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## ILR Impact Brief – Employee or Independent Contractor? Misclassification Comes at a Price

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# ILR Impact Brief – Employee or Independent Contractor? Misclassification Comes at a Price

## **Abstract**

Misclassification of workers occurs at the time of hiring, when individuals are categorized as employees or independent contractors. The legal distinction between the two relates to the right of control over work: *employees* take direction from employers as to the means, methods, and outcome; *independent contractors* are in business for themselves and retain the right to control how they will accomplish the task they've been hired to perform.

This study covers certain key industries in New York State for the years 2002-2005. Audits performed by the Department of Labor Unemployment Insurance Division indicate approximately 10% of private-sector employers did not comply with state regulations when classifying new hires; construction industry employers accounted for an estimated 14.9% of this group. The data also show that approximately 10.3% of private-sector workers were misclassified as independent contractors and about 14.8% of this cohort worked in construction.

## **Keywords**

impact brief, performance, worker, misclassification, employee, contractor, business, New York State, unemployment insurance, regulation, industry

## **Comments**

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To read the full report, please see: [The Cost of Worker Misclassification in New York State](#)

The ILR Impact Brief series highlights the research and project based work conducted by ILR faculty that is relevant to workplace issues and public policy. The Briefs are prepared by [Maralyn Edid](#), Senior Extension Associate, ILR School.

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# IMPACT BRIEF

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## Employee or Independent Contractor? Misclassification Comes at a Price

**Research question:** What is the cost to workers, businesses, and New York State government and taxpayers when employers misclassify workers as independent contractors instead of classifying them as employees?

**Conclusion:** The impacts on all parties are substantial and real. Misclassified workers are denied many of the legal protections and benefits enjoyed by workers appropriately classified as employees. Businesses that misclassify workers as independent contractors reap an unfair competitive advantage over businesses that properly classify workers as employees; misclassification occurs frequently in the construction industry. And finally, government and the public bear a financial burden through lost tax revenues.

**Policy implication:** Given the swelling ranks of independent contractors (alternatively known as contingent workers) in the workforce, the misclassification issue merits the attention of policymakers and regulators. This study offers several approaches that would eliminate the problem, including clarifying the guidelines used to determine the proper classification, ramping up enforcement, presuming employee status, bringing independent contractors under the protective labor law umbrella, and expanding education and outreach to workers and employers. Although the data used here are specific to New York State, its conclusions are consis-

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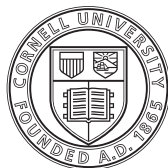
*The Impact Brief series highlights the research and project-based work conducted by ILR faculty that is relevant to workplace issues and public policy. Please visit <http://digitalcommons.ilr.cornell.edu/impactbrief/> for full-text pdfs.*

tent with similar studies conducted in other states and by the federal government.

**Abstract:** Misclassification of workers occurs at the time of hiring, when individuals are categorized as employees or independent contractors. The legal distinction between the two relates to the right of control over work: *employees* take direction from employers as to the means, methods, and outcome; *independent contractors* are in business for themselves and retain the right to control how they will accomplish the task they've been hired to perform.

This study covers certain key industries in New York State for the years 2002-2005. Audits performed by the Department of Labor Unemployment Insurance Division indicate approximately 10% of private-sector employers did not comply with state regulations when classifying new hires; construction industry employers accounted for an estimated 14.9% of this group. The data also show that approximately 10.3% of private-sector workers were misclassified as independent contractors and about 14.8% of this cohort worked in construction.

Assigning workers the wrong status may be inadvertent or purposeful. Employers sometimes err because the regulations are unclear; the report's authors note the rules are complex, inconsistent, and contain varying standards. But other employers intentionally misclassify workers as independent contractors. These employers are willing to risk the small chance of being caught — and paying the fines — because they perceive this ploy will lower their labor costs, give them a competitive ad-



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vantage, and limit their liability. Indeed, companies that hire independent contractors reduce their administrative costs and lower their tax obligations. They do not withhold income taxes or pay Social Security, Medicare, and unemployment insurance and also save on workers' compensation insurance; nor are they required to pay overtime or minimum wage or to extend health, vacation, pension, and other benefits. Moreover, employers are not liable for wrongful acts (torts) committed by independent contractors. Studies conducted at the national level note that the fiercely competitive construction industry has the highest incidence of misclassifying workers as independent contractors.

Workers and taxpayers bear the brunt of misclassification. Workers inappropriately categorized as independent contractors are denied the protections of various labor laws (such as minimum wage, the right to organize, health and safety, and family and medical leave) and are excluded from the benefits companies grant to employees. They are saddled with the administrative burden of withholding and reporting their own income taxes and also pay a higher self-employed tax rate. Still, some workers prefer independent contractor status because it affords them flexibility, greater control over their work, and the ability to claim several advantageous tax deductions.

With less tax revenues flowing into government coffers, public resources are strained. State unemployment insurance systems, for example, are forced to compensate by raising contribution rates for employers who comply with the regulations. According to the Government Accountability Office, underpayment of Social Security, unemployment insurance, and income taxes in 2006 due to misclassification amounted to an estimated \$2.72 billion; the researchers here argue that the real cost is substantially higher, particularly when losses at the state level are factored in.

The worker misclassification problem and its attendant consequences could be resolved through several policy initiatives. The authors first recommend developing clear classification guidelines that would be uniformly applied and recognized by all state agencies and the courts. They suggest all workers should be presumed employees unless certain limited criteria are met and advocate extending to independent contractors the legislative protections granted to employees, a revision in the law that would remove one incentive to misclassification. More resources for enforcement, stiff penalties, enhanced data collection, information sharing among agencies, and more education and outreach to workers and employers would also help minimize classification mistakes.

**Methodology:** Data for this study come from audits performed by the New York State Department of Labor Unemployment Insurance Division on 38,280 employers in certain industries, such as construction (5,606 employers), manufacturing, finance and insurance, health care and social assistance, and others, for the years 2002-2005.

**Source publication:** "The Cost of Worker Misclassification in New York State" was published in February, 2007. The study was sponsored by UNICON, a construction industry labor-management organization based in Rochester, NY, and was funded by the New York Senate Labor Committee (Senator George Maziarz, Chair).

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