

The Problem of Worker Misclassification

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Summary

Employee misclassification is a significant problem that continues to plague the labor market. Unscrupulous and unknowing employers alike are costing individual workers and society tremendously. Not only are workers missing out on legal protections, but society is losing contributions from employers that should be paid into different employment systems (payroll taxes, unemployment benefits, workers compensation benefits, etc.). In order to combat this problem I recommend

- targeted enforcement of misclassification,
- expansion of laws covering independent contractors,
- cross agency collaboration, and
- a single, unified test for determining whether a worker is an “employee.”

What is employee misclassification?

Employee misclassification occurs when an employer categorizes an employee or group of employees as an ‘independent contractor’ instead of an employee.¹

What is the difference between an employee and an independent contractor?

The fundamental difference between an employee and an independent contractor is control over the work being performed. “Employers have the right to direct the means, methods and outcome of their employees’ work. Independent contractors, properly classified, are not employees but are in business for themselves. They are hired to accomplish a task or tasks determined by the employer but retain the right to control how they will accomplish it².”



Why do employers misclassify their employees as independent contractors?

Perhaps a small reason, but one important to note, is that different laws (for example, tax laws and labor laws) define “employee” and “independent contractor” differently³. As a result, some employers, without any illegal intent, are misclassifying their employees due to the confusing and ambiguous nature of the law.

More centrally, many employers intentionally misclassify their employees as independent contractors to save money. “Employers have powerful economic incentives to limit or cut labor costs . . . The immediate advantages are, for many employers, worth the remote risk of being caught and penalized⁴.” Employers who misclassify their employees generally avoid many of their obligations under employment, including labor, tax, wage and anti-discrimination statutes. For example, the Fair Labor Standard Act (FLSA) sets a standard for minimum wages and overtime pay. However, the FLSA only applies to employees and not independent contractors⁵.

Further, the Americans with Disabilities Act (ADA), the Family Medical Leave Act (FMLA), Age Discrimination in Employment Act (ADEA), the National Labor Relations Act (NLRA) and Title VII, all statutes designed to protect and enhance worker rights, apply only to employees and not independent contractors⁶. Employers who misclassify also avoid paying worker’s compensation insurance, payroll taxes and unemployment insurance. This can give these employers an unfair increased advantage in the economic market by lowering their costs and expenses.

Of all these factors, avoiding workers compensation costs may be the largest motivation behind employers who misclassify their employees. “Avoiding workers compensation payments is the leading reason that employers intentionally misclassify workers, a larger factor than non-payment of unemployment insurance contributions⁷.” As will be elaborated on below, this leads to increased costs for the businesses who are properly classifying their workers as employees and it puts law abiding companies at a competitive disadvantage.

What are the costs associated with the misclassification of employees?

The costs to workers and society by misclassification are extensive. States are losing large amounts of revenue. “At income tax time, workers misclassified as independent contractors are known to under-report their personal income. Therefore, the state experiences a loss of income tax revenue⁸.” In 2004 this was estimated to cost the State of Massachusetts alone \$152 million in lost revenue⁹.

The misclassified employees are also victims; they may lose out on overtime or minimum wage pay, workers compensation benefits, and unemployment benefits. They may also face discrimination without the protection and remedies afforded by employment laws. Misclassified workers may also be discriminated against based on union affiliation or activities, because the National Labor Relations Act (“NLRA”) does not extend its protections to independent contractors.

Businesses that compete against employers who misclassify their employees are put in a competitive disadvantage¹⁰. “Misclassification destabilizes the business climate, creating an unlevel playing field and causing law-abiding businesses to suffer unfair competition¹¹.” As mentioned previously, employers who misclassify their employees avoid having to pay a number of taxes. This cuts an employer’s costs and allows them to underbid their law-abiding competition. This can be especially detrimental to employers in industries that use a competitive bidding system, such as the construction industry¹².

Furthermore, law-abiding businesses end up picking up the slack for businesses that are misclassifying their employees. “Responsible employers carry an undue burden: to the extent that misclassifying employers are not paying into insurance funds, responsible employers making up the difference in higher premiums¹³.” Therefore, not only are these employers causing the government to lose out on money, but they are also increasing costs for employers who are following the law and classifying their employees properly.

What are the costs of employee misclassification in New York?

New York State faces the same challenges as other states. A 2007 report based on Department of Labor (DOL) audits covering most of New York’s major industries¹⁴ found that between the period of 2002-2005 in New York State, each year the average amount of income underreported to the unemployment insurance program was \$4,283,663,772¹⁵. The amount in underreported unemployment insurance taxes over the same time equaled \$175,674,161. Given the difficult economic times the State is facing¹⁶, it desperately needs use of all possible revenue streams.

Individual workers across the state are suffering through misclassification as well. The DOL estimates that an estimated 39,587 New York employers in the audited industries misclassify some 704,785 employees each year. That amounts to 10.3% of the private sector workforce within the audited industries¹⁷.

What solutions have been suggested?

Given the widespread nature of worker misclassification, several solutions are needed. First, agencies that enforce labor standards should focus their

efforts on high profile cases of misclassification that will garner a lot of attention in the media and the employer's industry. Going after the largest employers or most blatant cases of misclassification in an industry will send a message that misclassification is taken seriously and that an employer will be prosecuted to the full extent of the law for a violation.

Next, the guidelines for determining whether a worker is an independent contractor or an employee should be clarified, and to the extent possible, made uniform. Many employers are not intentionally misclassifying their workers. The misclassification is the result of confusion over the existing laws and the ambiguous and multi-factored nature of the tests used to determine worker status.

Perhaps creating a legal presumption that all workers are employees would help to alleviate the problem of employers accidentally misclassifying their workers¹⁸. In 2008, a bill had been proposed in the New York State Senate creating just such a legal presumption, but no action has since been taken¹⁹. Another possibility is to simply extend more legal protections to independent contractors²⁰. Why should an employer be allowed to discriminate against workers based on sex, age, religion, national origin, disability, etc. simply because they are independent contractors?

New York could also pass legislation to increase penalties against employers who misclassify their employees²¹. If employers feel that the chance of getting caught is low and the penalties for being caught are also low, then they are less afraid to misclassify. By increasing penalties, the state will make many employers think twice about improperly misclassifying their employees.

Finally, the government should extend educational outreach programs to both employers and employees²². This helps honest employers by showing them how to determine a workers classification. This also helps employees by teaching them how classification status is determined. Employees could then determine whether they feel they are being misclassified and could go to the appropriate government agency for help. This helps to put power in the hands of workers so that they can help combat the misclassification problem that is occurring in an alarming rate across the state of New York.

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- ¹ “The Cost of Worker Misclassification in New York,” Donahue, Lamare, Kotler (Cornell, 2007)
- ² Ibid. note 1.
- ³ “Who's an Independent Contractor - Who's an Employee,” Barron, Myra H., 14 Lab. Law. 457 (1998-1999)
- ⁴ Ibid. note 1.
- ⁵ Ibid. note 3.
- ⁶ Ibid. note 3.
- ⁷ Ibid. note 1.
- ⁸ “The Social and Economic Costs of Employee Misclassification in Construction,” Carre and Wilson (Harvard, 2004)
- ⁹ Ibid. note 7.
- ¹⁰ “The Economic Costs of Employee Misclassification in Illinois,” Kelsay, Sturgeon, and Pinkham (2006).
- ¹¹ Ibid. note 1.
- ¹² Ibid. note 1.
- ¹³ Ibid note 1
- ¹⁴ Industries covered by DOL audits for the years 2002-2005 include: construction; manufacturing; wholesale and retail trade; transportation and warehousing; information; finance and insurance; real estate; professional, scientific, and technical services; administrative and support and waste management and remediation services; health care and social assistance; arts, entertainment, and recreation; other industries.
- ¹⁵ Ibid. note 1.
- ¹⁶ “New York State Budget Late for 15th day as Senators Squabble,” Seiler, Casey, Albany Times Union, <http://www.timesunion.com/AspStories/story.asp?storyID=921794&category=REGION>, Accessed April 14, 2010.
- ¹⁷ Ibid. note 1.
- ¹⁸ Ibid. note. 1.
- ¹⁹ “Summary of Independent Contractor Reforms State and Federal Activity,” Ruckelshaus, Catherine (July 2008).
- ²⁰ Ibid. note 1.
- ²¹ Ibid. note 10.
- ²² Ibid. note 1.