

Issue: PA Economy

Employee Misclassification in Pennsylvania

Introduction

Workers in America have less power now than decades ago, and they also have less clout than their counterparts in other wealthy industrial nations. One way they are taken advantage of is by falsely being labeled as independent contractors instead of as employees. The default classification for workers is to be employees; only if specific criteria are met can a worker be an independent contractor. Misclassified workers are generally paid less and lose many worker protections.

Consequences of Employee Misclassification

Loss of Workplace Protections

One consequence of employee misclassification is the loss of state and federal legal protections for workers because the vast majority of employment and labor laws do not apply to the self-employed.¹ Such protections include minimum wage and overtime pay, occupational safety, unemployment insurance, workers' compensation, family and medical leave, as well as safeguards against workplace discrimination. Independent contractors are also not eligible for employer-sponsored health coverage and pension plans.²

Since employers are not legally required to provide independent contractors with a minimum wage or to compensate them for overtime hours, workers are often underpaid. Employers are responsible for paying half of an employee's Social Security and Medicare taxes, and contributing to unemployment and worker compensation funds for their employees. Independent contractors pay their entire share of payroll taxes.

If independent contractors suffer from work-related injuries, they are forced to shoulder lost income and medical costs without the support of employer-sponsored workers' compensation insurance. Not only that, employers have less incentive to make the workplace safe and often circumvent OSHA requirements.³ Additionally, workers lose the right to join a union when designated as independent contractors, making it more challenging for them to form a united front against their employers.⁴

Unfair Competition

Employers who properly classify their workers are undercut by their competitors who misclassify. In the event of competitive bidding, those who do not play by the rules have a substantial advantage over law-abiding employers. One study estimated a 30% savings for employers when construction industry workers are misclassified as contractors.⁵ Clearly, such unfair practices stifle competition in Pennsylvania and hurts responsible businesses.

Loss of Revenue

It is difficult to get state-specific estimates for losses to state coffers due to worker misclassification. One approach is to extrapolate data from other states, as was done by the Keystone Research Center.

Their report, which pertains just to the construction industry, "uses three of these studies to estimate what Pennsylvania costs would be if scaled up based on the size of the Pennsylvania economy." The costs are as shown in Table 1 below.⁶ (UC refers to unemployment compensation.)

| Table 1. Projected 2016 Annual Costs of Worker Misclassification (millions of dollars) in Pennsylvania Construction Industry Based on Studies in Other States | | | | |
|--|----------|--------------------|------------------------|---------------|
| PA Estimated Costs | UC Taxes | State Income Taxes | Workers Comp. Premiums | Federal Taxes |
| Based on Illinois 2005 | \$11.0 | \$30.3 | \$28.6 | |
| Based on MN 1999-2002 | \$6.1 | \$47.2 | \$83.4 | \$199.7 |
| Based on MA 2001-03 | \$5.9 | \$15.0 | \$16.6 | |

Sometimes, misclassified workers are paid completely under-the-table, which makes it easier for employers to avoid paying the minimum wage and overtime. In turn, that leads to state and federal governments losing tax revenue.^{7 8} For information about Wage Theft, please see the Local Majority paper "Wage Theft in Pennsylvania."

The Extent of Misclassification

Hard statistics on the extent of this practice in Pennsylvania and elsewhere are difficult to obtain. Estimates can be made by auditing businesses and unemployment insurance claims, but the percentages of misclassified workers vary because of differing methods of selecting the businesses to be audited. Although the percent of misclassified workers varies dramatically—from 11% to 30%—states that use similar selection criteria tend to have similar rates of misclassification.⁹

Research from 2008 found that, overall, 9% of the workforce was misclassified as independent contractors in Pennsylvania.¹⁰ This is on the higher end of the range suggested by more recent work from 2017 that found the percentage of all independent contractors (nationwide)—both *correctly* and *incorrectly* classified—ranges from about 7 to almost 10%.¹¹ However, many experts believe the actual rate of misclassification is much higher than estimates. Misclassification tends to be most prevalent in industries with lower wages and higher numbers of immigrant workers. There is also a stronger incentive to misclassify workers in industries where this practice yields more profit. Worker's compensation premiums in the construction field are particularly high because of the dangerous nature of construction jobs.¹² As mentioned previously, construction companies can significantly reduce payroll costs by classifying employees as independent contractors.¹³

Other industries where this illegal practice is prevalent are trucking, restaurants, hotels, janitorial services, nail salons, car wash operations and home health care industries.¹⁴ Businesses which have workers in the sharing economy, such as ride services, are coming under scrutiny for their classification of workers as contractors.

Who is an employee and who is a contractor?

Workers are considered to be employees unless the worker meets specific requirements for being an independent contractor. The definition of an employee can be different under state and federal tests, in which case the more restrictive test would be applied. The general IRS criteria is "that an individual

is an independent contractor if the payer has the right to control or direct only the result of the work, not *what* will be done and *how* it will be done."¹⁵

Over half of the states use the ABC test, which specifies three criteria under which a worker can be considered an independent contractor. Pennsylvania uses only the A and C portions of the test, which are shown below.¹⁶ (The B portion is that the individual performers work outside of the usual course of the business of the hirer.)

A worker is considered to be an employee unless proven otherwise. To be an independent contractor **both** of the following must be shown to the satisfaction of the department:

- The individual has been and will continue to be free from control or direction over the performance of the services involved, both under the contract of service and in fact, **and**
- As to such services, the individual is customarily engaged in an independently established trade, occupation, profession or business.

<https://www.uc.pa.gov/employers-uc-services-uc-tax/covered/Pages/Employee-or-Independent-Contractor.aspx>

Employers in the construction industry in Pennsylvania must also abide by the Construction Workplace Misclassification Act (Act 72). This law, passed in 2011, expressly prohibits the misclassification of construction workers. Its provisions are below.

If an individual performs services in the construction industry, the Construction Workplace Misclassification Act (Act 72), imposes additional criteria that must be met for the individual to be recognized as an independent contractor. Under Act 72, **all** of the following requirements must be satisfied:

- The individual has a written contract to perform the services,
- The individual is free from control or direction over the performance of the services involved both under the contract of service and in fact, **and**
- As to such services, the individual is customarily engaged in an independently established trade, occupation, profession or business.

<https://www.uc.pa.gov/employers-uc-services-uc-tax/covered/Pages/Employee-or-Independent-Contractor.aspx>

Compliance and Enforcement

To enforce labor laws, the state must have a way to find those employers who are thwarting the laws. The graphic below shows how violations in the construction industry are found. Investigations are often instigated by complaints not just from workers but also from unions and worker centers. Industries which generate the most complaints aren't necessarily those where the practice is most widespread, which can make it challenging to find businesses engaging in misclassification. More pro-active approaches include on-site audits and auditing unemployment insurance claims.¹⁷ States are often constrained by limited resources.

There are three mechanisms for finding alleged Act 72 violations:

- 1) complaints filed with the Bureau of Labor Law Compliance,
- 2) findings made during construction job site visits, and
- 3) referrals from other agencies, such as the Office of Unemployment Compensation Tax Services

<https://www.dli.pa.gov/Individuals/Labor-Management-Relations/lmc/act72/Documents/2019%20Act%2072%20Report-final.pdf>

Although Pennsylvania collected over half a million dollars in fines from around 160 businesses in 2019, the penalties are not high enough to serve as a deterrent.¹⁸ A first violation results in a fine of \$1000, while subsequent violations carry a fine of \$2500.¹⁹

In Pennsylvania, the process specified in Act 72 to initiate a stop work order is so unwieldy that no job site had received a stop-work order as of the end of 2019.²⁰ The steps necessary to shut down a job site are shown in the graphic below. In contrast, when Connecticut inspectors do an on-site audit, they have the capability to immediately issue a stop-work order. Businesses quickly comply so as to be able to get back to work.²¹

Shut-Down Orders under Act 72

The process for the Secretary of Labor & Industry to shut down a job site is as follows:

- (1) the Department of Labor & Industry must receive information that there is a potential violation;
- (2) the Bureau of Labor Law Compliance must conduct an investigation into the allegation;
- (3) the Department of Labor & Industry must issue an administrative Order to Show Cause;
- (4) the employer is afforded 20 days to file an answer in writing;
- (5) the employer is then provided notice and a hearing is conducted;
- (6) if evidence presented at the hearing establishes the finding of a violation, the Secretary of Labor & Industry must petition a court of competent jurisdiction for an Order; and
- (7) the employer must be served the Order so it may take effect.

<https://www.dli.pa.gov/Individuals/Labor-Management-Relations/llc/act72/Documents/2019%20Act%2072%20Report-final.pdf>

Cross-agency and cross-state coordination has been useful in indentifying employers who break labor laws. In 2019, labor departments in Pennsylvania, New Jersey and Delaware agreed to share information and coordinate their enforcement efforts.²²

Among the recommendations in a comprehensive study done by the Labor and Worklife Program at Harvard Law School are:²³

- liability in cases of multiple sub-contractors should go up several levels to the general contractor
- individuals, and not just businesses, should be liable

Conclusion

Worker misclassification is a widespread problem that harms workers, compliant businesses and the revenue streams of government. Unfortunately, under the current administration in Washington, the will to enforce labor laws has diminished. Thus, it is more important than ever for states to protect their workers, receive the funds owed and ensure that all businesses are following the rules.

¹ <https://www.dol.gov/whd/workers/Misclassification/misclassification-facts.pdf>

² <https://www.nelp.org/wp-content/uploads/Policy-Brief-Independent-Contractor-vs-Employee.pdf>

³ https://www.osha.gov/Publications/inequality_michaels_june2015.pdf

⁴ https://dpeaflcio.org/programs-publications/issue-fact-sheets/misclassification-of-employees-as-independent-contractors/#_edn29

⁵ <https://www.keystoneresearch.org/sites/default/files/KRC%20Illegal%20Labor%20Con%20Final.pdf>

⁶ <https://www.keystoneresearch.org/sites/default/files/KRC%20Illegal%20Labor%20Con%20Final.pdf>

⁷ <https://www.gao.gov/new.items/d06656.pdf>

⁸ <https://www.nelp.org/publication/independent-contractor-misclassification-imposes-huge-costs-on-workers-and-federal-and-state-treasuries>

⁹ <https://www.epi.org/publication/independent-contractor-misclassification/>

¹⁰ <https://www.nelp.org/wp-content/uploads/Independent-Contractor-Costs.pdf>

See endnote 22: Testimony of Patrick T. Beaty, Deputy Secretary for Unemployment Compensation Programs, Pennsylvania Department of Labor and Industry, before the House of Representatives Commonwealth of Pennsylvania, Labor Relations Committee on HB 2400, The Employee Misclassification Prevention Act (April 23, 2008), note 22, supra.

¹¹ <https://equitablegrowth.org/how-u-s-companies-harm-workers-by-making-them-independent-contractors/>

¹² <https://www.epi.org/publication/independent-contractor-misclassification/>

¹³ <https://www.keystoneresearch.org/sites/default/files/KRC%20Illegal%20Labor%20Con%20Final.pdf>

¹⁴ <https://lwp.law.harvard.edu/files/lwp/files/misclassification.pdf>

¹⁵ <https://www.irs.gov/newsroom/understanding-employee-vs-contractor-designation>

¹⁶ <https://www.uc.pa.gov/employers-uc-services-uc-tax/covered/Pages/Employee-or-Independent-Contractor.aspx>

¹⁷ Illegal Labor Practices in the Philadelphia Regional Construction Industry: an Assemblment and Action Plan.

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<https://www.keystoneresearch.org/sites/default/files/KRC%20Illegal%20Labor%20Con%20Final.pdf>

¹⁸ [https://www.dli.pa.gov/Individuals/Labor-Management-](https://www.dli.pa.gov/Individuals/Labor-Management-Relations/llc/act72/Documents/2019%20Act%2072%20Report-final.pdf)

[Relations/llc/act72/Documents/2019%20Act%2072%20Report-final.pdf](https://www.dli.pa.gov/Individuals/Labor-Management-Relations/llc/act72/Documents/2019%20Act%2072%20Report-final.pdf)

¹⁹ <https://www.legis.state.pa.us/cfdocs/legis/li/uconsCheck.cfm?yr=2010&sessInd=0&act=72>

²⁰ [https://www.dli.pa.gov/Individuals/Labor-Management-](https://www.dli.pa.gov/Individuals/Labor-Management-Relations/llc/act72/Documents/2019%20Act%2072%20Report-final.pdf)

[Relations/llc/act72/Documents/2019%20Act%2072%20Report-final.pdf](https://www.dli.pa.gov/Individuals/Labor-Management-Relations/llc/act72/Documents/2019%20Act%2072%20Report-final.pdf)

²¹ <https://lwp.law.harvard.edu/files/lwp/files/misclassification.pdf>

²² https://www.nj.gov/labor/lwdhome/press/2019/20190710_tristatealliance.shtml

²³ <https://lwp.law.harvard.edu/files/lwp/files/misclassification.pdf>