pays all of his or her social security and Medicare taxes and has no income taxes withheld but is still responsible for paying them in full. Independent contractors are not covered by workers' compensation or unemployment insurance; nor do they receive overtime compensation or benefits such as health insurance. They are treated by the law as temporary, freelance workers and are comparable to self-employed individuals.

There is no typical misclassified worker. Misclassification happens at all levels and in most sectors of the job market. Misclassified workers may be male or female, old or young, well-educated or not, and of any racial or ethnic background. Prior studies indicate that worker misclassification occurs more often in certain sectors, such as the construction, hi-tech, dental, and home health industries. It also happens at higher rates among new or illegal immigrants who may be unfamiliar with the more obscure details of employment law and whose personal situations may leave them more susceptible to pressure from employers to work without formal recognition or proper legal protections while receiving lower wages and fewer benefits.

Employers who misclassify their workers create problems throughout society. They are not contributing their fair share to workers' compensation or unemployment insurance pools, and they can often outbid honest and law-abiding firms who do not misclassify, because of their reduced labor costs. Misclassified workers are known to underreport their income, which reduces income tax and social security





revenues. Misclassified workers are a concern at all levels and the state should take all reasonable steps to keep this illegal practice from occurring wherever possible.

### *Previous Studies by the Federal Government and Other States*

Because worker misclassification is a nationwide problem, Ohio can gain valuable insight by exploring the results of other state and national studies to find out how government can best understand, prevent, and address this problem. In each instance, these studies evidence recognition of the problem and attempt to gauge its effects and their scope. Ohio can benefit by learning from the work already done in these completed studies in order to develop a plan of attack for this state as well. In this section, we will discuss the most pertinent analysis and findings from those studies, which are presented here in chronological order.

#### *Connecticut*

In 1992, University of Connecticut economist William T. Alpert prepared the first state study that we have seen addressing the problem of worker misclassification. It is perhaps not surprising that the changes he advocated for sixteen years ago are many of the same ones being considered by policymakers and legislatures across the country today. These policies include clarifying the distinctions and consequences of labeling a worker an employee or an independent contractor; more vigorously enforcing worker classification schemes; increased auditing, especially in industries that are known for misclassification; and conducting more thorough research to understand the true scope of the misclassification problem. The research group advised that the problem of misclassification was expanding as employers sought to compete with increasingly low prices and younger workers became more disenchanted with and hesitant to rely on social security, workers' compensation, private pension plans, and employer-provided health insurance. Many younger workers were found to prefer to earn more in cash wages and seek to provide for



themselves without regard for the other benefits and protections to which they are legally entitled in the workplace.

Even in 1992 dollars, the study estimates that the State of Connecticut and the Federal government were losing \$500 million annually as a result of worker misclassification. The researchers believed that this estimate was low and was apt to rise in the coming years. They estimated that each year the state income tax receipts were reduced by \$65 million, workers' compensation was failing to collect \$57 million in premiums, and the unemployment insurance fund was being cheated out of \$17 million. Nationally, \$267 million in federal income taxes were going unpaid by misclassified Connecticut workers and over \$95 million in social security tax revenue was uncollected. The Connecticut study did not make any estimate of lost income tax revenue to local governments.

### *United States Department of Labor*

The only national study available was commissioned by the U.S. Department of Labor and released in 2000. The stated purposes of this study were to determine the extent of worker misclassification, why this misclassification occurs, and its potential impact on unemployment insurance. Researchers relied on information compiled from unemployment insurance audits from nine states (California, Colorado, Connecticut, Maryland, Minnesota, Nebraska, New Jersey, Washington, and Wisconsin), many of which target their audits to industries that are known to be subject to higher levels of misclassification.

The study found that worker misclassification is extensive, especially in certain fields like construction, trucking, home health care, and hi-tech, though the study acknowledges that these trades may be overrepresented due to the targeting. Somewhere between 10% and 30% of the employers audited were found to have misclassified workers. Employers misclassified their workers for a range of reasons, but topping the list were the ability to cut costs by not paying workers' compensation premiums and avoiding on-the-job injury and disability-related disputes. Other acknowledged reasons included avoiding unemployment insurance payments and remaining competitive in industries with a large presence in the



underground economy. Employers that engage in misclassification tend to target, in particular, members of immigrant communities and undereducated groups who often are unaware of the distinctions between employees and independent contractors, do not realize the protections that come with employee status, and are misled by employers who highlight the fact that independent contractors do not have taxes removed from their checks.

The study reported that in some states, up to 95% of workers who claimed they were misclassified as independent contractors were reclassified as employees following review. In states with highly randomized audits, on average approximately 10% of audited employers were found to have misclassified their workers. These percentages rose as high as 42% when selection was more targeted. Researchers found that if only 1% of workers were misclassified nationally, then the unemployment insurance trust funds alone would lose \$198 million each year. This amount does not even touch unpaid workers' compensation premiums and federal, state, and local income tax revenues that are forgone in these circumstances.

### *Massachusetts*

A study in Massachusetts in 2004 looked more narrowly at the problem of worker misclassification in the construction industry. The study used data obtained from random audits, which probably do not provide representative sampling because, again, certain industries have a more concentrated problem of misclassification. Researchers found that, conservatively, 5.4% of construction employees were misclassified compared to 4.5% in all industries. Less conservative estimates put the number at 11.4% of all construction employees and 8.9% of all employees. It also appears that when construction employers misclassify, they do so more extensively than other industries, as the data indicated that at least 40% of those individuals working at misclassifying companies were being paid as independent contractors.

The data in this study focused on the financial effects of the misclassification problem. The unemployment insurance system was estimated to lose up to \$35 million annually due to misclassification across all industries. Researchers estimated that 30% of the income of misclassified workers goes



unreported, amounting to a loss of \$91 million that was judged to have gone unpaid in income taxes.

Approximately \$90 million in workers' compensation premiums were determined to go unpaid by employers for their misclassified workers. Taken all together, if these estimates are accurate, then Massachusetts would be losing as much as \$217 annually as a result of worker misclassification.

The Massachusetts study advocated that a more detailed analysis be made of various sectors within the construction industry, such as carpentry and drywall, because initial evidence indicates that some sectors are more prone than others to misclassification. The researchers also encouraged following a procedure developed by the U.S. General Accountability Office, which uses tax information about businesses and individuals more closely to approximate projected revenue losses.

## *Maine*

In 2005, the same research group that completed the Massachusetts study – Harvard University's Labor and Worklife Program – performed a similar investigation in Maine. The employers audited in Maine represented a more random sampling of firms than in Massachusetts. There, researchers found that 11% of all employers and 14% of construction employers had misclassified some of their workers, totaling 4,792 workers across all industries. Compared to other states, an even higher number of employees, around 45%, are misclassified within companies that engage in the practice in Maine.

According to the study, the Maine unemployment insurance fund loses approximately \$98 per misclassified construction worker each year. The Maine Department of Revenue fails to collect between \$2.6 and \$4.3 million in taxes each year from underreported misclassified-worker income. Researchers estimate that the workers' compensation fund loses out on \$6.5 million annually in construction worker premiums, and this fails to account for the claims paid out to workers who were misclassified prior to being injured.



## *Illinois*

In December 2006, Illinois commissioned a study on the economic costs of worker misclassification in that state. The study used data provided by the Illinois Department of Employment Security to determine trends in misclassification and its impact on revenues for the state. The laws of Illinois provide strong incentives for workers to report misclassification when it occurs: former workers will be eligible for unemployment insurance benefits, even if paid on a 1099 basis, if they complete an affidavit and an investigation finds the circumstances of their employment was consistent with that of an employee. Former employers who are found to have misclassified workers are tracked down and fined to recover taxes from the unreported payroll.

The study found strong incentives for employers to misclassify their workers, including a total payroll savings of anywhere from 15-20% when all missed payments are included, which creates a strong competitive advantage for employers who are dishonest in violating the law. In 2005, state audits found nearly 20% of employers had misclassified at least one worker on their payroll, and overall estimates were that 8.5% of all workers in Illinois were being misclassified. Employers who misclassify their workers tend to do so extensively, with nearly 33% of all employees at these companies found to be misclassified as independent contractors. These numbers may be slightly high because 21.6% of the audits were targeted at employers whose workers complained. Nonetheless, Illinois also conducted a relatively high number of random audits (76.7%) in compiling these figures.

The higher figures found in the Illinois study led to staggering financial losses. The unemployment insurance system loses an estimated \$39 million each year because of worker misclassification. The Bureau of Workers' Compensation was determined to lose almost \$96 million each year, fully one-quarter of which stems from the construction industry. Worker misclassification also deprives the state of income taxes from those workers who are deemed to be independent contractors, who are more likely to underreport their incomes. Internal Revenue Service studies have shown that independent contractors may report as little as



68% of their income, compared to 99% of earned income reported by employees. In 2005 alone, that gap was calculated to cost Illinois between \$125 and \$248 million in income tax revenues.

Furthermore, the study found the impact upon law-abiding employers to be massive. Fair market competition can be nearly destroyed in industries with extensive misclassification. Not only do honest employers lose out on bidding contracts to employers that misclassify, but they also must foot the bill for others' dishonesty in the form of higher workers' compensation premiums. These premiums are paid out, in some cases, to workers who were put on the employee rolls only after their injury occurred. As long as states fail to enforce proper classification rules, scofflaws will continue to game the system and their honest counterparts will be forced to bear unjustified burdens or to cheat as well. The skewing of the unemployment compensation and income tax systems also no doubt leads to disproportionate burdens that must be borne by those who do not deserve them.

## *Minnesota*

A 2007 study in Minnesota found that 14% of employers misclassify at least one worker. However, researchers gathered this information from unemployment insurance audits, so the number fails to capture firms that misclassify all of their employees and thus are not recorded at all in the unemployment insurance system. Interestingly, while the construction sector did misclassify at a higher rate than average (with 15% of employers engaging in misclassification) the highest rates were found in the real estate industry. This is not a field that has been targeted for review by many states, so if the rates of misclassification are similarly high in other states, it is quite possible that total estimates of worker misclassification in prior studies may trend low.

In Minnesota, the state agencies that oversee income tax, unemployment insurance, and workers' compensation benefits each have their own methods for searching out employers that misclassify their workers. However, each agency sets somewhat different standards for what constitutes an "employee" as a legal matter, which creates confusion for employers and also clearly limits the effectiveness of information



sharing between the agencies themselves. The only direct auditing of employers is conducted by the unemployment insurance agency.

Compared with other states, Minnesota found a relatively low incidence of worker misclassification: only 1% of all workers were found to be misclassified. In contrast to other states, Minnesota found low levels of misclassification among employers who did misclassify, with 54% of such employers misclassifying only one or two employees. In only 4% of cases did auditors find evidence of more than 21 misclassified workers. All of these figures seem to be outliers, which are located at the low end of the spectrum in comparison to other studies of the problem. Investigators noted that the misclassification was not always intentional; often it was a result of lack of knowledge on the part of the employer or the worker, either of whom may have been under the impression that they had an unrestricted choice between the "employee" and "independent contractor" designations.

The researchers also advised that employers may begin to take the issue of worker misclassification more seriously if the action itself were outlawed. At this point in Minnesota, and in most states including Ohio, the unlawful action is not the misclassification itself, but rather the incorrect payment of taxes and premiums that are owed to the government. By legislating against the practice of misclassification more directly, it was suggested that a state could increase awareness, knowledge, and compliance, especially among employers that do not intentionally misclassify their workers.

## *California*

A California study focusing on workers' compensation was released in 2007 that revealed levels of misclassification to be rising at astonishingly high rates. Researchers attributed this rise to an increase in workers' compensation premiums from \$2.47/\$100 payroll to \$4.28/\$100 payroll. This was found to have dramatically increased the amount of underreported payroll, from as low as \$19.5 billion in 1997 to as much as \$100 billion in 2002.



The report found that the workers' compensation system in California was beset by pervasive manipulation by employers. That is, employers were found to be increasingly misclassifying their employees to avoid paying premiums, yet were putting those same employees back on the books when they were injured, leading to ongoing payouts from the fund while employer-reported payrolls decreased. This phenomenon meant that honest employers in the highest rate brackets (the most dangerous occupations) were paying up to eight times the rate they would be expected to pay if all employers were reporting truthfully. These inflated rates provided further incentives for honest employers to join their cheating counterparts in order to remain competitive.

The California report is groundbreaking because it was the first to use Census Bureau numbers to come up with a more accurate estimate of underreported income. Previous reports had estimated underreported income by relying on total reported income figures of all workers and then deriving the anticipated income of misclassified workers by multiplying the average reported income by the estimated number of misclassified employees. However, if the total reported income itself is already underreported, the result would be an artificially low figure for unreported income from misclassified workers.

Based on their work, the California researchers advised that auditing must be sharply increased in order to achieve compliance with the law. In their judgment, a moderate rise in the number of audits will not shock companies into compliance. They also suggested that civil and criminal penalties should be levied or increased against employers who misclassify their workers. If audits are made more extensive and this fact is publicized, and if the price paid for adverse audit findings is high enough to be dissuasive, then the state can hope to begin to impose a sense of deterrence on employers that would attain higher levels of obedience to the law.

## *New York*

In 2007, a task force was commissioned to study and combat worker misclassification in New York. In an initial study of misclassified workers, researchers found that 10.3% of private-sector workers were





misclassified in all of the industries audited, and in the construction industry this number rose to 14.8%. The result is that at least \$4 billion a year in unreported wages go untaxed for unemployment insurance purposes, which adds up to an annual loss of \$175 million that is placing the viability of the fund in question.

A second report, isolating the construction industry, went a step further than other state investigations to look at the consequences of misclassification for the workers. The findings were startling. Over \$148 million in health care costs are shifted to employees, taxpayers, and honest employers. At the same time, the New York workers' compensation fund is losing between \$506 million and \$1 billion annually due to premiums that go unpaid by misclassifying employers. To be competitive, construction workers at honest and law-abiding companies must accept wage cuts in order to win bids in an environment where misclassifying employers have severely driven down wages.

Another New York study addresses employers who do not attempt to classify their workers as employees or independent contractors, but simply pay them off the books. When this occurs, neither they nor their employees pay any taxes, unemployment insurance, or workers' compensation premiums whatsoever. These employers make up a large part of the underground economy, but are outside the scope of this report. However it is worth noting, as the New York study suggests, that when auditing contractors for worker misclassification, it would be more illuminating and financially beneficial to examine subcontractors also, in order to ensure that they are reporting all of their workers. Indeed, it is not surprising that there appears to be some correlation between misclassifying contractors and misclassifying subcontractors that they hire.

### *Implications of These Studies for Estimating the Scope of the Problem in Ohio*

As discussed earlier, the misclassification of workers creates a slew of problems, including adverse effects upon fair economic competition, respect for and compliance with the law, and the economic condition of individual workers. From the standpoint of public finances, however, three key effects on government occur when employees are misclassified: (1) workers' compensation systems lose their



insurance premiums; (2) unemployment insurance funds lose their payments due; and (3) federal, state, and local governments lose income taxes that go unpaid or are underpaid. All three of these effects shortchange government revenues and hurt the law-abiding citizens who pay into and rely on the programs and services provided.

The issue here is how best to estimate the magnitude of these problems in Ohio. At this point, Ohio has never conducted any systematic study of the worker misclassification issue, and like the other states that have undertaken such studies, there are reasons to think that would be a helpful approach, perhaps in conjunction with one or more colleges or universities, regional planning commissions, and associations of public officials at both the state and local level. Many people would and should have an interest in making sure that these substantial revenue collection efforts are made fairer and more effective for Ohioans.

Yet we can also begin to make some estimates of the magnitude of the problem by building on the extensive studies already undertaken elsewhere, and by zeroing in on such data as is available here in Ohio. Three plausible approaches to this task are presented below. None of them is entirely satisfactory as a precise calibration of the actual numbers, but taken together they allow us to place a reasonable range on the financial scope of the problem here. By doing so, they also underscore the importance of seizing any and all opportunities that may be available to improve the enforcement process for identifying and deterring worker misclassification.

### *First Estimated Approach*

One limited source of Ohio-specific data comes from the Unemployment Compensation Division of the Ohio Department of Job and Family Services (ODJFS), which is required by the U.S. Department of Labor to audit at least some of the companies that pay unemployment insurance premiums. Unfortunately, the Division only audits a small number of those companies (2.3%), and the audits do not appear to be targeted at the sectors that have been shown in other states to produce more systematic problems of worker misclassification.



Nonetheless, in 2005, approximately 5,300 employers were audited and 45% of the audits produced findings, in many cases for worker misclassification. From the results of these audits, the analysts determined that the unemployment insurance fund would have lost more than \$300,000 if these particular violations had not been identified. Extrapolating from this figure, in conjunction with other available data and experience, ODJFS officials, in a review of worker misclassification activities in other states, have recently estimated that as much as \$20 million in unemployment insurance premiums go unpaid annually.

We can extrapolate from these numbers to estimate the number of misclassified workers in Ohio. This can be done by taking this total amount of projected losses in unemployment insurance premiums and dividing it by the average cost of unemployment insurance for each employee (\$216). From these figures, we can estimate that there were approximately 92,500 misclassified workers in Ohio in 2005.

Using these figures, we can also make a preliminary estimate of the Bureau of Workers' Compensation (BWC) losses. In 2005, the average annual workers' compensation premium per employee was \$1,118 – more than five times the cost (\$216) of the average unemployment compensation payment per employee. Based on a figure of 92,500 misclassified workers, the Bureau's losses are at least \$103 million each year. The actual number is almost certainly higher because, as reported in the California study, employers who misclassify tend to pay above-average worker compensation premiums.

Estimating lost income tax revenues because of worker misclassification raises further complexities because Ohio does not have flat income taxes, like many of the other states that have been studied. Instead, Ohio has nine different income tax brackets, ranging between incomes of \$5,000 and \$200,000, making precise estimates more difficult. But here is a plausible calculation. In 2005, Ohio's median wage was \$14.08 per hour, which amounts to a median annual income for a full-time worker of \$29,286. Assuming that a typical misclassified worker's income is underreported by 30%, which is in line with the other studies, then the median reported annual income would be \$20,500. At the original income, the worker would pay \$1,305 in state income taxes, but at the underreported rate, the worker would pay \$913. Multiplying the difference



(\$392) by the estimated number of misclassified workers (92,500), the state would be losing over \$36 million annually from misclassified workers underpaying their income taxes.

In sum, using this first approach leads to total estimates that in 2005, the worker misclassification problem may have cost Ohio about \$20 million in payments for unemployment compensation, more than \$103 million in BWC premiums, and over \$36 million in forgone state income tax revenues.

### *Second Estimated Approach*

The numbers derived in our first estimated approach can also be compared to the numbers generated by other comparable states that have performed their own studies. Both Minnesota and Illinois are midwestern states, and the distribution of employment across economic sectors in these states is unlikely to be dramatically different from Ohio. Moreover, there is no reason to think that the worker misclassification problem itself would be much worse in any of these states as compared to the others.

On the lower side, the Minnesota study had estimated that only about 1% of workers are misclassified. (We noted earlier that this low estimate is subject to question.) In Ohio, 5.4 million people were reported as being employed in 2005. Adapting the Minnesota numbers would yield only about 54,000 misclassified workers. If this figure were taken to be correct, then the total costs for Ohio would be reduced to approximately \$12 million in payments for unemployment compensation, \$60 million in BWC premiums, and \$21 million in state income tax revenues.

On the higher side, the study made by the State of Illinois estimated that approximately 8.5% of workers were misclassified there. (We have also noted that this number may be high.) After performing the calculations, the Illinois study determined that worker misclassification is estimated to have cost about \$39 million in lost payments to the unemployment insurance system in 2005, almost \$96 million to the Bureau of Workers' Compensation, and between \$125 and \$248 million in state income tax revenues.

In that year, the population of Illinois was estimated at 12.76 million people, compared to 11.46



million people in Ohio, and Illinois had 5.9 million workers to Ohio's 5.4 million. If Ohio's estimates are correlated to the Illinois estimates, then, they would yield much higher numbers than the Minnesota comparison.

We can make the comparison to Illinois in either of two ways. First, and most simply, we could simply cut the estimated costs as determined in Illinois by about 10%, which would correct for the different levels of total employment in the two states. On this calculation, the results would almost double the size of the estimates derived from the small percentage of ODJFS audits. Estimating the aggregate size of the lost payments on this scenario would yield unemployment insurances losses of just about \$35 million, lost BWC premiums of \$86 million, and forgone state income tax revenues somewhere between \$112 million and \$223 million annually.

Or, since the proportion of these distinct costs may be different in Ohio than in Illinois, we could extrapolate these costs by using the estimate from the Illinois study that 8.5% of employees are misclassified. If this estimate were correct, then Ohio would have approximately 459,000 misclassified workers (which is almost five times the number that we used in the first estimated approach). On this basis, the extent of the annual costs from worker misclassification would be about \$100 million in payments for unemployment compensation, more than \$510 million in BWC premiums, and almost \$180 million in forgone state income tax revenues.

Although on their face these number may seem high, they are disproportionately lower (after correcting for the overall levels of employment within each state) than more recent studies in other states. The New York study aggressively pegged the amount of payments lost to the unemployment insurance pool at \$175 million annually and estimated \$1 billion lost annually in workers' compensation premiums. Again, if the estimate of misclassified workers is accurate, Ohio's workers' compensation losses would almost certainly be even higher because employers who misclassify tend to pay above-average worker compensation premiums. As for lost income tax revenues to the state, it is relevant that all of the studies reveal a strong correlation between worker misclassification and underreported income. The U.S. Department of Labor



study states that “almost all of the interviewees equated employee misclassification with the operation of the underground economy. There was little substantive difference between reporting an employee as an IC [independent contractor] and not reporting him or her at all.” In fact, the Massachusetts report cited IRS estimates that 30% of income earned by misclassified workers goes unreported, either because employers underreport the earnings of their independent contractors or because they fail to provide any 1099s at all for those workers. So while our estimated income tax losses may seem high, it is in the lower range of the losses estimated for Illinois, after correcting for proportional employment. And though no comparable figure was obtained in the New York study, this number is dwarfed by the estimate in the California study that determined state income tax losses to be as high as \$7 billion, even after correcting for levels of employment and taking into account the more pervasive issue of illegal immigration in California, which likely increases the scope of the worker misclassification problem there.

### *Effects on Local Government in Ohio*

In Ohio, moreover, many municipalities and some school districts levy their own income taxes. These political subdivisions are likewise hurt by worker misclassification, which deprives them of crucial revenues with little ability to enforce compliance. In order to estimate these effects, we can extrapolate from municipal income tax revenues found in the Comprehensive Annual Financial Reports filed by each city. For instance, in Columbus, assuming that 8.5% of the city’s income taxpayers (workers and residents) are misclassified, and that the average loss from each misclassified worker is approximately 30% of the underreported income, then the total losses in 2006 would have amounted to about \$9.3 million (on total income tax revenues of \$375 million). In the same year in Cleveland, income tax revenues would have been reduced by over \$7.6 million; in Cincinnati by almost exactly the same amount; in Toledo by about \$4.3 million; in Akron by about \$4.3 million; and in Dayton by about \$3 million. Of course, if the estimated number of misclassified workers were decreased below 8.5%, then these figures would be reduced by a corresponding amount.



Income taxes are a widespread source of revenue for Ohio's cities (and in fact about 90% of all income-taxing cities are located in Ohio or Pennsylvania). Over 500 cities and villages in Ohio currently tax their residents and their non-resident workers. In 2006, Ohio income taxes contributed a combined \$4 billion in revenues to municipalities, representing more than one-third of their operating revenues. The 170 school districts that levied an income tax in 2008 garnered \$307.6 million. (This represents a doubling in school district income tax revenues since 2000, and these numbers will only continue to grow.) Making the same calculations that we just used for the six major cities, then misclassification cost Ohio cities and villages more than \$100 million in local income tax revenues in 2006, and school districts lost an additional \$7.8 million in 2008. Income taxes are too important a revenue source for schools and municipalities to permit this much money to evaporate simply because of cheating or error. Income tax proceeds at the local level have become even more significant of late, and they will continue to be a key revenue source for local governments that are facing the fallout from the foreclosure crisis and its inevitable effects in reducing real estate valuations and increasing the incidence of property tax delinquency.

### *Effects on the Federal Government*

Worker misclassification harms the federal government, too. Social Security and Medicare contributions are reduced as income is underreported. In the case of Social Security, the benefits that workers receive are proportional to the amount of their contributions, so technically the state and federal governments are not losing any money directly. However, when classified as an independent contractor, the worker is required to pay not only the employee's contribution, but also the employer's contribution – so while the employer is enriched by its noncompliance with the law, the worker's take-home pay is reduced. And, of course, if workers do not report all of their income accurately, as is likely true in many instances where they are misclassified, then these payments will never be made in the first place.

Medicare eligibility is based on the amount of time that workers pay into it, not on how much they have contributed. Therefore, misclassified workers who underreport their income will still be eligible for



all the benefits of Medicare, provided they paid into the system for a total of ten years. Medicare program funds come from a combination of payroll taxes (which are paid into a trust fund), other revenues, and state and federal dollars. For every dollar that workers fail to pay because of unreported income, another dollar must come from somewhere else.

Employers are supposed to pay a 1.45% tax on their entire payroll for Medicare and 6.2% for Social Security. Employees pay a matching percentage of their paycheck, up to prescribed limits. Independent contractors must pay both of these amounts – thus the entire 2.9% for Medicare and 12.4% for Social Security – out of their own earnings. As with Social Security, therefore, misclassified workers in Ohio likely fail to contribute a substantial amount annually to the Medicare program. Half of this loss, as with Social Security, is money that rightly should come from the employer. From our estimates of the worker misclassification problem as set out earlier, we can generally estimate that misclassifying employers are keeping as much as \$350 billion each year that should have been earmarked for Social Security and Medicare, with total losses to those systems of as much as \$500 million to \$600 million from Ohio alone. If these numbers seem high, it is worth noting that even in Connecticut's 1992 study the losses to the Social Security system alone were projected at \$95 million, in a state one-third the size of Ohio and based on a relatively low (2%) estimate of the worker misclassification problem.

Turning from these figures, however, there is another huge problem. Clearly a very significant concern for the Federal Government is lost revenue from federal income taxes on income that is not properly reported. Making the same calculations that we had used to assess the amount of forgone state income taxes, based on an estimate that 8.5% of workers are misclassified, then the lost federal income tax revenue from Ohioans was also in the range of more than \$500 million for 2005.





## *Conclusion*

Allowing the practice of misclassification to continue creates a host of undesirable consequences. Evidence from other states indicates that Ohio is losing hundreds of millions of dollars in state and local revenues from employers who misclassify their workers along with the underreporting of income by misclassified workers. Consequently, we have convened an inter-agency Task Force to examine these issues more closely and propose steps that state government can take to address the problems resulting from worker misclassification.



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