

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

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A Report by the

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I. Summary Findings

This report is a first step in analyzing the economic implications of employee misclassification for both the public and private sectors in the State of Indiana. It is based upon 1) aggregate audit data for the five-year period 2004-2008 and 2) detailed audit data for the two-year period 2007-2008, both provided by the Indiana Department of Workforce Development (IDWD). It also utilizes the results of similar studies on misclassification previously developed in other states. In this report, we analyze the scope and trends of misclassification in Indiana. We provide estimates of the impact of misclassification in Indiana for state and local tax revenues, the unemployment insurance fund, and worker's compensation.

Misclassification negatively impacts the citizens of Indiana in a number of ways. First, the conditions for a fair and competitive marketplace are sabotaged. Employers who misclassify their workers have a pricing edge over their counterparts which results in unfair competition in the marketplace. Firms that misclassify workers 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 10% to 20%.

Secondly, misclassifying workers negatively impact the public sector in Indiana by: (1) reducing the unemployment insurance taxes the state would collect if these employees were properly classified; (2) reducing the worker's compensation fund because Indiana does not collect the insurance premiums due, and (3) reducing the amount of income taxes collected by both state and local governments.

While state laws vary with respect to who is an employee and who is classified as an independent contractor, each state uses some defined criteria. Indiana General Assembly Statute, IC 22-3-6-1(b) (7) states:

"A person is an independent contractor in the construction trades and not an employee under IC 22-3-2 through IC 22-3-6 if the person is an independent contractor under the guidelines of the United States Internal Revenue Service."

Because the State of Indiana has adopted the same guideline as the Internal Revenue Code, the IRS definitions apply at the state level in Indiana. Previously, the IRS used a "Twenty Factor Test" for the determination of

independent contractor status. It has recently simplified the test and now employs a multi-factor common law test that consolidates the twenty factors into eleven main tests, and organizes them into three main categories: (1) behavioral control, (2) financial control, and (3) the type of relationship between the parties.¹

Misclassification arises from two potential sources. First, an employer may claim that a worker meets the common law standard as defined by the Internal Revenue Service and is, in fact, an independent contractor. This may simply be an error or the employer may be attempting to avoid the legal and financial responsibilities they would incur if the worker was classified an employee rather than as an independent contractor. The second source of misclassification may be a situation of an unreported worker, i.e., a worker whose employment either as an employee or as an independent contractor is simply not reported in order to avoid the legal and financial responsibilities for the worker.

If an employee is classified as an independent contractor, the “employer” is not required to pay and/or withhold a variety of payroll-related taxes, fees and benefits (e.g., social security and medicare taxes, local, state and federal income taxes, unemployment insurance, workers compensation, pension and health benefits, etc.). Not only are these costs shifted to the individual worker, the “independent contractor” is also not fully protected by various employment laws (e.g., minimum wage and overtime requirements, workers compensation protection, the right to form a union and bargain collectively, etc.) and may, incorrectly, believe that he or she is protected by Indiana unemployment laws. If a person is classified as an independent contractor, “employers” are required to issue a 1099-MISC for payments for work in excess of \$600 or more.

The issue of misclassifying employees as independent contractors is a growing problem for the unemployment insurance system and state and local revenues in Indiana and other states, as well as the federal government. This occurs because employers remit their unemployment taxes and other tax streams based upon their payroll. Recent studies have shown that misclassification by employers is increasing. For example, the rate of misclassification by employers in Illinois was shown to be 22.8% in 2001 and had increased to 31.9% and 27.6%

¹ Department of the Treasury. Internal Revenue Service. Publication 15-A. Employer’s Supplemental Tax Guide. (Supplement to Publication 15 [Circular E], Employer’s Tax Guide). Pages 6-7.

in 2004 and 2005, respectively.^{2,3} In a report by the Ohio Attorney General on February 18, 2009, the number of workers who were reclassified in 2009 increased 53.5% over the total number reclassified in 2008.⁴ Note, the “underground economy” (workers paid in cash) is outside the scope of our study and, thus, the estimates we provide may underestimate the full extent of the problems associated with the employer practice of misclassification in Indiana.

A number of studies have shown that the problem of misclassification to be particularly acute in the construction sector. In three state level studies (Massachusetts, Maine, and New York), the incidence of misclassification in the construction sector is higher than other industries in those states. For Massachusetts, the moderate statewide rate is 19%, while the rate of misclassification in the construction sector is 24%⁵; for Maine, the low statewide estimate is 11% compared to 14% in the construction sector.⁶ In New York, the statewide rate of misclassification for 2005-2008 was 10%, while the rate of misclassification in the construction sector for this same time period was 15%.⁷ The United States Government Accounting Office [GAO] reported that the percentage of misclassified workers in all industries was 15%, while the percentage of misclassified workers in the construction sector was 20%.⁸

² Kelsay, Michael P., PhD, James I. Sturgeon, PhD., and Kelly D. Pinkham, M.S. *The Economic Costs of Employee Misclassification in the State of Illinois*. A Report by the Department of Economics. University of Missouri – Kansas City. December 6, 2006. Page 16.

³ Carre, Francoise, Ph.D. and Randall Wilson. *The Social and Economic Costs of Employee Misclassification in Construction*. A Report for the Construction Policy Research Center and Labor and Worklife Program. Harvard Law School and Harvard School of Public Health. Elaine Bernard, Ph.D. and Robert Herrick, ScD, Principal Investigators. December 17, 2004. Pages 12-13.

⁴ Cordray, Richard. Ohio Attorney General. *Report of the Ohio Attorney General on the Economic Impact of Misclassified Workers for State and Local Governments in Ohio*. February 18, 2010.

⁵ Carre, Francoise, Ph.D. and Randall Wilson. *The Social and Economic Costs of Employee Misclassification in Construction*. A Report for the Construction Policy Research Center and Labor and Worklife Program. Harvard Law School and Harvard School of Public Health. Elaine Bernard, Ph.D. and Robert Herrick, ScD, Principal Investigators. December 17, 2004.

⁶ Carre, Francoise, Ph.D. and Randall Wilson. *The Social and Economic Costs of Employee Misclassification in the Maine Construction Industry*. A Report for the Construction Policy Research Center and Labor and Worklife Program. Harvard Law School and Harvard School of Public Health. Elaine Bernard, Ph.D. and Robert Herrick, ScD, Principal Investigators. April 25, 2005.

⁷ Donahue, Linda H., James Ryan Lamare, and Fred B. Kotler, J.D. *The Cost of Worker Misclassification in New York State*. ILR Collection. Research Studies and Reports. Cornell University ILR School. Year 2007.

⁸ United States General Accounting Office. *Tax Administration: Issues in Classifying Workers as Employees or Independent Contractors*. GOA/T-GGD-96-130.

A U.S. Census Bureau analysis of projected nonfarm wage and salary employment by major industry division for the period 2008-2018 shows that the growth in overall employment is projected to increase 10.6%, or at an annual rate of increase of 1.0%; and, in construction, the growth in employment is projected to increase 18.5%, or at an annual rate of increase of 1.7%.⁹ Given the projected growth in the construction sector, the impacts of misclassification will worsen.

Specific Findings for Indiana Employee Misclassification

- For the years 2007-2008, state audits found that 47.5% of audited employers had misclassified workers as independent contractors. This translates into approximately 73,629 employers statewide of which 8,200 were in construction. In 2008, the rate of misclassification was slightly lower at 46.6%. This translates into 72,299 employers statewide of which 8,052 employers in construction.¹⁰ Based upon the fact that 35.5% of the total audits were industry targeted, **the rate of misclassification in Indiana would be higher than in those states with a low level of targeted or non-random audits.**
- **When an employer practices misclassification in Indiana, 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 IDWD, 29.5% of workers were misclassified by employers that were found to be misclassifying for the period 2007-2008. In 2007, 31.6% of workers were misclassified by employers who were found to be misclassifying; this rate of misclassification was 27.4% in 2008.
- **From our analysis of the labor force of all employers in Indiana (those that misclassify and those that don't), we estimate that 16.8% of employees in Indiana were misclassified as independent contractors for the period 2007-2008.** For the year ending 2008, we estimate that 15.3% of employees were misclassified.

⁹ Bartsch, Kristina J. *Occupational Employment Projections for 2008-2018*. Monthly Labor Review. November 2009. Pages 3-10.

¹⁰ Based upon data from the United States Bureau of Labor Statistics, Quarterly Census of Employment and Wages, the average number of all employers over the period 2007-2008 was 17,264 in construction and 154,155 in all industries. <http://www.bls.gov/data/>.

- The number of employees statewide that were affected by improper misclassification is estimated to have averaged 418,086 annually for the period 2007-2008. For 2008, the estimated number of employees affected by misclassification was 377,742. Within the construction sector for the period 2007-2008, the number of employees affected by misclassification is estimated to have averaged 24,891. In 2008, the estimated number of misclassified employees in the construction sector was 24,323.
- **Misclassification of employees has a negative financial impact on individual workers, Indiana state and local governments, and the private sector in Indiana.** 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 and local income tax revenues, the unemployment insurance system, and worker's compensation in Indiana are adversely affected as well. Misclassification also imposes other costs on employers who play by the rules, the general health delivery system, taxpayers, and the public at large.
- **We estimate that the unemployment insurance system lost an average of \$36.7 million each year for the period 2007-2008 in unemployment insurance taxes that were not levied as a result of misclassification. In 2008, we estimate that the unemployment insurance system in Indiana lost \$30.4 million in unemployment insurance taxes.** A portion of this lost revenue may be recaptured when an audit reveals a misclassified worker where contributions are due. In 2008, for example, the amount of net contributions recaptured from IDWD audits was approximately \$1.02 million; equaling 2.8% of the total amount that we project was not collected in 2008.
- **For the construction sector, we estimate that the unemployment insurance system lost an average of \$2.2 million annually for the period 2007-2008 in unemployment insurance taxes that were not levied as a result of misclassification.** For 2008, we estimate that the unemployment insurance system in Indiana lost \$2.0 million in unemployment insurance taxes 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, state and local governments in Indiana suffer a loss of income tax**

revenue. According to 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 Indiana is not reported, **we estimate that \$147.5 million annually of state income tax revenues were lost in Indiana for the years 2007-2008. In 2008, we estimate that \$134.8 million of state income tax revenues were not collected in Indiana.** For the construction sector, we estimate that \$10.7 million annually of state income tax revenues were lost in Indiana for the years 2007-2008. For 2008, we estimate that \$10.6 million of state income tax revenues were lost in the construction sector in Indiana.
- Based upon the higher estimate that up to 50% of the income of misclassified workers is not reported, **an estimated \$245.8 million annually of state income tax revenues were lost, on average, in Indiana for the years 2007-2008. For 2008, we estimate that \$224.6 million of state income tax revenues were lost in Indiana.** For the construction sector, we estimate that an average of \$17.7 million annually of state income tax revenues were lost in Indiana for the years 2007-2008. For 2008, we estimate that \$17.8 million of state income tax revenues were lost in the construction sector in Indiana.
- Based upon an estimate that 30% of the income of misclassified workers is not reported, **we estimate that an average of \$59.9 million of Indiana local government income tax revenues were lost annually during the period 2007-2008 due to unreported income. For 2008, we estimate that \$54.7 million of Indiana local income tax revenues were lost.** In the construction sector, we estimate that \$4.3 million of Indiana local government income tax revenues were lost during the period 2007-2008. For 2008, we estimate that \$4.3 million of Indiana local government income tax revenues were lost from construction sector income.
- Based upon an estimate that 50% of the income of misclassified workers is not reported, **we estimate that an average of \$99.8 million of Indiana local government income tax revenues were lost annually during the period 2007-2008 due to unreported income. For 2008, we estimate that \$91.2 million of Indiana local government income tax revenues was lost.** In the construction sector, we estimate that \$7.2 million of Indiana local government

income tax revenues were lost during the period 2007-2008. For 2008, we estimate that \$7.2 million of Indiana local government income tax revenues were lost from construction sector income.

- 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 conducted for the U.S. Department of Labor reported that **the cost of worker's compensation premiums is the single most dominant reason why employers misclassify.**¹¹ Employers who misclassify can underbid the legitimate employers who provide coverage for their employees. **The practice of misclassification shifts the burden of paying worker's 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 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 for 2008, we estimate that, for the period 2007-2008, \$24.1 million annually of worker's compensation premiums were not properly paid for misclassified workers.** For 2008, we estimate that \$26.3 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 Indiana, the statewide rate for all industries averaged \$2.06 in 2008 (per \$100 of payroll).¹² However, within construction, rates are substantially higher. For example, the workman compensation rate for Carpentry (Class 5403) was \$7.29 per \$100 of payroll and Roofing-All Kinds (Class 5551) was \$10.88 per \$100 of payroll.¹³

¹¹ Planmatics, Inc. For the U.S. Department of Labor – Employment and Training Administration. *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs*. February, 2000.

¹² One Southern Indiana. Chamber & Economic Development. Worker's Comp Rates. http://www.1si.org/taxes_workers_comp_rates.asp.

¹³ Oregon Department of Consumer & Business Services. *Oregon Workers' Compensation Premium Rate Ranking, Calendar Year 2008*. March 2009.

- Using an average premium rate of \$5 per \$100 of payroll, we estimate that for the period 2007-2008 an annual average of \$4.2 million of worker's compensation premiums were not properly paid by construction employers in Indiana. For 2008, \$4.6 million of worker's compensation premiums were not properly paid by construction employers in Indiana.
- Using a higher average premium rate of \$10 per \$100 of payroll, we estimate this average annual amount for the period 2007-2008 to be \$8.4 million. For 2008, \$9.2 million of worker's compensation premiums were not properly paid by construction employers in Indiana.

Summary of Losses to Indiana as a Result of Misclassification of Employees				
	Option 1 ¹		Option 2 ²	
	2007-2008 Average	2008	2007-2008 Average	2008
State of Indiana				
1. Lost Unemployment Insurance Taxes	\$36,700,000	\$30,400,000	\$36,700,000	\$30,400,000
2. Lost State Income Taxes	\$147,500,000	\$134,800,000	\$245,800,000	\$224,600,000
3. Lost Local Income Taxes	\$59,900,000	\$54,700,000	\$99,800,000	\$91,200,000
4. Lost Worker's Compensation Premiums	\$24,100,000	\$26,300,000	\$24,100,000	\$26,300,000
Total Economic Losses: State of Indiana	\$268,200,000	\$246,200,000	\$406,400,000	\$372,500,000
State of Indiana: Construction Industry				
1. Lost Unemployment Insurance Taxes	\$2,200,000	\$2,000,000	\$2,200,000	\$2,000,000
2. Lost State Income Taxes	\$10,700,000	\$10,600,000	\$17,700,000	\$17,800,000
3. Lost Local Income Taxes	\$4,300,000	\$4,300,000	\$7,200,000	\$7,200,000
4. Lost Worker's Compensation Premiums	\$4,200,000	\$4,600,000	\$8,400,000	\$9,200,000
Total Economic Losses: State of Indiana Construction Industry	\$21,400,000	\$21,500,000	\$35,500,000	\$36,200,000
NOTES:				
¹ Option 1 assumes that 30% of income is unreported and that the worker's compensation rate for construction is \$5 per \$100 of payroll.				
² Option 2 assumes that 50% of income is unreported and that the worker's compensation rate for construction is \$10 per \$100 of payroll.				

In Indiana, as well as in other states, the unemployment insurance trust fund has been experiencing increasing deficits. Since 2008, the primary contributing factor to this growing deficit has been the steep downturn in the Indiana and United States economies. In January, 2008, the unemployment rate in Indiana was 4.6%; the unemployment rate peaked in May and June, 2009 at 10.6% and was 10.1% in June, 2010. In January, 2008, 149,637 Indiana workers were officially classified as unemployed; in June, 2010, this reached 315,162, an increase of 110.6% in the number of unemployed workers in Indiana.

A review of the yearend balance in the Indiana Trust Fund for the public and private sector highlights the problems of the unemployment insurance in the state. The Trust Fund balance in Indiana was \$1.124 billion on December 31,

2002 and had decreased to about \$376 million on December 31, 2006. The Trust Fund balance on December 31, 2008 was a little less than \$13 million and the fund is now insolvent. This means that in eight years, through a combination of higher unemployment rates, misclassification, and other factors, the Trust Fund has gone from over \$1.1 billion to insolvency.

Indiana began receiving Title XII Advances from the Department of the Treasury in December, 2008. As of July 23, 2010, there were 34 states (and Virgin Islands) receiving Title XII advances. Indiana has the 8th largest amount of these advances; as of July 23, 2010, the balance for Indiana was \$1.7 billion.¹⁴ It is clear from our study that misclassification contributes to Indiana's shortfall, as those unemployment insurance revenues would be collected but for the misclassification of workers.

States, including Indiana, perform both random and non-random unemployment insurance audits. The IDWD (IDWD) conducts its random audits based upon criteria and guidelines provided by the U.S. Department of Labor. Indiana is required by the United State Department of Labor (USDOL) to perform UI tax compliance audits at a penetration rate equal to or greater than 2% of all active employers in the State of Indiana. Additionally USDOL requires that at least 10% of employer audits be random audits.

IDWD also conducts industry targeted audits with the purpose of auditing employers with a high probability of misclassification based upon past findings and records. Each year in the 3rd quarter of the year prior to building target audit universe file, the North American Industry Classification System (NAICS) is examined by audit supervision in order to determine what industries will be targeted to build target audit universe file.¹⁵ Examples of these targeted audit situations include industries that have been shown to exhibit a high degree of misclassified workers or non-compliance with state law (e.g. the delinquent filing of reports, late registration, past violations of state law, etc.)

Based upon data provided by the IDWD, the auditing department conducted 16,016 audits for the five-year period, 2004-2008. For the period 2007-2008 where we have detailed audit results, the IDWD conducted 5,695 audits

¹⁴ http://www.treasurydirect.gov/govt/reports/tfmp/tfmp_advactivitiesched.htm

¹⁵ Indiana Workforce Development. Response to Request for Misclassification Information. August 30, 2010.

over the two year period. Of those audits, 3,408 or 59.8% were randomly selected audits: 2,021 or 35.5% were industry targeted audits. These two audit types accounted for 95.3% of the total audits for the period 2007-2008. The remaining 4.7% were (1) blocked claim related, (2) anonymous tips, and (3) federal certification (see definitions in Table 5, Page 38). The percentage of random audits conducted by IDWD provides a moderate estimate on the prevalence of misclassification in Indiana.

Thus, we conclude that misclassification is an increasing problem in Indiana. 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.** Indiana 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 Indiana State Building & Construction Trades Council and the Indiana, Illinois, Iowa Foundation for Fair Contracting. According to the website of the Indiana State Building & Construction Trades Council, it “coordinates activities of common interest to its affiliated building trades unions and provides resources to Indiana's 13 local Building and Construction Trades Councils (BCTCs).” In this capacity, the council works “to promote economic development, work site safety, and apprenticeship and journey-level training” (<http://www.inbctc.org>).

According to the website of the Indiana, Illinois, Iowa Foundation for Fair Contracting, they are a “labor-management organization, funded solely through participating contractors, established to support, promote and encourage fair contracting. We provide a ‘level playing field’ in the public construction arena for both contractors and workers” (<http://www.iiifc.org>).

The authors wish to especially thank the Indiana Department of Workforce Development (IDWD) for their assistance in providing summary-level data to us, without which this study could not have been completed.

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 IDWD ranks at or near the top for all states in the U.S. for identifying and recovering unreported wages and in other measures of best practices and performance.

II. The Problem of Misclassification – Detailed Findings

Misclassification arises from two potential sources. First, an employer may claim that a worker meets the common law standard as defined by the Internal Revenue Service and is, in fact, an independent contractor. This may simply be an error or the employer may be attempting to avoid the legal and financial responsibilities they would incur if a person was classified as an employee rather than as an independent contractor. The second source of misclassification may be a situation of an unreported worker, i.e., a worker whose employment either as an employee or as an independent contractor is simply not reported in order to avoid the legal and financial responsibilities for the worker.

If an employee is classified as an independent contractor, the “employer” is not required to pay and/or withhold a variety of payroll-related taxes, fees and benefits (e.g., social security and medicare taxes, local, state and federal income taxes, unemployment insurance, workers compensation, pension and health benefits, etc.). Not only are these costs 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 protected by Indiana unemployment laws. If a person is classified as an independent contractor, “employers” are required to issue a 1099-MISC for payments for work in excess of \$600 or more.

Workers with alternative work arrangements are making up an increasing percentage of the workforce.¹⁶ According to the United States Bureau of Labor Statistics, workers with alternative work arrangements accounted for 12.0% of the total workforce in February, 2005. Of the total amount of workers with alternative work arrangements, independent contractors accounted for 70% of workers with alternative work arrangements. An examination of independent contractors by industry showed that the construction sector accounted for 22.0% of all independent contractors, the highest level of concentration of independent contractors in all industries.

¹⁶ 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>.

The issue of misclassifying employees as independent contractor is a growing problem for the unemployment insurance system and state and local revenues in Indiana and other states, as well as the federal government. This occurs because employers remit their unemployment taxes and other tax streams based upon their payroll. Recent studies have shown that misclassification by employers is increasing. For example, the rate of misclassification by employers in Illinois was shown to be 22.8% in 2001 and had increased to 31.9% and 27.6% in 2004 and 2005, respectively.^{17,18} In a report by the Ohio Attorney General on February 18, 2009, the number of workers reclassified in 2009 increased 53.5% over the total number reclassified in 2008.¹⁹ Note, the “underground economy” (workers paid in cash) is outside the scope of our study and thus, the estimates we provide may underestimate the full extent of the problems associated with the employer practice of misclassification in Indiana.

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 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

¹⁷ Kelsay, Michael P., PhD, James I. Sturgeon, PhD., and Kelly D. Pinkham, M.S. *The Economic Costs of Employee Misclassification in the State of Illinois*. A Report by the Department of Economics. University of Missouri – Kansas City. December 6, 2006. Page 16.

¹⁸ Carre, Francoise, Ph.D. and Randall Wilson. *The Social and Economic Costs of Employee Misclassification in Construction*. A Report for the Construction Policy Research Center and Labor and Worklife Program. Harvard Law School and Harvard School of Public Health. Elaine Bernard, Ph.D. and Robert Herrick, ScD, Principal Investigators. December 17, 2004. Pages 12-13.

¹⁹ Cordray, Richard. Ohio Attorney General. *Report of the Ohio Attorney General on the Economic Impact of Misclassified Workers for State and Local Governments in Ohio*.

suppliers accounted for almost 17% of all unpaid individual income and employment taxes in 1992.²⁰

Misclassification negatively impacts the citizens of Indiana in a number of ways. First, the conditions for a fair and competitive marketplace are sabotaged. Employers who misclassify their workers have a pricing edge over their counterparts which results in unfair competition in the marketplace. Firms that misclassify workers 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 10% to 20%.²¹

Secondly, misclassifying workers negatively impact the public sector in Indiana by: (1) reducing the unemployment insurance taxes the state would collect if these employees were properly classified; (2) reducing the worker's compensation fund because Indiana does not collect the insurance premiums due, and (3) reducing the amount of income taxes collected by both state and local governments.

A number of studies have shown the problem of misclassification to be particularly acute in the construction sector. In three state level studies (Massachusetts, Maine, and New York), the incidence of misclassification in the construction sector is higher than other industries in those states. For Massachusetts, the moderate statewide rate is 19%, while the rate of misclassification in the construction sector is 24%²²; for Maine, the low statewide estimate is 11% compared to 14% in the construction sector.²³ In New York, the statewide rate of misclassification for 2005-2008 was 9.9% while the statewide

²⁰ United States General Accounting Office. Taxpayer Compliance: Analyzing the Nature of the Income Tax Gap. GAO/T-GGD-97-35.

²¹ These avoided payroll-related taxes are (1) old age, survivors, and disability insurance [6.20%], (2) medicare basic hospital insurance [1.45%], (3) unemployment insurance [2% or greater], (4) workers compensation costs [2.06% or greater] as well as any pension and medical insurance. Workers compensation costs would be substantially higher in certain industries such as construction would could push payroll costs savings higher.

²² Carre, Françoise, Ph.D. and Randall Wilson. *The Social and Economic Costs of Employee Misclassification in Construction*. A Report for the Construction Policy Research Center and Labor and Worklife Program. Harvard Law School and Harvard School of Public Health. Elaine Bernard, Ph.D. and Robert Herrick, ScD, Principal Investigators. December 17, 2004.

²³ Carre, Françoise, Ph.D. and Randall Wilson. A Report for the Construction Policy Research Center and Labor and Worklife Program. Harvard Law School and Harvard School of Public Health. Elaine Bernard, Ph.D. and Robert Herrick, ScD, Principal Investigators. April 25, 2005.

rate of misclassification in the construction sector was 14.9%.²⁴ In a report by the United States Government Accounting Office [GAO] in 1996, it was reported that the percentage of employers with misclassified workers was 13.4% in 1984, while the percentage of employers with misclassified workers in the construction sector was 19.9%.²⁵

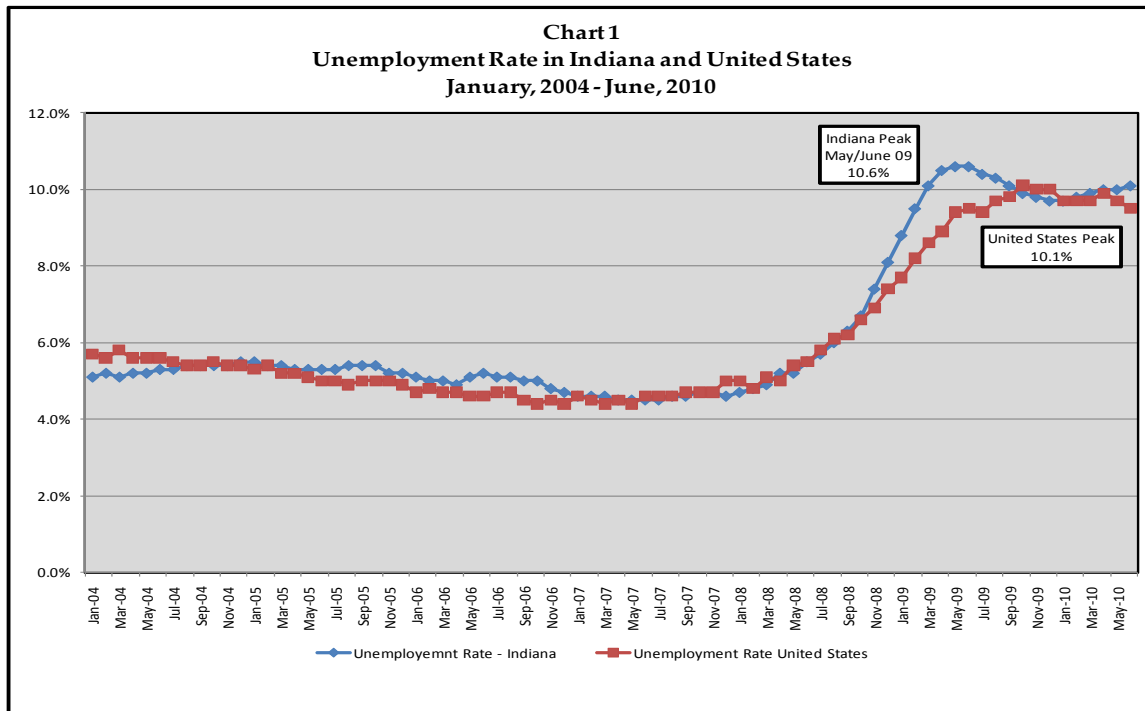
A U.S. Census Bureau analysis of projected nonfarm wage and salary employment by major industry division for the period 2008-2018 shows that the growth in overall employment is projected to increase 10.6%, or an annual rate of increase of 1.0%; in construction, the growth in employment is projected to increase 18.5%, or an annual rate of increase of 1.7%.²⁶ Given the projected growth in the construction sector, the impacts of misclassification will worsen.

In Indiana, as well as in other states, the unemployment insurance trust fund has been experiencing increasing deficits. Since 2008, the primary contributing factor to this growing deficit has been the steep downturn in the Indiana and United States economies. In January, 2008, the unemployment rate in Indiana was 4.6%; the unemployment rate in Indiana peaked in May and June, 2009 at 10.6% and was 10.1% in June, 2010 (Chart 1). In January, 2008, 149,637 Indiana workers were officially classified as unemployed; in June, 2010, this reached 315,162, an increase of 110.6% in the number of unemployed in Indiana.

²⁴ Donahue, Linda H., James Ryan Lamare, and Fred B. Kotler, J.D. *The Cost of Worker Misclassification in New York State*. ILR Collection. Research Studies and Reports. Cornell University ILR School. Year 2007.

²⁵ General Accounting Office. *Tax Administration: Issues in Classifying Workers as Employees or independent Contractors*. GOA-GGD-96-130.

²⁶ Bureau of Labor Statistics. "The Employment Projections for 2008-2018." *Monthly Labor Review*. November, 2009. Pages 3-10.



Source: <http://www.bls.gov>.

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 and local income tax revenues in Indiana. This may be particularly acute in the construction sector.²⁷ It was reported by Planmatics that the construction industry had the highest rate of incidence of misclassification, and the one that lures workers into becoming independent contractors.²⁸

Misclassification also presents societal costs to workers and the private and public sectors in Indiana. 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

²⁷ 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%.

²⁸ Planmatics, Inc. For the U.S. Department of Labor – Employment and Training Administration. *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs*. February, 2000.

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 individual workers and private sector employers, the health delivery 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.²⁹ The health system also bears an economic cost as well. It is reported that the total medical care received by the uninsured in 2001 was \$98.9 billion.³⁰ Of this amount, \$35 billion was uncompensated care, or care paid out-of-pocket by the public and private sector.

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.³¹ Employers also engage in misclassification in order to avoid the economic costs associated with litigation against employees alleging discrimination, sexual harassment, and putting in place the regulations and reporting procedures required for employees.³² Additionally, if an employee is classified as an independent contractor, the employer is not required to pay a variety of payroll taxes (i.e., 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.³³

²⁹ 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.

³⁰ American College of Physicians. A White Paper. *The Cost of Lack of Health Insurance*. 2004.

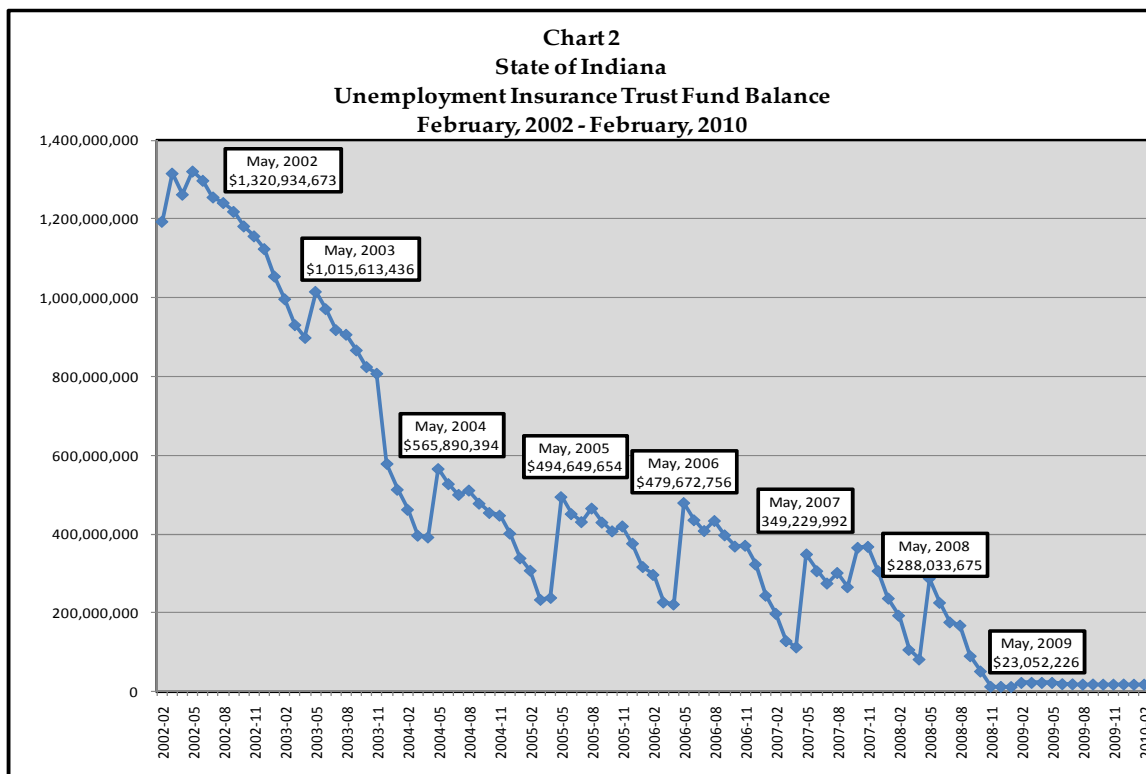
³¹ Planmatics, Inc. For the U.S. Department of Labor – Employment and Training Administration. *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs*. February, 2000.

³² Ibid.

³³ Ibid.

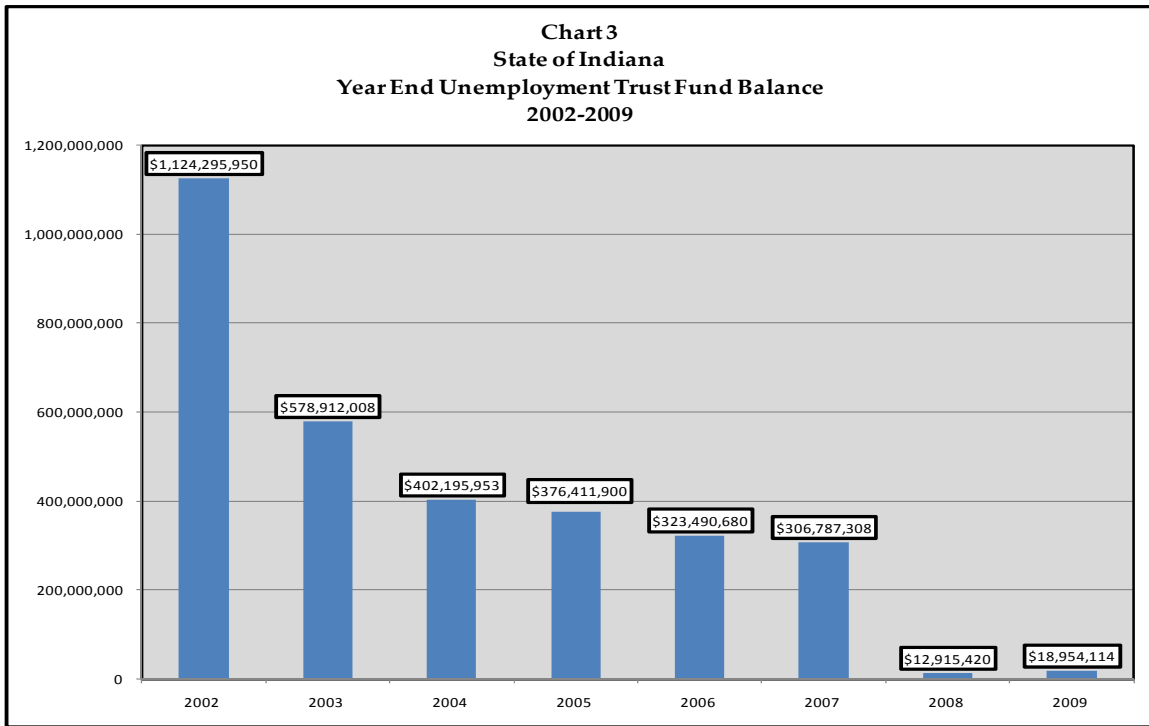
A review of the yearend balance in the Indiana Trust Fund for the public and private sector highlights the problems of the unemployment insurance in the state (Charts 2 and 3). The Trust Fund balance in Indiana was \$1.124 billion on December 31, 2002 and had decreased to about \$376 million on December 31, 2006. The trust fund balance on December 31, 2008 was a little less than \$13 million and the fund is now insolvent. This means that in eight years, through a combination of higher unemployment rates, misclassification, and other factors, the Trust Fund has gone from over \$1.1 billion to insolvency.

Indiana began receiving Title XII Advances from the Department of the Treasury in December, 2008. As of July 23, 2010, there were 34 states (and Virgin Islands) receiving Title XII advances. Indiana has the 8th largest amount of Title XII advances; as of July 23, 2010, the balance for Indiana was \$1.7 billion.³⁴ It is clear from our study that misclassification contributes to Indiana's shortfall since unemployment insurance revenues would be collected but for the misclassification of workers.



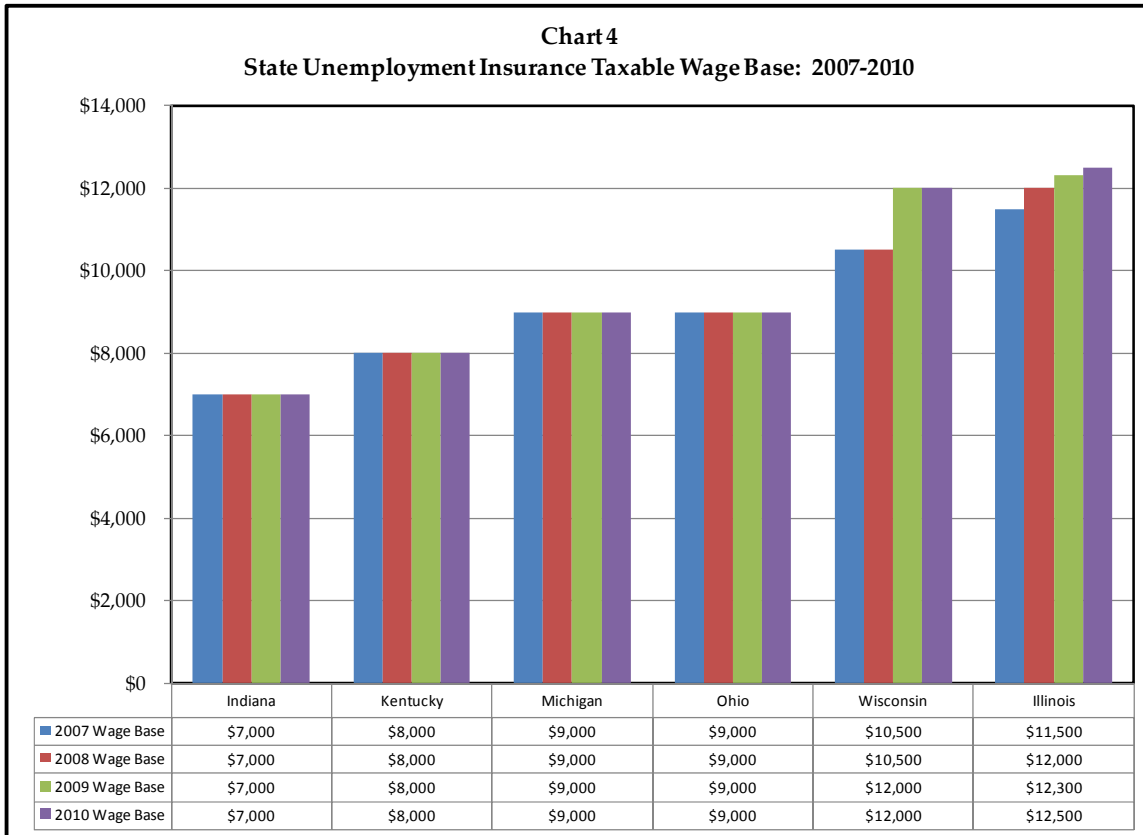
Source: Treasury Direct. Unemployment Trust Fund Report

³⁴ http://www.treasurydirect.gov/govt/reports/tfmp/tfmp_advactivitiesched.htm and http://www.treasurydirect.gov/govt/tfmp/tfmp_utf.htm.



Source: Treasury Direct. Unemployment Trust Fund Report

In the State of Indiana, the state unemployment insurance taxable wage base for the period 2007-2010 has remained constant at 7.0%. Chart 4 depicts the taxable wage base in surrounding states, which illustrates that Indiana has the lowest taxable wage base in the region. For 2010, the taxable wage base in Kentucky is 8.0%, while in Michigan and Ohio it is 9.0%. In Wisconsin and Illinois, the taxable wage base is \$12,000 and \$12,500, respectively.



Source: State Unemployment Insurance Departments of Above States

Table 1 provides estimates from a number of studies and analyses undertaken to determine the extent of employer misclassification in a number of states. For the 16 states where studies have been conducted, the moderate rate of misclassification was from 13-24%. In three state-level studies (Massachusetts, Maine, and New York), the incidence of misclassification in the construction industry is higher than all industries in their states. For Massachusetts, the moderate statewide rate is 19%, while the rate of misclassification in the construction sector is 24%; the low statewide estimate is 9% in New Jersey and Pennsylvania. In New York, the statewide rate was 10% while the incidence of misclassification in the construction sector was 15%. In a report by the United States General Accounting Office (1996), it was reported that the percentage of misclassified workers in all industries was 13%, while the percentage of misclassified workers in the construction sector was 20%.

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

	Low	Moderate	High
All Industries (9 States) ¹			
California			29%
Colorado			34%
Connecticut			42%
Maryland		20%	
Minnesota		14%	
Nebraska	10%		
New Jersey	9%		
Wisconsin		23%	
Washington	10%		
All Industries (United States) ²		13%	
All Industries (Massachusetts ³)	13%	19%	
All Industries (Maine ⁴)	11%		
All Industries (Illinois ⁵)		18%	
All Industries (New York ⁶)	10%		
All Industries (Minnesota ⁷)		15%	
All Industries (Pennsylvania ⁸)	9%		
All Industries (Michigan ⁹)			30%
All Industries (Ohio ¹⁰)			
All Industries (Wisconsin ¹¹)			44%
Construction Sector (New York ¹²)	15%		
Construction Sector (Massachusetts ¹³)	14%	24%	
Construction Sector (Maine ¹⁴)	14%		
Construction Sector (United States ¹⁵)		20%	

SOURCE

- ¹ Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs. February, 2000.
² United States General Accounting Office, GAO/T-GGD-96-130, pg. 13. 1996.
³The Social and Economic Costs of Employee Misclassification in Construction. December 17, 2004.
⁴The Social and Economic Costs of Employee Misclassification in the Maine Construction Industry. April 25, 2005.
⁵The Economic Costs of Employee Misclassification in the State of Illinois. December 6, 2006.
⁶The Cost of Worker Misclassification in New York State. February, 2007.
⁷Misclassification of Employees as Independent Contractors. November, 2007.
⁸Testimony of the Pennsylvania Deputy Secretary for Unemployment Compensation Programs. April 23, 2008.
⁹Informing the Debate: The Social and Economic Costs of Employee Misclassification in Michigan. 2009.
¹⁰Report of the Ohio Attorney General on the Economic Impact of Misclassified Workers. February 18, 2009.
¹¹Report of the Worker Misclassification Task Force, Wisconsin Department of Workforce Development. June, 2009.
¹²Misclassification of Employees as Independent Contractors. November, 2007.
¹³The Social and Economic Costs of Employee Misclassification in Construction. December 17, 2004.
¹⁴The Social and Economic Costs of Employee Misclassification in the Maine Construction Industry. April 25, 2005.
¹⁵ United States General Accounting Office, GAO/T-GGD-96-130, pg. 13. 1996.

States, including Indiana, perform both random and non-random unemployment insurance audits. The IDWD conducts its random audits based upon criteria and guidelines provided by the U.S. Department of Labor. Indiana is required by the United State Department of Labor (USDOL) to perform

Unemployment Insurance tax compliance audits at a penetration rate equal to or greater than 2% of all active employers in the State of Indiana. Additionally USDOL requires that at least 10% of employer audits be randomly selected.

IDWD also conducts industry targeted audits with the purpose of auditing employers with a high probability of misclassification based upon past findings and records. Each year in the 3rd quarter of the year prior to building target audit universe file, the North American Industry Classification System (NAICS) is examined by audit supervision in order to determine what industries will be targeted to build target audit universe file.³⁵ Examples of these targeted audit situations include industries that have been shown to exhibit a high degree of misclassified workers or non-compliance with state law (e.g. the delinquent filing of reports, late registration, past violations of state law, etc.)

For the years 2007 and 2008, the highest number of audits was in the construction industry (Table 2). Of the total amount of 2,955 audits in 2007, 409 or 13.8% of audits were in the construction industry; in 2008, 474 or 17.3% of all audits were performed in the construction industry. In 2007, IDWD found 14,757 misclassified workers of which 2,182 were in the construction industry; this represents 14.8% of all misclassified workers. In 2008, IDWD found 10,493 misclassified workers of which 2,812 were in the construction industry; this represented 26.8% of all misclassified workers in the state.

For the years 2007 and 2008, the 2nd highest number of audits was in the retail sector. Of the total amount of 2,955 audits in 2007, 350 or 11.8% of audits were in the retail sector; in 2008, 399 or 14.6% of all audits were performed in the retail sector. In 2007, IDWD found 14,757 misclassified workers of which 1,658 were in the retail; this represents 11.2% of all misclassified workers. In 2008, IDWD found 10,493 misclassified workers of which 914 were in the retail sector; this represented 8.7% of all misclassified workers in the state.

In 2007, the five highest number of target industries (construction, retail, other services, health care & social assistance, and manufacturing) account for 54% of all audits and 49.6% of all misclassified workers. In 2008, the five highest number of target industries (construction, retail, other services, health care &

³⁵ Indiana Workforce Development. Response to Request for Misclassification Information. August 30, 2010.

social assistance, and manufacturing) account for 56.2% of all audits and 52.4% of all misclassified workers.

Table 2
Analysis of Audits Conducted: 2007-2008

2007				
NAICS Category	Number of Audits Performed	Number of Misclassified Workers	Percent of Audits Performed	Percent of Misclassified Workers
Construction	409	2,182	13.8%	14.8%
Retail	350	1,658	11.8%	11.2%
Other Services	328	1,129	11.1%	7.7%
Manufacturing	255	1,364	8.6%	9.2%
Health Care & Social Assistance	253	985	8.6%	6.7%
Total of Five Highest Industry Targets	1,595	7,318	54.0%	49.6%
Other Audits	1,360	7,439	46.0%	50.4%
Total of Audits	2,955	14,757	100.0%	100.0%
2008				
NAICS Category	Number of Audits Performed	Number of Misclassified Workers	Percent of Audits Performed	Percent of Misclassified Workers
Construction	474	2,812	17.3%	26.8%
Retail	399	914	14.6%	8.7%
Health Care & Social Assistance	230	495	8.4%	4.7%
Manufacturing	229	498	8.4%	4.7%
Other Services	208	775	7.6%	7.4%
Total Five Highest Industry Targets	1,540	5,494	56.2%	52.4%
Other Audits	1,200	4,999	43.8%	47.6%
Total of Audits	2,740	10,493	100.0%	100.0%

Source: Indiana Department of Workforce Development. 2007-2008 Results

The IDWD reported five types of unemployment insurance audits (Table 5, Page 38). The IDWD conducted 16,016 audits from 2004 through 2008. For the period 2007-2008, for which we have detailed audit data, 5,695 audits were conducted. The largest category of audits was audit type “randomly selected”. The number of random audits was 3,408 or 59.8% of the total number of audits. For the period 2007-2008, the 2nd largest category was audit type “industry targeted.” The number of industry targeted audits was 2,021 or 35.5% of the total number of audits. These two audit types accounted for 95.3% of the total number of audits. The other types of audits were “blocked claim related”, “anonymous tip”, and “federal certification” (see definitions in Table 5, Page 38).

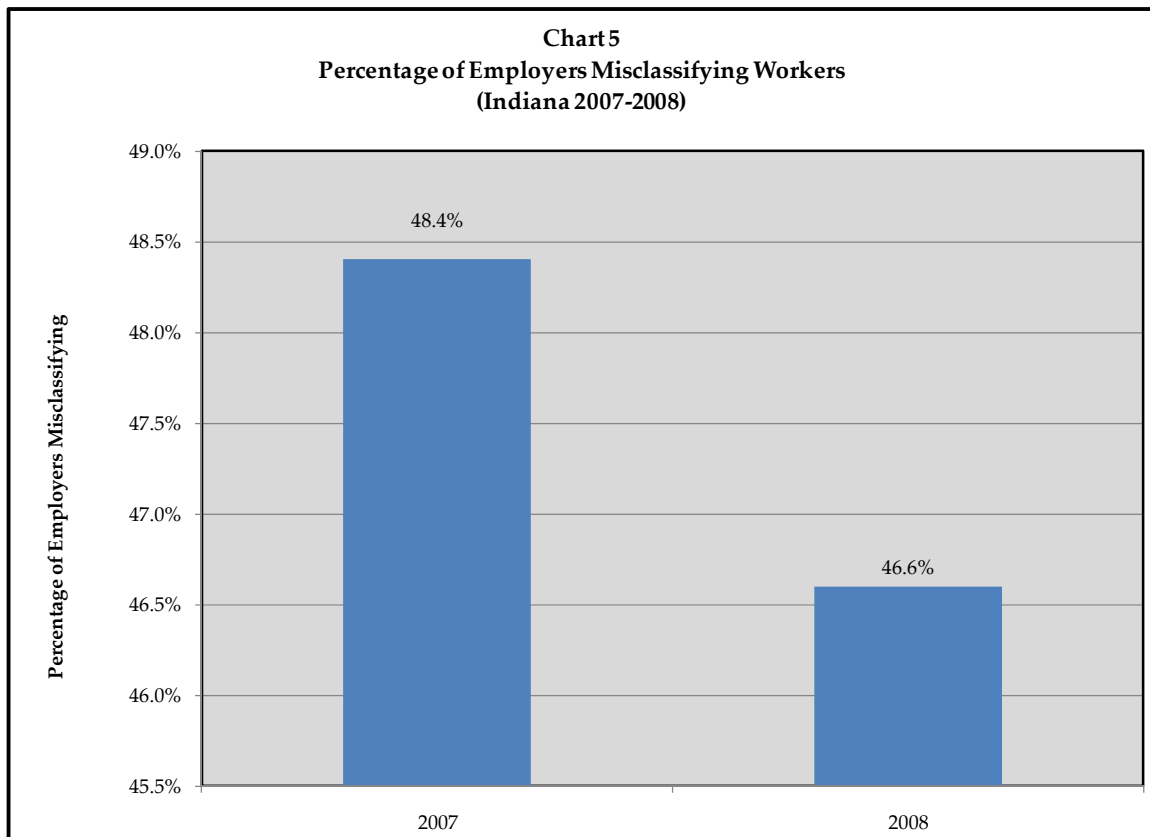
Using aggregate level data on unemployment insurance tax audits provided by the IDWD, we have developed reliable estimates of statewide misclassification. Using methodologies developed in earlier studies, we present projections of the economic costs of misclassification for unemployment insurance, income taxes (state and local), and the worker compensation system in Indiana.

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. We were provided with aggregate level data for 2007-2008. From this data we have been able to reliably estimate the overall rate of misclassification in Indiana.

III. Extent of Misclassification in Indiana

When Employers Engage in Misclassification

For the years 2007-2008, state audits found that, on average, 47.5% of Indiana employers that were audited were found to have misclassified workers as independent contractors (Chart 5). The Wisconsin Unemployment Division found that 44% of the workers they investigated during the employer audits were misclassified.³⁶ In the Planmatics, Inc. study conducted for the U.S. Department of Labor, they reported misclassification rates in Colorado and Connecticut of 34% and 42%, respectively.³⁷



³⁶ *Report of the Worker Misclassification Task Force*, Submitted to Secretary Roberta Gassman, Wisconsin Department of Workforce Development (June 2009).

³⁷ Planmatics, Inc. For the U.S. Department of Labor – Employment and Training Administration. *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs*. February, 2000.

Targeted audits accounted for 35.5% of total audits in Indiana for 2007-2008. Because misclassification has a higher likelihood of occurring in these targeted industry sectors based upon past studies, this represents a moderate-upper bound of the overall misclassification rate in Indiana.

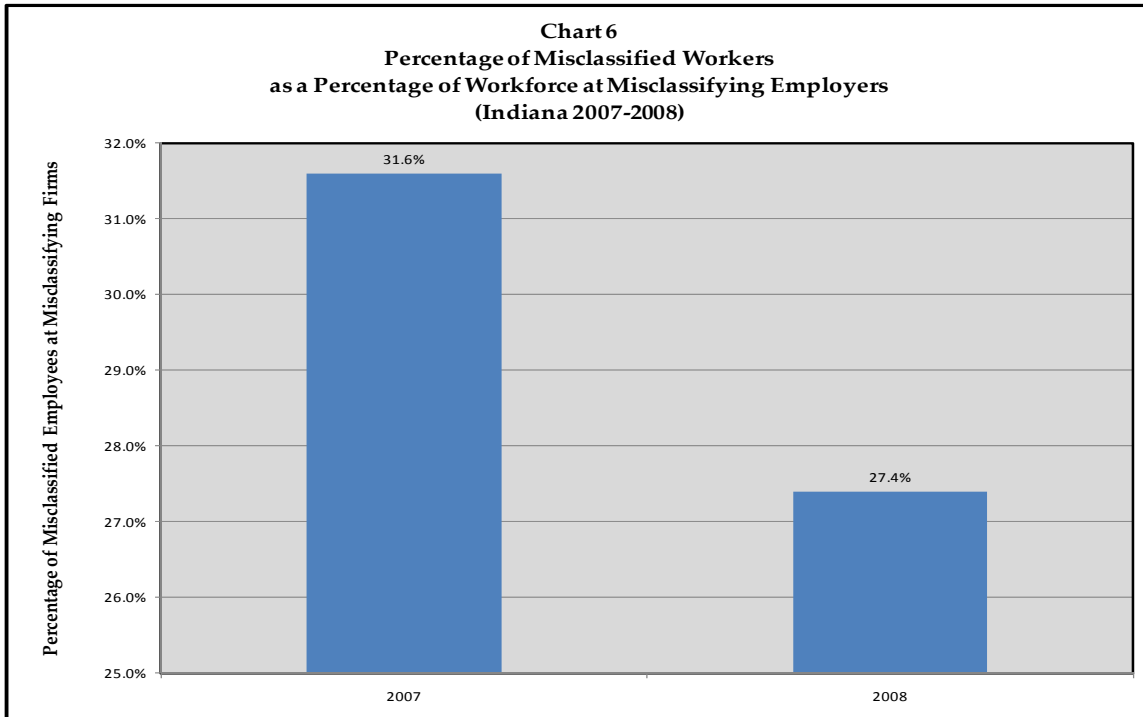
This estimate of misclassification in Indiana translates into an estimate of approximately 73,629 employers statewide annually for 2007-2008, of which 8,200 were estimated to be in the construction sector. The rate of misclassification decreased from 2007 to 2008 from 48.4% to 46.6%, respectively. For 2008, this translates into an estimate of approximately 72,299 employers statewide in 2008, of which 8,052 were estimated to be in the construction sector.

Workers Impacted by Misclassification

To assess the impact of workers impacted by misclassification, we use the methodology used in earlier studies (See Carre and Wilson, 2004; Kelsay, Sturgeon, Pinkham, 2006). 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 that are misclassified among *all workers in the state*.

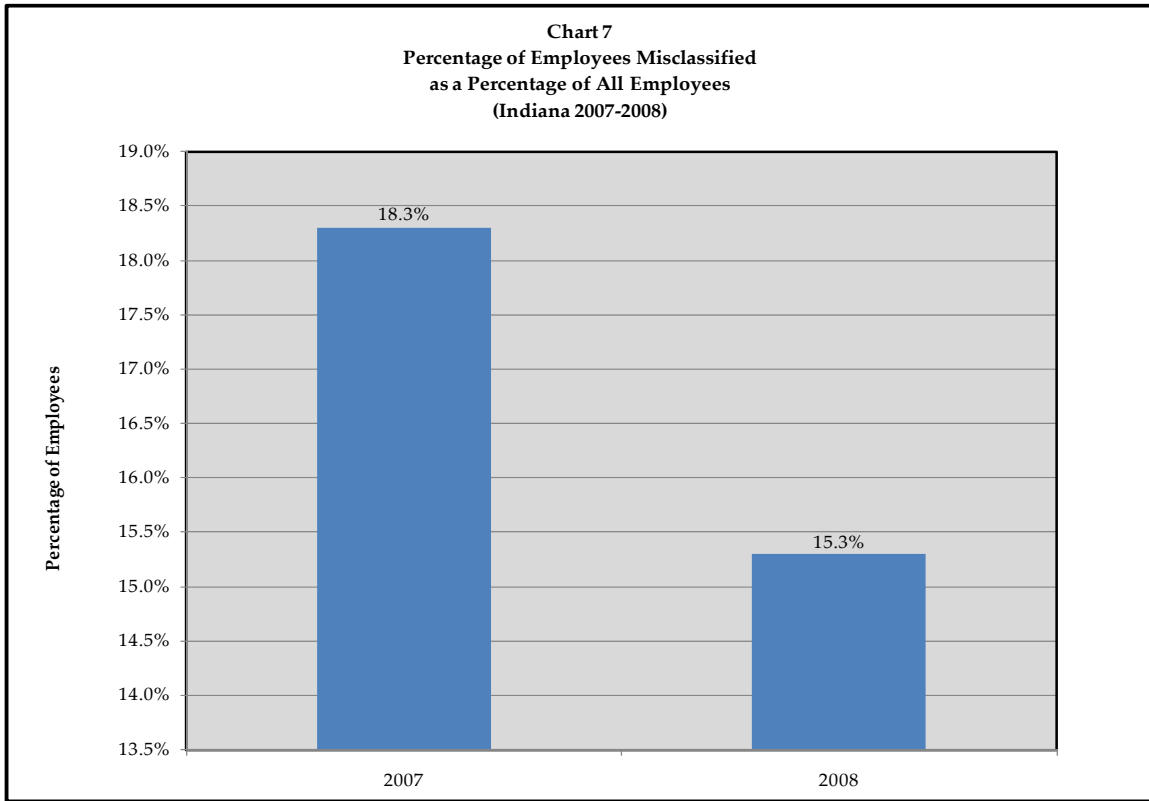
Severity of the Impact of Misclassification

When employers misclassify in Indiana, 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, 31.6% of workers are misclassified by employers that were found to be misclassifying for 2007; for 2008, 27.4% of workers are misclassified by employers that were found to be misclassifying (Chart 6).



Extent of Misclassification

From our analysis of the labor force of all employers in Indiana (those that misclassify and those that do not), we estimate that 16.8% of employees in Indiana are misclassified as independent contractors for the period 2007-2008; for 2007 and 2008, we found that 18.3% and 15.3%, respectively, of employees in Indiana are misclassified as independent contractors (Chart 7).



The estimated number of employees statewide that are affected by the improper misclassification is estimated at 418,086 annually for the period 2007-2008. For 2008, the estimated number of employees affected by misclassification was 377,742. For the construction sector the estimated number of employees affected by misclassification was 24,891 annually for the period 2007-2008. The estimated number of employees in the construction sector affected by misclassification was 24,323 in 2008.

IV. Implications of Employee Misclassification in Indiana

Misclassification of employees has a negative financial impact on individual workers, Indiana state and local governments, and the private sector in Indiana. 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 and local income tax revenues, and (3) the amount of worker' 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 Indiana.

We estimate that the unemployment insurance system has lost an average of \$36.7 million annually for the period 2007-2008 in unemployment insurance taxes that are not levied on the payroll of misclassified workers as they should be. For 2008, we estimate that the unemployment insurance system in Indiana lost \$30.4 million in unemployment insurance taxes. A portion of this lost revenue may be recaptured when an audit reveals a misclassified worker where contributions are due. In 2008, for example, the amount of net contributions recaptured from their audits was approximately \$1.02 million; equaling 2.8% of the total amount that we project was not collected in 2008.³⁸

³⁸ In Illinois, our study found that the net amount recaptured from their audits was approximately 2.0% of the total amount we projected was not collected (Kelsay, Sturgeon, and Pinkham, 2006).

For the construction sector, we estimate that the unemployment insurance system in Indiana has lost an average of \$2.2 million annually for the period 2007-2008 in unemployment insurance taxes that were not levied on the payroll of misclassified workers in construction as they should have been. For 2008, we estimate that the unemployment insurance system in Indiana lost \$2.0 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 for automobiles, homes, medical insurance, retirement plans, and business trips. As a result Indiana 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).³⁹

The State of Indiana imposes a flat 3.4% 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 as a result of misclassification. The Internal Revenue Service reported that in its last comprehensive study on misclassification in 1984, about 15% of employers misclassified a total of 3.4 million employees as independent contractors, resulting in an estimated revenue loss of \$1.6 billion (in 1984 dollars)⁴⁰ According to a 2009 report by the Treasury Inspector General for Tax Administration, the IRS's most recent estimate of the cost of misclassification is \$54 billion in the

³⁹ Tax Administration: Issues in Classifying Workers as Employees or Independent Contractors. United States General Accounting Office. GAO/T-GGD-96-130.

⁴⁰ Employee Misclassification. Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention. United States General Accounting Office. GAO-09-717.

underreporting of employment tax and losses of \$15 billion in unpaid FICA taxes and UI taxes.⁴¹ The \$15 billion estimate is based on 1984 data that has not been updated and, according to the IRS, may be substantially higher.

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 derive the annual earnings of all workers in the State of Indiana and the annual earnings of construction workers in the State of Indiana.⁴²

Based upon an estimate that 30% of the income of misclassified workers is not reported, we estimate that an average of \$147.5 million of Indiana state income tax revenues were lost annually during the period 2007-2008 due to unreported income. For 2008, we estimate that \$134.8 million of Indiana state income tax revenues were lost. In the construction sector we estimate that an average of \$10.7 million of Indiana state income tax revenues were lost annually for 2007-2008. For the year 2008, we estimate that \$10.6 million of Indiana state income tax revenues were lost from construction sector income not reported.

Based upon an estimate that 50% of the income of misclassified workers is not reported, we estimate that an average of \$245.8 million of Indiana state income tax revenues were lost annually during the period 2007-2008 due to unreported income. For 2008, we estimate that \$224.6 million of Indiana state income tax revenues were lost. In the construction sector we estimate that \$17.7 million of Indiana state income tax revenues were lost during the period 2007-2008. For 2008, we estimate that \$17.8 million of Indiana state income tax revenues were lost from construction sector income not reported.

⁴¹ Treasury Inspector General for Tax Administration. *While Actions have been Taken to Address Worker Misclassification, an Agency-Wide Employment Tax Program and Better Data are Needed*. February 4, 2009. Reference Number: 2009-30-035.

⁴² We obtained the average annual earnings for all private sector employees and annual earnings for the construction sector from the United States Bureau of Labor Statistics. Local Area Unemployment Statistics. Series ID: LASST183000003, LASST183000004, LASST183000005, LASST183000006. For all private sector employees in Indiana, the average annual salary for 2007-2008 was \$48,026; for the construction sector, the average annual earnings for 2007-2008 were \$45,948.

Implications of Employee Misclassification for Local Income Tax Revenue

Indiana has allowed local governments to adopt local income taxes since 1974. The three forms of local income taxes are the County Adjusted Gross Income tax (CAGIT), the County Option Income Tax (COIT), and the County Economic Development Tax (EDIT or CEDIT). As of 2009, 91 counties have adopted local income taxes, and local governments receive about \$1.5 billion in local income tax revenues. The average tax rate of CAGIT, COIT, and CEDIT revenue bases for local governments in Indiana was 1.38% for the 91 counties.⁴³

Based upon an estimate that 30% of the income of misclassified workers is not reported, we estimate that an average of \$59.9 million of Indiana local government income tax revenues were lost annually during the period 2007-2008 due to unreported income. For 2008, we estimate that \$54.7 million of Indiana local income tax revenues were lost. In the construction sector, we estimate that \$4.3 million of Indiana local government income tax revenues were lost during the period 2007-2008. For 2008, we estimate that \$4.3 million of Indiana local government income tax revenues were lost from construction sector income not reported.

Based upon an estimate that 50% of the income of misclassified workers is not reported, we estimate that an average of \$99.8 million of Indiana local government tax revenues were lost annually during the period 2007-2008 due to unreported income. For 2008, we estimate that \$91.2 million of Indiana local government income tax revenues were lost. In the construction sector, we estimate that \$7.2 million of Indiana local government income tax revenues were lost during the period 2007-2008. For 2008, we estimate that \$7.2 million of Indiana local government income tax revenues were lost from construction sector income not reported.

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 was reported by Planmatics (2000) that the cost of worker's compensation insurance premiums is the primary reason why

⁴³ State of Indiana. Department of Revenue. Departmental Notice #1. Effective Dec 1, 2009. (R11 / 12-09)

employers misclassify.⁴⁴ 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 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.⁴⁵

According to a report on worker's compensation rates in Indiana, the 2008 average worker's compensation rate statewide was \$2.06 per \$100 of payroll. Based upon this workman's compensation rate, we estimate that for the period 2007-2008, an annual average of \$24.1 million of premiums were not properly paid for misclassified workers. For 2008, we estimate that \$26.3 million of worker's compensation insurance premiums were not properly paid for misclassified workers. 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.

Worker's compensation premiums are much higher in the construction industry. As reported, the statewide rate for all industries averaged \$2.06 in 2008 (per \$100 in payroll). However, within construction, rates are substantially higher. For example, the workman compensation rate for Carpentry (Class 5403) was \$7.29 per \$100 of payroll and Roofing-All Kinds (Class 5551) was \$10.88 per \$100 of payroll.⁴⁶

We present two estimates for worker's compensation premiums in construction trades in Indiana based upon (1) a rate of \$5 per \$100 of payroll and (2) a rate of \$10 per \$100 of payroll. Based upon a rate of \$5 per \$100, we

⁴⁴ Planmatics, Inc. For the U.S. Department of Labor – Employment and Training Administration. *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs*. February, 2000

⁴⁵ “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)

⁴⁶ Oregon Department of Consumer & Business Services. *Oregon Workers' Compensation Premium rate Ranking, Calendar Year 2008*. March 2009.

estimate the annual cost shift of premiums to be \$4.2 million for the period 2007-2008. For 2008, we estimate the annual cost shift of premiums to be \$4.6 million. Based upon a rate of \$10 per \$100 of payroll, we estimate the annual cost shift in premiums to be \$8.4 million. For 2008, we estimate the annual cost shift of premiums to be \$9.2 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 Indiana 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 reported that from 1%-18% of the audit group was randomly audited. For all industries reported in Indiana, the rate of employee misclassification was 16.8% for the period 2007-2008, with 59.8% random audits and 35.5% targeted audits.

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 Indiana. Our study has confirmed the fact that misclassification is a severe problem which impacts the public and private sectors in Indiana. We have shown that misclassification has direct and significant impacts on workers, employers, taxpayers and markets. Table 3 summarizes the losses to the State of Indiana. Under Option 1, the estimated annual economic loss for the period 2007-2008 to Indiana is \$268,200,000; under option 2, the estimated annual economic loss for the period 2007-2008 to Indiana is \$406,400,000.

State of Indiana	Option 1 ¹		Option 2 ²	
	2007-2008 Average	2008	2007-2008 Average	2008
1. Lost Unemployment Insurance Taxes	\$36,700,000	\$30,400,000	\$36,700,000	\$30,400,000
2. Lost State Income Taxes	\$147,500,000	\$134,800,000	\$245,800,000	\$224,600,000
3. Lost Local Income Taxes	\$59,900,000	\$54,700,000	\$99,800,000	\$91,200,000
4. Lost Worker's Compensation Premiums	\$24,100,000	\$26,300,000	\$24,100,000	\$26,300,000
Total Economic Losses: State of Indiana	\$268,200,000	\$246,200,000	\$406,400,000	\$372,500,000
State of Indiana: Construction Industry				
1. Lost Unemployment Insurance Taxes	\$2,200,000	\$2,000,000	\$2,200,000	\$2,000,000
2. Lost State Income Taxes	\$10,700,000	\$10,600,000	\$17,700,000	\$17,800,000
3. Lost Local Income Taxes	\$4,300,000	\$4,300,000	\$7,200,000	\$7,200,000
4. Lost Worker's Compensation Premiums	\$4,200,000	\$4,600,000	\$8,400,000	\$9,200,000
Total Economic Losses: State of Indiana Construction Industry	\$21,400,000	\$21,500,000	\$35,500,000	\$36,200,000
NOTES:				
¹ Option 1 assumes that 30% of income is unreported and that the worker's compensation rate for construction is \$5 per \$100 of payroll.				
² Option 2 assumes that 50% of income is unreported and that the worker's compensation rate for construction is \$10 per \$100 of payroll.				

The Office of the Inspector General for the U.S. Department of Labor reported on best practices to improve identification of noncompliant employers for state UI field audits.⁴⁷ The IDWD should be lauded for the implementation of certain of these best practices. This has resulted in Indiana ranking in the top tier of states for return per audit hour. Among these best practices that Indiana uses are a selective process based upon NAICS code for determining targeted industries and employers and the implementation of blacked claim audits. As a result, IDWD is allocating the department's scarce resources toward those

⁴⁷U.S. Department of Labor, Office of Inspector General. *Adopting Best Practices Can Improve Identification of Noncompliant Employers for State UI Field Audits*. Final Report No. 03-99-006-03-315.

industries and/or employers where the problem of misclassification has been shown to be most acute. Certain efficiency measures derived from the audit data reveal that the Indiana Department of Workforce is utilizing its scarce resources efficiently (Table 4)

	2004	2005	2006	2007	2008
Misclassified Per Audit Hour	0.282	0.331	0.398	0.389	0.344
Net Underreported Taxable Wages for Misclassified Per Audit Hour	\$362.49	\$647.96	\$631.78	\$464.81	\$652.93
Net Underreported Contributions Per Audit Hour	\$11.67	\$18.98	\$26.59	\$24.87	\$33.39

Misclassified per audit hour has increased from 0.282 in 2004 to .344 in 2008, a 21.9% increase; net underreported taxable wages for misclassified per audit hour has increased from \$362.49 in 2004 to \$653.93 in 2008, a 80.1% increase; and net underreported contributions per audit hour has increased from \$11.67 in 2004 to \$33.39 in 2008, a 186.2% increase.

We believe we have shown that workers, businesses, revenue collection agencies, and policy analysts in Indiana will benefit from better documentation of misclassification in Indiana. 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 Indiana: (1) the State of Indiana should continue to perform a high degree of “targeted” audits on problem employers like those done in other states,⁴⁸ (2) develop meaningful penalties to deter those employers who intentionally and/or repeatedly violate state laws on misclassification, (3) review current authorities and procedures for the collaboration among revenue, labor, and enforcement 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

⁴⁸ 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).

willful violations, and (4) expand outreach to educate employers and employees about classification rules.

Table 5					
Unemployment Insurance Audit Statistics and Audit Definitions for Indiana *					
	2004	2005	2006	2007	2008
Audit Activity					
Total Audits	3,484	3,481	3,313	2,955	2,270
Total Employers	123,609	123,394	125,955	128,195	128,997
Gross Payroll (Pre Audit)	3,231,025,873	2,013,068,562	2,132,062,272	1,526,285,133	1,294,951,684
Gross Payroll (Post Audit)	3,263,712,198	2,022,003,054	2,193,712,198	1,568,023,579	1,354,796,447
Hours Spent Auditing	46,126	47,095	44,415	38,229	30,487
Audit Types:(1)					
1. Random	NA	NA	NA	1,627	1,781
2. Industry Targeted	NA	NA	NA	1,171	850
3. Blocked Claim Related	NA	NA	NA	80	55
4. Anonymous Tip	NA	NA	NA	65	27
5. Federal Certification	NA	NA	NA	12	27
Audit Results					
Total Employers Misclassifying Workers	NA	NA	NA	1,429	1,278
Total Workers Employers Misclassified	13,023	15,595	17,697	14,866	10,496
Total Employees at Audited Firms	NA	NA	NA	81,074	68,450
Total Employees at Employers Found to be Misclassifying	NA	NA	NA	47,106	38,262
Revenue Data from Audited Employers					
Underreported Taxable Wages for Misclassified	\$24,878,501	\$35,712,138	\$33,257,033	\$23,961,333	\$24,476,600
Contributions for Underreported	\$679,095	\$1,001,965	\$1,289,953	\$1,068,499	\$1,136,984
Overreported Taxable Wages for Misclassified	\$8,158,086	\$5,196,682	\$5,196,682	\$6,192,195	\$4,570,610
Contributions for Overreported	140,897	107,934	108,943	117,853	118,934
* NOTE: Audit statistics in Indiana for the period 2004-2008 provided by the Indiana Department of Workforce Development (IDWD).					
(1) <u>Audit definitions [per Indiana Department of Workforce Development]:</u>					
1. Random --	Any account that is not selected from the target universe file is placed in the random audit universe file. A random audit sample list is then derived from that universe file.				
2. Industry targeted --	Each year in the 3rd quarter prior to building the target audit universe file, the North American Industry Classification System (NAICS) categories are examined in detail by audit supervision to determine what industries will be targeted in order to build the target audit universe file. Historically, these industries have been those which have high incidence of misclassified workers or non-compliance with Indiana law.				
3. Blocked Claim --	Field auditors are to request audits of employers from blocked claim investigations, the following situations:				
	a) the employer is not voluntarily complying with the reporting requirements because multiple claimants are missing.				
	b) the employer appears to have misclassified the majority of the employees.				
	c) the employer has been inactive for a period of two or more years, but had employees during that time.				
	d) the employer has been in business for many years, but did not report to the Agency and did not send in reports to the Agency.				
4. Anonymous Tip --	Tax Administration or field auditors receive tips from other employers, claimants, or from Benefit Payment Control (BPC) investigators of employers that may be non-compliant or have misclassified workers.				
5. Federal Certification --	Discrepancies in wages reported by an employer to IDWD versus those reported to the Federal Government (FUTA).				

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 Indiana. Thus, we assumed that the sample of employers selected for auditing was representative of all UI-covered employers in Indiana.

- 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 Indiana. We calculated the percentage of workers among those audited employers who were misclassifying workers and applied that result to derive an estimate of the severity of misclassification among all Indiana 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 Indiana. 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 Indiana.

- 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 Indiana. This result was multiplied by the estimated number of workers misclassified in Indiana.

Most of these figures are taken from the information provided by the IDWD (Table 5, Page 38). For example, divide audited "Total Workers Employers Misclassified" in 2008 (10,496) by "Total Employees" audited in 2008 (68,450) to obtain a 15.3% rate of misclassification. Then, multiply total Indiana private sector employment for 2008 (2,463,458) times the 15.3% misclassification rate to determine that 377,742 statewide private sector employees were misclassified in 2008. This figure will be multiplied by the average unpaid unemployment insurance tax per employee. To determine that figure, we divide the 2008 "UI Taxes (net underreported contributions) for Misclassified" (\$1,019,131) by "Total Workers Employers Misclassified" in 2005 (10,496). For 2008, this results in an average unpaid unemployment insurance tax per employee of \$97.10. We next multiply 377,742 times \$97.10 for the total estimated loss of uncollected unemployment insurance taxes for Indiana in 2008 of \$36.7 million.

V. Calculating the Loss in Indiana Income Tax

In order to calculate the loss in state income taxes for the construction sector and statewide, we multiplied the estimated number of construction workers and 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 workers in Indiana annually for 2007-2008 (24,891 workers) and multiplied that by the estimated annual earnings of construction workers in Indiana from 2007-2008 (\$45,948). For workers statewide, we estimated the number of misclassified workers in Indiana annually for 2007-2008 (418,056) and multiplied that by the estimated annual earnings for worker in Indiana from 2007-2008 (\$38,026)

For the construction sector in 2008, we estimated the number of misclassified construction workers in Indiana in 2008 (24,323) and multiplied that by the estimated annual earnings of construction workers in Indiana in 2008 (\$47,198). For workers statewide in 2008, we estimated the number of misclassified in Indiana in 2008 (377,742) and multiplied

that by the estimated annual earnings for workers in Indiana in 2008 (\$38,454).

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 3.4% (Indiana State Income Tax Rate) yielded a range of two estimates for loss state income tax revenues for the construction sector and all workers in Indiana.

VI. Calculating the Loss in Indiana Local Government Income Tax

We provide two estimates of (“income not reported”), using alternative assumptions regarding the amount of income not reported (30% and 50%) as we did in calculating lost state income tax revenue. We multiply these results by 1.38% (Average Local Indiana Income Tax for 91 counties). These results yield a range of two estimates for loss state income tax revenues for the construction sector and all workers in Indiana.

VII. 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 Indiana, we calculated gross private sector payroll reported in Indiana. We then calculated the unreported wages as percentage of gross payroll reported in the audit results and applied this percentage to total wages reported for private sector wages by Indiana. We then multiplied this by the \$2.06 workers’ compensation premium per \$100 of payroll (2008 statewide average).

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) \$5 per \$100 of payroll and (2) \$10 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 for Indiana. We then multiplied this by

workers' compensation premiums per \$100 of payroll of \$5 and \$10, respectively.

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