EMPLOYEE MISCLASSIFICATION

Improved Outreach Could Help Ensure Proper Worker Classification

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What GAO Found

The number of independent contractors in the total employed workforce grew from 6.7 percent in 1995 to 7.4 percent in 2005. In 2005, there were 10.3 million independent contractors. Independent contractors, in 2005, had an average age of 46 years, were almost twice as likely to be male than female, and almost two-thirds had some college or higher education. Independent contractors were employed in a wide range of industries (such as professional services and construction) and occupations (including sales and management).

When employees are misclassified as independent contractors, they may be excluded from coverage under key laws designed to protect workers and may not have access to employer-provided health insurance coverage and pension plans. Moreover, misclassification of employees can affect the administration of many federal and state programs, such as payment of taxes and payments into state workers' compensation and unemployment insurance programs. Notably, the tests used to determine whether a worker is an independent contractor or an employee are complex, subjective, and differ from law to law.

DOL detects and addresses misclassification of employees as independent contractors by investigating complaints, but does not always forward misclassification cases to other federal and state agencies. DOL investigators detect and address employee misclassification primarily when responding to FLSA minimum wage and overtime pay complaints. DOL procedures require officials to share information with other federal and state agencies whenever investigators find possible violations of other laws. However, the district offices GAO contacted vary in how often they forward misclassification as a possible violation of other laws. As one form of outreach to workers, DOL has an FLSA workplace poster that explains the act, but it is missing key contact information.

What GAO Recommends

GAO is not making new recommendations at this time. The Department of Labor generally agreed with the recommendations in the GAO report, which focused on improvements to a worksite poster reaching out to workers and DOL's efforts to forward misclassification cases to other agencies.


To view the full product, including the scope and methodology, click on the link above. For more information, contact Sigurd Nilsen at (202) 512-7215 or nilsens@gao.gov.
Mr. Chairmen and Members of the Subcommittees:

Thank you for inviting me here today to discuss the misclassification of employees as independent contractors. Some workers do not receive worker protections to which they are entitled because employers misclassify them as independent contractors when they should be classified as employees. Key worker benefits and protections include the guarantee of workers' rights to safe and healthful working conditions, a minimum hourly wage and overtime pay, freedom from employment discrimination, and access to unemployment insurance. In its last comprehensive misclassification estimate, the Internal Revenue Service (IRS) estimated that 15 percent of employers misclassified 3.4 million workers as independent contractors in 1984, resulting in an estimated tax loss of $1.6 billion (or $2.72 billion in inflation-adjusted 2006 dollars\(^1\)) in Social Security tax, unemployment tax, and income tax.

The Department of Labor (DOL) enforces a wide range of labor laws that provide protections to workers, including the Fair Labor Standards Act (FLSA), which provides minimum wage, overtime pay, and child labor protections. Other federal and state agencies enforce laws that provide workers with additional workforce benefits and protections.

The information I am presenting today is based on findings from a July 2006 report, which examined various aspects of the contingent workforce.\(^2\) Today, as requested, I will focus specifically on independent contractors, one of eight categories of contingent workers included in our report. I will discuss (1) the number and characteristics of independent contractors, (2) the workforce protections and benefits provided to employees that typically are not available to independent contractors, and (3) the actions that DOL takes to detect and address employee misclassification. To identify information on the contingent workforce, we analyzed data from the Bureau of Labor Statistics' (BLS) Current Population Survey (CPS),

\(^1\)The $2.72 billion is intended to be an estimate of the magnitude of tax loss due to misclassification in 2006 dollars—not an updated estimate. The actual tax loss due to misclassification in 2006 may be higher or lower based on the tax rates, the level of independent contractors used in various sectors of the economy, and the types and levels of misclassification observed in 2006.

\(^2\)GAO, Employment Arrangements: Improved Outreach Could Help Ensure Proper Worker Classification, GAO-06-656 (Washington, D.C.: July 11, 2006). In this report, we define “contingent work” as work arrangements that are not long-term, year-round, full-time employment with a single employer.
which is used to survey people about their work and workplace benefits, and a CPS supplement developed to collect information on the contingent workforce; interviewed BLS officials and other researchers about contingent worker issues; and reviewed key workforce protection laws to determine coverage of contingent workers. To obtain information on DOL’s efforts to detect and address employee misclassification, we reviewed DOL documents and interviewed DOL officials and reviewed literature and interviewed researchers about employee misclassification issues. We performed our work in accordance with generally accepted government auditing standards between July 2005 and June 2006.

In summary, the number of independent contractors in the total employed workforce grew from 6.7 percent in 1995 to 7.4 percent in 2005. In 2005, there were 10.3 million independent contractors. Independent contractors, in 2005, had an average age of 46 years, were almost twice as likely to be male than female, and almost two-thirds had some college or higher education. Independent contractors were employed in a wide range of industries (such as professional services and construction) and occupations (including sales and management). The tests used to determine whether a worker is an independent contractor or an employee are complex, subjective, and differ from law to law. Nevertheless, when employees are misclassified as independent contractors, they may be excluded from coverage under key laws designed to protect workers and may not have access to employer-provided health insurance coverage and pension plans. Moreover, misclassification of employees can affect the administration of many federal and state programs, such as payment of taxes and payments into state workers’ compensation and unemployment insurance programs. Finally, DOL detects and addresses misclassification of employees as independent contractors by investigating complaints, but does not always forward misclassification cases to other federal and state agencies. DOL investigators detect and address employee misclassification primarily when responding to FLSA minimum wage and overtime pay complaints. DOL procedures require officials to share information with other federal and state agencies whenever investigators find possible violations of other laws. However, the district offices GAO contacted vary in how often they forward misclassification as a possible violation of other laws.

3 Estimates of the size and characteristics of the contingent workforce are based on CPS sample data and are subject to sampling error. For example, the 95 percent confidence intervals for percentages of the total workforce are within +/- 1 percentage point of the estimate itself. For a full explanation of the methodology that we used and for the magnitude of sampling error for CPS estimates, see GAO-06-656.
laws. As one form of outreach to workers, DOL has an FLSA workplace poster that explains the act, but is missing key contact information. GAO recommended in its July 2006 report that DOL revise the workplace poster to include additional contact information that would facilitate the reporting of potential employee misclassification complaints, and evaluate the extent to which misclassification cases identified through investigations are referred to the appropriate federal or state agency, and take action to make improvements as necessary. DOL generally agreed with both recommendations.

The term “contingent work” can be defined in many ways to refer to a variety of nonstandard work arrangements. Broadly defined, “contingent work” refers to work arrangements that are not long-term, year-round, full-time employment with a single employer. For example, an employer may hire workers when there is an immediate and limited demand for their services, without any offer of permanent or even long-term employment. Independent contractors, temporary workers, and part-time workers are examples of contingent workers. Specifically, independent contractors can be seen as individuals who obtain customers on their own to provide a product or service (and who may have other employees working for them), such as maids, realtors, child care providers, and management consultants.

Research has shown that employers use contingent work arrangements for a variety of reasons. Employers may hire contingent workers to accommodate workload fluctuations, fill temporary absences, meet employees’ requests for part-time hours, screen workers for permanent positions, and save on wage and benefit costs, among other reasons. Previous analyses of data from the CPS Contingent Work Supplement have indicated that workers also take temporary and other contingent jobs for a variety of personal and economic reasons. For example, workers in various types of contingent jobs indicated that they (1) preferred a flexible schedule to accommodate their school, family, or other obligations; (2) needed additional income; (3) could not find a more permanent job; or (4) hoped the job would lead to permanent employment. Studies using data from the BLS National Longitudinal Survey of Youth show that events such as the birth of a child or a change in marital status affect the likelihood of entering different types of employment arrangements and prompt some workers to enter contingent work arrangements.

Concerns arise when employers misclassify workers as independent contractors, who are excluded from certain worker protections. Employee
misclassification occurs when an employer improperly classifies a worker as an independent contractor when the worker should be classified as an employee. In 2000, we reported that because most key workforce protection laws cover only workers who are employees, independent contractors and certain other contingent workers, such as self-employed workers, are, by definition, not covered.\footnote{GAO, \textit{Contingent Workers: Incomes and Benefits Lag Behind Those of Rest of Workforce}, GAO/HEHS-00-76 (Washington, D.C.: June 30, 2000).}

DOL may encounter employee misclassification while enforcing worker protection laws. DOL’s mission is to promote the welfare of job seekers, workers, and retirees in the United States by improving their working conditions, advancing their opportunities for profitable employment, protecting their retirement and health care benefits, helping employers find workers, strengthening free collective bargaining, and tracking changes in employment, prices, and other national economic measurements. In carrying out this mission, DOL enforces a variety of worker protection laws, including those guaranteeing workers’ rights to safe and healthful working conditions, a minimum hourly wage and overtime pay, freedom from employment discrimination, and unemployment insurance.

In particular, DOL’s Employment Standards Administration’s (ESA) Wage and Hour Division enforces FLSA. The Wage and Hour Division—with staff located in 5 regional and 72 district, area, and field offices throughout the country—conducts investigations of employers who have $500,000 or more in annual sales volume. In addition, the division conducts outreach efforts for employers and workers to ensure compliance with FLSA. District directors oversee investigators, who play a key role in carrying out FLSA enforcement. Investigators are trained to investigate a wide variety of workplace conditions and complaints and enforce a variety of labor laws in addition to FLSA.\footnote{Complaints are a key component of DOL enforcement efforts under many federal labor laws. DOL enforcement generally relies on two types of information to identify potential violations: (1) complaints from individuals who believe they may have suffered a violation and (2) analysis of data to specifically target problematic industries or work sites.} Regional and district offices conduct outreach to employers and workers through brochures, workplace posters, presentations or training sessions for individuals or groups, and Web-based information.
FLSA—which provides minimum wage and overtime pay protections—requires that employers pay those employees covered by the act at least the minimum wage and pay overtime wages when they work more than 40 hours a week. FLSA requires that an employer-employee relationship exist for a worker to be covered by the act’s provisions.

In 2005, an estimated 7.4 percent of the total employed workforce were independent contractors. By comparison, 6.7 percent of the workforce were independent contractors in 1995. During this time period, the number of independent contractors grew from an estimated 8.3 million to 10.3 million workers in 2005. (In 2005, there were about 42.6 million contingent workers in the workforce—representing an estimated 31 percent of the workforce.)

Independent contractors, in 2005, were on average 46 years old. The majority were men (65 percent), had attended or graduated from college, and 8 out of 10 were white, non-Hispanic. Independent contractors were employed in a wide range of industries, but in 2005, 23 percent were employed in professional services and 22 percent were employed in construction. Regarding occupations, the percentage of independent contractors in sales and related occupations (17 percent) and management (16 percent) were greater than in other occupations. In 2005, 9 percent of independent contractors indicated that they would prefer to work for someone else. About 11 percent of independent contractors reported family income below $20,000.

The tests used to determine whether a worker is an independent contractor or an employee are complex, subjective, and differ from law to law. Nevertheless, when employees are misclassified as independent contractors, they may be excluded from coverage under key laws designed to protect workers and may not have access to certain employer-provided benefits, such as health insurance coverage and pension plans. Moreover, misclassification of employees can affect the administration of many federal and state programs. For example, misclassification could affect payment of taxes and payments into state workers’ compensation and unemployment insurance programs.
No definitive test exists to distinguish whether a worker is an employee or an independent contractor. The tests used to determine whether a worker is an independent contractor or an employee are complex, subjective, and differ from law to law. For example, the National Labor Relations Act, the Civil Rights Act, the Fair Labor Standards Act, and the Employee Retirement Income Security Act each use a different definition of an employee and various tests, or criteria, to distinguish independent contractors from employees.

In determining whether an employment relationship exists under federal statutes, courts have developed several criteria. These criteria have been classified as the economic realities test, the common law test, and a combination of the two sometimes referred to as a hybrid test. The economic realities test looks to whether the worker is economically dependent upon the principal or is in business for him or herself. The test is not precise, leaving determinations to be made on a case-by-case basis. The test consists of a number of factors, such as the degree of control exercised by the employing party over the worker, the worker's opportunity for profit or loss, the worker's capital investment in the business, the degree of skill required for the job, and whether the worker is an integral part of the business. The traditional common law test examines the employing party's right to control how the work is performed. To determine whether the employing party has this right, courts may consider the degree of skill required to perform the work, who supplies the tools and equipment needed to perform the work, and the length of time the worker has been working for the employing party. When the tests are combined in some type of hybrid, a court typically weighs the common law factors and some additional factors related to the worker’s economic situation, such as how the work relationship may be terminated, whether the worker receives leave and retirement benefits, and whether the hiring party pays Social Security taxes.

Aside from the complexities of distinguishing employees from independent contractors, employers have economic incentives to misclassify employees as independent contractors. Namely, employers are not obligated to make certain financial expenditures for independent contractors that they make for employees, such as paying certain taxes (Social Security, Medicare, and unemployment taxes), providing workers’ compensation insurance, paying minimum wage and overtime wages, or including independent contractors in employee benefit plans.
Contingent workers who are employees are generally protected under key laws designed to protect workers, but certain categories of contingent workers—such as independent contractors—may be excluded from coverage under these laws. While most of the key worker protection laws do not distinguish between types of employees (i.e., contingent and standard full-time employees), some laws contain requirements that exclude certain categories of contingent workers or contain certain time-in-service requirements that make it difficult for them to be covered. In addition, because these laws are based on the traditional employer-employee relationship, they generally cover only workers who are employees; independent contractors, therefore, are not covered.

Some of the key laws designed to protect workers but that only apply to “employees” include the following:

- Fair Labor Standards Act—establishes minimum wage, overtime, and child labor standards;
- Family and Medical Leave Act—requires employers to allow employees to take up to 12 weeks of unpaid, job-protected leave for medical reasons related to a family member’s or the employee’s own health;
- Occupational Safety and Health Act—requires employers to maintain a safe and healthy workplace for their employees and requires employers and employees to comply with all federal occupational health and safety standards;
- National Labor Relations Act—guarantees the right of employees to organize and bargain collectively;
- Unemployment Insurance—pays benefits to workers in covered jobs who become unemployed and meet state-established eligibility rules; and
- Workers’ Compensation—provides benefits to injured workers while limiting employers’ liability strictly to workers’ compensation payments.

When employers have misclassified workers as independent contractors, workers may need to go to court to establish their employee status and their eligibility for protection under the laws. In addition, DOL may bring a lawsuit on behalf of the worker or group of workers to require that the employer provide the benefit or protection under the law.
Employees who are misclassified as independent contractors, because by definition they would not be considered employees, may not have access to certain employer-provided benefits, such as health insurance coverage and pension plans. Some states and professional associations have developed health insurance programs that help contingent workers access health care. While these public and private initiatives are relatively new and long-term outcomes have yet to be determined, the programs have succeeded in expanding health insurance options for some contingent workers.

Misclassification of employees can affect the administration of many federal and state programs, such as payment of taxes and pension benefits. For example, if employers misclassify workers as independent contractors, then they may not be paying the payroll taxes required to be paid for employees. At the federal level, misclassification can reduce tax payments, Medicare payments, and Social Security payments. At the state level, misclassification can affect payments into state tax, workers’ compensation, and unemployment insurance programs.

DOL detects and addresses employee misclassification when enforcing the FLSA minimum wage and overtime pay provisions. As part of its FLSA investigation process, DOL examines the employment relationship—whether a worker is an employee or an independent contractor—to determine which workers are covered. Investigators use various methods to test the employment relationship of workers, including interviewing employers and workers, reviewing payroll and related documents, and touring work sites. While misclassification alone is not an FLSA violation, it may contribute to FLSA violations or violations of other laws, such as tax violations. DOL’s outreach efforts provide some information to employers and workers on employee misclassification issues. DOL procedures require officials to share information with other federal and state agencies whenever investigators find possible violations of other laws. However, the district offices that we contacted vary in how often they forward misclassification cases as a possible violation of other agencies’ laws.
DOL relies on complaints as a primary way to identify potential violations for investigation. All FLSA investigations of minimum wage and overtime pay complaints begin with an examination of workers’ employment relationship because FLSA applies only to employees, not to independent contractors. If investigators determine that a worker is an employee and not an independent contractor, they continue with their FLSA investigation to determine whether the employer has provided the minimum wage and overtime pay required by the act.

Employee misclassification alone is not a violation of FLSA, but may contribute to FSLA minimum wage and overtime pay violations or violations of tax, workers’ compensation, or unemployment insurance laws. DOL investigations have identified FLSA violations associated with employee misclassification. For example, one misclassification case involved a valet parking company located in Arizona that provided services to local restaurants, sports venues, hotels, and theaters. In 2004, this company paid $66,947 in minimum wage and overtime pay back wages to 262 employees who had been misclassified as independent contractors. When reviewing the employment relationship, the DOL investigator found that the services provided by these workers were integral to the business, and that the employer had imposed strict policies and procedures to follow, and told them when they would work, where they would work, what their pay rate would be, and what uniforms they would wear. The investigator determined that the workers were not required to use initiative, judgment, or foresight to be successful as independent contractors, did not have any investment in facilities or equipment, and were not operating to make a profit.

As part of general FLSA outreach efforts to employers and workers, DOL provides some information on establishing the employment relationship. While these outreach efforts primarily focus on how to comply with provisions of FLSA—minimum wage, overtime pay, and child labor—they also include some information on the employment relationship. Specifically, information on employment relationship issues is available to employers and workers through brochures, pamphlets, fact sheets, and Web-based information. According to DOL officials, outreach efforts conducted specifically for industries likely to use independent contractors may also address the topic of employee misclassification.

Another form of outreach that DOL provides is its workplace poster. FLSA regulations require that every employer that has employees subject to the
act's provisions post a notice explaining the act in a prominent and accessible place at the work site. While DOL relies heavily on complaints from workers to enforce FLSA, the FLSA workplace poster does not provide a telephone number for workers or others to call to register complaints.

DOL Offices We Studied Vary in How Often They Forward Misclassification Cases to Other Federal and State Agencies

Employers’ misclassification of workers as independent contractors may in some circumstances violate tax, unemployment insurance, and workers’ compensation laws. According to the Field Operations Handbook, DOL regional or district officials are required to share information with other appropriate federal and state agencies whenever investigators conducting FLSA investigations find instances of possible violations of other laws. At the same time, however, the handbook cautions investigators not to interpret laws outside their authority. We discussed whether DOL forwards misclassification cases identified during an FLSA investigation. The DOL officials we spoke to in nine district offices could not provide the number of misclassification cases they referred to other agencies because they do not track this information. However, their responses indicated that district offices vary in how often they implement the procedures to refer cases to other agencies. Some of the DOL district offices told us that they notified IRS and state agencies when they found misclassification, while others told us that they had little or no contact with other agencies regarding misclassification issues. These district offices also reported that it was rare for them to receive misclassification referrals from other federal or state agencies.

Conclusions and Recommendations for Executive Action

DOL investigators identify instances of employee misclassification when responding to minimum wage and overtime pay complaints. However, because the FLSA workplace poster does not provide an easy method for workers to report complaints, DOL may be missing opportunities to address other instances of potential misclassification. Improving the workplace poster would reinforce DOL's complaint-based strategy and would help further protect the wages of employees who may be misclassified.

While DOL investigators conducting FLSA investigations are required to share information with other federal and state agencies whenever they find instances of possible violations of other laws, DOL district offices we studied varied in how often they forwarded misclassification cases to other agencies. DOL does not know the extent to which district offices refer misclassification cases to other agencies. DOL cautions investigators
not to interpret laws outside their authority, but referring misclassification cases identified through FLSA investigations would not require DOL to interpret other agencies’ laws. In addition, referring this information may assist other federal and state agencies in addressing misclassification. Furthermore, when DOL does not refer cases of misclassification, other agencies lose opportunities to fulfill their fiduciary duties in conserving government funds.

To facilitate the reporting of FLSA complaints, we recommended that the Secretary of Labor instruct the Wage and Hour Division to revise the FLSA workplace poster to include national, regional, and district office telephone numbers and a Web site address that complainants may use to report alleged employee misclassification issues. Following the publication of our report, DOL notified the Congress that it was redesigning the poster and expected the work to be completed in spring 2007.

To facilitate addressing employee misclassification across federal and state programs, we recommended that the Secretary of Labor instruct the Wage and Hour Division to evaluate the extent to which misclassification cases identified through FLSA investigations are referred to the appropriate federal or state agency potentially affected by employee misclassification, and take action to make improvements as necessary. In addressing its referral mechanism, the Wage and Hour Division officials should consider building upon efforts by district offices currently engaging in referrals. Following the publication of our report, DOL notified the Congress that it was researching the nature and effectiveness of the referral of potential employee misclassification by different district offices to various federal and state agencies. DOL also noted that it will consider appropriate revisions to its procedures, and expected the work to be done by the end of September 2007.

Mr. Chairmen, this concludes my prepared statement. I will be happy to answer any questions that you or other members of the subcommittees may have.
For future information regarding this testimony, I can be contacted at (202) 512-7215. Key contributors to this testimony were Brett Fallavollita and Linda Siegel.
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