

**STATEMENT OF
SETH D. HARRIS
DEPUTY SECRETARY
U.S. DEPARTMENT OF LABOR
BEFORE THE
COMMITTEE ON HEALTH, EDUCATION, LABOR, AND PENSIONS
U.S. SENATE**

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Chairman Harkin, Senator Enzi, and members of the Committee. Thank you for the opportunity to speak today about “worker misclassification.”

“Misclassification” seems to suggest a technical violation or a paperwork error. But “worker misclassification” actually describes workers being illegally deprived of labor and employment law protections, as well as public benefits programs like unemployment insurance and workers’ compensation because such programs generally apply only to “employees” rather than workers in general. Worker misclassification occurs when a worker who is legally an employee is treated as a self-employed worker, often referred to as an “independent contractor.” Some misclassification is the result of uncertainty or misapplication of often complicated laws or situations. However, much worker misclassification is intentional. Misclassification as independent contractors also increases the opportunities for tax evasion, and some take advantage of those opportunities, with a resulting loss of Federal and state revenue. Too many workers are being deprived of overtime premiums and minimum wages forced to pay taxes their employers are legally obligated to pay and are left with no recourse if they are injured or discriminated against in the workplace. Misclassification is no mere technical violation. It is a serious threat to workers and the fair application of the laws Congress has enacted to assure workers have good, safe jobs.

In this difficult economic climate, millions of Americans are struggling to stay in the middle class. We can see the impact of these struggles in many different areas of the economy: workers trying to keep good jobs with good wages and benefits; small businesses struggling to compete in a difficult market; and state governments and the United States government working to fund budgets that can provide the essential services Americans need. Worker misclassification exacerbates all of these challenges. It shortchanges workers, employers, states, and the federal government. Workers are not paid the wages to which they are entitled. Law-abiding, responsible employers are denied a level playing field in a hyper-competitive business environment. And the revenues flowing into federal and state treasuries are diminished when employers that should be treating workers as employees avoid paying, unemployment taxes, workers' compensation premiums, and (unless the workers pay them) payroll taxes. When the misclassified workers themselves do not pay some or all of the employment taxes for self-employed workers, the Social Security trust funds suffer a permanent loss.

Most workers in this country simply assume they are protected by our nation's basic employment laws – minimum wage, overtime, health and safety, workers' compensation, anti-discrimination, and unemployment insurance, among others. What they may not realize is that these protections are directly linked to their status as “employees.” For example, independent contractors, a label given to individuals who are genuinely self-employed, are not “employees” and, therefore, are not protected by these laws.

Unfortunately, it is all too easy for employers to misclassify employees and get away with it. Misclassification alone does not violate the Fair Labor Standards Act (FLSA), the Occupational Safety and Health Act (OSH Act), the Mine Safety and Health Act (Mine Act), or most other statutes administered by the Labor Department. No penalty attaches under these laws when employers misclassify workers, even when the employer knows and ignores a worker's true legal status. Furthermore, employers are not obligated to perform a written classification analysis before unilaterally deciding to treat workers as though unprotected by employment laws. For these reasons and others, it can be difficult for the Labor Department's worker protection agencies to protect workers and for workers to protect themselves under our existing laws. There are, however, severe Federal tax penalties for employers who are discovered to have misclassified workers, and such employers may also be required to pay their unpaid unemployment insurance premiums.

The Labor Department's experience has shown that misclassification can be a tool for employers to evade their legal obligations to workers and thereby gain a competitive advantage over employers that obey the law. While some employers misclassify their workers in error, the Government Accountability Office (GAO) concluded that some employers choose to misclassify their employees in order to avoid laws that restrict their labor practices or require them to provide rights and benefits to employees.¹ These are the cases we are targeting.

Workers are not the only ones harmed by misclassification—honest employers are as well. At a recent hearing of the House Education and Labor Committee's Subcommittee on Workplace

¹ *Employee Misclassification: Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention*, GAO-09-717 (2009).

Safety, a representative of the Mason Contractors Association of America estimated that companies that misclassify their workers expect to reduce labor costs by as much as 30 percent, in part by not paying workers' compensation premiums. Law-abiding business owners who play by the rules are being forced out of competition by companies that skirt the law and play games with the definition of "employee".

In a 2000 study of nine states commissioned by the Department of Labor's (DOL) Employment and Training Administration (ETA), the most significant reason for misclassifying employees as independent contractors was to avoid paying workers' compensation premiums and not being subject to workplace injury and disability-related disputes.² At least one study estimates that employers can reduce their labor costs by 20-40% by misclassifying their employees as independent contractors.³ This underscores the need to level the playing field for high road employers - we should ensure that they are not facing these unfair downward pressures in order to stay competitive.

Mr. Chairman, the Obama Administration agrees with you that our current system cannot continue. The rules governing employers' decisions about whether to respect employees' rights under our nation's employment laws must change, and they must change now. We must restore a level playing field for responsible employers and employees and ensure that workers benefit from the protections Congress intended them to have.

² *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs*, Lalith de Silva et al, Planmatics, Inc. (2000).

³ *The Social and Economic Costs of Employee Misclassification in the Michigan Construction Industry*, Dale L. Belman and Richard Block, School of Labor and Industrial Relations, Michigan State University (2008).

The Obama Administration – from the Office of the Vice President and the Middle Class Task Force to the Treasury Department and DOL – is organizing itself to address this issue. Most prominently, the President’s Fiscal Year 2011 budget proposes \$25 million for a DOL initiative that will include close cooperation with our partners in the Treasury Department’s Internal Revenue Service (IRS) to address worker misclassification. In addition, we look forward to working with this Committee, through the leadership of Chairman Harkin and Senator Sherrod Brown, along with Representatives Lynn Woolsey, George Miller and Rob Andrews, to enact legislation that will address worker misclassification under the Fair Labor Standards Act. We strongly support many provisions of the Employee Misclassification Prevention Act (EMPA) and view it as a critically important legislative vehicle for addressing worker misclassification. The President’s 2011 Budget also includes a proposal to help employers and the IRS clarify the status of workers for employment tax purposes, so that the incidence of (and, in some instances, the excuses for) misclassification will be reduced.

In the remainder of my testimony, I will seek to define the scope of the misclassification problem, outline the Labor Department’s current plans to address it, and offer the Administration’s views on the proposals that are before this committee that would make important contributions to finding a comprehensive and effective long-term solution.

The Scope of the Misclassification Problem

In order to understand the scope of the problem, it is necessary to define what we mean by “worker misclassification.” In simple terms, worker misclassification is the practice of treating a worker who is an employee under the law as something other than an employee, thus depriving

the employee of rights and benefits to which they are entitled. Whether a worker is an employee depends on which law is applicable. For example, there is the “economic realities” test employers must apply to determine the nature of their relationship with their workers under the FLSA. Under that test, which is broader than, for example, the common law test used by the IRS, employers must consider the following factors when determining whether a worker meets the statute’s definition of “employee”:

- The extent to which the services rendered are an integral part of the employer’s business;
- The permanency of the relationship;
- The amount of the worker’s investment in facilities and equipment;
- The nature and degree of control by the employer;
- The worker’s opportunities for profit and loss;
- The amount of initiative, judgment, or foresight in open market competition with others required for the worker’s success; and
- The degree of the worker’s independent business organization and operation.

We recognize that it is conceivable for a worker to be correctly classified differently under the different standards that apply for different statutory purposes. However, that is not typical, and in most cases, applying the various laws does result in the same worker classification.

Of course, there are legitimate independent contractors who enter into arms-length contractual arrangements with other business owners for their mutual benefit. I want to be clear that the DOL does not define misclassification as an “independent contractor” problem. Legitimate independent contractors can play an important role in our economy and many companies make good and legally appropriate use of their services. But some employers intentionally misclassify

workers as independent contractors who, under the law, are employees. Sometimes the misclassification may be forced on workers. Other times, the workers are complicit in the misclassification in an effort to increase their incomes by evading income and payroll taxes. Such workers may or may not realize the risks they are taking in losing all of the protections of the social safety net that are provided to employees but not to independent contractors.

It is important to remember, however, that the workforce is not just divided into employees and independent contractors. Industries have developed a number of business models that are based on using the lowest cost labor possible, including independent contractors, leased employees, and outsourcing. Although the use of these models can be legitimate, they are frequently used without an analysis of the actual legal relationship between the company and the worker, which leads to the possibility that an employee will be misclassified and denied the rights and protections to which he or she is entitled.

Many workers do not know they have been misclassified by an employer until they need the law's protection. As a result, they are often not prepared for the consequences. For example, I recently learned about a case settled a while back by the Wisconsin Department of Workforce Development. Alvaro was a dishwasher at a family-style restaurant in Madison, Wisconsin. He was being paid less than minimum wage and did not receive overtime. When Alvaro met with the employer to discuss the issue, the employer initially said he would pay all of the overtime wages Alvaro earned. A few days later, Alvaro was visited by the employer's attorney who said that the employer would only pay a fraction of what Alvaro was owed and if he made trouble they would make trouble for him. When Alvaro filed a wage complaint with his state's

Department of Workforce Development, the employer's attorney claimed that the company did not owe him the minimum wage or overtime pay because Alvaro was an independent contractor. Remember, Alvaro's job was washing dishes for the restaurant in the restaurant's kitchen.

If we take this example in the hypothetical, outside of the wage and hour context, Alvaro could have also found that his employer had treated him as an independent contractor under the workers' compensation laws. If so, Alvaro would have received no compensation if he were severely burned by scalding dish water in the workplace. He may have also found that his employer had failed to pay its share of payroll taxes for unemployment insurance (UI), Social Security, and Medicare. If so, Alvaro would have had to pay all of those taxes himself, and he would not have been entitled to UI benefits if he lost his job. There is every reason to believe that Alvaro's employer did not perform an appropriate analysis of his status under any law. It is difficult to imagine a dishwasher for a restaurant could ever be a legitimate independent contractor. Typically, these workers do not bring their own equipment, do not decide their own hours or method of work, and do not have a profit or loss motive. In this example, the employer's motive to evade the law seems clear and has devastating consequences: Alvaro did not receive wages he rightfully earned until he filed a complaint with the appropriate state agency and they settled the case.

One measure of the scope of the misclassification problem is its effect on tax revenues. A 1984 IRS survey estimated that nearly 15% of employers misclassified some employees as independent contractors under the tax laws, with an estimated revenue loss of \$1.6 billion in

1984 dollars.⁴ A 1994 Coopers & Lybrand study estimated that misclassification would cost the Federal government \$34.7 billion between 1996 and 2004.⁵ The Planmatics 2000 study concluded that between 10% and 30% of the employers audited had misclassified some employees as independent contractors.⁶ The economy has changed significantly since those studies were performed, and even the number of workers that self-identify as independent contractors has grown.⁷ Still, these numbers suggest that misclassification occurs in significant numbers and, across the country, workers are finding themselves without the basic protections that Congress has enacted to ensure they receive fair pay, safe workplaces, and necessary supports when they are hurt or lose their jobs.

Several recent studies suggest that misclassification results in significant losses to state UI and workers' compensation funds in addition to tax revenue. When employees are misclassified, their employers typically do not pay unemployment taxes or carry workers' compensation insurance for those employees. As a result, UI and workers' compensation funds are underfunded. Moreover, employers that obey the law end up carrying the weight for scofflaws in the form of higher workers' compensation premiums.

A recent Tennessee study, for example, conservatively estimated that, due to misclassification in the construction industry alone, Tennessee lost between \$4.9 million and \$11.4 million in employers' unemployment insurance payments and between \$30 million and \$70 million in

⁴ *Strategic Initiative on Withholding Noncompliance (SVC-1), Employer Survey, Report of Findings*, Ken Beier, Unpublished: Department of the Treasury, Internal Revenue Service, June 1989.

⁵ *Projection of the Loss in Federal Tax Revenues Due to Misclassification of Workers*, Coopers & Lybrand (June 1994).

⁶ *Independent Contractors*, *supra* note 2.

⁷ In its 2005 Survey on Contingent and Alternative Employment Arrangements, the Bureau of Labor Statistics found that the number of workers who identified as independent contractors increased by 15%, from 6.4% to 7.4%, since 2001. <http://www.bls.gov/news.release/pdf/conemp.pdf>.

workers' compensation premiums in 2006.⁸ A Michigan study estimated that the state forgoes almost \$17 million annually in unemployment insurance payments because of misclassification.⁹ An Ohio Attorney General's Report concluded that, according to conservative estimates, misclassification cost his state \$20 million in payments for unemployment compensation, \$103 million in workers' compensation premiums, and over \$36 million in forgone state income tax revenues in 2005.¹⁰

Misclassification also affects an unknown number of employees in the "underground" or "shadow" economy. These workers are typically paid in cash with no regard for wage standards, no tax forms are provided, and the wages are neither recorded nor reported. Many of these workers are otherwise vulnerable for a variety of reasons, including limited English language skills. While some may prefer an "under the table" arrangement, others may not know their rights or they may be afraid to assert them. The lack of record keeping and documentation makes it difficult to quantify just how prevalent misclassification is in this area.

DOL's Ongoing Efforts Against Misclassification

Addressing worker misclassification is a necessary part of the Labor Department's "Good Jobs for Everyone" mission. We are exploring all possible options for addressing the worker misclassification problem, including regulatory innovations by several DOL agencies,

⁸ *Misclassified Construction Employees in Tennessee*, Dr. William Canak and Dr. Randall Adams, Study presented to the Tennessee House Committee on Consumer and Employee Affairs on February 17, 2010. Copy available for download at <http://carpenters.org/misclassification/ALL%20DOCUMENTS/TN%20fraud%20study%201-15-10.pdf>.

⁹ *Informing the Debate: the Social and Economic Costs of Employee Misclassification in Michigan*, Dale L. Belman and Richard Block, Michigan State University Institute for Public Policy and Social Research (2009).

¹⁰ *Report of the Ohio Attorney General on the Economic Impact of Misclassified Workers for State and Local Governments in Ohio*, 2009.

opportunities to provide better guidance to both workers and employers, and improved enforcement through information-sharing among DOL agencies and between the Labor Department, the Treasury Department, and state labor and tax agencies.

Regulatory Agenda

The Labor Department's Spring 2010 Regulatory Agenda announced our intention to use new tools to detect and prevent worker misclassification. Generally, DOL announced its intent to move towards a broad strategy that requires employers to understand that the burden is on them to obey the law before they are visited by a DOL investigator. We call this compliance strategy "Plan/Prevent/Protect." This new strategy will require employers and other regulated entities to: (1) create a "plan" for identifying and remediating risks of employment law violations and make the plans available to workers so they can participate in their creation, fully understand them, and help to monitor their implementation; (2) thoroughly and completely implement the plan in a manner that "prevents" legal violations; and (3) ensure that the plan's objectives are met on a regular basis so that it actually "protects" workers from violations of their workplace rights.

One way in which "Plan/Prevent/Protect" will be implemented is by increasing transparency in employers' recordkeeping requirements under the FLSA. DOL's Wage and Hour Division (WHD) is considering a rule that would propose that employers, before declaring that a worker is not an "employee" under the FLSA, not only perform a written analysis of the worker's status applying the "economic realities" test described above, but also be required to disclose the analysis to the affected worker, and keep a record of the analysis in their files for review should a Wage & Hour investigator seek this information. The proposed rule WHD is considering, if it

becomes a final regulation, would not change the criteria that employers use to make this determination.

This proposed rule would increase the likelihood that an employer makes the correct classification decision in the first place. The goal is to create transparency in employment relationships for both parties. Workers should have up-front knowledge of their employment status and what the implications may be for their wages and hours. Employers should be clear about their responsibilities under the law, and take affirmative steps to ensure that they are meeting those responsibilities. Employers who want to play by the rules should find compliance with those rules to be simpler and their obligations and responsibilities more transparent. By better ensuring that the employer-employee relationship is defined at the outset, all parties involved will have the opportunity to resolve any conflicts or misunderstandings before DOL has to get involved.

Since “Plan/Prevent/Protect” is a department-wide initiative, both the Occupational Safety and Health Administration (OSHA) and the Office of Federal Contract Compliance Programs (OFCCP) will consider similar rules in the coming years. To properly protect workers under all of our DOL statutes, employers across the United States should plan ahead, perform the requisite analyses to prevent misclassification, communicate with their workers before proceeding, and actually protect workers from employment law violations.

Enforcement

WHD is emphasizing misclassification in its ongoing enforcement strategy. All new investigators are being trained how to determine workers' employment status and to ensure they have been classified properly. In 2008, WHD began tracking whether misclassification was the primary reason for a violation of the laws it enforces – and these data suggest the practice is growing. In Fiscal Year (FY) 2009, the Department's Wage and Hour Division (WHD) found \$2,650,510.28 in back wages owed to 2,190 employees in cases where misclassification was the primary reason why the employer failed to pay the minimum wage or proper overtime. This is an increase of almost 50% from FY 2008, when WHD found \$1,320,343.46 owed to 1,278 employees for the same reason. WHD is currently exploring ways to improve its tracking system so that investigators can always record when they discover that an employee has been misclassified, even if this was not the primary reason for a violation or did not result in any violations. This will give WHD a more accurate picture of the scope of the problem and allow it to better target its resources.

Additionally, as noted earlier, DOL is working with the Vice President's Middle Class Task Force and the Department of Treasury on a multi-agency initiative to develop strategies to address worker misclassification. The President's budget request for fiscal year 2011 included \$12 million for WHD's increased enforcement of wage and overtime laws in cases where employees have been misclassified together with additional funding for our Office of the Solicitor and OSHA for their work in this area. It also included \$10.95 million to provide grants to states to build capacity to identify and address worker misclassification in the Unemployment Insurance program through targeted employer audits and enhanced information sharing to enable

detection. States that are the most successful will receive high performance bonuses that can also be used to further reduce worker misclassification. WHD is currently considering how best to use its proposed funding for a targeted enforcement strategy informed by the agency's experience that misclassification is particularly prevalent in industries with large numbers of low-wage, vulnerable workers..

Education and Outreach

This past April, WHD launched a campaign called "We Can Help." This effort is tailored to inform low wage, vulnerable workers of their rights and benefits, how to get help if they believe those rights are violated, and to assure them that their complaint is confidential. The campaign will place a special focus on reaching employees in industries where misclassification is most prevalent, such as construction, janitorial work, hotel/motel services, food services and home health care. Through this campaign, we hope to ensure workers know more about their employment rights.

Information Sharing

One important step we are taking as part of the Administration's employee misclassification initiative is to explore ways to increase information sharing among DOL agencies, DOL and other Federal agencies, and DOL and state agencies. In its 2009 Report, the GAO concluded that increased information sharing between DOL and Treasury, and among DOL agencies, would help to increase detection and prevention of misclassification – and we agree.¹¹ Information

¹¹ GAO-09-717, *supra* note 1.

sharing would allow government agencies at all levels to better leverage their resources against practices that violate the laws they enforce.

DOL's ETA is already a part of a joint initiative with the IRS and the states that is designed to improve information sharing and lead to better detection of tax and revenue losses due to worker misclassification. Through this initiative, often referred to as the "Questionable Employment Tax Practices" program (QETP), 39 states have signed memorandums of understanding with the IRS that enable the state and the IRS to participate in a two-way exchange of information. Participating states are now able to receive tax information and audit leads from the IRS, which allows them to target their state UI employer audits effectively. It is our hope that we can build on these existing relationships and develop agreements that also include Federal and state worker protection agencies to share information in a way that is meaningful despite our different jurisdictions and enforcement emphases.

Partnering with the States

The importance of working with the states on employee misclassification cannot be overemphasized. Last month, DOL hosted a State Forum on Misclassification. We invited representatives from a number of state agencies and misclassification task forces to meet with DOL staff and tell us about what their states have been doing on this issue. Attendees included representatives from the states of Connecticut, Iowa, Louisiana, Maryland, Massachusetts, Ohio, New York, and Washington.

During the Forum, we learned about a wide range of tools and practices the states are using to stop and prevent misclassification, including sophisticated data analysis, various enforcement strategies, and laws passed by state legislatures to create a presumption of “employee status” or authorizing state agencies to issue stop work orders. We also heard from the states that they are looking to the Administration to provide some leadership on this issue. We look forward to working closely with our state partners in a variety of effective ways to counter misclassification.

The Need for Congressional Action

The passage of legislation like S. 3254, the “Employee Misclassification Prevention Act” (EMPA) is critically important. Even considering the President’s FY 2011 budget initiative and the Labor Department’s concerted efforts to expand regulatory protections, enforcement efforts, and partnerships with other government entities, legislation is needed to provide DOL with additional tools that the Department cannot use without action by the Congress.

First, EMPA would make misclassification a violation of the FLSA. For the first time, misclassification would be against the labor law. We believe this would provide employers with an important additional incentive to make the correct call when determining whether a worker is “employee.” Only Congress can strengthen the law in this way. .

Second, consistent with DOL’s upcoming proposed rulemaking, EMPA would codify in the FLSA an employer’s obligation to provide their workers with notice of how the worker is classified. If an employer fails to give this notice, EMPA establishes a legal presumption that the worker is an “employee.” This presumption will put the burden of proof on the employer to

demonstrate that the worker should be excluded from coverage under the FLSA. We have discussed whether DOL has the regulatory authority to create such a presumption and concluded that action by Congress will significantly reduce the litigation risks.

Finally, the EMPA provision that authorizes WHD to seek Civil Monetary Penalties for recordkeeping violations provides an important enforcement tool not only against misclassification, but against all FLSA recordkeeping violations. Time and time again, WHD investigators and employees find minimum wage and overtime violations, but the employer's failure to keep adequate records makes it difficult or even impossible to guarantee that the employee is made whole. Employers who violate the law should not be able to avoid paying fair compensation to their workers by failing to keep records as the FLSA requires.

We strongly endorse these provisions of EMPA and look forward to working with Congress to pass effective legislation to address the misclassification problem.

I also want to briefly highlight the Unemployment Compensation Integrity Act. This is draft legislation the Department recently shared with Congress and we believe it is another necessary element of a comprehensive strategy to end misclassification. The Unemployment Compensation Integrity Act contains provisions that would enable states to retain a percentage of delinquent employer UI taxes, including those resulting from misclassification, to use for increased efforts to identify worker misclassification. This incentive for expanded state tax efforts targeted at misclassification would be another way for us to help the states in their UI tax enforcement efforts.

Conclusion

Thank you again for the opportunity to testify before you today, and for your thoughtful leadership in drafting the EMPA. We believe that addressing this issue is essential to ensuring a level playing field in the marketplace, and protecting workers as Congress intended when it enacted a long list of employment laws. During this fragile economic recovery, workers are too often exploited and caused to lose out on the benefits they rightfully earned, while employers who do right by their employees are placed at a competitive disadvantage that they cannot afford.

DOL , along with the White House, the Treasury Department, and states across the country are taking meaningful steps to prevent worker misclassification and address it whenever and wherever it occurs, but we need your help to make misclassification illegal and to assemble a truly comprehensive solution to this problem. We applaud your work on EMPA. We look forward to working with you in this endeavor. Thank you for your time. I am available to answer your questions.