

EXECUTIVE SUMMARY

As the economy continues to change, workers seeking a more flexible work environment and some who were displaced by corporate downsizing have become independent contractors. Also, the changing nature of employment and the increased use of those in the alternative workforce by businesses, including independent contractors (ICs), has attracted the attention of policymakers, because the prevailing employment and labor laws often do not cover those in the alternative workforce.

The purpose of the study was to provide a better understanding of the IC work arrangement and its potential impact on Unemployment Insurance (UI). The research design addressed the following questions: Who are ICs? Is there a variance in the IC classification system? Which occupations and industries are they in? Is the IC phenomenon employer driven or worker driven? Do employers deliberately misclassify employees as ICs, and if so, what is the impact on trust funds?

In order to obtain information on ICs from as wide a variety of sources as possible, and in a cost-effective manner, the methodology used included a review of literature, research on the definitions and tests used by states to determine IC status and data collection on a variety of relevant issues. Interviews were conducted with representatives from State Employment Security Agencies (SESAs), Wage and Hour, Workers' Compensation, employer organizations, unions and advocacy groups to obtain insight on IC use, misclassification and the strategies implemented to regulate and monitor ICs.

Based on definitions of standard employer-employee relationships and the classification criteria used by the Internal Revenue Service (IRS) and SESAs, ICs are:

1. Those who are classified as ICs according to their state classification systems and receive the IRS form 1099-Misc from employers reporting receipt of "non-employee compensation,"

2. those employees who should receive the IRS form W-2 reporting receipt of “employee compensation,” but are deliberately misclassified by employers as ICs and instead receive form 1099s, and
3. those ICs and workers who operate underground and don’t receive either a 1099 or a W-2 from their employers.

The statewide variance in the IC classification system concerns many within the government and business communities. The legal research revealed that the basic rationale in determining IC status is the extent of control exercised by the employer over the manner and means under which an activity is to be performed by the worker. State laws dealing with classification vary and reflect each state’s social and economic philosophy and are shaped and clarified by the judicial process. Ultimately, for UI purposes, in the absence of clearly defined standards for determining IC status and employer liability, in each state the administrative agency officials and courts settle disputes by consulting their state’s definition, applying their state’s test and law (ABC, common law or economic reality test).

The issue of which test is better continues to be debated because each side has a vested interest in safeguarding their legal position. Proponents of change want to introduce a greater degree of certainty and simplification to the classification process, asserting that the current system has outlived its usefulness and is not responsive to the changing ways in which individuals work and business is conducted. Those who oppose changes to the current system believe that the underlying reason is an attempt to shift most of the costs of social benefits and protections from employers to workers.

There is a debate as to whether the IC phenomenon is driven by worker preference or employer demand. Employers and conservative politicians believe that worker preference is driving IC growth. They focus on the benefits of the working arrangement and view ICs as a positive force shaping the economic and social landscape. Union leaders and liberal politicians focus on the human costs of independent contracting, without acknowledging that the new arrangements may also provide more productive

ways of organizing work in today's environment. They view the growth as being primarily employer driven and as a disadvantage to workers. They are troubled by the fact that employees who prefer the stability of regular full-time employment are being compelled by employers to accept IC status or are being deliberately misclassified.

The general consensus of the study respondents on the demographic profile ICs was that there is no typical profile. ICs are males or females and of all ages and of a variety of ethnic origins. They have different education and skill levels. The majority earns middle to low-level wages and has no health insurance or retirement benefits. Construction, trucking, home health and hi-tech industries were frequently mentioned as examples of industries most likely to use ICs or lure workers into becoming ICs and contain high incidences of misclassification.

The number one reason employers use ICs and/or misclassify employees is the savings in not paying workers' compensation premiums and not being subject to workplace injury and disability-related disputes. Another reason is the avoidance of costs associated with employee lawsuits against employers alleging discrimination, sexual harassment, and implementing regulations and reporting procedures that go along with having employees. Understanding and complying with all the labor and worker protection laws is often beyond the capabilities of many small businesses. Even governmental agencies use ICs to avoid conferring employee status and attendant benefits because they have authorization to spend money on contracted services, but not on full-time employees.

The report contains an analysis of aggregate employer audit data from nine states that was extrapolated to each state's workforce to provide a rough measure of the extent of employee misclassification as ICs. The percentage of audited employers with misclassified workers ranged from approximately 10% to 30%. The percentages of UI tax revenues underreported due to misclassification varied from 0.26% to 7.46%.

A national-level estimate of the impact of misclassification on the trust fund was also computed for the period 1990-98. It showed a net impact on trust funds ranging from a

\$100 million outflow in 1991 to a \$26 million inflow in 1997. Assuming a 1% level of misclassification over the 9-year period, the loss in revenue due to underreporting UI taxes would be an annual average of \$198 million. If unemployment remained at the 1997 level, the benefits payable to misclassified claimants would be on average \$203 million annually. ***A more significant item of concern is that annually there are estimated to be some 80,000 workers who are entitled to benefits and are not receiving them. One observation expressed by most interviewees was that an increase in the unemployment rate could precipitate an avalanche of IC related issues.*** Workers operating under what at present looks like a good IC agreement would be filing UI claims alleging employee status. The administrative burden associated with a significant rise in contested claims could prove disruptive to orderly claims processing.

A new breed of accountants and attorneys has emerged to counsel employers on how to convert employees into ICs to reduce payroll costs and avoid complying with labor and workplace legislation. In every state that participated in the study, in occupations where misclassification frequently occurs and is discovered by audit staff, these firms have gone to the state legislatures to represent the employers and request exemptions from UI. Such efforts if they are successful, deprive claimants of the coverage they are entitled to and reduce the shared cost intent of the UI trust funds. The current mood in the judicial and legislative systems in many states is very pro-employer and political events are resulting in even more occupations receiving exclusions.

A multi agency dialogue needs to be started to explore the feasibility of extending some or all of the social protections now available to employees to ICs, who are currently denied protection or cannot afford to take full advantage of its availability. For example, should ICs participate in unemployment insurance, including payment of contributions? Should workers' compensation be mandatory for them? Should independent contractor agreements be subject to certain requirements such as the payment of a minimum wage? These are a few of the questions that need to be answered in order to respond to the needs of this increasingly important segment of the nation's workforce.