

# Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs

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Planmatics, Inc.  
15200 Shady Grove Road, Suite 450  
Rockville, MD 20850

*For*

U.S. Department of Labor  
Employment and Training Administration  
200 Constitution Ave., NW  
Room S-4231  
Washington, DC 20210

## **ABSTRACT**

This report presents the results of a study on independent contractors (ICs) conducted in 1998-99. It begins with a description of ICs in the alternative workforce and definitions and tests used by federal and state agencies to classify them. Next, the motivations of employers to use ICs, the motivations of workers to become ICs, and selected industries where they predominate are described. Profiles of employees misclassified as independent contractors are described, and the results of an attempt to determine the extent of misclassification of employees as ICs and its effects on Unemployment Insurance (UI) trust funds are presented. Then the efforts of state administrators in dealing with ICs and other significant workforce issues related to ICs are described. Finally, the report presents the findings and recommendations of the study.

# Preface

Planmatics is pleased to offer this final report titled “Study of Alternative Work Arrangements: Independent Contractors.” The project was funded under Department of Labor Contract No: K6878-8-00-80-30. The authors are Dr. Lalith de Silva, Mr. Adrian W. Millett, Mr. Dominic M. Rotondi, and Mr. William F. Sullivan. Ms. Elizabeth Fischer and Mr. Mark Sillings also contributed. The Department of Labor project officer for the study was Mr. Wayne Gordon.

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## **DEFINITIONS OF ALTERNATIVE AND NONSTANDARD WORK ARRANGEMENTS\***

**Alternative Work Arrangement** – Individuals whose employment is arranged through an employment intermediary such as a temporary help firm, or individuals whose place, time, and quantity of work are potentially unpredictable.

**Contingent worker** – Any worker in a job which does not have an explicit or implicit contract for long-term employment. The BLS uses three different definitions; the broadest of which includes all wage and salary workers who do not expect their jobs to last.

**Contract worker** – Workers employed by a company that provides them or their services to others under contract and who are usually assigned to only one customer and usually work at the customer's work site. EPI defines a contract worker as anyone who does contract work regardless as to whether they work at the customers' work site or for more than one customer.

**Day Laborers** – Workers who wait at a location where employers pick up people to work for the day; a type of on-call worker.

**Full-time employees** – Wage-and-salary workers who work 35 hours or more each week.

**Independent contractors** – Individuals who are not employees in the traditional sense but who instead work for themselves; someone who obtains customers on their own to provide a product or service

**Independent contractors: self-employed** – Workers identified in the basic CPS as self-employed who answer affirmatively to the question in the CPS supplement, "Are you self-employed as an independent contractor, independent consultant, freelance worker or something else (such as a shop or restaurant owner)?"

**Independent contractors: wage-and-salary** – Workers identified as wage and salary workers in the basic CPS who answered affirmatively to the question in the CPS supplement, "Last week, were you working as an independent contractor, an independent consultant, or a free-lance worker? That is, someone who obtains customers of their own to provide a product or service."

**Leased employees** – A type of contract worker, but “in a classic leasing arrangement, a leasing company provides all the employees to a client firm. In contrast, contract workers usually fill specialized occupational niches within client firms, working closely with the permanent employees of client firms.” (see Vroman)

**Nonstandard Work Arrangement** – any job that differs from standard jobs due to one or more of the following ways: the absence of an employer, a distinction between the organization that employs the worker and the one for whom the person works, or the temporary instability of the job. (see Kalleberg, Arne, and Rasell, Edith, et al)

**Part-time employees** – Wage and salary workers who work less than 35 hours a week.

**On-call workers** – Workers who are called to work as needed, although they can be scheduled to work for several days or weeks in a row. (Examples include substitute teachers and construction workers supplied by a union hall)

**Outside worker** – Where there is a difference between the employer directing the content of the work (the client employer) and the employer who hires and pays the worker (see Vroman). Examples include contract workers and temporary help agency employees.

**Self-employed** – Workers who identified themselves as self-employed in response to the following question in the basic CPS, “Are you employed by government, by a private company, a non-profit organization, or were you self-employed?” Includes independent contractors as well as other self-employed such as restaurant and shop owners.

**Temporary worker** – equivalent to a contingent worker; encompasses temporary help agency employees, on-call workers, and wage and salary workers who are temporary direct hires. (see Vroman)

**Temporary help agency workers** – Workers paid by a temporary help agency, whether or not their job was actually temporary.

\*This glossary draws primarily on the original definitions from the Bureau of Labor Statistics but also includes variations as defined by other analysts.

## EXECUTIVE SUMMARY

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

## **CHAPTER 7**

### **SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS**

This chapter provides some recommendations for addressing a problem that may become significant if the economy undergoes a downturn and the level of unemployment increases.

#### **7.1 Summary of Findings**

The primary purpose of this study was to supplement existing knowledge on independent contractors and their role in the alternative workforce in order to provide policymakers with a more objective basis for understanding this work arrangement. BLS surveys of nonstandard workers in 1995 and 1997 found that ICs were the largest category, with 8.3 million & 8.5 million workers respectively, or 6.7% of the workforce. In the 1999 BLS survey, ICs were still the largest component of the alternative workforce, however their share had diminished slightly from 6.7% to 6.3%. Although the BLS results show a decline in ICs, the perception of the majority of those interviewed for the study was that independent contractor use is indeed growing.

There are no universal rules to determine who is an employee and who is an IC because the line between them shifts over time. Each state determines which individuals are employees and which are ICs by consulting the state definition and applying the state test (common law or ABC) and the state law. Critics assert that the current system has outlived its usefulness and is not responsive to the ever-changing ways in which business is being conducted.

Many workers displaced by corporate downsizing, as well as those seeking a more flexible work environment, have become independent contractors. Compared with the traditional workers, independent contractors are disproportionately found in construction, insurance, finance, real estate and services.

Some employees voluntarily left their regular jobs to start working for themselves as independent contractors for a variety of reasons. Independence, choice of employer and work hours, control over one's destiny, job stability, and higher levels of remuneration were the reasons frequently given by writers and artists, insurance and real estate sales agents, software and Web page designers, construction trade employees, and managers and administrators. However, there are other workers who left regular employment involuntarily and who prefer the stability of regular full-time employment, but were compelled by employers to accept independent contractor status. These are found in all types of occupations and industries.

In the study reported here, the demographic characteristics of independent contractors compiled from data provided by UI agency staff and advocacy groups indicate a great deal of variability in the makeup of ICs. ICs are males or females and of all ages and of a variety of ethnic origins. They have different education and skill levels. The majority has no health insurance or retirement benefits and earns middle to low-level wages.

One of the major issues of concern to federal and state policymakers at the labor department as well as many employers is the misclassification of employees as ICs. This particular practice is not only denying many workers protections and benefits they are entitled to, but it also has important implications for the financial viability of UI trust funds. Analysis of employer misclassification by industry for five states in this study showed that construction, manufacturing, home healthcare and retail had high levels of misclassification.

There was also a perception among employers and workers, especially those in the medium to high wage occupations that the designation of employee or independent contractor status was an option to be agreed upon by both parties. What mattered was the existence of a written agreement between both parties.

The economic factors that encourage employers to misclassify employees as ICs include heightened competition, new management paradigms, deregulation, and downsizing. The use of ICs allows employers to save on payroll taxes, fringe benefits, and workers compensation. They circumvent compliance with labor and workplace legislation designed to protect employees. They increase their workforce flexibility by hiring ICs to replace and supplement regular employees on an as needed-basis.

The number one reason for misclassifying workers or hiring independent contractors is the savings in not paying workers' compensation premiums and thereby not being subject to workplace injury and disability-related disputes. In high-risk industries, workers' compensation was the single most dominant reason for misclassification. Many employers believe the risk of being caught is acceptable if it means the survival of their business. Their view of the risk involved, however, fails to take into account violations of federal statutes that have substantial penalties.

Misclassification has a significant impact on those individuals who are told by their employers that they are ICs, not employees. These individuals are generally not financially able to make contributions to a retirement program and do not file for unemployment, although they could be eligible. In the long term, their retirement benefits are significantly reduced and in the short term, they do not collect unemployment insurance if they become unemployed. Utilization of IRS incentives such as self-employment plans is not a viable option for ICs because of their limited earnings.

UI employer audit data from selected states were used to estimate the proportion of employers who misclassify employees and the impact of misclassification on UI revenues and the trust fund. States that relied on targeted audits had a range of 30 to 45% of audited employers with misclassified employees. The proportion was around 10% in states with high levels of randomness in their audit selection process. Underreporting of UI tax revenues due to misclassification ranged from less than one half of 1% to 7.5%.

Assuming a 1% level of worker misclassification, and unemployment at the 1997 level, the average loss in revenue to the trust fund resulting from employer underreporting of UI taxes from 1990 to 1998 would be \$198 million. The average outflow of benefits, if paid to the misclassified claimants, would be \$203 million. These estimates show that the financial impact of misclassification is nominal at present. However, thousands of workers who have a legal right to UI protection are not being afforded such protection because of misclassification. Other social protections are also being denied to these workers, who are often the ones most in need of such protection.

Furthermore, an increase in the unemployment rate could cause enormous increases in independent contractor-related issues that would have to be investigated. The additional claims would also drain the trust fund, and this drain would most likely have to be offset by assigning higher contribution rates to those employers that correctly classify their workers and pay their taxes, placing them at a further economic disadvantage.

## **7.2 Recommendations**

The increasing use of all types of nontraditional workers, including ICs, has created renewed interest in changing the employee classification criteria. To date, state employment security agencies have dealt with this problem by enacting specific exclusions from the definition of employment. There is a need to establish a system that ensures that determinations of employee and ICs are made simply, consistently, and fairly.

To address the issue of misclassification, several states have set up task forces to monitor employers' classification practices and reporting on employees. IRS data are an integral component of these efforts. However, state officials indicated that in the majority of cases, the shared information consisted primarily of UI audit results provided by states to the IRS. This information sharing should flow both ways. The use of Form 1099-Misc on which non-employee compensation is reported to the IRS in California proved to be extremely effective in detecting employee misclassifications. Other states need to make

this type of information part of their unemployment insurance tax enforcement programs. The Employment and Training Administration (ETA) should take a leadership role in forging a strong relationship between the IRS and SESAs to routinely share 1099 data. The USDOL should develop software and a computer program that will extract data that are useful to the states from the IRS 1099 tapes.

The ETA must also develop a dialogue with other agencies within the USDOL and outside it, such as the Immigration and Naturalization Service, which have major interest in employer-employee relationships and other worker protection issues. State agencies that determine employee and independent contractor status, such as workers' compensation and state departments of revenue, should be encouraged to exchange relevant information. Information should be shared, not only among state agencies, but also between states and their neighboring partners. Several states such as Montana, Wyoming, Connecticut, and California have taken the lead in establishing interagency reporting and cooperation, and these efforts can be used as models by other states. There are new technologies (e.g. intelligent collection systems, pattern recognition) that can be used to track independent contractors and their employers.

Another workplace related issue that affects UI revenue and erosion of coverage is the increasing requests by employers for exclusion of certain job classifications and wages from the payment of state UI taxes. If an employer had wages subject to FUTA but **not** subject to the state, that employer should not be allowed a FUTA credit and be required to pay the full 6.2% FUTA tax. To offset the enactment of specific exclusions from the definition of unemployment at the state level, at the federal level there should be a way of fixing this obvious lapse in the process. It is this process that gives the federal government the sanction necessary to insure compliance among the states. (Note: If your state's law is not in compliance with the federal guidelines of the world, an employer's tax is increased eight-fold.) A workgroup should be established to assess whether the intent of this provision of FUTA is being met and how it may be used to prevent further erosion of UI coverage.

The USDOL should undertake a comprehensive campaign to educate employers on voluntary compliance (not only the publication of successful prosecution, but also a systematic continuing educational campaign). The ETA must develop a repository of information on independent contractor issues, best practices, new initiatives, and legislative measures. This information should be updated frequently and publicized, and its contents made accessible to agencies dealing with independent contractors.

The short and long term impact of the IC work arrangement on the individual workers are that social protections now available to employees are currently denied to independent contractors, and the majority of them cannot afford to take advantage of the available measures. A multi agency dialogue needs to be started to explore the feasibility of extending some or all of the social protections to them. For example, should ICs participate in unemployment insurance, including payment of contributions? Should workers' compensation be mandatory for them? Should IC agreements be subject to requirements such as the payment of a minimum wage? These are a few of the questions that need to be answered in order to respond to the needs of this workforce. The way in which they are answered may determine the well being, not only of ICs, but also of the American economy as a whole in the coming century.