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.*

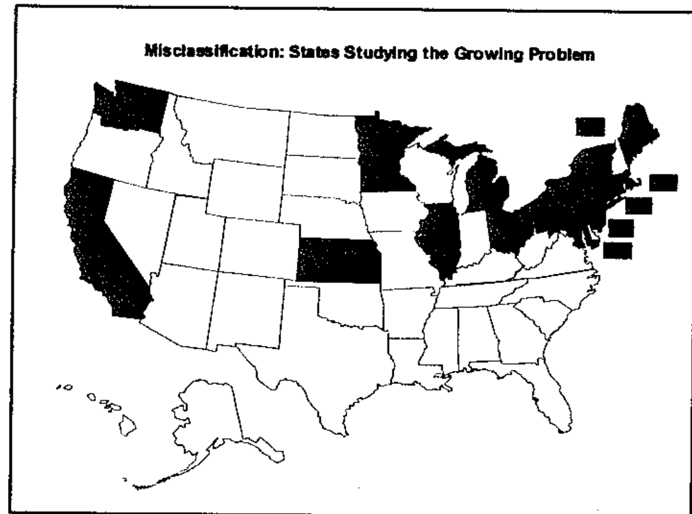
- ***Fact: A small state appropriation today will reap huge financial rewards in the future. In 15 states in which the issue has been studied, cracking down on misclassification would inject substantial future revenue into income and unemployment tax systems as well as in workers' compensation premiums.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

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

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.

Lost Unemployment Taxes (in millions annually):

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

Ohio

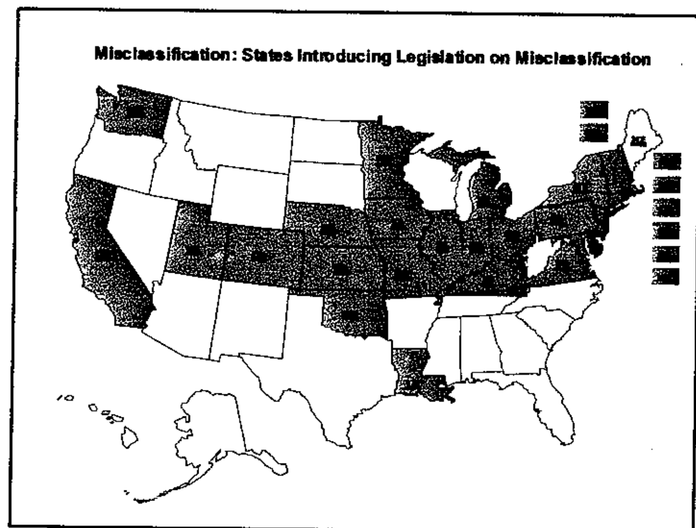
- The State Treasurer's Office estimates more than 92,000 misclassified employees work in the state, costing Ohio more than $36 million in uncollected income taxes, $20 million lost in its unemployment insurance fund, and $103 million lost in workers' compensation premiums.

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.



The Economic Costs of Employee Misclassification in the State of Illinois

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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.[1] 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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[1] 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.[2]

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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[2] The Unemployment Insurance Trust Fund. Illinois Department of Employment Security. August 19, 2004.

construction.[3] 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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[3] 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)

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.[4] 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 contactors 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.[5]

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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[4] 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)

[5] 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.[6]

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.[7] This may be particularly acute in the construction sector.[8] 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

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

[7] Illinois Department of Employment Security. Office of Revenue. EA-2005.

[8] 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.[9] 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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[9] 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 <u>deficit</u> which was projected to increase to a $627 million deficit in 2004.[10] 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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[10] 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 I
Prevalence of Misclassification in All Industries and the Construction Sector

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

[1] Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs, February, 2000.
[2] United States General Accounting Office, 1996.
[3] The Social and Economic Costs of Employee Misclassification in Construction. December 17, 2004.
[4] The Social and Economic Costs of Employee Misclassification in the Maine Construction Industry, April 25, 2005.
[5] The Social and Economic Costs of Employee Misclassification in Construction. December 17, 2004.
[6] The Social and Economic Costs of Employee Misclassification in the Maine Construction Industry, April 25, 2005.
[7] 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/employer 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.

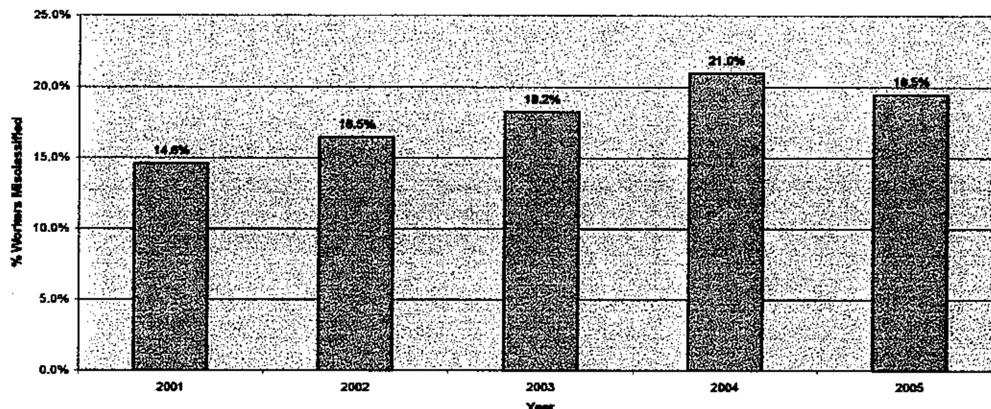
Some studies of misclassification in other states have been able to obtain de-identified data from unemployment insurance tax audits from which to derive estimates of misclassification. De-identified data is data that does not identify an individual or company and from which there is no reasonable basis 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

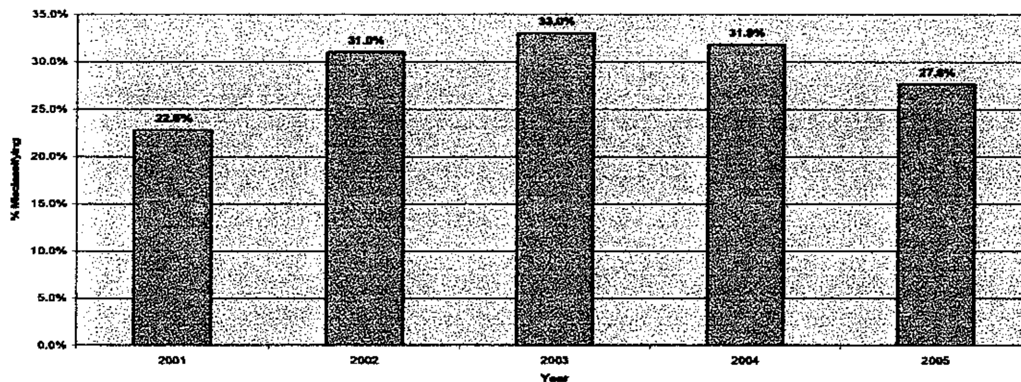
To assess the impact of workers impacted by misclassification, we use the methodology developed in earlier studies (See Carre and Wilson, 2004). First, in order to determine the ***severity*** of the impact of misclassification we determine the percent of workers misclassified ***within employers found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

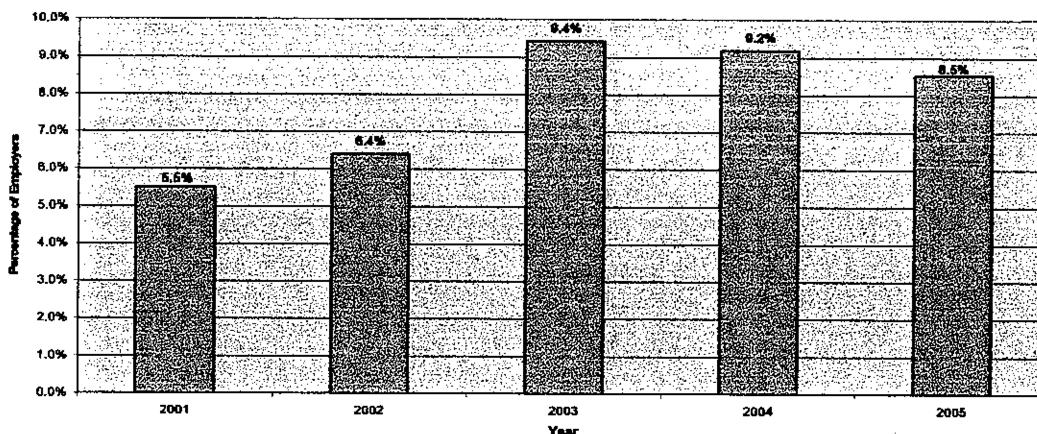


Extent of Misclassification

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.[11]

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

[11] 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).[12]

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.[13]

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

[13] 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.) 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.[14]

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.

[14] "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.[15]

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

[15] 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,[16] (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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[16] 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 *

	2001	2002	2003	2004	2005
Audit Activity					
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
Audit Types:(1)					
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
Audit Results					
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
Employers Misclassifying by Audit Section					
Metro Misclassified	0	114	150	165	147
North Misclassified	376	366	288	303	356
South Section Misclassified	372	411	365	391	384
Revenue Data from Audited Employers					
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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Report of the Ohio Attorney General on the Economic Impact of Misclassified Workers for State and Local Governments in Ohio

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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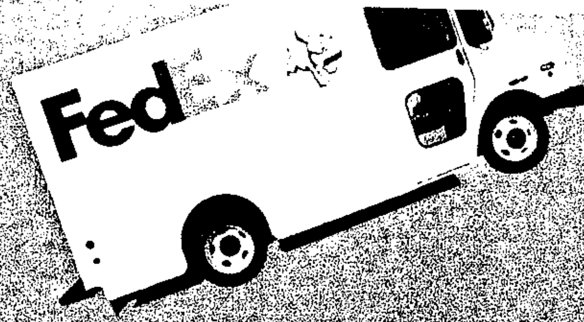

FedUp with FedEx:

How FedEx Ground Tramples Workers' Rights and Civil Rights

AMERICAN RIGHTS AT WORK

LCCR

Fed Up with FedEx: How FedEx Ground Tramples Workers' Rights and Civil Rights
By Erin Johansson.
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Executive Summary

America's workers have fought long and hard for workplace dignity and a fair share of our nation's economic prosperity. With the help of leaders from the civil rights and labor movements, workers have achieved passage of vital workplace laws guaranteeing important rights such as the right to form a union and the right to equal opportunity. These laws have helped to overcome workplace discrimination and improve living standards, especially for women, minorities, and the working poor, thus making America a more equal society. Today, some of America's most respected corporations have begun a sustained effort to exploit weaknesses in these laws and unravel much of the progress workers have made.

FedEx Corporation is a striking example of a company widely considered to be a pillar of American success and corporate responsibility. Unfortunately, FedEx is contributing to the deepening problem of inequality in our society. FedEx's troubling labor practices are masked by the company's globally recognized brand name and its reputation for both getting the job done and being a great place to work. Most Americans remain unaware of what has become an insidious pattern of anti-union conduct and efforts to subvert labor and discrimination law that call FedEx's reputation into question.

The Leadership Conference on Civil Rights and American Rights at Work shed light on a disturbing pattern at the driver delivery section of FedEx Ground, a subsidiary of FedEx Corporation, in *Fed Up with FedEx: How FedEx Ground Tramples Workers' Rights and Civil Rights*. At the heart of this problem is the claim that FedEx Ground misclassified approximately 15,000 of its drivers as independent contractors, placing them outside the protection of numerous labor and employment laws.

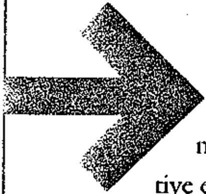
Millions of Americans are classified as independent contractors but essentially work as employees. Under the law, true independent contractors are supposed to enjoy entrepreneurial control over the methods they use to do their work. But these misclassified workers suffer the worst of both worlds: they are without meaningful control over their work and they are without the legal protections and benefits of employees. Nonetheless, employers persist in their misclassification, attempting to convince courts and other agencies that their workers are independent contractors in order to avoid their legal obligations to their workers.

Employee misclassification at FedEx Ground has thwarted workers' attempts to assert their workplace rights. Additionally, significant violations of labor and employment laws have been alleged against FedEx Ground. These charges and workers' accounts reveal that when FedEx Ground drivers attempt to form unions, they are subject to intimidation, interrogation, and firings. Court cases filed by FedEx Ground drivers allege workplace discrimination and harassment, including ongoing racial and ethnic slurs. As purported independent contractors, and not employees, drivers must first undergo long, expensive, and arduous court processes to prove that they are in fact employees of FedEx Ground before they can begin to seek redress for violations of their civil or workers' rights.

This report exposes pernicious and widespread use of misclassification at FedEx Ground, which tramples workers' rights and civil rights. It concludes with recommendations for the redress and prevention of future violations, including:

1. Urge FedEx Corporation to comply in good faith with labor laws.
2. Increase public awareness to make corporations more accountable for undermining America's promise of equality and economic advancement.
3. Pass the Employee Free Choice Act to better protect the freedom to form unions.
4. Improve enforcement of existing laws, encourage federal and state legislatures and agencies to close loopholes, and enact strong new protections for workers.
5. Improve procedures and increase congressional oversight of the National Labor Relations Board.

Introduction



Fifty years ago, the nation's first modern civil rights act passed as a result of cooperative efforts between men and women of both the civil rights movement and America's labor organizations. This was neither the first nor the last time that civil rights advocates and labor activists would join together to right a grave wrong.

Working together, these movements helped pave the way to the enactment and enforcement of labor and employment laws that make society more equal. Unions have been instrumental in passing civil rights legislation and helping to monitor workplaces for discriminatory practices. Labor unions also raise the standards of living for women, racial and ethnic minorities, and the working poor. Meanwhile civil rights organizations have supported labor standards legislation and have been strong advocates for labor unions. As a result of this cooperation, more Americans enjoy a greater share of our nation's economic prosperity.

However, these important gains are now jeopardized by a new era of race-to-the-bottom policies and insidious corporate attacks on worker protections. Some of America's largest, most prominent companies maintain a sterling public image despite their efforts to weaken unions and undercut worker benefits. Hiding behind a veneer of glossy logos and self-serving claims of employee-friendliness, many major American companies have suffered little public condemnation or government sanction for their efforts to undermine workers by exploiting weaknesses in our laws. As a result, American society has reversed course, moving away from greater upward mobility and economic parity and toward economic stratification and a widening gulf between the haves and have-nots.

The situation faced by drivers at FedEx Ground, a subsidiary of FedEx Corporation, brings together American Rights at Work and the Leadership Conference on Civil Rights to detail how a respected corporation like FedEx takes advantage of weaknesses in laws to undermine workplace protections. FedEx epitomizes an American corporation in good public standing,[1] which nonetheless chooses to shortchange its workers through the use of dubious legal defenses and maneuvers.

FedEx At a Glance

FedEx Corporation[4]

Federal Express was founded in 1971; the corporation was created in 1998, and rebranded as FedEx Corporation in 2000.

Revenue: $32.6 billion, FY06

Workforce: More than 280,000 employees and contractors worldwide

Subsidiaries:

FedEx Corporation	FedEx Kinko's
FedEx Express	FedEx Custom Critical
FedEx Ground and Home Delivery	FedEx Supply Chain
FedEx Freight	FedEx Trade Networks
	FedEx Services

FedEx Ground and Home Delivery[5]

Founded in 1985 as RPS (Roadway Package System); rebranded as FedEx Ground in 2000.

Revenue: $6 billion, FY07 (includes FedEx SmartPost)

Workforce: More than 65,000 workers, nearly 15,000[6] of whom are drivers classified as independent contractors

Average Daily Volume: More than 3 million packages daily

Operating Facilities: 29 ground hubs; over 500 pickup/delivery terminals worldwide

FedEx Ground serves both residential and commercial customers with pick-up and delivery services, Monday through Friday. FedEx Home Delivery, part of FedEx Ground, serves primarily residential customers Tuesday through Saturday.

In particular, this report investigates FedEx Ground's strategy of misclassifying its drivers as independent contractors, which places them outside the protection of most labor and employment laws. Independent contractors are, by most legal definitions, supposed to enjoy significant control over the methods by which they accomplish their assigned work. But many companies abuse the independent contractor label to deny the protection of workplace laws to workers who do not fit the definition. A class action suit against Microsoft thrust the misclassification issue into the media spotlight nearly a decade ago. The case resulted in a $97 million settlement and Microsoft took voluntary steps to reform its system for classifying workers and compensating them for benefits lost.[2] Yet, the Microsoft suit involving 1,000 employees is dwarfed by the potential case of 15,000 drivers classified as independent contractors building against FedEx Ground.

Despite allegations of widespread misclassification, FedEx Ground shows no signs of changing its course. FedEx Ground told *The New York Times* last year that its model "works for the company, the contractors and the customers."[3] Numerous courts and government agencies have ruled that FedEx Ground drivers are in fact employees, revealing that the company's business model is a means to deny drivers their workplace rights.

One major concern is the effect of misclassification on drivers at FedEx Ground battling discrimination. Numerous cases against FedEx alleging racial and ethnic discrimination and harassment paint a disturbing picture. Arab-American drivers involved in a current Massachusetts case contend the company failed to act after managers assaulted and hurled ethnic slurs at them. These charges echo revelations from a similar case in California where the jury found FedEx Ground acted

"with oppression and malice" in failing to stop managers' excessive harassment of two Arab-American drivers. Before drivers can begin to seek redress for violations of their civil rights, they must undergo long, expensive, and arduous court proceedings to prove that they are in fact employees and not independent contractors.

Moreover, FedEx Ground has used misclassification along with other weaknesses in American labor laws to prevent workers from forming unions. Federal charges and workers' accounts reveal that when drivers at FedEx Ground attempt to form unions to have a say in their work lives, they are subject to an onslaught of retaliation: intimidation, bribery, interrogation, and even firings. Drivers who overcome these challenges are saddled with further complications on their path to forming a union—the company delays legal proceedings by arguing the drivers are independent contractors and ineligible to form unions.

Without a significant reform of labor law, FedEx Ground can continue to violate its drivers' civil and workplace rights with near impunity. Many drivers never realize that they may be entitled to legal protection because FedEx Ground tells them that they are independent contractors. Others lack the ability to engage in protracted litigation over their status. Meanwhile, union organizing drives are derailed as slow legal proceeding sap union momentum. With formidable financial and legal resources at its disposal, nearly 15,000 workers are left vulnerable by this corporate giant's policies.

Just as the civil rights and workers' rights communities came together in the past to fight workplace injustice, American Rights at Work and the Leadership Conference on Civil Rights are now joining together to right a grave wrong. We hope to call serious attention to employee misclassification, at FedEx Ground, and elsewhere. A number of well-respected companies, like United Parcel Service (UPS) and AT&T, not only talk the talk, but they walk the walk when it comes to sustainable business practices which respect workers' rights and civil rights. FedEx Ground has the opportunity to be true, business leader, the question is, will it?

The Growing Trend to Misclassify Employees as Independent Contractors

Americans love the idea of entrepreneurship—of being your own boss and succeeding in business on individual merit and initiative. For those who embrace these ideals, independent contracting is an attractive career path. A report by the U.S. Chamber of Commerce touts the advantages of being an independent contractor, which include "the opportunity to be one's own boss, exerting greater control over time and daily activities ...and [having] the opportunity to grow and expand their businesses as they choose, ensuring greater financial security for themselves and their families."[7] And so these men and women trade the benefits and security of traditional employment for the freedom of being independent businesspeople.

In reality, there are millions of Americans classified as independent contractors by the companies they work for, but effectively working as employees. These workers suffer the worst of both worlds: they toil without the protections and benefits of employees, yet are without the control over their work that true independent contractors enjoy.

The Internal Revenue Service (IRS) uses several factors to test whether someone is an independent contractor. However, the general rule "is that an individual is an independent contractor if you, the person for whom the services are performed, have the right to control or direct only the result of the work and not the means and methods of accomplishing the result."[8] This general rule underlies most legal tests for independent contractor status. Given the exclusion of independent contractors from myriad federal and state employment laws, including those governing minimum wage, safety and health, discrimination, and freedom of association, the distinction between who is an employee and who is a contractor is crucial to determining a person's legal rights.

In a 2006 report, the Government Accountability Office (GAO) warned that "employers have economic incentives to misclassify employees as independent contractors because employers are not obligated to make certain financial expenditures for independent contractors that they make for employees, such as paying certain taxes (Social Security, Medicare, and unemployment taxes), providing workers' compensation insurance, paying minimum wage and overtime wages, or including independent contractors in employee benefit plans."[9] Misclassification can save employers upwards of 30 percent on payroll costs.[10] According to a 2000 Department of Labor report, the number one reason employers misclassify employees as independent contractors is to save on workers' compensation taxes and to avoid liability for workplace injury and disability claims.[11]

Given these incentives, it is no surprise that the misclassification problem has worsened in recent years. In February 2005, the Department of Labor classified 10.3 million individuals as independent contractors, comprising 7.4 percent of the total workforce—an increase from 6.4 percent in 2001.[12] Hard data on misclassification is difficult to obtain, but in 1988, an IRS model estimated the number of misclassified independent contractors potentially ranged from 187,000 to as many as 1.6 million.[13] In 1994, a Coopers & Lybrand (now Pricewaterhouse Coopers) report used IRS data to project that the number of misclassified employees will have grown from 3.3 million in 1984 to 5 million by 2005.[14] The 2000 Department of Labor report estimated that 10 to 30 percent of employers misclassify employees as contractors.[15] And a 2002 audit by the Department revealed a 42 percent increase in misclassification over the previous year.[16] The 2000 report notes: "A new breed of accountants and attorneys has emerged to counsel employers on how to convert employees into [independent contractors] to reduce payroll costs and avoid complying with labor and workplace legislation."[17]

One reason employers pull off such pervasive employee misclassification, according to Rebecca Smith of the National Employment Law Project, is because "under current law, there are only limited penalties, reporting requirements, and complaint procedures that regulate employers who hire independent contractors."[18] There are also significant loopholes in the laws that allow for such extensive misclassification. The IRS has a "safe harbor" provision which relieves offending employers from employment tax liability both retroactively and prospectively, and from paying penalties, if they meet certain requirements indicating that they "reasonably" misclassified their workers. If an employer is part of an industry where misclassification is common, they can use that practice as an excuse to qualify for this loophole. A lack of procedural rules and information sharing within and among government agencies allows companies to assert and reassert that their workers are independent contractors in different forums.

Those hit hardest by misclassification are the workers themselves. Independent contractors are excluded from laws protecting employees from occupational hazards, minimum wage and overtime violations, discrimination, and sexual harassment. Without the right to form a union under federal law, independent contractors have little recourse to address their problems at work. Because they are ineligible for workers' compensation, unemployment, and disability benefits, contractors work without a real safety net, and on top of this, they are rarely eligible for employer-provided health insurance or retirement plans.

Law-abiding businesses must compete with employers who misclassify their employees. John Kendzierski, president of Professional Drywall Construction Inc., testified before a recent House Committee hearing on how contractors who misclassify their employees avoid payroll expenses that "add over 25 percent to the cost of labor, putting us 'legitimate' contractors at a competitive disadvantage when competing for the same work. This also causes insurance and other rates to rise because there is less money being contributed in total therefore burdening the contractor who pays the appropriate taxes and fees."[19]

Such extensive misclassification also costs federal and state governments lost tax revenue. Coopers & Lybrand used data from the IRS and the Bureau of Labor Statistics to estimate that the proper classification of all misclassified employees would have yielded nearly $35 billion in federal tax receipts from 1996 to 2004.[20] At the state level, a 2000 Department of Labor study estimated that misclassifying one percent of workers resulted in an average of $198 million lost annually to state unemployment insurance funds.[21]

Independent Contractors Denied Protections on the Job

Independent Contracting at FedEx Ground

Labeling its drivers as independent contractors has been an effective strategy for FedEx Corporation since it inherited the practice after purchasing RPS (Roadway Package Systems, later renamed FedEx Ground) in 1998. By classifying nearly 15,000 drivers as independent contractors rather than employees, FedEx Ground lowers its labor costs by avoiding payroll taxes and benefits. This practice gives it an unfair advantage over competitors such as UPS and DHL, which have costs associated with hiring employees to deliver packages. UPS employs drivers directly, and DHL uses subcontractors who then employ drivers. Drivers at both companies have union representation with the International Brotherhood of Teamsters, along with paid vacation, health benefits, a pension, and overtime—none of which are provided to FedEx Ground drivers.

FedEx Ground entices people to deliver as independent contractors with a pitch that conjures up the American Dream: "Independent Contractors at FedEx Home Delivery own their own business and work in partnership with FedEx. This opportunity requires an entrepreneurial spirit.... Come build your business and be your own boss as you partner with FedEx Home Delivery."[22] Knowing that FedEx Ground will

A Tale of Two Drivers

An *Orlando Sentinel* article profiled a FedEx Ground driver and a union-represented UPS driver, revealing stark differences between two similar jobs.

	FedEx Ground Driver	UPS Driver
Annual earnings	Roughly $50,000-60,000, paid per delivery	$70,000, includes $26.17/hour wage plus overtime
Job-related expenses	Fuel, maintenance, other supplies; cost of route/truck: $30,000	None specified
Health care	Driver can opt into plan with some contribution from FedEx Ground	UPS covers full cost of family-covered health insurance*
Retirement	Driver can opt into plan with some contribution from FedEx Ground	UPS pays into a defined benefit pension plan*
Leave	Unpaid time off, based on availability of replacement	4 weeks paid vacation, 1 week paid for personal or sick leave
Job security	FedEx Ground can terminate driver's contract at any time**	Union contract mandates UPS demonstrates "just cause" for dismissal*

Wessel, Harry. "Tale of 2 drivers," *Orlando Sentinel*, 21 Dec. 2005: G1.
* "National Master United Parcel Service Agreement," for the period of Aug. 1, 2002 through July 31, 2008.
** *Estrada v. FedEx Ground*, BC 210130 (CA Super. Ct. 2004).

not be providing benefits typically afforded to employees, the drivers interviewed in this report still enthusiastically signed up. Dave McMahon, a former driver, was "sold on the idea that he could grow his business, could expand his business, sell his business."[23] Donna Eickhorst, a former driver, recalled how FedEx Ground sold the job to her: "You could make your own hours. You could make what you want when you want. It sounded perfect."[24]

It isn't long before new drivers discover their lack of independence. From the start, they are unable to negotiate the terms of their work as they are all required to sign the Operating Agreement, which is "presented on a take-it-or-leave-it basis."[25] FedEx Ground gives itself "unilateral control over the termination" of the agreement.[26] Under it, drivers are given a Primary Service Area and must deliver all packages assigned to them within that area, as well as any other area the company assigns.[27] FedEx Ground has the right to reconfigure that route at any time.[28] This reconfiguring led Rudy Trbovich, a former driver, to give up on his dreams for success at the company: "My goal was to buy other routes, hire drivers, and build a sizeable business for myself. After two and a half years there and [FedEx] changing my route once or twice, I said I'm not going to buy any more."[29] According to Bill Gardner, a current driver, the routes are worthless because drivers have no control over them. He quipped, "I suppose someone could sell you the Washington Monument."[30]

The Operating Agreement also details how drivers are compensated, which includes piece-rate payments based on the number of packages delivered, a "vehicle availability fee" for days they deliver, "core zone" payments based on the density of deliveries in the driver's area, fuel supplements if the price of gas exceeds a certain amount, and various bonuses. These rates are unilaterally determined by the company, though drivers have the right to appeal the core zone payments.[31] Because the majority of compensation is based on the number of deliveries made,[32] FedEx Ground exerts enormous control over a driver's income when assigning deliveries.

"Truths" in Advertising at FedEx Ground

"We have to buy our own sweatshop."
Bill Gardner, FedEx Ground driver, Wilmington, MA

International Brotherhood of Teamsters

Since drivers must deliver all assigned packages, they have little control over when and how much they work. Former driver Paul Infantino described the situation: "You can't just leave when you want. You can't say, 'Ok, it's my business. I'm going to shut down the shop for the day'...You can't do it, because they'll just terminate your contract."[36] To Cathy Curran, a current driver, the requirement to deliver all the packages assigned has meant years of an excessive workload.[37] She reported working a minimum of 12 hours per day, five days a week on average, and 14 hours per day, six days a week during the busy holiday season—all without receiving overtime.

FedEx Ground also limits drivers when they want to take time off. They are responsible for finding a replacement to drive their route, and the company must approve that driver. When Bill Gardner's son was involved in a serious accident, time spent visiting him in the hospital meant Gardner wasn't able to complete his deliveries on time, and he couldn't hire his brother to take over the route for him because he was not a FedEx-approved driver. To Gardner, the excessive workload, coupled with the huge financial investment, makes FedEx Ground "a modern day sweatshop. But the older sweatshops...were better because you didn't have to buy the sweatshop. We have to buy our own sweatshop."[38]

In defense of its contractor model, FedEx Ground cites the department it created called Contractor Relations, which is supposed to serve as a liaison between drivers and the company and reviews requests to terminate drivers' contracts in case managers overstep any bounds.[39] Yet as one court ruling put it, Contractor Relations "is nothing more than a mere branch of management," with any decision it makes "subject to higher management's approval or veto."[40]

Exposing the independent contractor "guise" at FedEx Ground

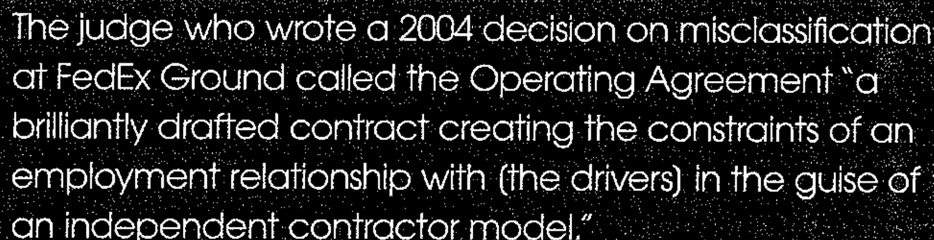
In recent years, courts and government agencies have debunked FedEx Ground's misleading independent contractor model. In a major decision in 2004, the Los Angeles County Superior Court ruled in ***Estrada v. FedEx Ground*** that FedEx Ground drivers in California were employees, not contractors.[43] In 1999, California drivers filed a class action suit arguing that they were misclassified and that FedEx Ground owed them for the expenses they incurred as employees. The Court found that drivers operating single routes (excluding multiple route drivers) were employees, and in 2005, ordered FedEx Ground to reclassify all its single route drivers in California.

The judge who wrote the 2004 decision called the Operating Agreement "a brilliantly drafted contract creating the constraints of an employment relationship with [the drivers] in the guise of an independent contractor model."[44] Among the reasons the Court determined the drivers were employees:

- the company has the sole right to interpret the Operating Agreement;
- drivers' routes can be reconfigured without drivers' say;
- the work drivers perform is core to the company's business;
- the company controls who drivers can hire; and
- the company can effectively terminate drivers "at will."

Given all the evidence, the Court concluded that FedEx Ground "not only has the right to control, but has close to absolute actual control" over the drivers. In August 2007, the California Appeals court unanimously affirmed that decision.[45]

FedEx Ground responded to the legal rulings against the contractor model in California by re-organizing its contractor workforce in that state in September 2007. Because the civil courts and state tax authorities have ruled repeatedly that single-route contractors are in fact employees, the company will terminate contracts with its 700 single-route drivers in California after June 2008.[46] These drivers will leave the company or will be re-hired only if the drivers take on additional routes and become multiple-route operators. It remains to be seen whether FedEx Ground will give the new multiple-route operators the entrepreneurial freedom of true independent contractors or whether they will remain misclassified employees with neither that freedom nor workplace rights. And it is unclear whether the drivers hired by the multiple-route operators will be treated as FedEx employees, or whether FedEx will seek to classify them as employees solely of the multiple-route operators and thereby deny them the wages and benefits enjoyed by other employees of FedEx. FedEx announced no changes in its model in the rest of the country, though it is offering incentives to encourage drivers to take on more than one route.



In 2005, a U.S. District Court in Washington state found that two temporary drivers who filed federal and state wage and hour claims were in fact employees of both FedEx Ground and of the drivers who hired them to work their routes.[47] The Court corroborated the allegation that the workers were not contractors as it concluded: "The undisputed facts show that the Drivers were dependent on [the company] for virtually every aspect of their job."[48]

Government agencies have also weighed in on the issue. The National Labor Relations Board (NLRB) consistently rules that FedEx Ground drivers are employees. Since 2005, NLRB regional offices made such determinations for five different terminals, and upon FedEx's appeals, the Board in Washington, DC, affirmed the rulings in all five cases.[49] And in the past year, the IRS has made at least two determinations that individual drivers were employees.[50]

States also continue to expose misclassification at FedEx Ground. A 2004 audit by the California Employment Development Department determined the company owed $7.88 million in back taxes for misclassifying drivers over a two year period.[51] When the company appealed the audit, the California Unemployment Insurance Appeals Board denied its appeal, writing, "The substantial control exercised by [the company] as a practical matter, its power to define satisfactory

performance, the fact that drivers are not a distinct occupation and their services are integral to the business favor finding an employment relationship."[52] State agencies in New Jersey, Massachusetts, Oregon, and Montana also recently determined that FedEx Ground drivers were employees.[53]

In what could be the largest case of misclassification in the country, FedEx Ground drivers from 30 states have joined together in a federal class action lawsuit, currently being litigated in the U.S. District Court in Indiana, where they claim the company misclassified them as independent contractors. The drivers demand that the company reimburse them for expenses and benefits wrongfully denied them under federal law, such as the Family and Medical Leave Act, and various state laws.[54]

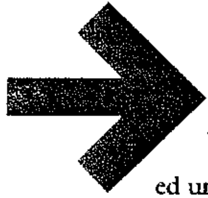
Despite the recent spate of rulings exposing FedEx Ground's contractor model, shareholders may be unaware of the company's potential liability. Brian Hamilton of ProfitCents, a financial research company, estimates that if FedEx Ground had to reclassify all of its independent contractor drivers as employees, it could owe $1.4 billion in payroll taxes, health insurance, and overtime—excluding the costs of retirement benefits and paid vacations.[55] Hamilton told *Forbes* that FedEx faces "a significant financial risk," but discloses little of it to its investors.[56] In its December 2006 quarterly report to the Securities and Exchange Commission, FedEx Ground dismissed any major liability: "We strongly believe that FedEx Ground is not an employer of these drivers and that we will prevail in these proceedings. Given the nature and preliminary status of these claims, we cannot yet determine the amount or a reasonable range of potential loss in these matters, if any."[57]

Driver's Contractor Status Adds to Widow's Grief

On August 8, 2006, 36-year-old Tony Marcellino was killed in a traffic accident while delivering packages for FedEx Ground. Marcellino worked for 11 years at the Stockton, CA, terminal. In 2004, he testified before a California Superior Court judge about how he was misclassified by the company as an independent contractor, noting that the company would not let him a wear an earring or ponytail, and that it reconfigured his route over his objections. He concluded that "it was obvious that I was not in control of my destiny."[41]

Because FedEx Ground classified Marcellino as an independent contractor, his widow and two young children are not eligible to collect death benefits awarded to the families of employees killed on the job through California Workers' Compensation Act. Instead, they receive half as much through the company's Protective Insurance Work Accident policy. Marcellino's widow, Terri, has taken their case before the Workers' Compensation Appeals Board to plead that her husband was misclassified and is entitled to the state's death benefit. She says that this ordeal has "caused me enormous stress and financial uncertainty."[42]

An Anti-Civil Rights Atmosphere at FedEx Ground



Based on court interpretations, independent contractors are not protected under several federal laws prohibiting discrimination, including Title VII of the Civil Rights Act of 1964, which protects against employment discrimination based on race, sex, religion, and national origin; the Age Discrimination in Employment Act; and the Americans with Disabilities Act.[58] According to a 2000 Department of Labor report, avoiding the costs of complying with these statutes, such as paying damages for violations, is a primary reason employers misclassify their employees as independent contractors.[59]

While FedEx Ground and FedEx Express drivers perform virtually the same work—picking up and delivering packages, often to the same customers—there are major differences in how they are able to address alleged discrimination based on their employment status. Because FedEx Express classifies its drivers as employees, they are automatically afforded protections from discrimination under state and federal laws.

Recently, African-American and Latino drivers and other employees at FedEx Express exercised their rights under the law, alleging that the company discriminated against them in job assignment, compensation, promotion, and discipline.[60] The company tentatively agreed to settle the charges for $55 million, and more significantly, agreed to name a third party to oversee widespread changes to its personnel policies to avoid bias.[61]

Drivers at FedEx Ground, who are classified by the company as independent contractors, encounter a vastly different situation. FedEx Corporation does not even have a policy against harassment and discrimination of independent contractors, despite having a zero tolerance policy for employees. It also does not train its managers to prevent and address such behavior at FedEx Ground.[62] Paul Callahan, a division vice-president of FedEx Ground, testified that "we don't train contractors, we train employees in the company. And we talked to our employees about discrimination, about harassment, and—well, I have human resource managers in every regiment in this company and that's what their job is."[63] This lack of company policy surely leaves drivers more vulnerable to discrimination.

Independent contracting creates hurdles to drivers' pursuit of discrimination claims

Unlike their counterparts at FedEx Express, FedEx Ground drivers who file discrimination claims must first challenge the company's assertion that they are independent contractors and ineligible for civil rights protections—an enormous barrier that could leave them in bureaucratic limbo for months, even years. Adalberto Garcia claimed FedEx Ground refused to hire him because of his disability, but the company argued that he "cannot bring a disability discrimination claim because he was not an employee of FedEx Ground, nor was he seeking employment with FedEx Ground. The ADA does not protect independent contractors."[64] Garcia failed to dispute the company's assertion, and the judge dismissed the case on that basis.[65] Fortunately for four Arab-American drivers who recently filed claims of racial, ethnic, and religious discrimination, the Massachusetts Commission Against Discrimination was unconvinced by FedEx Ground's faulty contractor defense and determined that the drivers were employees, allowing their case to proceed.[66]

KulbakoPhoto.com

"It was surprising to see something like that at such a big company."

Four Arab-American drivers from the FedEx Ground terminal in Wilmington, MA, allege that they were the victims of racial, ethnic, and religious discrimination, and that senior company management failed to respond to their multiple complaints. Loay El-Dagany maintains a savings account through FedEx, and when he requests a withdrawal to send money back to his family, his manager, David Goyette, "always comments that I'm sending the money to the al Qaeda organization or Bin Laden." Montaser Harara recalls Goyette telling him, "I believe you are a terrorist." Harara also alleges that when he was exiting a bathroom in the terminal, Goyette asked him if he "was reading the Koran inside," a particularly offensive statement for a Muslim.

All four drivers complained that managers assigned them a huge workload—larger than the white drivers. Harara recalled being given 500 stops in one day—an impossible amount of work, especially given that his truck only fit packages for about 300 stops. The drivers complained that when they returned with packages they couldn't deliver, Goyette threw the packages at them, yelled at them, and even pushed Oukhayi Ibrahim in front of the other managers. Though Ibrahim complained to Contractor Relations, he asserts: "Everybody knows but nobody does anything about it."

In 2005, all seven of the Arab-American drivers who worked at the Wilmington terminal were moved from the southern location to the northern one, forcing them to drive much farther for deliveries. At the new location, the drivers allege the manager, John Rose, intimidated them. According to Ibrahim, before a union representation election was held for Wilmington terminal drivers, Rose "wanted to make sure we voted 'no' for the union. And after [the vote] he said 'I can't trust Muslim people because they are liars.'"

Having proven their status as employees before the Massachusetts Commission Against Discrimination, the four drivers are now hoping to prevail in their discrimination claims in a case filed with a Massachusetts Superior Court. In reflecting on his experience at FedEx Ground, El-Dagany noted, "It was surprising to see something like that at such a big company…a big international company."

FedEx Ground drivers' contractor status also leaves them more vulnerable to retaliation when filing discrimination claims. Days after Annette Craig filed a claim against FedEx Ground alleging that as an African-American woman, she was the target of racial and gender discrimination by her managers, the company fired her.[77] Craig took a risk by filing the claim, because the Pennsylvania Human Relations Commission (PHRC) could still determine that she is an independent contractor and without protection from discrimination, and from what could have been retaliatory termination by FedEx. When employees file a discrimination claim, the law protects them from retaliation by their employer,

"I want to be treated by Federal Express the way every other driver is treated."

Leslie Walker

When Annette Craig started as a driver for FedEx Ground at the Philadelphia terminal in 2005, her manager, Pete Adams, routinely diverted her from her primary route to deliver through dangerous parts of Philadelphia that required more customer signatures and took longer to complete. For six months, Craig, a single mother, didn't return home until after 11:00 p.m. and hardly saw her children. She claims that despite repeatedly complaining to Adams, he continued to assign her the difficult route, while giving more desirable routes and stops from her easier primary route to white male drivers—some of whom were newer than she.[79]

In her complaint to the Pennsylvania Human Relations Commission (PHRC), Craig also alleges that Adams called her a "baboon," and when she reported his comment to a regional manager, he told her to resolve it with Adams herself.[80] She also recounted how when she called Adams to tell him that she had to care for her sick daughter and couldn't deliver one day, he allegedly replied: "This is why I will not hire women with children."

Despite eventually speaking to a representative from Contractor Relations about the alleged discrimination and harassment, Craig said the mistreatment continued. In October 2006, Craig was injured after being hit by a car while delivering packages. While she was forced to hire her own replacement to cover her route, she claimed that FedEx hired and paid for a temporary replacement for a white male driver who fell ill during the same time. On November 27, 2006, she filed a discrimination claim with the PHRC. In the claim she wrote, "I want to be treated by Federal Express the way every other driver is treated. I want to pay off my truck and make money without interference, and, as a single mom, to see my children more often." Days later, FedEx Ground terminated her contract.

regardless of whether or not they win their discrimination suit. Now Craig is stuck in legal limbo, hoping the PHRC will determine that she is an employee in order to win civil rights protections. In April 2007, the PHRC rejected FedEx Ground's motion to dismiss the case on the basis that she was an independent contractor, and has decided that an investigation is necessary to determine her employee status.[80] There is no word on how long this investigation will take.

Catherine Ruckelshaus of the National Employment Law Project notes that misclassified independent contractors "have a lot of barriers to overcome before you even get to the merits of their cases."[81] First, an employer may tell the worker she is an independent contractor without protection, and so she won't even bother to file a claim; second, if she does file a claim, the agency may simply take the employer's word that she is a contractor without pursuing an investigation; third, because an investigation into employee status is fact-intensive, agencies may not have the resources or legal guidance to reach fair determinations.[82]

Illustrating Ruckelshaus' point are several recent discrimination cases filed against FedEx Ground that were dismissed because of the alleged independent contractor status of the claimant.[83] The agencies likely followed normal administrative procedures in reviewing submissions by FedEx to make their determinations. But the "evidence" cited was often the company's job posting or Operating Agreement which refer to drivers as independent contractors; one agency called the agreement "undisputed documentation" of the claimant's independent contractor status.[84] Without the benefit of full investigation and testimony concerning actual conditions and practices, an agency may fail to understand the true nature of the drivers' relationship to FedEx Ground. Though claimants may have the right to appeal such rulings, those who claim discrimination during the hiring process would not have personal experience on the job to counter the company's claims that they are contractors. Other claimants may not be able to obtain legal representation to navigate a viable appeal. At least in Annette Craig's case, the PHRC determined that an investigation into her employment status was warranted, and that the Operating Agreement presented by FedEx was "not dispositive in establishing that [Craig] was an independent contractor."[85]

Few protections from discrimination for independent contractors

FedEx Ground drivers who live in California or Massachusetts are fortunate enough to have limited protections from discrimination in laws that don't require them to prove they are employees. The Massachusetts Equal Rights Act protects independent contractors from discrimination. And in 1999, the California legislature expanded the Fair Employment and Housing Act to protect independent contractors from employment-based harassment in order to "provide needed protections for the ever-growing numbers of workers who are hired as independent contractors rather than employees, and who currently work unprotected against harassment simply by virtue of the contractual nature of their work and their lesser cost to the businesses who hire them."[86] This legislation helped two FedEx Ground drivers win a major harassment suit against the company in June 2006 without having to prove employee status.

Independent contractors can file discrimination suits under Section 1981, part of the post-Civil War era Civil Rights Act of 1886. Because Section 1981 prohibits racial discrimination in "making and enforcing contracts," drivers do not have to prove they are employees to be covered.[95] In *Carey v. FedEx Ground*, an African-American driver sued the company alleging discrimination when he was denied a delivery route during the time that white applicants were awarded several routes.[96] A court allowed his claim to proceed under Section 1981, and the case was settled shortly before it reached trial.[97]

Section 1981 at best provides limited recourse for FedEx Ground drivers. The law requires the plaintiff to prove discriminatory intent, not just disparate impact. It also requires the plaintiff to hire a private lawyer to pursue the claim, which many cannot afford, and only protects against racial discrimination.[98] Neither Section 1981 nor the California statute offer independent contractors the kinds of broad protections offered to employees under the various federal and state laws.

As case after case demonstrates, the independent contractor classification at FedEx Ground poses major problems for drivers who feel they are the victims of discrimination. Drivers must surmount bureaucratic hurdles before federal and state agencies will even consider the merits of their claims—challenges that may dissuade many from even filing claims.

Federal law also excludes independent contractors from the right to form unions and collectively bargain, depriving them of the protection unions provide against workplace discrimination.

"We thank God that the jury stood up to the giant Federal Express"

In *Issa v. Roadway Package Systems*, two Lebanese drivers, Edgar Rizkallah and Kamil Issa, brought a case against FedEx Ground alleging harassment based on their race and national origin. According to the testimony of several drivers, managers physically assaulted Rizkallah and Issa; called them "camel jockeys,""sand niggers," and "terrorists;" regularly commented about Lebanese bombs; and threatened to fire them.[87] Drivers also testified that the managers created a hostile environment for minorities.[88] Issa testified: "...over the last three or four years...I was harassed, I was discriminated against, I was called names, and things that I don't think anybody will tolerate in a work environment."[89]

When the men complained to senior managers, including the Western Regional Manager for FedEx Ground, drivers testified that the company did nothing.[90] The primary perpetrator of the harassment, terminal manager Stacy Shoun, was promoted by the company four times, and was still employed there after the trial.[91] In June 2006, an Alameda Superior Court jury found that the company acted "with oppression and malice" and awarded Issa and Rizkallah $61 million,[92] which was later reduced by a judge to $12.4 million.[93] After the jury reached its verdict, the drivers commented, "We thank God that the jury stood up to the giant Federal Express and made a statement that we count, that we have rights, and that we should not be forced to work under conditions where we are treated as less than human."[94]

A union contract offers fair and transparent guidelines for promotions, wage increases, and discipline, eliminating much of the bias and discrimination in these processes. If a union-represented worker encounters discrimination, her contract provides her with a grievance process to remedy the issue. FedEx Ground drivers who want to organize unions must first prove they are employees. And as the following section demonstrates, the drivers who manage to surmount this first legal obstacle find an even bigger hurdle in the anti-union campaign orchestrated by FedEx Ground.

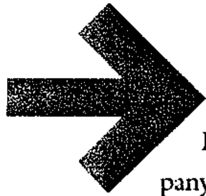
After Serving His Country, Driver Denied Right to Return

Rich Farrell was a FedEx Ground driver for the Camden, N.J. terminal. He also serves as a medic in the Army National Guard. He was activated on September 11, 2001, and in December 2003 Farrell informed his terminal manager that he would soon be deployed overseas for six months. His manager informed him that they would hire someone to deliver on his route while he was away. In January 2004 FedEx Ground gave Farrell [illegible] notice that it would not renew his contract, which expired the next month. Dave McMahon, a fellow driver, approached their manager and asked why Farrell was terminated. According to McMahon, the manager replied, "What do you think we were, going to hold his contract until he gets done playing Army?"

After serving overseas, Farrell met with a military lawyer who informed him that since FedEx Ground classified him as an independent contractor, he was not protected under the Uniformed Services Employment and Reemployment Rights Act (USERRA). The Act prohibits employers from discriminating against those who serve in the National Guard or other uniformed services. If Farrell was classified as an employee, USERRA would have protected him from termination when he was deployed and given him the right to reclaim his route when he returned.

Farrell returned home in January 2005 and was not able to find a full-time job until April 2006. He tried calling his old terminal to inquire about getting a route, but no one returned his messages. He sold his $40,000 truck on eBay for a mere $18,000. Farrell summarized his experience at FedEx Ground: "I kind of took a beating."

The Anti-Union Campaign at FedEx Ground



One may wonder why, if FedEx Ground drivers are unhappy with the company's independent contractor model, they wouldn't simply quit. Bob Williams, a former driver, explains: "The truck is the hook. The reason why these guys can't quit is because they're into a lease situation with the truck and they can't get out of the lease."[101] To address their working conditions without potentially losing their financial investment, drivers may decide to try to form unions—but this proves a daunting task.

Independent contractors are among the estimated 34 million Americans—nearly one quarter of the workforce—without the federally protected right to form a union and collectively bargain.[102] The National Labor Relations Act (NLRA) expressly excludes independent contractors, along with agricultural, domestic, supervisory, and other categories of workers.[103] Because FedEx Ground classifies drivers as independent contractors, the company likely convinces many that they are without the right to form a union and should not bother pursuing union representation. When Rudy Trbovich attended a meeting held by managers soon after his Fairfield, NJ, terminal began organizing, he recounted how "They said that FedEx's policy, as well as their personal opinion, is that there is no benefit to unionizing and organizing and technically…we do not have the right."[104]

Organizing a union is challenging enough for America's workers without having to prove they are employees under the NLRA. When faced with organizing efforts, 30 percent of employers fire pro-union workers, 49 percent threaten to close the worksite, and 51 percent of employers coerce workers into opposing unions with bribery or favoritism.[105]

Unfortunately for the FedEx Ground drivers seeking union representation, they face similar retaliation by the company.[106] This is not surprising, given the company's long history fighting its workers' union efforts.[107]

FedEx has managed to keep its entire company union free, including 60,000 of its drivers, with the exception of its pilots.[108] In 1989, shortly before FedEx acquired Tiger International airline, whose pilots were union members,

CEO Fred Smith told *The Wall Street Journal*, "I don't intend to recognize any unions at Federal Express."[109] In 1991, the federal government found that FedEx illegally interfered with the representation election for the merged group of pilots, and ordered another election, where they then voted for union representation.[110] In 1996, FedEx successfully lobbied Congress to keep its Express employees covered by the Railway Labor Act, which poses huge barriers to organizing compared to the NLRA.[111] And FedEx Ground's decision to classify its drivers as independent contractors appears to be one more anti-union tactic. Philip Harvey, a professor at Rutgers University, spoke to *The Philadelphia Inquirer* about classifying workers as contractors: "As a tactic of avoiding unionization this is very effective. Organizing is much more difficult if it is not clear who the employee is."[112]

When employees who want to form unions are misclassified as independent contractors, they must first convince the NLRB that they are employees. All FedEx Ground drivers who have tried to form a union since 2004 have successfully cleared this hurdle and been declared employees by the Board. These organizing attempts occurred at five terminals: Fairfield, NJ, Barrington, NJ, Hartford, CT, Northboro, MA, and Wilmington, MA.[113] The NLRB rulings were based on several elements, including the fact that drivers performed functions essential to the company's operations, the company exercised substantial control over drivers' performance, and drivers had no proprietary interest in the routes and little opportunity for profit gain or loss.[114] The Regional Director wrote in the Fairfield decision that FedEx Ground "confers little entrepreneurial opportunities… [given] the Employer's unlimited ability to reconfigure routes without drivers receiving payments and by the Employer itself regularly obtaining and providing routes at no cost."[115]

Though the NLRB eventually determined that the drivers were employees, it took an average of 91 days from the day drivers filed a petition seeking an election to certify the union, to the day the NLRB Regional Director ruled on their employee status, and an additional 29 days until the election was held (excluding Northboro, where the election is pending). This significant delay exposes a problem with the system: the more time that passed before workers could proceed to a vote, the longer they were exposed to the vicious anti-union campaign that FedEx Ground unleashed.

Mike Kain, a former driver from the Fairfield terminal, explained how "the whole [NLRB] system is geared toward the company, not the worker."[116] Kain contacted the International Brotherhood of Teamsters, wanting the same benefits they had successfully negotiated for UPS drivers. Almost immediately, 20 of about 38 drivers at Fairfield signed cards supporting the union, and they petitioned for an NLRB election.[117] Yet Kain recounts the effect of FedEx's anti-union campaign as time passed: "Guys started off gung-ho. You go to the first meeting, the second meeting and you get 30 people. Then the company finds out and by the third meeting, you get only 10 people." Over four months after they petitioned with majority support, drivers voted against union representation. This experience is typical of NLRB election campaigns; a recent survey of campaigns by the University of Chicago at Illinois found that 91 percent of union recognition petitions were filed with the NLRB with majority support for the union, yet by the time the election was held, only 31 percent of campaigns voted for union representation.[118]

In response to recent organizing efforts around the company, FedEx Ground sent a company-wide letter to all drivers, warning: "a union would not be helpful to our mutual business relationship," and suggested drivers visit the anti-union Center for Union Facts website.[119] But this anti-union pronouncement was tame compared to the company's targeted anti-union campaigns when drivers at the Fairfield, Northboro, and Wilmington terminals attempted to organize with the Teamsters, and when drivers at the Barrington terminal formed their own union, the FXG-HD Drivers Association. It appears from interviews with drivers involved that FedEx Ground orchestrated the same clearly-laid out plan to quash the union efforts at each of these four terminals.

Elements of the campaign

The following are some of the ways FedEx Ground launches its campaign to search out and destroy union organizing activity.

1. Saturate terminals with anti-union propaganda

Once management gets word of workers' organizing efforts, the first stage of the anti-union campaign is to saturate the terminal with anti-union propaganda. Dennis Lynch, a former driver at the Barrington terminal, recalls that once he and his fellow drivers petitioned for an election with the NLRB, anti-union posters appeared all over the terminal, including in the bathroom stalls.[120] Rudy Trbovich attended an early union meeting for Fairfield drivers on a Friday, and by the following Monday, managers had saturated the terminal with posters.[121]

FedEx Ground also distributed anti-union videos to drivers, and according to complaints filed by the NLRB, it "coercively solicited employees to appear in an anti-union video" in Northboro.[122] Lynch recalls that the company warned in the video "that FedEx could send boxes elsewhere, or even close the terminal at anytime, leaving drivers with their trucks and no work."[123] The NLRB complaints charged the company with illegally threatening to close the Barrington and Northboro terminals.[124]

2. Send in the managers

According to drivers, high-level management from all over the country descended upon the terminals where union organizing was rumored or underway so that they could spread an anti-union message. Donna Eickhorst actively supported the union effort at the Northboro terminal. She estimates that managers from across the country rode in her truck with her six times over the course of three weeks, whereas before the union effort, these "service rides" typically occurred once a year.[125] On one ride, she was accompanied by a manager from Kansas. Shortly before the ride, one of her terminal managers had called her the "ring leader" of the union effort, which caused her to wonder how they knew of her involvement. She asked

Dave McMahon, a former driver in Barrington, NJ, was fired after showing his support for a union

the Kansas manager where he was staying in town. According to Eickhorst, "when he told me the Holiday Inn in Marlboro, which is where we had our union meetings, I almost choked. Then I knew how they knew."

Lynch similarly recalled seeing managers "all over the terminal" once the union effort began, and they would ride with drivers and inquire about the union effort. According to Trbovich, shortly after a union meeting, high-level management from Pittsburgh showed up and held a series of meetings with food for drivers at the end of the day.[126] In a meeting he attended, five different managers spoke: "They announced to us that they 'know a group of drivers met with the Teamsters twice, they know which drivers.'" And in Northboro, Ken Flynn told *The New York Times* that FedEx Ground added six managers who were primarily engaged in the anti-union campaign to the terminal.[127]

3. Woo the drivers

Another element of FedEx Ground's anti-union campaign attempts to address grievances to dissuade drivers from voting for the union. Cathy Curran, of the Wilmington terminal, said: "Every little thing that you told [the company] was wrong, nobody cared about it for five years, and then all of a sudden they are fixing everything that they could possibly

fix."[128] She witnessed the company finally repay drivers for payments long overdue, remove an aggressive manager that drivers complained about, and reconfigure routes to help drivers with the excessive workload. Curran's reaction to the company's effort: "This is the best year I've ever worked for this company."

Dave McMahon recalled similar efforts at the Barrington terminal, as managers helped drivers load their trucks and took people out to steak dinners to sway them against the union.[129] An NLRB complaint charged FedEx Ground with unlawfully soliciting drivers' grievances and bribing drivers with the promise of benefits to discourage them from supporting this union effort.[130]

4. Isolate, intimidate, and even terminate union supporters

The fourth element of FedEx's anti-union campaign is to isolate, harass, and even fire union supporters. Trbovich was among several union supporters terminated during the campaign at the Fairfield terminal. Trbovich attended a union meeting held on a Friday. FedEx got word of the effort, held meetings the following Wednesday, and fired him the next day. He believes "they let me go first because I was the big mouth of the terminal…and I think they thought I organized [the union effort]." He later settled with the company through a private arbitration. Mike Kain, a fellow driver, felt he was forced to quit because of his union activities, and after filing a charge with the NLRB, the company settled.[131]

International Brotherhood of Teamsters

Dennis Lynch, an officer of the union at the Barrington terminal, was fired in March 2005. An NLRB complaint charged that FedEx Ground fired him in retaliation for his testimony at the NLRB hearing to determine drivers' status as employees.[132] He had volunteered to stick his neck out and testify because he "knew there would be bloodshed," and unlike the other drivers, he didn't have a family to support.[133] But Dave McMahon, a fellow officer of the Drivers Association who has three young children, had already been terminated shortly after a brief attempt to form a union at the Camden terminal in December 2004. McMahon recounted that after he was fired, managers told his fellow drivers that they "got rid of the cancer."[134] That organizing attempt ended after McMahon was fired, but he continued to help his fellow drivers in the union effort at the Barrington terminal.

Rick Lacina and Donna Eickhorst spoke about isolation at the Northboro terminal. Lacina recalled how a fellow driver told him that after they spoke at the terminal, a manager immediately called and asked the other driver what they were discussing, later telling him: "It's in your best interest to stay away from [Lacina]."[135] And Eickhorst recounted how a manager accosted her when she spoke to people on the other side of the terminal.[136] An NLRB complaint charged that FedEx Ground illegally separated known union supporters from other drivers where they loaded their vehicles to discourage union activity at Northboro and Barrington.[137] It also charged FedEx Ground with retaliating against Lacina by taking away his pri-

> "In the old days of FedEx, it was 'people, service, profits,' now it's 'profits, service, people.'"
>
> Bob Williams, fired from his Northboro, MA, route, had previously worked as a senior manager for FedEx

mary route, and retaliating against Eickhorst by canceling her direct deposit.[138] Shortly after the NLRB issued this complaint, FedEx Ground fired Eickhorst.

International Brotherhood of Teamsters

"It's good to know that every day, regardless of what's handed to you, you know that the other guys are all going to have your back."

Cathy Curran, right, voted to form a union with her fellow drivers in Wilmington, MA.

Bob Williams, another union supporter at the Northboro terminal, worked as a senior manager for FedEx in the late 1970s, and had enjoyed working for the company. After retirement didn't suit him, he went back to work as a driver. He quickly became frustrated: "In the old days of FedEx, it was 'people, service, profits,' now it's 'profits, service, people.'"[139] He contacted the union, testified at the NLRB hearing to determine the drivers' status as employees, and was fired soon after. An NLRB complaint charged FedEx Ground with illegally firing him in retaliation for his testimony.[140]

5. Challenge election results and stymie negotiations

FedEx Ground also uses legal obstacles to stall union efforts of its drivers. At the Wilmington terminal, despite the company's anti-union campaign, drivers voted to form a union with the Teamsters in October 2006. The company filed an objection to the election, asserting that the immigrant workers could not comprehend English and were misled by a sample ballot distributed by the union before the election.[141] An Administrative Law Judge overruled the objection, writing: "While the Employer here focused its attention on the foreign born, reading difficulties, of course, are not limited to those with a non-English native tongue. Indeed, I do not accept, as the Employer here seems to contend, that one can generalize that there is something qualitatively different between the non-English speaking native's English language deficiencies and reading deficiencies of a native English speaker."[142]

Consistent with its strategy of delay, FedEx Ground appealed the judge's ruling to the Board, which in June 2007 overruled the company's objections and certified the union. In order to throw the case back into the legal system, the company refused to bargain,[143] forcing the union to file an unfair labor practice with the NLRB. According to driver Bill Gardner, FedEx Ground has told drivers that they intend to take the case all the way to the Supreme Court if they have to.[144] Gardner described the frustrations drivers are facing: "It's been shocking. You have a group of people who want to form a union. They go by the book to form the union, and you're not going to let them form the union? It doesn't make any sense. Meanwhile, morale goes down the tubes." Driver Cathy Curran is still hopeful that they will eventually prevail, and in the meantime, "Everyone made a promise to each other that we're going to see this through together. And we are. It's good to know that every day, regardless of what's handed to you, you know that the other guys are all going to have your back."[145]

International Brotherhood of Teamsters

Rick Lacina has seen 15 people leave FedEx Ground in Northboro, MA, in the last year and a half, but says he "wouldn't give them the satisfaction" of quitting

In response to the anti-union tactics employed by FedEx Ground, the NLRB issued complaints charging the company with unlawful threats, interrogation, bribery, soliciting grievances, creating the impression that it was spying on workers' union activities, and harassing, isolating, and firing union supporters.[146] The complaints in Fairfield, Barrington, and Northboro were settled with compensation for the affected drivers, but with no admission by the company that the drivers were employees.

Those who were fired face few solutions, even if the complaints are resolved in their favor. The legal remedy for a terminated employee consists solely of lost wages and cannot compensate for the frustration and humiliation of the job loss, nor can it restore the energy of an organizing effort chilled by the effect of the termination.

Drivers at the Barrington terminal voted for representation by their Drivers Association in December 2005 despite FedEx's anti-union effort there. As Dave McMahon noted of the vote, "It was unbelievable how we prevailed after all this."[147] However, they were never able to negotiate a contract with FedEx Ground. According to McMahon, "We were told that no one was going to tell them how to run their business, and they would never sit and negotiate with us...[and] by the time we were done with the election, FedEx terminated every union supporter except for a few." He is now happily working as an employee, and union member, at DHL.

In Northboro, drivers are continuing to push for union representation, despite fierce opposition by FedEx Ground. After settling with the drivers for proper compensation, the Board has rescheduled the election for February 2008. However, FedEx's fierce opposition to the drivers' union effort has taken its toll.[148] Rick Lacina has seen 15 people leave in the last year and a half, whereas before the union effort, he estimates that roughly five drivers left the terminal in five years.[149] Yet Lacina says he "wouldn't give them the satisfaction" of quitting.

By treating its drivers as independent contractors, FedEx Ground forces those who want to form unions to first prove their status as employees. The time it takes for drivers to prevail at the NLRB further exposes them to FedEx's anti-union campaign. But the impact of this misclassification spreads beyond these terminals. Because FedEx Ground still claims its drivers are independent contractors and the lack of publicity surround NLRB decisions, drivers across the country are likely dissuaded from even attempting to organize. And so 15,000 FedEx Ground drivers toil without the freedom independent businesspeople truly enjoy, and without the freedom to form unions or any collective bargaining rights.

Conclusion and Recommendations:

Changing FedEx's Course

FedEx Ground underscores the impact of crafty legal strategies by employers to defeat employee rights and suppress wages and benefits. Misclassification of workers as independent contractors is an especially pernicious method, which denies civil rights protections and benefits to employees, withholds federal and state tax revenue, and undercuts competition with employers who follow the law. Employees who miss out on the law's benefits and protections carry serious financial burdens and risks. In short, misclassification costs everyone in the system.

The extent of these practices is a growing problem at both FedEx Ground and in the economy as a whole. FedEx Corporation's brand and reputation suffer little despite FedEx Ground's rampant misclassification of so many workers for so many years. Dramatic steps are needed to address these problems at FedEx and other companies. Therefore, the Leadership Conference on Civil Rights and American Rights at Work make the following recommendations:

1. Urge FedEx Corporation to comply in good faith with labor laws

FedEx Ground should cease thwarting its workers' rights by manipulating the legal system. FedEx Ground drivers have repeatedly been deemed employees, and not independent contractors, by legal tribunals. FedEx Corporation should voluntarily classify FedEx Ground drivers as employees and bestow them with all the legal rights and protections to which employees are entitled. This would prevent drivers from being misled or discouraged from asserting their rights as employees because they have been misclassified as independent contractors. It would also eliminate costly litigation hurdles for drivers who wish to assert employment claims against FedEx Ground, and time-consuming delays in union elections that drain momentum from organizing drives.

2. Increase public awareness

The conduct of FedEx Ground and other major companies to this problem has not made headlines or attracted much public attention. Alerting socially-conscious consumers can generate customer-based pressure on FedEx, which will force it to change its ways or risk losing some of its loyal customers. Public pressure can also be brought to bear on responsible shareholders who can use their influence help FedEx to treat workers justly.

3. Pass the Employee Free Choice Act

To better protect the freedom to form unions for drivers at FedEx Ground and elsewhere around the country who encounter fierce resistance from their employers, Congress should pass the Employee Free Choice Act. The bill would grant workers union representation after a majority present signed authorization cards to demonstrate their choice to belong to a union. This right to a "majority sign-up" would have given FedEx Ground drivers union recognition at the Hartford, Wilmington, Northboro, Fairfield, and Barrington terminals when they first petitioned for an election at the NLRB, preventing exposure to FedEx's anti-union campaign while they awaited an election.

The Employee Free Choice Act also includes a provision for "first contract arbitration" to prevent employers from engaging in "bad faith bargaining" and otherwise refusing to sign an agreement. This provision could have provided the drivers at the Barrington terminal with the power to reach a contract with FedEx, despite the company's apparent unwillingness to bargain. Finally, the legislation would increase penalties against employers who engage in illegal activity during organizing and first contract campaigns, potentially preventing the slash-and-burn tactics used by FedEx Ground against its drivers in the form of interrogation, threats, bribes, and firings.

4. Improve enforcement of existing laws, encourage closing loopholes, and enact strong new protections for workers

At both the federal and state levels, legislators must devote more resources to strengthening enforcement of the existing law. A greater investment may even pay for itself when offending employers are forced to pay taxes owed, as mentioned by the IRS in a recent announcement to focus on employer misclassification.[150] Agencies must use the resources they do have to perform more targeted audits of employers based on industries where misclassification is widespread, such as construction and trucking. The various agencies involved should also be encouraged, to the extent possible, to pool resources, share information and investigatory results, and jointly remedy instances of worker misclassification.

Officials appointed to enforce our labor laws must be willing to protect the rights of workers with diligence and resolve. Recent lax enforcement among executive agencies and departments has threatened to moot existing laws that protect workers from misclassification and anti-union conduct.

In addition to greater enforcement of current law, federal and state legislators must act to protect workers regardless of labels as employees or contractors. One way to accomplish this is to enact a presumption of employee status for all individuals who perform labor or services for a fee. Massachusetts and Illinois enacted such laws that place the burden of proving independent contractor status on employers, giving misclassified workers access to key benefits and protections. Congress must also close the loopholes in the Internal Revenue Code that allows pervasive misclassification and increase the penalties for companies that misuse independent contractor status as a primary means of employment.

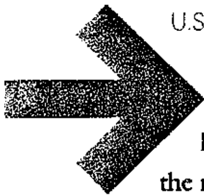
5. Improve procedures and increase congressional oversight at the National Labor Relations Board

The NLRB must do a better job of guaranteeing collective bargaining rights at FedEx Ground and other employers where supposed independent contractors are organizing. In case after case at each individual FedEx Ground facility, the Board has ruled that the drivers are in fact employees. Despite these rulings, drivers that sought to organize still had to endure additional proceedings at which FedEx Ground re-litigated the same issue, further delaying an election and exposing drivers to the company's anti-union campaign. According to former NLRB General Counsel Fred Feinstein, "The agency should be able to find ways to inhibit an employer's ability to delay an election by asserting an already settled issue."[151] Congress must look closely at the agency to be certain it is doing its utmost to safeguard the rights of workers it is charged with protecting, such as using accelerated election and complaint-processing schedules, as well as discretionary injunctions to promptly stop unlawful employer conduct during union campaigns.

FedEx Ground epitomizes corporate America's use of clever maneuvering and exploitation of legal loopholes to deny workers their rights and dignity. That such a well-known brand can get away with what appears to be widespread misclassification of its workers indicates a serious lack of public awareness and government responsiveness toward this problem. American Rights at Work and the Leadership Conference on Civil Rights call for significant labor reforms to ensure that the drivers who are battling workplace intimidation and harassment and lengthy, expensive court cases will have their rights recognized and vindicated.

Epilogue

By Ray Marshall
U.S. Secretary of Labor, 1977-1981

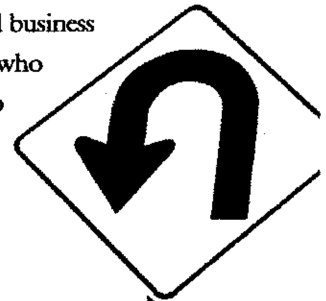


Fed Up with FedEx documents serious threats to legal protections for America's workers, especially the right to organize and bargain collectively. All who are interested in strengthening workers' rights, democratic institutions, and promoting broadly shared prosperity should support the recommendations outlined in this report.

The 1935 National Labor Relations Act (NLRA) extended this basic right to private sector employees and, like every other advanced industrial democracy, the United States subscribed to the principle that independent labor organizations, that represent employees at work and in the larger society, are essential to free and democratic societies. Indeed, this principle has long been a basic tenet of U.S. foreign policy, especially during the Cold War. There can be little doubt that free trade unions played important roles in the transition to democracy in Eastern Europe, South Africa, Asia, and the Americas. The United States also has joined most other countries in declaring the ability to organize and bargain collectively as a fundamental human right.

Despite these acknowledgements, America's workers have less representation at work and in the society and polity than their counterparts in other advanced democratic countries. Indeed, despite polls showing that a clear and growing majority of non-union workers would like to be represented by unions,[152] a declining percentage of private sector workers actually have collective bargaining coverage. There are many reasons for this mismatch between reality and what workers would like, including the NLRA's weak penalties and basic unfairness to workers, the National Labor Relations Board's reluctance to use its power to protect workers' rights, and the fact that union avoidance by legal and illegal means has become both more acceptable and institutionalized by anti-union employers and consultants. A major objective of these campaigns is to strike fear in the hearts of workers by showing them that not even the federal government can protect their bargaining rights from assaults by determined employers and their anti-union allies.

The Carter administration's labor law reforms were designed to improve workers' organizing rights by strengthening the NLRA's penalties and creating more fairness in representation elections by preventing tactical delays designed to erode union support. These reforms had broad public and bipartisan political support as demonstrated by the fact that our bill passed the House of Representatives with almost a 100-vote majority. Although we had 58 solid votes for passage in the Senate, we were unable to break a filibuster by anti-union senators backed by solid business opposition. Even those employers who privately acknowledged the need to modernize the NLRA refused to openly support this legislation.



It is ironic that the same forces that blocked our attempt to ensure fair representation elections now oppose the Employee Free Choice Act on the grounds that majority sign-up, designed to preempt unfair campaigns and delaying tactics, violates workers' rights to fair elections. To paraphrase Alfred North Whitehead, to believe that NLRB elections are fair would require a temporary suspension of disbelief. The Employee Free Choice Act would not take away employees' ability to have elections, but it would moderate employers' ability to use delaying tactics and other actions documented in this report to intimidate enough employees to erode majority support for collective bargaining. What anti-union employers and consultants fear most is that the Employee Free Choice Act would demonstrate that the federal government could, in fact, protect workers' free choice.

The damage FedEx Ground does to workers' rights by misclassifying employees as independent contractors goes far beyond employers' fairly common anti-union tactics. These misclassifications would nullify the protections that the U.S. and other advanced democracies have extended to all workers. Wage and hour, anti-discrimination, occupational safety and health, pension protection, and unemployment compensation policies are all designed to protect employees from discriminatory actions by employers, as well as from damage that could be done to workers, their families, and the public by unemployment or substandard wages and working conditions. Some measures, like safety and health protections, prevent employers from shifting the costs of injuries and occupational health hazards to workers and the public. By maintaining workers' purchasing power, labor standards strengthen the national economy.

Misclassifying employees as independent contractors comes at a time when workers' ability to protect themselves has already been seriously weakened by globalization and court interpretations which have eroded worker protections. It is predictable that the competitive advantage FedEx Ground would gain from this subterfuge would cause this practice to spread rapidly to other employers, thus multiplying the damage to the national economy.

It is ironic that one of the factors causing FedEx Ground to argue that its drivers are independent contractors—the technical ownership of their trucks—binds these employees to the company, just as indebtedness to the company store bound workers to plantations, mines, and mill factories. It has become fashionable in some circles to argue that worker protections cause our economy to be less competitive in global markets. This argument is based on the belief that authoritarian management systems and low wages are the best way to compete. However, a low-wage strategy is a loser—it implies lower and more unequal wages and economic instability, since there are always places with lower wages. It would be much better, and more compatible with democratic institutions, to compete by improving value added (i.e., productivity and quality).

A value-added strategy promotes broadly shared prosperity and stresses the development of human resources, high performance organizations, worker participation, and continuous innovation and improvement through research and development. This sustainable high-road strategy clearly requires worker protections and social safety nets both to facilitate effective employee involvement in workplace and national decisions, and moderate management's natural preference for low-wage strategies.

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