

Testimony of Patrick T. Beaty
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Before the House Labor Relations Committee
Public Hearing on House Bill 2400
(Misclassification of Employees as Independent Contractors)
April 23, 2008

Good afternoon, Chairman Belfanti, Chairman DiGirolamo, and members of the House Labor Relations Committee.

My name is Patrick Beaty and I am Deputy Secretary for Unemployment Compensation Programs in the Department of Labor & Industry.

On behalf of Acting Secretary Sandi Vito, I want to thank you for the opportunity to appear before you today to give you the Department's perspective on the growing problem of misclassified workers. My testimony today will attempt to describe the scope of the problem and its effects on various parties and on the programs administered by the Department.

At the outset, I believe it is important to state the problem clearly so that we all understand what the objective is in proposing any legislative solution, whether it is HB 2400 or any of the alternatives that have been debated in recent years.

The first thing we need to acknowledge is that there are many individuals in Pennsylvania and across the country who are in the business of doing jobs or projects for others on a contract basis. Their livelihood depends upon the ability to continually find new clients who are willing to pay them by the job and not as an employee. They have invested in their own business with all of the overhead costs that go along with that and they have taken a substantial risk that the business might succeed or fail. These independent contractors are entrepreneurs in many cases and they play a very important role in Pennsylvania's economy.

Likewise, businesses that choose to contract for the services of an independent contractor, rather than to hire an employee for that purpose, usually have very legitimate reasons for doing so. Those reasons might even include the fact that the business does not want to take on the additional cost of paying unemployment compensation tax or workers' compensation premiums for an employee to do that same work. So long as those arrangements are entered into willingly by both parties – and the party doing the work is truly an independent contractor – the Department of Labor & Industry has no desire to second-guess legitimate business decisions or to express a preference for hiring employees rather than contractors.

The problem arises when the person doing the work is in reality an employee, but has been misclassified by his employer as an independent contractor. All kinds of consequences flow from misclassification, particularly for the worker himself if he is underpaid or injured on the job or let go. Even if he is eventually successful in establishing his true status as an employee, a misclassified worker can find it much harder to qualify for workers' compensation and

unemployment compensation, since the business that he worked for has not been listing him as an employee in the reports they provide to their insurance carrier or in quarterly wage reports filed with the Department.

There can also be significant consequences for the competitors of businesses that misclassify their workers in order to reduce their costs of doing business. Misclassification creates an unfair advantage for those who engage in the practice, allowing them to underbid their competitors who play by the rules.

The balance of my comments today will relate to the area for which I am responsible, which is the unemployment compensation system. It is important to realize, however, that other programs in L&I and other labor laws are also affected by misclassification, including for example: minimum wage law, Wage Payment and Collection Law, personal income tax withholding and workers' compensation.

In Pennsylvania, as in all other states, employers pay Unemployment Compensation (UC) taxes based on the wages they pay to their employees, up to a certain amount (\$8,000 in wages per employee in PA). Businesses do not pay UC taxes on any payments they may make to workers who perform services as independent contractors, even if the services are indistinguishable from services provided by employees. The UC Law presumes that an individual who is compensated for work is an employee who is potentially eligible for UC benefits and whose wages are subject to tax unless the worker qualifies as an independent contractor.

The lack of any requirement that employers identify contracted labor in their UC filings makes it difficult to accurately estimate the number of workers who are not being reported as employees and the extent to which those workers may be misclassified as independent contractors. However, every misclassified worker represents a loss of revenue to the UC Trust Fund (an average of \$400 per worker in 2007) and an unfair competitive advantage compared to other employers who do not misclassify workers.

There are indications that misclassification of workers is becoming more prevalent, particularly in certain industries. This is occurring at a time when employers in Pennsylvania have been paying higher UC tax rates, including additional solvency taxes needed to replenish the Trust Fund following the 2001 economic recession.

A recent study of misclassification by employers in Massachusetts estimated that between 13 - 19% of all employers in that state engage in misclassification. The 2004 Massachusetts study focused on the construction industry in which the study found misclassification was only slightly more prevalent than in other industries (ranging between 14 - 24% of all construction employers). However, the study also found that, among construction employers who engage in misclassification, between 40 - 48% of their workers are misclassified.

Moreover, the study concluded that worker misclassification is a growing phenomenon as employers look for ways to cut costs and gain a competitive advantage. Estimates of misclassification in Massachusetts grew from 8% of employers in 1995-97, to 11% in 1998-2000, to 13% in 2001-03.

The Massachusetts study estimated that between 4.5 – 8.9% of all employees in that state are misclassified as independent contractors. Studies in other states have reached similar results. In 2006, a report by the University of Missouri, Department of Economics, estimated that 7.5% of employees in Illinois were misclassified during the period 2001-2005. Again, the problem was seen to be growing in severity from 5.5% of employees in 2001 to 8.5% in 2005 – a 55% increase over four years.

Tim Wisecarver with the Pennsylvania Compensation Rating Bureau has recently completed an analysis using Pennsylvania UC data and applying a similar methodology to the one used in the Massachusetts study. The PCRB analysis concludes that 9% of Pennsylvania workers are misclassified for UC purposes on an annual basis (over 580,000 workers). Based upon Pennsylvania's taxable wage base of \$8,000 and the average UC tax rate, the Department estimates that worker misclassification cost the UC Trust Fund over \$200 million in lost revenue last year.

We believe this is a conservative estimate because it is based primarily upon audits of employers who are already in our system; that is, employers who typically *do* file reports containing wages for *some* workers that they consider to be employees. In most cases, the audits discover additional workers who we believe should also have been reported. However, because the estimate of misclassified workers is based on the universe of known employers, it does not take into account much of the so-called “underground economy”, which includes employers who act as if they have no employees at all and who pay everybody “under the table” and off the books.

The majority of Pennsylvania businesses who properly report employee wages are losing out twice as a result of this practice. First, as I mentioned previously, they are finding it more difficult to compete against businesses that wrongfully avoid paying their fair share of workers' compensation premiums and UC taxes. And, in the case of UC taxes, they are paying more into the UC Trust Fund in the form of solvency taxes that kick in when the Trust Fund balance is low.

As our national economy continues to weaken, the temptation for some employers to engage in misclassification will only increase as they look for ways to cut costs and gain a competitive advantage. This will mean fewer UC tax dollars and an increased tax burden on the majority of employers who continue to play by the rules.

As I stated earlier, the UC Law presumes that a worker who performs services for another is an employee. However, the decision to report the money paid to that worker as wages paid to an employee is up to the employer in the first instance. Often, the Department of Labor & Industry will only discover the existence of misclassified workers either as a result of an audit, when the worker files for unemployment compensation, or when we receive a complaint from a competitor. Even when we do discover misclassification, the penalties are not substantial and are obviously not sufficient to deter this practice or prevent it from growing more prevalent.

Proving misclassification has also become more difficult as the courts have gradually weakened the two-part test to qualify as an independent contractor under the UC Law. Current law requires proof that the worker is free from direction and control by the employer AND that the worker is engaged in an independently established trade, occupation, profession or business. Unfortunately, the courts have interpreted the second part of this test to require only that the worker have the *ability* to perform services for other customers or clients – even if in reality he only does work for one and even if that one “client” provides all the tools needed to do the job.

The Department of Labor & Industry believes that tightening up the definition of who can qualify as an independent contractor is the most important change you can make in the law on this subject. A stronger definition will not only be a big help to our enforcement efforts, it would also provide some much-needed clarity for the business community and for the vast majority of employers who strive to play according to the rules.

In conclusion, I want to thank this committee for focusing on the issue of worker misclassification and I look forward to working with you to find workable solutions to this growing problem.