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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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