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Stretching the Law, Stressing the State Misclassified Workers in Maine's Construction Industry

The classification of independent contractors (ICs) is problematic in a number of industries and employment situations. This paper is intended as a survey of IC issues as they affect the construction industry in Maine. Construction companies have recourse to hourly labor for much of their work requirements, but like many other businesses, they also often employ independent contractors for some parts of their various building contracts.

There is considerable evidence that these two job categories are being manipulated by some employers to bypass the legal intent of IC classification. A 2000 report produced for the U.S. Department of Labor found employee misclassification in the construction industry to be critical nationally: "The construction industry was the industry frequently cited by interviewees as most likely to use ICs, contain the highest incidence of misclassification, or as one that lures workers into becoming ICs."¹

Opportunities for fairness in taxation, insurance premiums, and employee benefits are increased by proper classification of ICs. Employees and ICs are very different with regard to how they are paid, and how they are taxed. It is very important that they be classified correctly. The interests of employee and employer are in conflict in some ways over classification distinctions: hourly workers often receive benefits such as pension and health insurance. Employers must withhold the proper federal taxes due for their hourly employees, who file a W2 form when paying taxes. By statutory requirement, employers must also provide Workers' Compensation (WC) coverage for their employees. Independent contractors, on the other hand, are technically self employed. They must file a 1099 form to declare their income for taxes. With a 1099 filing, they must assume much of the taxation and insurance liabilities paid by employers for their hourly employees, including both the employer and employee portions of Social Security taxes (FICA). Their pay needs to reflect this fact.

Given these arrangements, employers are likely to favor the IC classification. IC status is generally appropriate for professionals like doctors and lawyers, and a wide range of consultants. However, it is important to note that ICs set their rates to cover the payroll taxes, insurance and other expenses for which they are responsible. Problems arise when an employee is expected to work as an IC while receiving the same relative pay as an hourly worker.

Is this really a problem for Maine?

There are some reliable and readily available data to help assess the extent of employee misclassification in Maine, published in April, 2005 by Harvard University's Labor and Worklife Program. The report, *The Social and Economic Costs of Employee Misclassification in the Maine Construction Industry (Harvard Report)*,² looks at Maine's independent contractor problem specifically. It finds considerable evidence of widespread abuse of employee classification in Maine.

The Harvard researchers used Maine Unemployment Compensation audits to formulate their estimates: "These cost estimates rely upon our estimates of prevalence and extent of misclassification from random

¹ Lalith de Silva et al. 2000. *Independent contractors: prevalence and implications for Unemployment Insurance programs*. Planmatics, Inc., prepared for US Department of Labor and Training Administration. Planmatics, 2000. http://wdr.doleta.gov/research/FullText_Documents/op%5F05%2D00%2Epdf p. 41 Hereafter, US DOL.

² By Carré, Françoise, Ph.D., and Randall Wilson, University of Massachusetts Boston; Bernard, Elaine, Ph.D., and Robert Herrick, Sc.D., Principal Investigators, Construction Policy Research Center, Labor and Worklife Program, Harvard Law School and Harvard School of Public Health, April 2005. <http://www.law.harvard.edu/programs/lwp/Maine%20Misclassification%20Maine.pdf> Hereafter, Harvard.

audits. They are therefore conservative estimates Data used here from Maine employer audits are closer to a truly random sample than those available in many states.”³ Random audits have a lower detection rate than targeted audits based on tips and records of past infractions. In addition, audits only reveal cases that can be documented and thus do not “fully capture the scope of underground economy activities in construction.”⁴ Employees working “under the table” on a cash-only basis do not leave a paper trail. With random audits, some employers also undoubtedly escape detection by simple chance. Thus the Harvard estimates, which cite substantial losses, may not show the full extent of the problem.

Employee misclassification and Maine construction workers

In its report, Harvard estimates cases of misclassification that average 3,213 annually for all occupations of the Maine construction industry from 1999 through 2002.⁵ But perhaps most alarmingly,

[s]ometimes, before workers can begin employment, employers require them to purchase their own workers’ compensation and liability insurance coverage. They are expected to sign certificates of worker’s [*sic*] compensation insurance and liability insurance as well as various other waivers absolving the employer of obligations. (However, because this workers’ compensation insurance only covers the holders’ employees, it has no value for the [misclassified] worker and only protects the employer in case of tax and/or insurance audits.)⁶

These workers are put in a very tenuous position by their employers. The problem is not uncommon. “During the years 1999-2002, *at least one in seven, or 14% annually, of ME construction employers are estimated to have misclassified workers as independent contractors.*”⁷ This may seem like a small percentage of contractors, and therefore a small number of violations. However the *Harvard Report* also finds that “[w]hen construction employers misclassify, they do so extensively. . . . [O]ver 4 in 10 workers (45%) are misclassified annually in construction employers found to be misclassifying in the period 1999-2002.”⁸ So while the percentage of employers misclassifying (14%) is relatively low, this is offset by the extent of infractions (45%) by individual employers *within the relatively small group (14%) who do misclassify.*

A closer look can be revealing. While the *Harvard Report* bases its estimates on all construction occupations, some audits by the Maine Department of Labor’s (DOL) Bureau of Unemployment Compensation looked at general construction contractors specifically. For this smaller group of employers, for 2005, the Maine DOL found that nearly 40% of the audits revealed misclassified workers. Clearly, the Maine DOL is on the right track with its audit focus on general construction contractors: it reports that this number is “almost twice the number of misclassified workers usually found in a year when the same number of random audits are conducted over a random sampling of all industries.”⁹

³ *Ibid*, p. 9.

⁴ *Ibid*, p. 1. Both employer and employee avoid taxes through underground activities. Cash-based, “under the table” arrangements also allow workers to avoid mandated child care payments.

⁵ *Ibid*, p. 2.

⁶ *Ibid*, p. 6.

⁷ *Ibid*, p. 1. Emphasis in original.

⁸ *Ibid*, p. 2.

⁹ Ms. Laura Boyett, Director, Bureau of Unemployment Compensation, Maine DOL, communication from January 22, 2007. In addition, the US DOL report found that: “ ‘[in Minnesota,] . . . over 86% of the time when a claim is filed and the employer alleges that the individual was an independent contractor, the determination of the department is that the individual performed services for the employer in insured employment.’ In Colorado and Florida, contested [UC] claims have led to reclassification of ICs to employees in approximately 90 to 95% of the cases.” US DOL, p. 54.

Such a high incidence of worker misclassification has hidden social costs:

“The majority [of ICs] has no health insurance or retirement benefits and earns middle to low-level wages. . . .¹⁰ 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.”¹¹

This profile of misclassified workers suggests that many such misclassifications are not errors, but deliberate employment practices on the part of some of these contractors. Maine construction workers are misclassified at more than double the rate of Massachusetts construction workers, 11% and 5% respectively, for all construction employers in each state.¹²

Employee misclassification and Maine construction contractors

While correct employee classification is important in all industries, the construction industry has some special vulnerabilities in that construction contractors often rely on bids to win contracts. Employers who misclassify can have much lower labor costs than those who do not violate the law. When such infractions are ignored, some contractors are rewarded for breaking the law, a situation that, arguably, neither the industry, nor the state, should tolerate.

Employee misclassification may be an increasing threat to the construction industry. Nationwide, several states have observed that when inquiring about IC classification policy, employers are increasingly likely to question the rules. There is a perception that such employers are aware that their competitors are enjoying an advantage by using ICs, sometimes with the help of consultants who advise them on ways to classify employees as independent contractors.¹³

Employee misclassification and Maine’s economy

There are three major stress points for the state with widespread worker misclassification: income tax collection, UC tax collection, and payment of WC premiums. Law-abiding contractors and employees, as well as the state, all stand to lose from violations of classification rules by some employers. In addition, a lateral problem is created when the state is liable for the healthcare and other social services for workers without health insurance and other benefits due to incorrect classification as ICs.

Competent research has concluded that workers’ compensation costs are the major motive for employer misclassification.¹⁴ Over the four years studied by the *Harvard Report*, the estimated loss in WC premiums ranges from \$15.6 million to \$26 million, cumulatively for those four years.¹⁵ In addition, some reports have found that uninsured workers have been added to WC policies *after* they are injured.¹⁶

¹⁰ US DOL p. 91.

¹¹ *Ibid*, p. 92, emphasis added.

¹² Harvard, p. 2. These numbers may be related to the higher rate of unionization in Massachusetts construction firms, 28%, against 10% for Maine, p. 14.

¹³ US DOL, p. 55.

¹⁴ Harvard, p. 7.

¹⁵ *Ibid*, p 12.

¹⁶ *Ibid*, p 11.

These losses have an inevitably negative impact by driving up the premium costs for employers who do not misclassify. Once again, those who observe the law are penalized, while those who break the law enjoy an advantage.

Unemployment Compensation funds suffer as well. For 2005, the Maine DOL found losses in underreported unemployment taxes of \$59,802, for 970 misclassified workers employed just by Maine general construction contractors.¹⁷ Losses to state income tax estimated by the *Harvard Report* range from \$2.6 million to \$4.3 million.¹⁸ The Maine State Revenue Service estimated loss at the more conservative level of \$2.7 million.¹⁹ At the federal level, losses to FICA, or Social Security payments, from the state of Maine alone, are estimated at nearly \$10.3 million per year for the same period.²⁰

Researchers for the US DOL certainly saw the misclassification as a serious problem:

The use of ICs allows employers to save on payroll taxes, fringe benefits, and workers [*sic*] compensation. They circumvent compliance with labor and workplace legislation designed to protect employees. . . . 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.²¹

What Needs to be Done?

The first tool needed to control this problem is reliable detection of violations. Two-way interagency information sharing between UC and IRS officials for detection of misclassifications, as recommended by the US DOL report,²² is a good place to start in restoring the rights of hourly workers employed in construction. As documented previously, the Maine DOL Bureau of UC is showing results by sharpening its industry focus for audits. Legislative remedies also could be useful in stating IC rules clearly and defining penalties, and in providing for adequately funded government enforcement to assure deterrence. It is essential that contractors who respect the rights of their employees not be penalized for following the law. Nor should the state lose out on tax and other revenues that have been established by law. A level playing field in the bidding process is the best way to protect the well-being of construction contractors, their workers, and the state of Maine.

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¹⁷ Ms. Boyett, *Ibid.*

¹⁸ Harvard, p. 10

¹⁹ *Ibid.*, p. 11. Based on underreporting at a rate of 50%, and using different assumptions about taxpayer households.

²⁰ *Ibid.*, p. 12.

²¹ US DOL, p. 92.

²² *Ibid.*, pp. 93-94.