

**The Economic Costs
of
Employee Misclassification
in the
Construction Sector
in the
Commonwealth of Kentucky**

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A Report by the

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I. Summary Findings

This report is a first step in analyzing the economic implications of employee misclassification for both the public and private sectors in the Commonwealth of Kentucky. It is based upon (1) UI Audit Data for the Calendar Years 2007-2010, (2) UI Audit Data for Calendar Quarters 2009-2010, (3) 2006-2010 ETA 581 Reports for the Commonwealth of Kentucky that was provided by the Kentucky Office of Employment and Training, and (4) state and federal government databases. The report also utilizes the results of similar studies on misclassification previously developed in other states. In this report, we analyze the scope and trends of misclassification in the construction sector in Kentucky. We provide estimates of the impact of misclassification in the construction sector in Kentucky for state tax revenues, the unemployment insurance fund, worker's compensation, and avoided FICA, Medicare, and federal income taxes to the Department of the Treasury.

Misclassification negatively impacts the citizens of Kentucky in a number of ways. First, the conditions for a fair and competitive marketplace are sabotaged. Employers who misclassify their workers have a pricing edge over their counterparts which results in unfair competition in the marketplace. Firms that misclassify workers can bid for work without having to account for many normal payroll-related costs. This illegal practice can decrease payroll costs by as much as 15% to 25% for those employers that misclassify their employees.

Secondly, misclassifying workers negatively impact the public sector in Kentucky by: (1) reducing the unemployment insurance taxes the state would collect if these employees were properly classified; (2) reducing the worker's compensation fund because Kentucky does not collect the insurance premiums due, (3) reducing the amount of income taxes collected by the Commonwealth of Kentucky, and (4) reducing the amount of social security, Medicare, and federal income taxes collected by the federal government.

While state laws vary with respect to who is an employee and who is classified as an independent contractor, each state uses some defined criteria. Kentucky's definition of an employee is found in Kentucky Revised Statutes § 141, 337, and Kentucky common law. Kentucky Revised Statutes § 141.010 (20) states:

"Employee" means "employee" as defined in Section 3401C of the Internal Revenue Code.

According to the Internal Revenue Service, *"the general rule is that an individual is an independent contractor if you, the person for whom the services are performed, have the right to*

control or direct only the result of the work and not the means and methods of accomplishing the result." In the past, the IRS used a "Twenty Factor Test" for the determination of independent contractor status. It has recently simplified the test and now employs a multi-factor common law test that consolidates the twenty factors into eleven main tests, and organizes them into three main categories: (1) behavioral control, (2) financial control, and (3) the type of relationship between the parties.¹

Internal Revenue Service: 3-Point Test for Employer-Employee Relationship
1. Behavioral: Does the company control or have the right to control what the worker does and how the worker does his or her job?
2. Financial: Are the business aspects of the worker's job controlled by the payer? (These include things like how worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc.)
3. Type of Relationship: Are there written contracts or employee type benefits (i.e. pension plan, insurance, vacation pay, etc.)? Will the relationship continue and is the work performed a key aspect of the business?

In 2002, the Supreme Court of Kentucky ruled that the following factors, among others, are to be considered in determining whether or not one is an independent contractor in Kentucky.² The Supreme Court stated that any or all of the following factors may be useful in determining whether or not one is an independent contractor, and they held that "the chief criterion is the right to control the details of the work."

Supreme Court of Kentucky: Factors to Consider (2000-SC-0884-DG)
1. The extent of control which, by the agreement, the master may exercise over the details of the work;
2. Whether or not the one employed is engaged in a distinct occupation or business;
3. The kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the employer or by a specialist without supervision;
4. The skill required in the particular occupation;
5. Whether the employer or the workman supplies the instrumentalities, tools, and the place of work for the person doing the work;
6. The length of time for which the person is employed;
7. The method of payment, whether by the time or the job;

¹Department of the Treasury. Internal Revenue Service. Publication 15-A. Employer's Supplemental Tax Guide. (Supplement to Publication 15 [Circular E], Employer's Tax Guide). Pages 6-7.

² Supreme Court of Kentucky. 2000-SC-0884-DG.

Supreme Court of Kentucky: Factors to Consider (2000-SC-0884-DG) [Continued]

8. Whether or not the work is a part of the regular business of the employer;

9. Whether or not the parties believe they are creating the relation of master and servant; and

10. Whether the principal is or is not in business.

For unemployment insurance, the fifty states and the District of Columbia generally use either one of two standards to determine whether a worker is an employee or an independent contractor. These two rules are the "ABC Rule" and the "Common Law Rule." Nineteen states have adopted the "ABC" rule; seven states use a variation of the ABC Rule. Twenty-four states and the District of Columbia use the "Common Law Rule" to determine whether or not a worker is an independent contractor. Kentucky uses the common law test to determine who qualifies as an independent contractor for unemployment insurance and workers compensation.

Misclassification arises from two potential sources. First, an employer may claim that a worker meets the common law standard as defined by the Internal Revenue Code and is, in fact, an independent contractor. This may simply be an error or the employer may be attempting to avoid the legal and financial responsibilities they would incur if the worker was classified an employee rather than as an independent contractor. The second source of misclassification may be a situation of an unreported worker, i.e., a worker whose employment either as an employee or as an independent contractor is simply not reported in order to avoid the legal and financial responsibilities for the worker.

If an employee is classified as an independent contractor, the "employer" is not required to pay and/or withhold a variety of payroll-related taxes, fees and benefits (e.g., social security and Medicare taxes, local, state and federal income taxes, unemployment insurance, workers compensation, pension and health benefits, etc.). Not only are these costs shifted to the individual worker, the "independent contractor" is also not fully protected by various employment laws (e.g., minimum wage and overtime requirements, workers compensation protection, the right to form a union and bargain collectively, etc.) and may, incorrectly, believe that he or she is protected by Kentucky unemployment laws. If a person is classified as an independent contractor, "employers" are required to issue a 1099-MISC for payments for work in excess of \$600 or more.

In addition to the variety of payroll-related taxes, fees, and benefits that an employer is not required to pay, there are additional costs to employers that are

avoided such as record keeping, minimum wage, and overtime. The relevant statute under wage and hour is KRS 337.010 and its accompanying regulation is 803 KAR 1:005.

The issue of misclassifying employees as independent contractors is a growing problem for the unemployment insurance system and state revenues in Kentucky and other states, as well as the federal government. This occurs because employers remit their unemployment taxes and other tax streams based upon their payroll. Recent studies have shown that misclassification by employers is increasing. For example, for the years 2007-2008, state audits found that, on average, 47.5% of Indiana employers that were audited were found to have misclassified workers as independent contractors.³ The rate of misclassification by employers in Illinois was shown to be 22.8% in 2001 and had increased to 31.9% and 27.6% in 2004 and 2005, respectively.⁴ In a report by the Ohio Attorney General on February 18, 2009, the number of workers who were misclassified in 2009 increased 53.5% over the total number misclassified in 2008.⁵ Note, the "underground economy" (workers paid in cash) is outside the scope of our study and, thus, the estimates we provide may underestimate the full extent of the problems associated with the employer practice of misclassification in Kentucky.

A number of studies have shown that the problem of misclassification is particularly acute in the construction sector. In three state level studies (Massachusetts, Maine, and New York), the incidence of misclassification in the construction sector is higher than other industries in those states. For Massachusetts, the moderate statewide rate is 19%, while the rate of misclassification in the construction sector is 24%⁶; for Maine, the low statewide estimate is 11% compared to 14% in the construction sector.⁷ In New York, the statewide rate of misclassification for 2005-2008 was 10%, while the

³Kelsay, Michael P., PhD and James I. Sturgeon, PhD. *The Economic Costs of Employee Misclassification in the State of Indiana*. A Report by the Department of Economics. University of Missouri – Kansas City. September 16, 2010. Page 26.

⁴Kelsay, Michael P., PhD, James I. Sturgeon, PhD., and Kelly D. Pinkham, M.S. *The Economic Costs of Employee Misclassification in the State of Illinois*. A Report by the Department of Economics. University of Missouri – Kansas City. December 6, 2006. Page 16.

⁵Cordray, Richard. Ohio Attorney General. *Report of the Ohio Attorney General on the Economic Impact of Misclassified Workers for State and Local Governments in Ohio*. February 18, 2010.

⁶Carre, Françoise, Ph.D. and Randall Wilson. *The Social and Economic Costs of Employee Misclassification in Construction*. A Report for the Construction Policy Research Center and Labor and Worklife Program. Harvard Law School and Harvard School of Public Health. Elaine Bernard, Ph.D. and Robert Herrick, ScD, Principal Investigators. December 17, 2004.

⁷Carre, Françoise, Ph.D. and Randall Wilson. *The Social and Economic Costs of Employee Misclassification in the Maine Construction Industry*. A Report for the Construction Policy Research Center and Labor and Worklife Program. Harvard Law School and Harvard School of Public Health. Elaine Bernard, Ph.D. and Robert Herrick, ScD, Principal Investigators. April 25, 2005.

rate of misclassification in the construction sector for this same time period was 15%.⁸ In a recent study on the employee misclassification in Tennessee, the overall rate of misclassification ranged between 12%-19%.⁹ In a study on employee misclassification in Michigan, it was found that 26.4% of construction employers were misclassified.¹⁰ The United States Government Accounting Office [GAO] reported that the percentage of misclassifying employers in all industries was 15%, while the percentage of misclassified workers in the construction sector was 20%.¹¹

A U.S. Census Bureau analysis of projected nonfarm wage and salary employment by major industry division for the period 2008-2018 shows that the growth in overall employment is projected to increase 10.6%, or at an annual rate of increase of 1.0%; and, in construction, the growth in employment is projected to increase 18.5%, or at an annual rate of increase of 1.7%.¹² According to Workforce Kentucky, the growth rate in construction in Kentucky is projected to increase 13.3% from 2008-2018; the estimated employment in construction in Kentucky is projected to be 84,354. Given the projected growth in the construction sector in Kentucky and the United States, the impacts of misclassification in the construction sector will worsen.

⁸Donahue, Linda H., James Ryan Lamare, and Fred B. Kotler, J.D. *The Cost of Worker Misclassification in New York State*. ILR Collection. Research Studies and Reports. Cornell University ILR School. Year 2007.

⁹Canak, William, PhD and Randall Adams, PhD. *Misclassified Construction Employees in Tennessee*. January 15, 2010.

¹⁰Belman, Dale L., PhD. and Richard Block, PhD. *Informing the Debate. The Social and Economic Costs of Employee Misclassification in Michigan*. Institute for Public Policy and Research

¹¹United States General Accounting Office. *Tax Administration: Issues in Classifying Workers as Employees or Independent Contractors*. GOA/T-GGD-96-130.

¹²Bartsch, Kristina J. *Occupational Employment Projections for 2008-2018*. Monthly Labor Review. November 2009. Pages 3-10.

Specific Findings for Kentucky Employee Misclassification

- For the years 2007-2010, state audits found that, on average, 26.4% of audited construction employers had misclassified workers as independent contractors. This translates into approximately 2,816 construction employers in Kentucky misclassified employees.¹³
- For the Commonwealth of Kentucky, audit results show that misclassification is a growing problem in Kentucky as well as other states. The number of misclassified workers statewide increased from 1,488 in 2007 to 3,180 in 2010, a 113.6% increase while the number of audits conducted increased from 1,686 in 2007 to 1,850 in 2010, only a 9.7% increase in the number of audits.
- For the construction sector in Kentucky there were 224, 220, and 201 audits for the period 2007-2009, respectively. The percentage of construction firms misclassifying one or more employees over the period 2007-2009 was 29.5%, 28.2%, and 19.4%, respectively. In 2010, there were only 25 construction firms audited; the rate of misclassification was 40% for 2010.
- For the construction sector in Kentucky, the number of misclassified workers found during audits is substantially higher than for other industries. For the construction sector, the number of misclassified workers per audit was 1.260 while it was only 0.957 for all other industries combined.
- When an employer practices misclassification in Kentucky, the results show that this behavior is pervasive. An analysis of the number of misclassified workers in all industries for the period 2007-2010 show that 41.5% of firms that were found to be misclassifying had 3 or more misclassified employees and 25% of those firms that were found to be misclassifying had 5 or more misclassified workers.
- From our analysis of the construction unemployment insurance audits in Kentucky, U.S. Department of Commerce data, and Internal Revenue Service data, we estimate that 8.01% of employees in construction in Kentucky were misclassified as independent contractors.

¹³Based upon data from the United States Bureau of Labor Statistics, Quarterly Census of Employment and Wages, the average number of all employers in the construction sector in Kentucky was 10,658 in construction Workforce Kentucky (QECW)

- **Within the construction sector in Kentucky, the number of employees affected statewide by misclassification is estimated to have averaged 11,215 annually.**
- **Misclassification of employees has a negative financial impact on individual workers, Kentucky state government, and the private sector in Kentucky.** The workers are directly impacted by being denied the protection of various employment laws and by being forced to pay costs normally borne by employers. State income tax revenues, the unemployment insurance system, and worker's compensation in Kentucky are adversely affected as well. Misclassification also imposes other costs on employers who play by the rules, the general health delivery system, taxpayers, and the public at large.
- **We estimate that the unemployment insurance system lost an average of \$1.75 million each year in the construction sector for the period for the period 2007-2010 in unemployment insurance taxes that were not levied as a result of misclassification.** A portion of this lost revenue may be recaptured when an audit reveals a misclassified worker where contributions are due. In 2008, for example, the amount of net contributions recaptured from their audits was approximately \$46,391; equaling 2.7 % of the total amount that we project was not collected in 2008 based upon an 8.01% misclassification rate in the construction sector in Kentucky¹⁴
- **According to published data, workers misclassified as independent contractors are known to underreport their personal income as well. As a result, the Commonwealth of Kentucky suffers a loss of income tax revenue from the construction sector.** According to IRS reports, wage earners report 99% of their wages, whereas non-wage earners (such as independent contractors) report approximately only 68% of their income. This represents a gap of 31%. Other studies estimate the gap to be as high as 50%.
- **Based upon IRS estimates that 30% of the income of misclassified workers in Kentucky is not reported, we estimate that \$6.13 million annually of state income tax revenues from the construction sector were lost in Kentucky for the period 2007-2010 as a result of employee misclassification**

¹⁴In Illinois, our study found that the net amount recaptured from their audits was approximately 2.0% of the total amount we projected was not collected (Kelsay, Sturgeon, and Pinkham, 2006). In our Indiana study, our study found that the net amount recaptured from their audits was approximately 2.8% of the total amount we projected was not collected (Kelsay and Sturgeon, 2010).

- Based upon the higher estimate that up to 50% of the income of misclassified workers is not reported, we estimate that \$11.59 million annually of state income tax revenues from the construction sector were lost in Kentucky for the period 2007-2010 as a result of employee misclassification.
- Misclassification also impacts worker's compensation insurance. Among other effects, costs are higher for employers that follow the rules placing them at a distinct competitive disadvantage. A large, national study conducted for the U.S. Department of Labor reported that the cost of worker's compensation premiums is the single most dominant reason why employers misclassify.¹⁵ Employers who misclassify can underbid the legitimate employers who provide coverage for their employees. The practice of misclassification shifts the burden of paying worker's compensation insurance premiums onto those employers who properly classify their employees. It has the further effect of destroying the fairness and legitimacy of the bidding process. The same national study reported that many previously misclassified workers were later added to their company's worker's compensation policy by their employer after they were injured, resulting in the payment of benefits even though premiums had not been collected.
- Worker's compensation premiums are much higher in the construction sector than they are in other sectors. In Kentucky, the statewide index rate for workers compensation premiums in 2008 was \$2.27 per \$100 of payroll.¹⁶ However, within construction, rates are substantially higher. For example, the workman compensation rate for Concrete Construction (Class 5213) was \$12.43 per \$100 of payroll, Carpentry – Detached Dwellings (Class 5645) was 24.42 per \$100 of payroll, and roofing – All Kinds (Class 5551) was \$30.03 per \$100 of payroll.¹⁷
- Using an average premium rate of \$10 per \$100 of payroll, we estimate that for the period 2007-2010, an annual average of \$3.4 million of worker's compensation premiums were not properly paid by construction employers in Kentucky. Using a higher average premium rate of \$15 per \$100 of payroll, we estimate this average annual amount for the period 2007-2010 was \$5.1 million of worker's compensation premiums were not properly paid by construction employers in Kentucky.

¹⁵ Planmatics, Inc. For the U.S. Department of Labor – Employment and Training Administration. *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs*. February, 2000.

¹⁶ Oregon Department of Consumer & Business Services. *Oregon Workers' Compensation Premium Rate Ranking, Calendar Year 2008*. March 2009.

¹⁷ Oregon Department of Consumer & Business Services. *Oregon Workers' Compensation Premium rate Ranking, Calendar Year 2008*. March 2009.

- When an employer engages in misclassification and the income goes unreported, social security and Medicare taxes are not paid. The total amount of social security and Medicare taxes payable by the employee is 7.65%.¹⁸ The employer is also legally responsible for a like match of 7.65% for a total social security and Medicare tax of 15.30%. **Based upon the assumption that 30% of the income of misclassified workers is not reported, we estimate that \$10.8 million in employee contributions from the construction sector for social security and Medicare are not made.** In addition to these losses from employees for social security and Medicare, employers are also legally responsible for the same amounts.
- **Based upon the assumption that 50% of the income of misclassified workers is not reported, we estimate that \$18.0 million in employee contributions from the construction sector for social security and Medicare are not made.** In addition to these losses from employees for social security and Medicare, employers are also legally responsible for the same amounts.
- Based upon the assumption that 30% of the income of misclassified workers is not reported, we estimate that \$18.1 million in federal income tax payments is not made as a result of misclassification in the construction sector annually.
- Based upon the assumption that 50% of the income of misclassified workers is not reported, we estimate that \$30.2 million in federal tax payments is not made as a result of misclassification in the construction sector annually.

¹⁸ In 2011, the employee portion of the social security tax has been reduced by 2.0%

Summary of Losses to Kentucky and the Federal Government in the Construction Sector as a Result of Misclassification of Employees

	Option 1 ¹ Annually: 2007-2010	Option 2 ² Annually: 2007-2010
State of Kentucky: Construction Industry		
1. Lost Unemployment Insurance Taxes	\$1,750,000	\$1,750,000
2. Lost State Income Taxes	\$6,130,000	\$11,590,000
4. Lost Worker's Compensation Premiums	\$3,400,000	\$5,100,000
Total Economic Losses: State of Kentucky in Construction Industry	\$11,280,000	\$18,440,000
Loss to Federal Government: Construction Industry		
1. Social Security and Medicare Taxes (Employee Portion)	\$10,800,000	\$18,000,000
2. Social Security and Medicare Taxes (Employer Portion)	\$10,800,000	\$18,000,000
2. Federal Income Taxes	\$18,100,000	\$30,200,000
Total Economic Losses: Federal Government in Construction Industry	\$39,700,000	\$66,200,000
Total Economic Losses from Construction Industry: State of Kentucky and Federal Government	\$50,980,000	\$84,640,000

NOTES:

¹ Option 1 assumes that 30% of income is unreported and that the worker's compensation rate for construction is \$10 per \$100 of payroll.

² Option 2 assumes that 50% of income is unreported and that the worker's compensation rate for construction is \$15 per \$100 of payroll.

In Kentucky, as well as in other states, the unemployment insurance trust fund has been experiencing increasing deficits. Since 2008, the primary contributing factor to this growing deficit has been the steep downturn in the Kentucky and United States economies. However, the unemployment insurance fund in Kentucky decreased dramatically from 2002-2007 prior to the recession. In January, 2008, the unemployment rate in Kentucky was 5.6%; the unemployment rate in Kentucky peaked in July/August, 2009 at 11.1% and was 9.8% in May, 2011. In January, 2008, 112,833 Kentucky workers were officially classified as unemployed; in May, 2011, the number of unemployed in Kentucky reached 206,908, an increase of 83.4% in the number of unemployed in Kentucky.

A review of the year-end balance in the Kentucky Trust Fund highlights the problems of the unemployment insurance in the state. The Trust Fund Balance in Kentucky was \$602.0 million in May, 2002. It had decreased to \$64.3 million by April, 2007. In January, 2009, tax collections and trust fund reserves were insufficient to meet benefit obligations and became insolvent. On January 28, 2009, the Commonwealth of Kentucky began borrowing from the Federal Unemployment Account.

Kentucky began receiving Title XII Advances from the Department of Treasury in January, 2009. As of July 13, 2011, there were 29 states (and the Virgin Islands) receiving Title XII advances. Kentucky has the 12th largest amount of Title XII advances as of July 13, 2011; the outstanding loan balance on July 13, 2011 was \$948.7 million.¹⁹ In

¹⁹http://www.treasurydirect.gov/govt/reports/tfmp/tfmp_advactivitiesched.htm and http://www.treasurydirect.gov/govt/tfmp/tfmp_utf.htm.

seven years, through a combination of higher unemployment rates, misclassification, and other factors, the Trust Fund in Kentucky has gone from over \$602.0 million in May, 2002 to insolvency in January, 2009.

States, including Kentucky, perform both random and non-random unemployment insurance audits. The Kentucky OET conducts its random audits based upon criteria and guidelines provided by the U.S. Department of Labor. Kentucky is required by the United State Department of Labor (USDOL) to perform Unemployment Insurance tax compliance audits at a penetration rate equal to or greater than 2% of all active employers in the Commonwealth of Kentucky. Additionally USDOL requires that at least 10% of employer audits be randomly selected.

Beginning in 2009, Kentucky OET began following the approach in Indiana whereby they conduct industry targeted audits with the purpose of auditing employers with a high probability of misclassification based upon past findings and records.²⁰For example, in Indiana, each year in the 3rd quarter of the year prior to building target audit universe file, the North American Industry Classification System (NAICS) is examined by audit supervision in order to determine what industries will be targeted to build target audit universe file. The Commonwealth of Kentucky now follows this methodology whereby they target their audit efforts by focusing on those NAICS Codes with the highest level of misclassification. Examples of these targeted audit situations include industries that have been shown to exhibit a high degree of misclassified workers or non-compliance with state law (e.g., the delinquent filing of reports, late registration, past violations of state law, etc.).

Thus, we conclude that misclassification is an increasing problem in Kentucky. The effects of increasing misclassification negatively impact workers, employers, small businesses, insurers, taxpayers and tax authorities. Furthermore, the operation of fair, competitive markets is compromised when the bidding process is undermined by the practice of misclassification. Kentucky will stand to benefit from better documentation of misclassification, from adopting measures that help to improve compliance with state statutes and from targeting employers who intentionally and repeatedly misclassify their employees.

²⁰Discussion with the Kentucky Division of Unemployment Insurance on July 19, 2011.

Acknowledgements

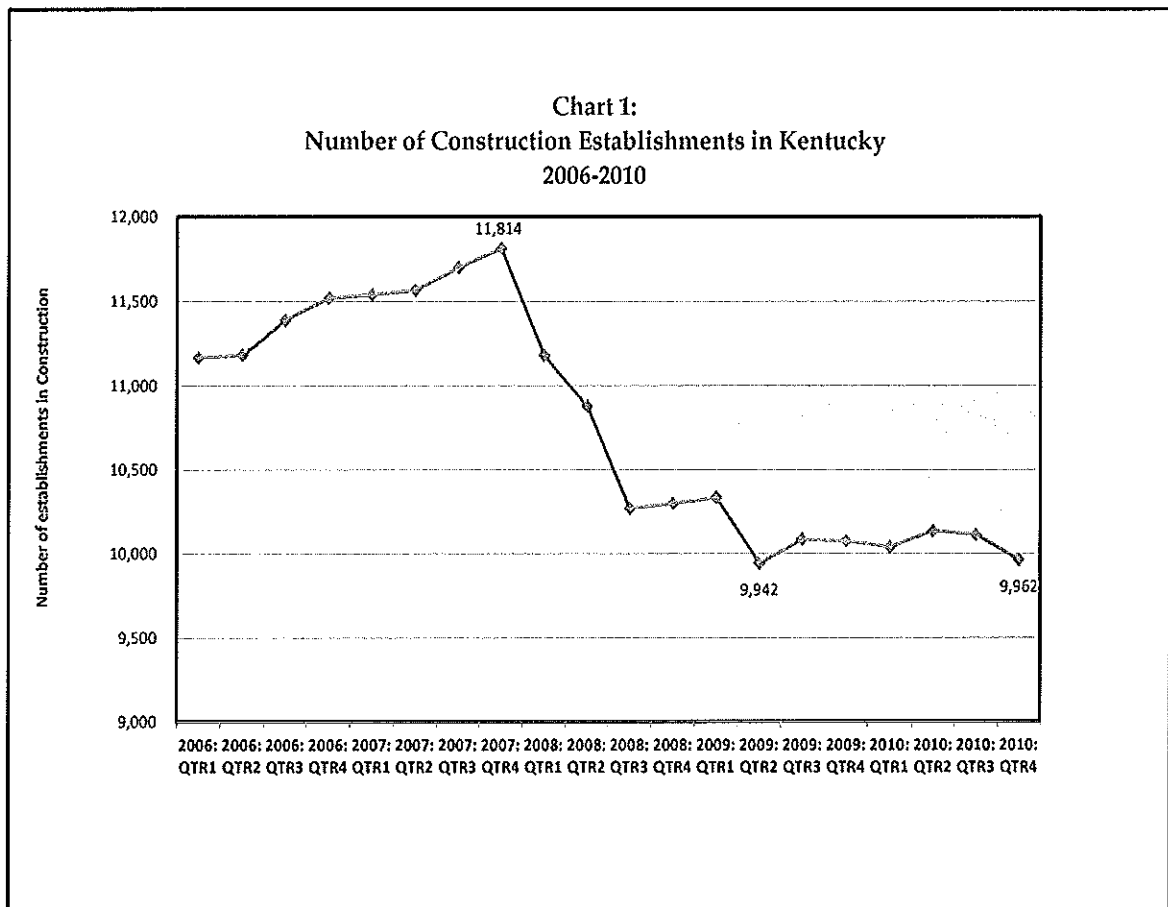
This project received funding from the Kentucky State Building & Construction Trades Council. The Kentucky State Building & Construction Trades Council, AFL-CIO, consists of 15 construction trade unions representing over 25,000 workers. The authors wish to especially thank the Kentucky Office of Employment and Training (KOET) for their assistance in providing the detailed audit data, and discussions with personnel at the Kentucky Office of Employment and Training, Division of Unemployment Insurance.

Note: Studies such as ours that project economic costs to a given state due to the employer practice of misclassification should not be taken as report cards, so to speak, on the departments in those states responsible for collecting various revenues. In fact, the Kentucky OET, Division of Unemployment Insurance ranks at or near the top in certain key metrics for all states in the U.S. for identifying and recovering unreported wages and in other measures of best practices and performance.

II. The Construction Industry in Kentucky

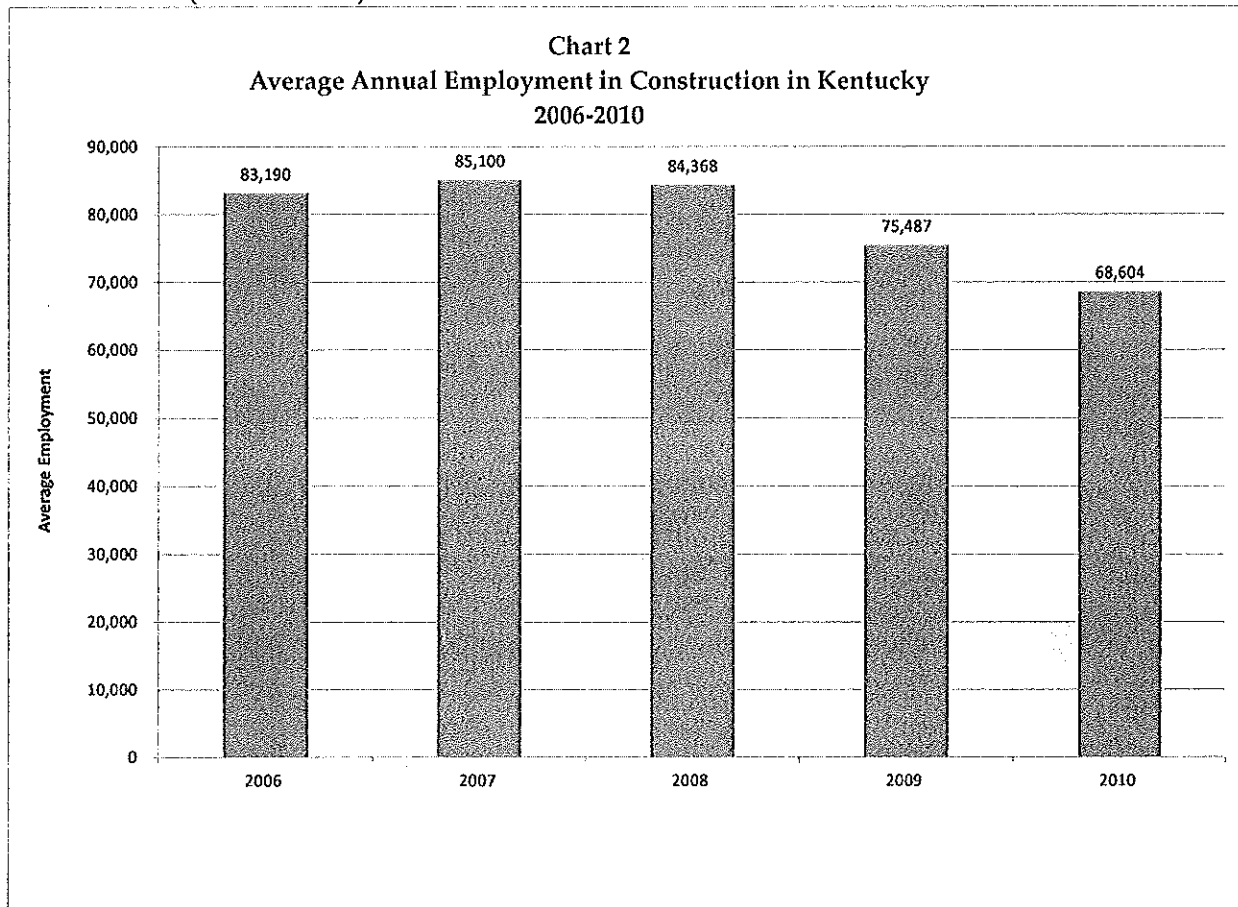
According to Workforce Kentucky, Quarterly Census of Employment and Wages (QCEW), there were 9,962 establishments in the construction industry in Kentucky in the 4th quarter of 2010. In the 4th quarter of 2007, there were 11,841 construction establishments in Kentucky. There has been a 15.7% decrease in the number of construction firms in Kentucky since the 4th quarter of 2007. Graph 1 depicts the trend in the number of establishments for the period 2006-2010.

Most construction firms in Kentucky have few employees. According to the U.S. Census Bureau, 80.3% of construction firms in Kentucky have nine or fewer employees; 62.7% of construction firms in Kentucky have 4 or fewer employees.



Employment in the construction sector in Kentucky has decreased significantly since the onset of the recession. According to Workforce Kentucky, Quarterly Census of Employment and Wages (QCEW), the average employment levels in construction in Kentucky in 2008 were 84,368; it had declined to an average of 68,604 in 2010. This

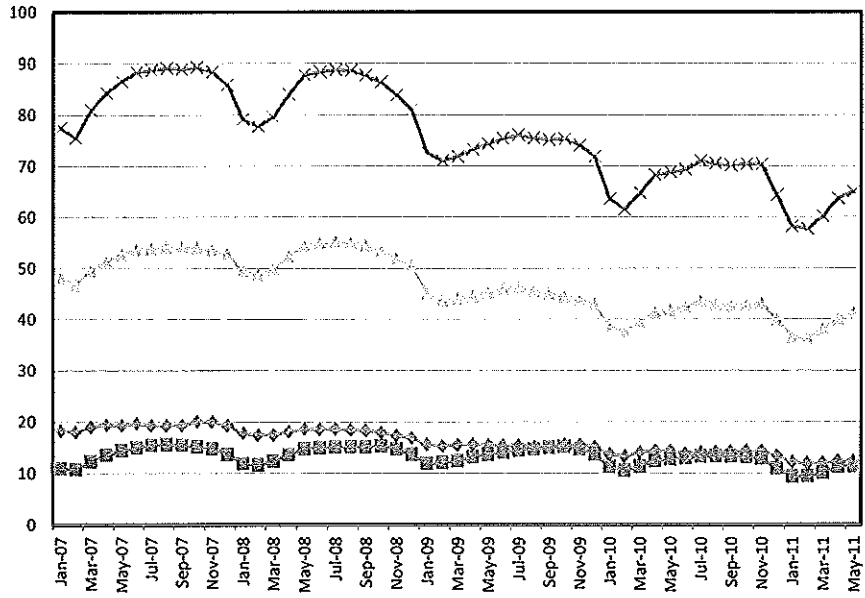
represents an 18.9% decline in employment in the construction sector in Kentucky from 2008 to 2010 (See Chart 2)



The decline in construction has been uniform across all types of construction. The United States Department of Commerce provides monthly employment (1,000s) by type of construction activity. For construction of buildings in Kentucky, the level of employment has fallen from 19,300 in 2008 in December, 2008 to 12,300 in May, 2011, a 36.3% decrease in construction of buildings. For heavy and civil engineering construction in Kentucky, the level of employment has fallen from 13,700 in December, 2008 to 11,500 in May, 2011, a 16.1% decrease in heavy and civil engineering construction. For specialty trade contractors in Kentucky, the level of employment has fallen from 50,400 in 2008 to 41,200 in May, 2011, a 22.3% decline for specialty trade contractors (See Chart 3)

Chart 3
 Employment in Construction Trades in Kentucky
 January, 2007 - May, 2011

- ◆ Construction of Buildings
- Heavy & Civil Engineering Construction
- ▲ Specialty Trade Contractors
- ← Total



III. The Problem of Misclassification– Detailed Findings

Misclassification arises from two potential sources. First, an employer may claim that a worker meets the common law standard as defined by the Internal Revenue Service and is, in fact, an independent contractor. This may simply be an error or the employer may be attempting to avoid the legal and financial responsibilities they would incur if a person was classified as an employee rather than as an independent contractor. The second source of misclassification may be a situation of an unreported worker, i.e., a worker whose employment either as an employee or as an independent contractor is simply not reported in order to avoid the legal and financial responsibilities for the worker.

If an employee is classified as an independent contractor, the “employer” is not required to pay and/or withhold a variety of payroll-related taxes, fees and benefits (e.g., social security and Medicare taxes, local, state and federal income taxes, unemployment insurance, workers compensation, pension and health benefits, etc.). Not only are these costs shifted to the individual worker, the “independent contractor” is also not fully protected by various employment laws (minimum wage and overtime requirements, workers compensation protection, the right to form a union and bargain collectively, etc.) and may, incorrectly, believe he or she is protected by Kentucky unemployment laws. If a person is classified as an independent contractor, “employers” are required to issue a 1099-MISC for payments for work in excess of \$600 or more.

Workers with alternative work arrangements are making up an increasing percentage of the workforce.²¹ According to the United States Bureau of Labor Statistics, workers with alternative work arrangements accounted for 12.0% of the total workforce in February, 2005. Of the total amount of workers with alternative work arrangements, independent contractors accounted for 70% of workers with alternative work arrangements. An examination of independent contractors by industry showed that the construction sector accounted for 22.0% of all independent contractors, the highest level of concentration of independent contractors in all industries.

The issue of misclassifying employees as independent contractor is a growing problem for the unemployment insurance system and state revenue streams in Kentucky and other states, as well as the federal government. This occurs because

²¹The Bureau of Labor Statistics defines workers with alternative work arrangements as (1) independent contractors, (2) on-call workers, (3) temporary help agency workers, and (4) workers provided by contract firms. <http://www.bls.gov/news.release/conemp.t08.htm>.

employers remit their unemployment taxes and other tax streams based upon their payroll. Recent studies have shown that misclassification by employers is increasing. For example, the rate of misclassification by employers in Illinois was shown to be 22.8% in 2001 and had increased to 31.9% and 27.6% in 2004 and 2005, respectively.²²In a report by the Ohio Attorney General on February 18, 2009, the number of workers misclassified in 2009 increased 53.5% over the total number misclassified in 2008.²³Note, the “underground economy” (workers paid in cash) is outside the scope of our study and thus, the estimates we provide will *underestimate* the full extent of the problems associated with the employer practice of misclassification in Kentucky.

There are a number of different practices whereby misclassification is accomplished. First, many employers may hire labor as self-employed independent contractors and provide them with a 1099-Miscellaneous Income for tax purposes. An emerging problem takes the form of simply paying labor with cash with no trail of the independent contractor agreement. State and federal revenue bases are significantly impacted when employees are improperly classified as independent contractors. The IRS reports that voluntary compliance in reporting income varies significantly across groups of individual taxpayers. Among those filing tax returns, wage earners report 99% of their wages; self-employed individuals who receive a 1099, report 68% of their business income; and “informal suppliers” - self-employed individuals who operate informally on a cash basis - report just 19% of such income on their tax returns. Informal suppliers accounted for almost 17% of all unpaid individual income and employment taxes in 1992.²⁴

Misclassification negatively impacts the citizens of Kentucky in a number of ways. First, the conditions for a fair and competitive marketplace are sabotaged. Employers who misclassify their workers have a pricing edge over their counterparts which results in unfair competition in the marketplace. Firms that misclassify workers can bid for work without having to account for many normal payroll-related costs. This illegal practice can decrease payroll costs by as much as 15% to 25%.²⁵

²²Kelsay, Michael P., PhD, James I. Sturgeon, PhD., and Kelly D. Pinkham, M.S. *The Economic Costs of Employee Misclassification in the State of Illinois*. A Report by the Department of Economics. University of Missouri – Kansas City. December 6, 2006. Page 16.

²³ Cordray, Richard. Ohio Attorney General. *Report of the Ohio Attorney General on the Economic Impact of Misclassified Workers for State and Local Governments in Ohio*.

²⁴ United States General Accounting Office. *Taxpayer Compliance: Analyzing the Nature of the Income Tax Gap*. GAO/T-GGD-97-35.

²⁵These avoided payroll-related taxes are (1) old age, survivors, and disability insurance [6.20%], (2) Medicare basic hospital insurance [1.45%], (3) unemployment insurance [2% or greater], (4) workers compensation costs [2.27% or greater] as well as any pension and medical insurance. Workers

Secondly, misclassifying workers negatively impact the public sector in Kentucky by: (1) reducing the unemployment insurance taxes the state would collect if these employees were properly classified; (2) reducing the worker's compensation fund because Kentucky does not collect the insurance premiums due, and (3) reducing the amount of income taxes collected by Kentucky.

A number of studies have shown that the problem of misclassification to be particularly acute in the construction sector. In three state level studies (Massachusetts, Maine, and New York), the incidence of misclassification in the construction sector is higher than other industries in those states. For Massachusetts, the moderate statewide rate is 19%, while the rate of misclassification in the construction sector is 24%²⁶; for Maine, the low statewide estimate is 11% compared to 14% in the construction sector.²⁷ In New York, the statewide rate of misclassification for 2005-2008 was 10%, while the rate of misclassification in the construction sector for this same time period was 15%.²⁸ In a recent study on the employee misclassification in Tennessee, the overall rate of misclassification ranged between 12%-19%.²⁹ In a study on employee misclassification in Michigan, it was found that 26.4% of construction employers were misclassifying.³⁰ The United States Government Accounting Office [GAO] reported that the percentage of misclassified workers in all industries was 15%, while the percentage of misclassified workers in the construction sector was 20%.³¹

A U.S. Census Bureau analysis of projected nonfarm wage and salary employment by major industry division for the period 2008-2018 shows that the growth

compensation costs would be substantially higher in certain industries such as construction and would push payroll costs savings even higher.

²⁶ Carre, Francoise, Ph.D. and Randall Wilson. *The Social and Economic Costs of Employee Misclassification in Construction*. A Report for the Construction Policy Research Center and Labor and Worklife Program. Harvard Law School and Harvard School of Public Health. Elaine Bernard, Ph.D. and Robert Herrick, ScD, Principal Investigators. December 17, 2004.

²⁷ Carre, Francoise, Ph.D. and Randall Wilson. *The Social and Economic Costs of Employee Misclassification in the Maine Construction Industry*. A Report for the Construction Policy Research Center and Labor and Worklife Program. Harvard Law School and Harvard School of Public Health. Elaine Bernard, Ph.D. and Robert Herrick, ScD, Principal Investigators. April 25, 2005.

²⁸ Donahue, Linda H., James Ryan Lamare, and Fred B. Kotler, J.D. *The Cost of Worker Misclassification in New York State*. ILR Collection. Research Studies and Reports. Cornell University ILR School. Year 2007.

²⁹ Canak, William, PhD and Randall Adams, PhD. *Misclassified Construction Employees in Tennessee*. January 15, 2010.

³⁰ Belman, Dale L., PhD. and Richard Block, PhD. *Informing the Debate. The Social and Economic Costs of Employee Misclassification in Michigan*. Institute for Public Policy and Research

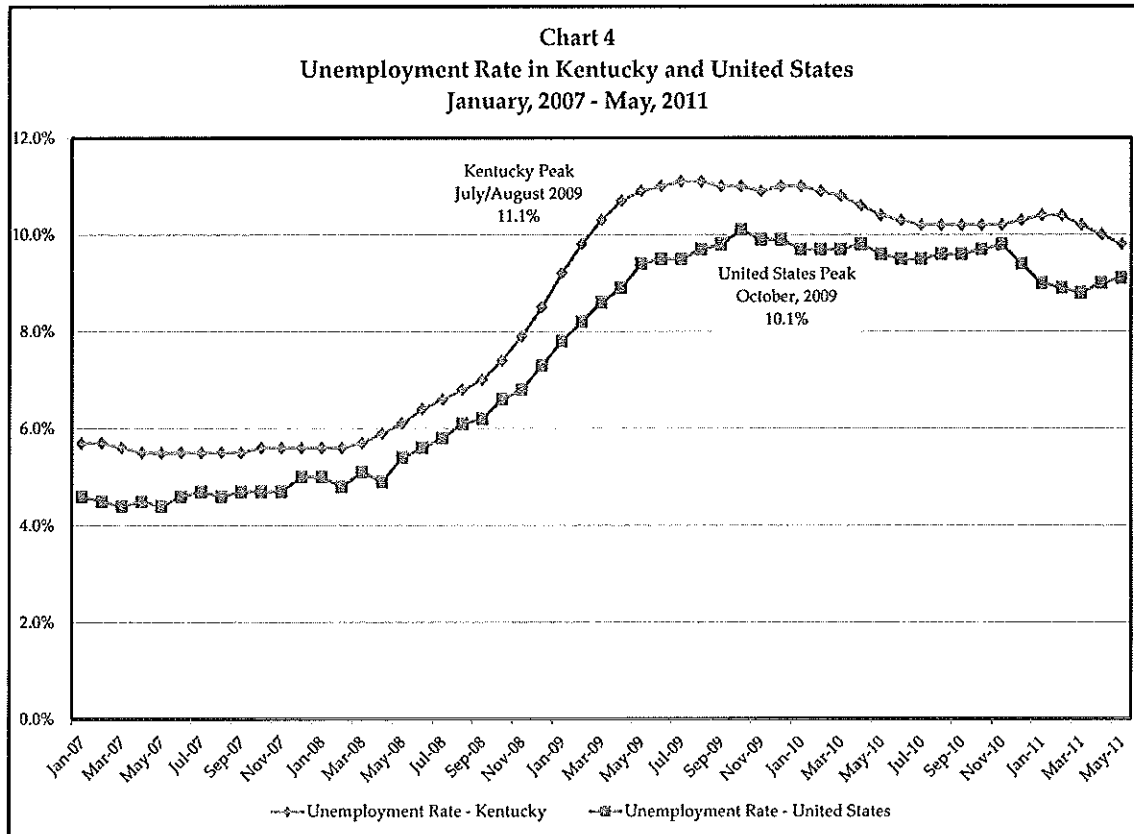
³¹ United States General Accounting Office. *Tax Administration: Issues in Classifying Workers as Employees or Independent Contractors*. GOA/T-GGD-96-130.

in overall employment is projected to increase 10.6%, or at an annual rate of increase of 1.0%; and, in construction, the growth in employment is projected to increase 18.5%, or at an annual rate of increase of 1.7%.³² According to Workforce Kentucky, the growth rate in construction in Kentucky is projected to increase 13.3% from 2008-2018; the estimated employment in construction in Kentucky is projected to be 84,354.³³ Given the projected growth in the construction sector in Kentucky and the United States, the impacts of misclassification in the construction sector will worsen.

In Kentucky, as well as in other states, the unemployment insurance trust fund has been experiencing increasing deficits. Since 2008, the primary contributing factor to this growing deficit has been the steep downturn in the Kentucky and United States economies. However, the unemployment insurance fund in Kentucky decreased dramatically from 2002-2007 prior to the recession. In January, 2008, the unemployment rate in Kentucky was 5.6%; the unemployment rate in Kentucky peaked in July/August, 2009 at 11.1% and was 9.8% in May, 2011 (Chart 4). In January, 2008, 112,833 Kentucky workers were officially classified as unemployed; in May, 2011, the number of unemployed in Kentucky reached 206,908, an increase of 83.4% in the number of unemployed in Kentucky.

³²Bartsch, Kristina J. *Occupational Employment Projections for 2008-2018*. Monthly Labor Review. November 2009. Pages 3-10.

³³ Workforce Kentucky. Industry Employment Projections (Future Job Growth). <http://www/workforcekentucky.ky.gov/cgi/dataanalysis>.



Source: <http://www.bls.gov>.

Employers who correctly classify their employees are at a distinct competitive disadvantage over those employers who misclassify their employees. This practice also has distinct budgetary implications for the unemployment insurance fund, workers compensation fund, and state income tax revenues in Kentucky. This may be particularly acute in the construction sector.³⁴ It was reported by Planmatics that the construction industry had the highest rate of incidence of misclassification, and the one that lures workers into becoming independent contractors.³⁵

Misclassification also presents societal costs to workers and the private and public sectors in Kentucky. Although these costs are not quantified in this report, the societal costs are substantial. For example, workers that are misclassified do not receive health insurance benefits. The lack of health insurance coverage exacts a large toll on

³⁴ The General Accounting Office (1996) reported that the estimated percentage of employees with misclassified workers was 13.4%, while the estimated percentage in the construction sector was the highest of all industry groups at 19.8%.

³⁵ Planmatics, Inc. For the U.S. Department of Labor – Employment and Training Administration. *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs*. February, 2000.

the uninsured – avoidable deaths, poorly managed chronic conditions, and underutilizes life-savings medical procedures. In addition to the direct toll the lack of health insurance coverage takes on the uninsured, there are other substantial social and economic costs as well. The economic costs of being uninsured or under-insured are borne by individual workers and private sector employers, the health delivery system, taxpayers, and the public at large. The costs borne by the uninsured include a greater probability of death, reduced preventive care, and a smaller likelihood of early detection of medical problems.³⁶ The health system also bears an economic cost as well. It is reported that the total medical care received by the uninsured in 2004 which included those without coverage for all or part of the year was \$124.5 billion. Uncompensated care, or care paid-out-of-pocket by the public and private sector was estimated to be \$40.7 billion in 2004.³⁷ Utilizing the consumer price index for medical care from the U.S. Bureau of Labor Statistics, the total medical care cost in 2011 dollars is \$158.8 billion and the uncompensated care cost is \$51.8 billion.³⁸

There are a number of reasons why employers engage in misclassification. It is reported that the cost of workers' compensation premiums is the single most dominant reason for misclassification.³⁹ Employers also engage in misclassification in order to avoid the economic costs associated with litigation against employees alleging discrimination, sexual harassment, and putting in place the regulations and reporting procedures required for employees.⁴⁰ Additionally, if an employee is classified as an independent contractor, the employer is not required to pay a variety of payroll taxes (i.e., social security, Medicare, unemployment insurance, workers compensation) and the independent contractor is not fully protected by employment laws. This allows employers to underbid the legitimate employers who provide coverage for their employees. In the construction sector, worker misclassification penalizes legitimate contractors in the bidding process. It has been reported that many workers are added after an injury to a company's worker's compensation policy, resulting in payment of benefits even though premiums were not paid.⁴¹

³⁶The Commonwealth Fund reports that the lack of health insurance leads to 18,000 deaths per year. The Commonwealth Fund. *The Costs and Consequences of Being Uninsured*. Commonwealth Fund Publication #663.

³⁷ Hadley, Jack, Ph.D and John Holahan, Ph.D. *The Cost of Care for the Insured: What Do We Spend, Who Pays, and What Would Full Coverage Add to Medical Spending*. The Kaiser Commission on Medicaid and the Insured. May, 2010.

³⁸ U.S. Bureau of Labor Statistics. Consumer Price Index for Medical Care. Series ID CUSR000SAM.

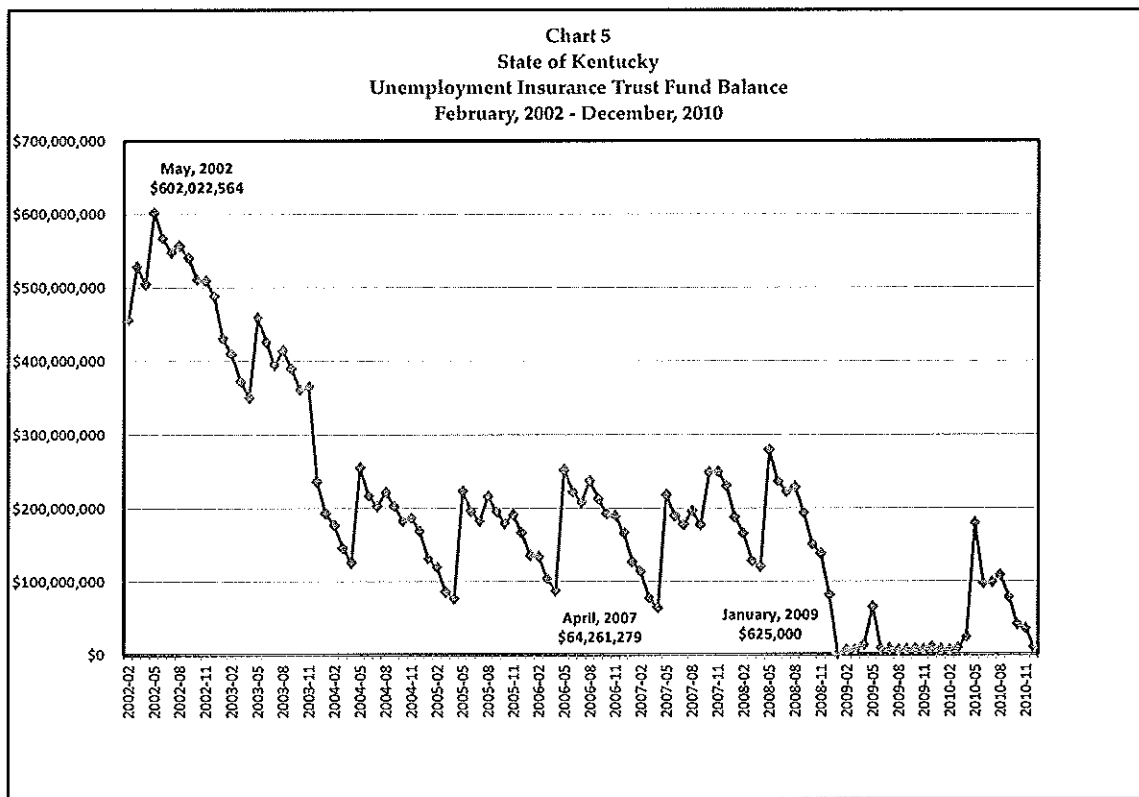
³⁹Planmatics, Inc. For the U.S. Department of Labor – Employment and Training Administration. *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs*. February, 2000.

⁴⁰Ibid.

⁴¹ Ibid.

A review of the year-end balance in the Kentucky Trust Fund highlights the problems of the unemployment insurance in the state (Chart 5). The Trust Fund Balance in Kentucky was \$602.0 million in May, 2002. It had decreased to \$64.3 million by April, 2007. In January, 2009, tax collections and trust fund reserves were insufficient to meet benefit obligations and became insolvent. On January 28, 2009, the Commonwealth of Kentucky began borrowing from the Federal Unemployment Account.

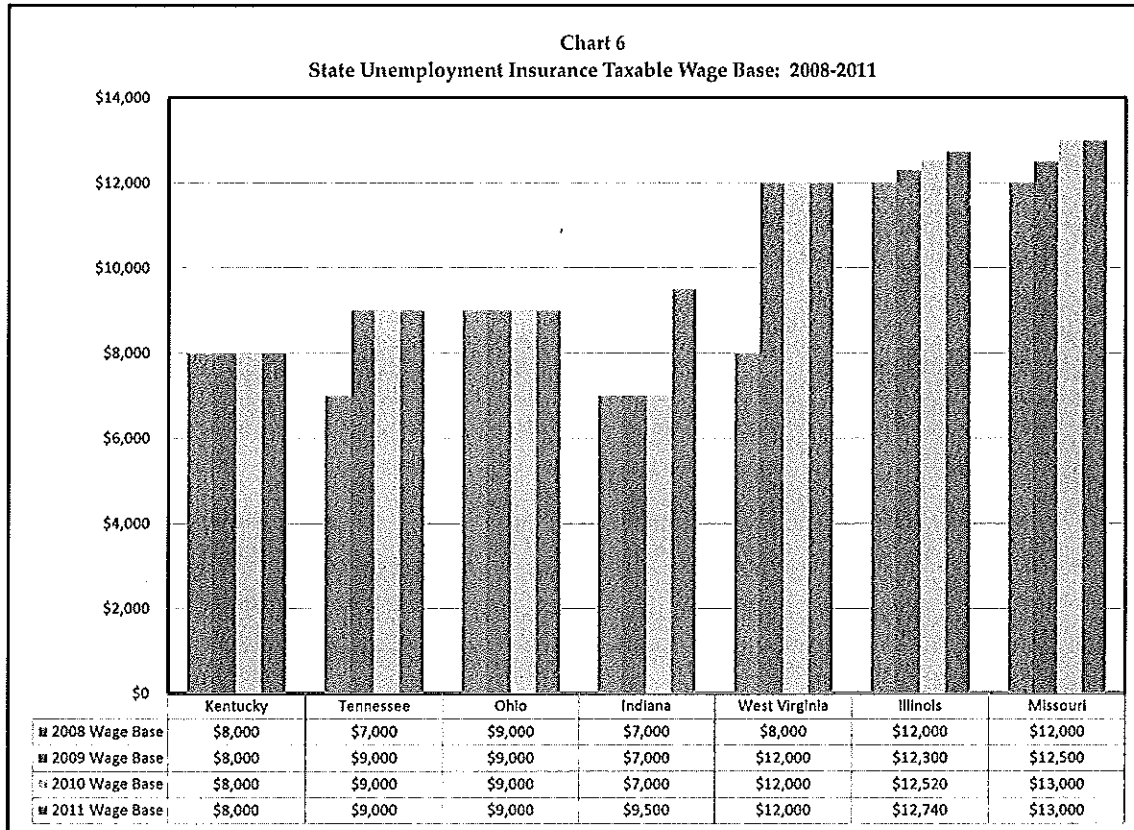
Kentucky began receiving Title XII Advances from the Department of Treasury in January, 2009. As of July 13, 2011, there were 29 states (and the Virgin Islands) receiving Title XII advances. Kentucky has the 12th largest amount of Title XII advances as of July 13, 2011; the outstanding loan balance on July 13, 2011 was \$948.7 million.⁴² In seven years, through a combination of higher unemployment rates, misclassification, and other factors, the Trust Fund in Kentucky has gone from over \$602.0 million in May, 2002 to insolvency in January, 2009.



Source: Treasury Direct. Unemployment Trust Fund Report. <http://www.treasurydirect.gov>

⁴²http://www.treasurydirect.gov/govt/reports/tfmp/tfmp_advactivitiesched.htm and http://www.treasurydirect.gov/govt/tfmp/tfmp_utf.htm.

In the Commonwealth of Kentucky, the state unemployment insurance taxable wage base for the period 2008-2011 has remained constant at \$8,000. Chart 6 depicts the taxable wage base in surrounding states. Indiana had the lowest taxable wage base in the region at 7.0% until 2011; they increased their taxable wage base to \$9,500 in 2011. West Virginia, Illinois, and Missouri have the highest taxable wage base at \$12,000, \$12,740, and \$13,000, respectively, in 2011.



Source: State Unemployment Insurance Departments of Above States

TABLE 1
Prevalence of Misclassification in All Industries
and the Construction Sector

	Low	Moderate	High
All Industries (9 States) ¹			
California			29%
Colorado			34%
Connecticut			42%
Maryland		20%	
Minnesota		14%	
Nebraska	10%		
New Jersey	9%		
Wisconsin		23%	
Washington	10%		
All Industries (United States) ²		14%	
All Industries (Massachusetts ³)	13%	19%	
All Industries (Maine ⁴)	11%		
All Industries (Illinois ⁵)		18%	
All Industries (New York ⁶)	10%		
All Industries (Minnesota ⁷)		15%	
All Industries (Pennsylvania ⁸)	9%		
All Industries (Michigan ⁹)			30%
All Industries (Ohio ¹⁰)			
All Industries (Wisconsin ¹¹)			44%
All industries (Indiana ¹²)			46%
All Industries (Michigan ¹³)		30%	
Construction Sector (New York ¹⁴)		15%	
Construction Sector (Massachusetts ¹⁵)	14%	24%	
Construction Sector (Maine ¹⁶)	14%		
Construction Sector (Tennessee ¹⁷)	12%	19%	
Construction Sector (Michigan ¹⁸)		26%	
Construction Sector (United States ¹⁹)		20%	

¹ Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs. February, 2000.

² United States General Accounting Office, GAO/T-GGD-96-130, pg. 13. 1996.

³The Social and Economic Costs of Employee Misclassification in Construction. December 17, 2004.

⁴The Social and Economic Costs of Employee Misclassification in the Maine Construction Industry. April 25, 2005.

⁵The Economic Costs of Employee Misclassification in the State of Illinois. December 6, 2006.

⁶The Cost of Worker Misclassification in New York State. February, 2007.

⁷Misclassification of Employees as Independent Contractors. November, 2007.

⁸Testimony of the Pennsylvania Deputy Secretary for Unemployment Compensation Programs. April 23, 2008.

⁹Informing the Debate: The Social and Economic Costs of Employee Misclassification in Michigan. 2009.

¹⁰Report of the Ohio Attorney General on the Economic Impact of Misclassified Workers. February 18, 2009.

¹¹Report of the Worker Misclassification Task Force, Wisconsin Department of Workforce Development. June, 2009.

¹²The Economic Costs of Employee Misclassification in Indiana, 2010.

¹³Informing the Debate. The Social and Economic Costs of Employee Misclassification in Michigan, 2009).

¹⁴Misclassification of Employees as Independent Contractors. November, 2007.

¹⁵The Social and Economic Costs of Employee Misclassification in Construction. December 17, 2004.

¹⁶The Social and Economic Costs of Employee Misclassification in the Maine Construction Industry. April 25, 2005.

¹⁷Misclassified Construction Employees in Tennessee, January 15, 2010.

¹⁸ Informing the Debate. The Social and Economic Costs of Employee Misclassification in Michigan, 2009).

¹⁹United States General Accounting Office, GAO/T-GGD-96-130, pg. 13. 1996.

SOURCE:

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States, including Kentucky, perform both random and non-random unemployment insurance audits. The Kentucky OET conducts its random audits based upon criteria and guidelines provided by the U.S. Department of Labor. Kentucky is required by the United State Department of Labor (USDOL) to perform Unemployment Insurance tax compliance audits at a penetration rate equal to or greater than 2% of all active employers in the Commonwealth of Kentucky. Additionally USDOL requires that at least 10% of employer audits be randomly selected.

Beginning in 2009, Kentucky OET began following the approach in Indiana whereby they conduct industry targeted audits with the purpose of auditing employers with a high probability of misclassification based upon past findings and records.⁴³ For example, in Indiana, each year in the 3rd quarter of the year prior to building target audit universe file, the North American Industry Classification System (NAICS) is examined by audit supervision in order to determine what industries will be targeted to build target audit universe file. The Commonwealth of Kentucky now follows this methodology whereby they target their audit efforts by focusing on those NAICS Codes with the highest level of misclassification. Examples of these targeted audit situations include industries that have been shown to exhibit a high degree of misclassified workers or non-compliance with state law (e.g., the delinquent filing of reports, late registration, past violations of state law, etc.).

Table 2 provides a summary analysis of the unemployment insurance audit records provided for the period 2007-2010. The number of audits reflected by the data suggests that the Commonwealth of Kentucky is targeting their scarce resources to those sectors where misclassification has shown to be a large problem nationwide. The Commonwealth of Kentucky's audit records show that 63.5% of all audits over the period 2007-2010 are concentrated in five sectors: (1) Health Care & Social Assistance {15.2%}, (2) Retail Trade {13.8%}, (3) Professional Scientific & Technical Services {13.1%}, (4) Other Services {11.5%} and (5) Construction {9.8%}.

In terms of the number of misclassified workers found, the three sectors for the period 2007-2010 with the largest number of misclassified workers were (1) Accommodation and Food Services {1,364}, (2) Retail Trade {1,123}, and (3) Construction {881}.

⁴³Discussion with the Kentucky Division of Unemployment Insurance on July 19, 2011.

Table 2
 Summary Analysis of Unemployment Insurance Audits: 2007-2010
 Analysis of Unemployment Insurance Audit Records: 2007

Industry	NAICS	Number of Audits	Number of Misclassified Workers	Percent of Audits Performed	Percent of Misclassified Workers	Misclassified Workers Per Audit
Forestry, Fishing, Hunting, and Agriculture Support	11	20	32	1.2%	2.2%	1.600
Mining	21	16	27	0.9%	1.8%	1.688
Utilities	22	12	8	0.7%	0.5%	0.667
Construction	23	224	334	13.3%	22.4%	1.491
Manufacturing	31-33	82	99	4.9%	6.7%	1.207
Wholesale Trade	42	89	72	5.3%	4.8%	0.809
Retail Trade	44-45	252	232	15.0%	15.6%	0.921
Transportation & Warehousing	48-49	90	84	5.3%	5.6%	0.933
Information	51	27	12	1.6%	0.8%	0.444
Finance and Insurance	52	74	28	4.4%	1.9%	0.378
Real Estate & Rental & Leasing	53	70	61	4.2%	4.1%	0.871
Professional, Scientific & Technical Services	54	183	103	10.9%	6.9%	0.563
Management of Companies & Enterprises	55	2	0	0.1%	0.0%	0.000
Administrative Support, Waste Management & Remediation Services	56	56	39	3.3%	2.6%	0.696
Educational Services	61	9	3	0.5%	0.2%	0.333
Health Care & Social Assistance	62	197	155	11.7%	10.4%	0.787
Arts, Entertainment & Recreation	71	22	34	1.3%	2.3%	1.545
Accommodations and Food Service	72	56	82	3.3%	5.5%	1.464
Other Services (Except Public Administration)	81	174	65	10.3%	4.4%	0.374
Unclassified Establishments	99	30	18	1.8%	1.2%	0.600
TOTALS		1,685	1,488	100.0%	100.0%	0.883

Analysis of Unemployment Insurance Audit Records: 2008

Industry	NAICS	Number of Audits	Number of Misclassified Workers	Percent of Audits Performed	Percent of Misclassified Workers	Misclassified Workers Per Audit
Forestry, Fishing, Hunting, and Agriculture Support	11	13	10	0.9%	0.6%	0.769
Mining	21	19	52	1.3%	3.1%	2.737
Utilities	22	7	3	0.5%	0.2%	0.429
Construction	23	220	271	14.5%	16.4%	1.232
Manufacturing	31-33	73	78	4.8%	4.7%	1.068
Wholesale Trade	42	93	48	6.1%	2.9%	0.516
Retail Trade	44-45	225	262	14.9%	15.8%	1.164
Transportation & Warehousing	48-49	85	138	5.6%	8.3%	1.624
Information	51	12	1	0.8%	0.1%	0.083
Finance and Insurance	52	71	19	4.7%	1.1%	0.268
Real Estate & Rental & Leasing	53	57	66	3.8%	4.0%	1.158
Professional, Scientific & Technical Services	54	164	155	10.8%	9.4%	0.945
Management of Companies & Enterprises	55	4	0	0.3%	0.0%	0.000
Administrative Support, Waste Management & Remediation Services	56	53	271	3.5%	16.4%	5.113
Educational Services	61	7	8	0.5%	0.5%	1.143
Health Care & Social Assistance	62	196	95	12.9%	5.7%	0.485
Arts, Entertainment & Recreation	71	18	16	1.2%	1.0%	0.889
Accommodations and Food Service	72	37	48	2.4%	2.9%	1.297
Other Services (Except Public Administration)	81	139	98	9.2%	5.9%	0.705
Unclassified Establishments	99	21	15	1.4%	0.9%	0.714
TOTALS		1,514	1,654	100.0%	100.0%	1.092

Table 2 (Continued)
Summary Analysis of Unemployment Insurance Audits: 2007-2010
Analysis of Unemployment Insurance Audit Records: 2009

Industry	NAICS	Number of Audits	Number of Misclassified Workers	Percent of Audits Performed	Percent of Misclassified Workers	Misclassified Workers Per Audit
Forestry, Fishing, Hunting, and Agriculture Support	11	20	23	1.1%	1.3%	1.150
Mining	21	19	27	1.1%	1.5%	1.421
Utilities	22	9	3	0.5%	0.2%	0.333
Construction	23	201	214	11.2%	11.6%	1.065
Manufacturing	31-33	128	105	7.1%	5.7%	0.820
Wholesale Trade	42	91	80	5.1%	4.4%	0.879
Retail Trade	44-45	275	214	15.3%	11.6%	0.778
Transportation & Warehousing	48-49	76	456	4.2%	24.8%	6.000
Information	51	25	17	1.4%	0.9%	0.680
Finance and Insurance	52	97	51	5.4%	2.8%	0.526
Real Estate & Rental & Leasing	53	73	68	4.1%	3.7%	0.932
Professional, Scientific & Technical Services	54	203	75	11.3%	4.1%	0.369
Management of Companies & Enterprises	55	6	8	0.3%	0.4%	1.333
Administrative Support, Waste Management & Remediation Services	56	70	141	3.9%	7.7%	2.014
Educational Services	61	13	19	0.7%	1.0%	1.462
Health Care & Social Assistance	62	229	96	12.8%	5.2%	0.419
Arts, Entertainment & Recreation	71	27	17	1.5%	0.9%	0.630
Accommodations and Food Service	72	60	153	3.3%	8.3%	2.550
Other Services (Except Public Administration)	81	146	70	8.1%	3.8%	0.479
Unclassified Establishments	99	24	0	1.3%	0.0%	0.000
TOTALS		1,792	1,837	100.0%	100.0%	1.025

Analysis of Unemployment Insurance Audit Records: 2010

Industry	NAICS	Number of Audits	Number of Misclassified Workers	Percent of Audits Performed	Percent of Misclassified Workers	Misclassified Workers Per Audit
Forestry, Fishing, Hunting, and Agriculture Support	11	125	156	6.8%	4.9%	1.248
Mining	21	0	0	0.0%	0.0%	0.000
Utilities	22	0	0	0.0%	0.0%	0.000
Construction	23	25	62	1.4%	1.9%	2.480
Manufacturing	31-33	12	129	0.6%	4.1%	10.750
Wholesale Trade	42	12	10	0.6%	0.3%	0.833
Retail Trade	44-45	195	415	10.5%	13.1%	2.128
Transportation & Warehousing	48-49	88	123	4.8%	3.9%	1.398
Information	51	0	0	0.0%	0.0%	0.000
Finance and Insurance	52	40	10	2.2%	0.3%	0.250
Real Estate & Rental & Leasing	53	83	40	4.5%	1.3%	0.482
Professional, Scientific & Technical Services	54	343	144	18.5%	4.5%	0.420
Management of Companies & Enterprises	55	0	0	0.0%	0.0%	0.000
Administrative Support, Waste Management & Remediation Services	56	10	23	0.5%	0.7%	2.300
Educational Services	61	1	17	0.1%	0.5%	17.000
Health Care & Social Assistance	62	421	249	22.8%	7.8%	0.591
Arts, Entertainment & Recreation	71	80	461	4.3%	14.5%	5.763
Accommodations and Food Service	72	83	1,081	4.5%	34.0%	13.024
Other Services (Except Public Administration)	81	331	260	17.9%	8.2%	0.785
Unclassified Establishments	99	1	0	0.1%	0.0%	0.000
TOTALS		1,850	3,180	100.0%	100.0%	1.719

Table 2 (Continued)
 Summary Analysis of Unemployment Insurance Audits: 2007-2010
 Analysis of Unemployment Insurance Audit Records: 2007-2010

Industry	NAICS	Number of Audits	Number of Misclassified Workers	Percent of Audits Performed	Percent of Misclassified Workers	Misclassified Workers Per Audit
Forestry, Fishing, Hunting, and Agriculture Support	11	178	221	2.6%	2.7%	1.242
Mining	21	54	106	0.8%	1.3%	1.963
Utilities	22	28	14	0.4%	0.2%	0.500
Construction	23	671	881	9.8%	10.8%	1.313
Manufacturing	31-33	295	411	4.3%	5.0%	1.393
Wholesale Trade	42	285	210	4.2%	2.6%	0.737
Retail Trade	44-45	947	1,123	13.6%	13.8%	1.186
Transportation & Warehousing	48-49	339	601	5.0%	9.8%	2.363
Information	51	64	30	0.9%	0.4%	0.469
Finance and Insurance	52	282	108	4.1%	1.3%	0.383
Real Estate & Rental & Leasing	53	283	235	4.1%	2.9%	0.830
Professional, Scientific & Technical Services	54	893	477	13.1%	5.8%	0.534
Management of Companies & Enterprises	55	12	8	0.2%	0.1%	0.667
Administrative Support, Waste Management & Remediation Services	56	189	474	2.8%	5.8%	2.508
Educational Services	61	30	47	0.4%	0.6%	1.567
Health Care & Social Assistance	62	1,043	595	15.2%	7.3%	0.570
Arts, Entertainment & Recreation	71	147	528	2.1%	6.5%	3.592
Accommodations and Food Service	72	236	1,364	3.4%	16.7%	5.780
Other Services (Except Public Administration)	81	790	493	11.5%	6.0%	0.624
Unclassified Establishments	99	76	33	1.1%	0.4%	0.434
TOTALS		6,842	8,159	100.0%	100.0%	1.192

With respect to the number of misclassified workers per audit, the construction sector has the highest ratio of misclassified workers per audit for the five sectors that have the highest audit penetration rate. For the period 2007-2010, the construction sector was found to have 1.313 misclassified workers per audit. For the period 2007-2010, the retail sector was found to have 1.186 misclassified workers per audit. For the remaining three sectors (other services, health care and social assistance and professional, scientific, & technical services), the number of misclassified workers per audit was only 0.624, 0.574, and 0.534. This result suggests that misclassification is higher in the construction sector and more resources should be devoted to the construction sector audits.

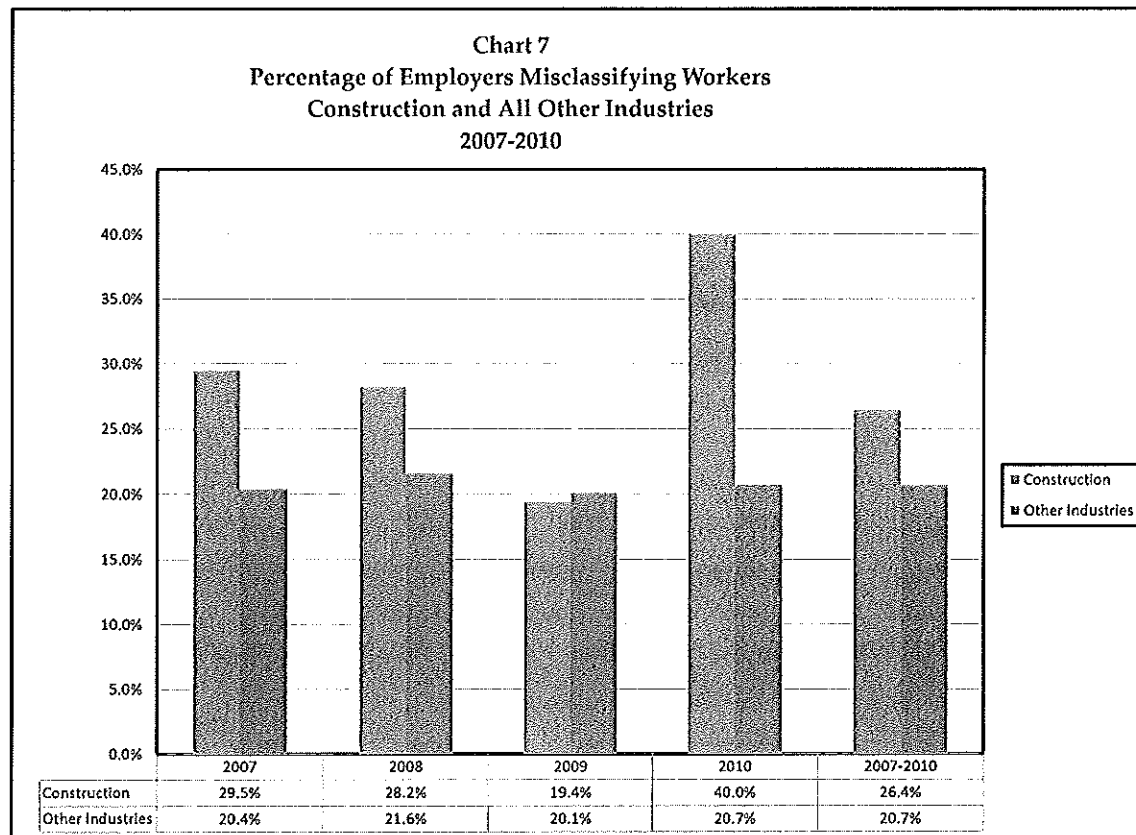
For the period 2007-2010, of the 671 audits performed in the construction sector, 177 construction firms were found to be misclassifying. This represents 26.4% of all construction firms in Kentucky were found to be misclassifying. For the five sectors where audits have been concentrated over the period 2007-2010, the construction sector has the highest percentage of firms that are misclassifying. The overall rate of misclassification in Kentucky across all other sectors over the period 2007-2010 was 21.3%. It should be noted that the construction sector had 224, 220, and 201 audits performed in 2007, 2008, and 2009, respectively. Construction audits as a percentage of all construction firms were 2.2%, 2.2%, and 1.9%, in 2007-2009, respectively. In 2010, there were only 25 audits in the construction sector. Construction audits as a percentage of all construction firms were only 0.2% in 2010.

The Kentucky OET reports six types of unemployment insurance audits (Table 6, 7, Pages 41-42). The Kentucky OET conducted 6,816 audits from 2007 through 2010. Using de-identified audit data provided by the Kentucky OET for the period 2007-2010 and other state and federal government databases, we have developed reliable estimates of misclassification in the construction sector. De-identified data is data that does not identify an individual or company and from which there is no reasonable basis to believe that the information provided can be used to identify an individual or a company. Using methodologies developed in earlier studies, we present projections of the economic costs of misclassification for unemployment insurance, state income taxes, worker compensation, social security and Medicare taxes, and federal income taxes.

IV. Extent of Misclassification in Kentucky

When Employers Engage in Misclassification

For the years 2007-2010, state unemployment audits found that, on average, 20.7% of all Kentucky employers, except construction, that were audited were found to have misclassified workers as independent contractors. For the years 2007-2010, state unemployment audits found that, on average, 26.4%, of all construction employers were found to have misclassified workers as independent contractors (Chart 7).

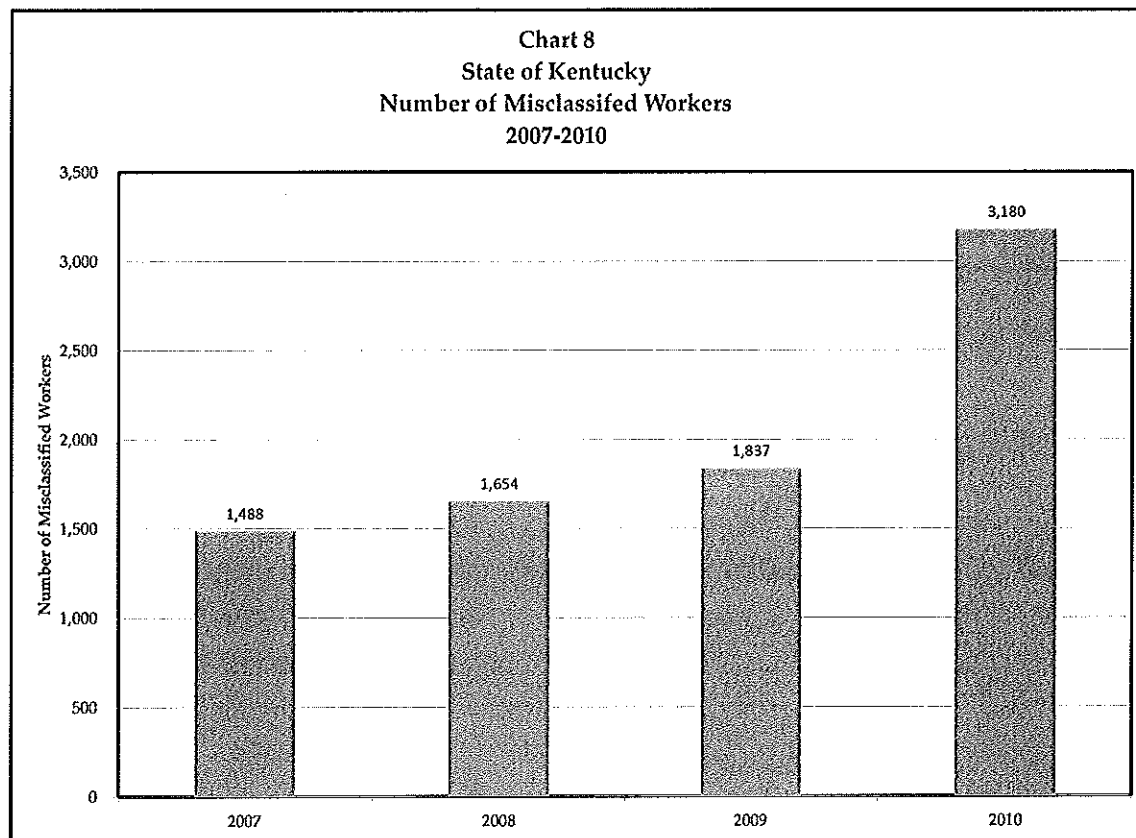


For 2007 data, Kentucky OET provided the type of audit for those audits conducted. Of the 1,686 audits conducted in 2007, 73.7% of the audits were excess wage audits (EA). The Kentucky OET, Division of Unemployment Insurance, has changed its methodology and now targets those sectors with higher probabilities of misclassification. For the construction sector, 72.3% of the audits conducted in 2007 were excess wage audits. Because misclassification has a higher probability of occurring in those excess wage audits, this represents a moderate-upper bound of the overall misclassification rate by employers in Kentucky.

This estimate of misclassification in the construction sector in Kentucky translates into an estimate of approximately 2,816 construction employers statewide annually for the period 2007-2010 misclassify their employees.

Severity of the Impact of Misclassification

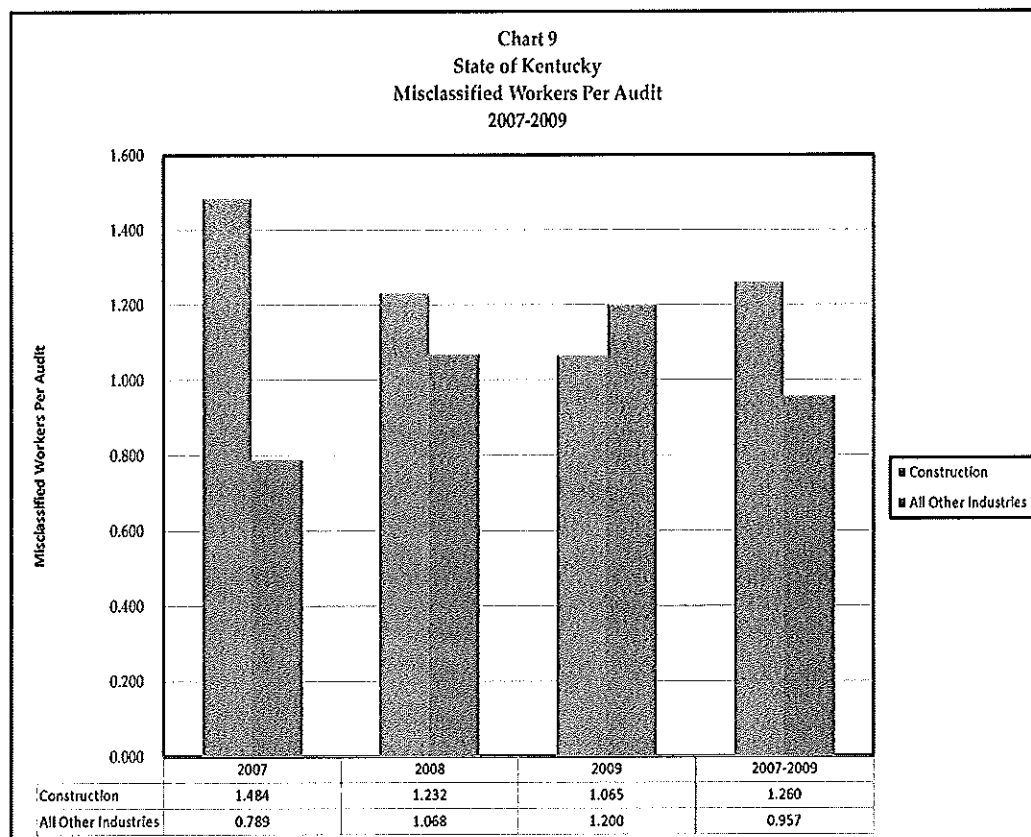
In order to assess the trend and severity of the impact of misclassification in Kentucky, we examine the trend in misclassification in Kentucky for the period 2007-2010 and the trend in the number of misclassified workers per audit in Kentucky. The number of misclassified workers found in 2007 audit records was 1,488. The number of misclassified workers has increased each year for the period 2007-2010. The number of misclassified workers had increased to 3,180 in 2010 (Chart 8).



Workers Impacted by Misclassification

When employers misclassify in Kentucky, the results show that this behavior is pervasive. An analysis of the percentage of employees that are misclassified indicates that misclassification is a common occurrence rather than a random event in those companies that do misclassify. Of the 1,460 firms that were identified as misclassifying

1 or more employees, 606, or 41.5% of those firms were found to have misclassified 3 or more employees; 25% of those firms were found to have misclassified 5 or more employees at their firm. An analysis of the number of workers misclassified per audit found that the ratio of misclassified workers per audit is more severe in construction. For the period 2007-2009, the number of workers misclassified per audit was 1.260, while it was only 0.957 for all other industries in Kentucky. The ratio of misclassified workers per audit was 31.7% higher in construction than all other industries in Kentucky (Chart 9).



Extent of Misclassification

According to the 2008 American Community Survey, 139,965 workers were working in the Kentucky construction industry.⁴⁴The Quarterly Census of Employment and Wages Program is a cooperative program involving the Bureau of Labor Statistics (BLS) of the U.S. Department of Labor and the State Employment Security Agencies (SESAs). The QCEW program produces a comprehensive tabulation of employment

⁴⁴U.S. Bureau of the Census. American Fact Finder. B24020.

http://factfinder.census.gov/servlet/DTTable?_bm=y&-context=dt&-ds_name=ACS_2008_1YR_G00_&-mt_name=ACS_2008_1YR_G2000_B24020&-CONTEXT=dt&-tree_id=308&-redoLog=true&-geo_id=04000US21&-search_results=01000US&-format=&-_lang=en

and wage information for workers covered by State unemployment insurance (UI) laws and Federal workers covered by the Unemployment Compensation for Federal Employees (UCFE) program. There were 84,400 employees according to Workforce Kentucky (QCEW). We present an estimate for the number of misclassified construction workers based upon the difference between Kentucky's wage workers and the self-employed, on the one hand, and total construction employment, on the other.

For the self-employed in Kentucky, we utilized estimates from the Internal Revenue Service for 2008 Nonemployer Statistics for Kentucky. The Internal Revenue Service reports that there were 44,350 non employer firms. Based upon Workforce Kentucky (QCEW) data and IRS data, the total number of reported construction workers in Kentucky was 128,750 ($84,400 + 44,350 = 128,750$).

According to the 2008 American Community Survey, there were 139,965 construction workers in Kentucky. We estimate that there were 11,215 ($139,965 - 128,750 = 11,215$) construction workers in Kentucky that were misclassified. The rate of employee misclassification in the construction sector in Kentucky was 8.01%. In our report on Illinois, we found that 7.5% of all employees in Illinois were misclassified

V. Implications of Employee Misclassification in Kentucky

Misclassification of employees has a negative financial impact on individual workers, Kentucky state government, the federal government, and the private sector in Kentucky. In addition, the integrity of the bidding process for the construction sector, upon which a merit-based free-market economy relies, is sabotaged by unscrupulous employers seeking an illegal competitive advantage. Here, we estimate the economic implications of employee misclassification with respect to (1) the unemployment insurance tax revenues, (2) state income tax revenues, (3) the amount of worker' compensation insurance premiums not properly paid due to misclassification, (4) unpaid social security and Medicare taxes and (5) unpaid federal income taxes.

Implications of Employee Misclassification for Unemployment Insurance Tax

As stated earlier, the problem of misclassification has implications for the unemployment insurance system in several ways. Firms that misclassify employees as independent contractors pay no unemployment insurance on those workers. The violating employer saves additional money because the large majority of laid-off employees are never charged to their unemployment insurance account. This places those employers who are correctly classifying their employees at a distinct competitive disadvantage over those employers who are misclassifying their employees. This behavior has distinct budgetary implications for the unemployment insurance fund in Kentucky.

Based upon a misclassification rate in the construction sector of 8.01%, we estimate that the unemployment insurance system has lost an average of \$1.75 million annually, on average, for the period 2007-2010 in unemployment insurance taxes that are not levied on the payroll of misclassified workers in the construction industry as they should be.

A portion of this lost revenue may be recaptured when an audit reveals a misclassified worker where contributions are due. In 2008, for example, the amount of net contributions recaptured from their audits was approximately \$46,391; equaling 2.7% of the total amount that we project was not collected in 2008 based upon an 8.01% misclassification rate in the construction sector in Kentucky⁴⁵

⁴⁵In Illinois, our study found that the net amount recaptured from their audits was approximately 2.0% of the total amount we projected was not collected (Kelsay, Sturgeon, and Pinkham, 2006). In our Indiana study, our study found that the net amount recaptured from their audits was approximately 2.8% of the total amount we projected was not collected (Kelsay and Sturgeon, 2010).

Implications of Employee Misclassification for State Income Tax Revenue

According to published data workers misclassified as independent contractors are known to under-report their personal income because they do not have their taxes withheld. Also employees misclassified as independent contractors can reduce their tax liability by deducting certain expenses that employees are not entitled to deduct. For example, independent contractors can deduct expenses for automobiles, homes, medical insurance, retirement plans, and business trips. As a result, Kentucky suffers a loss of state income tax revenue. According to published IRS figures, wage earners report 99% of their wages. Non-wage earners report approximately 68% of their income. This represents a gap of 31% in reported income. Other estimates report the gap as high as 50%. The IRS reports that when informational returns (e.g., 1099 Miscellaneous Income) are examined, misclassified workers reported 77% of that income on their tax returns, but reported only 29% of the income not covered by informational returns (e.g., wages paid in cash).⁴⁶

The Commonwealth of Kentucky imposes a graduated income tax rate from 2% of taxable income to 6% of taxable income.⁴⁷ We assume that personal exemptions and federal exemptions are fully incorporated into their reported tax returns and we do not apply these exemptions to unreported income. The Internal Revenue Service reported that in its last comprehensive study on misclassification in 1984, about 15% of employers misclassified a total of 3.4 million employees as independent contractors, resulting in an estimated revenue loss of \$1.6 billion (in 1984 dollars)⁴⁸ According to a 2009 report by the Treasury Inspector General for Tax Administration, the IRS's most recent estimate of the cost of misclassification is \$54 billion in the underreporting of employment tax and losses of \$15 billion in unpaid FICA taxes and UI taxes.⁴⁹ The \$15 billion estimate is based on 1984 data that has not been updated and, according to the IRS, may be substantially higher.

We present two estimates for lost income taxes. The first estimate is based upon the assumption that 30% of the income of misclassified workers is not reported; our

⁴⁶Commonwealth of Kentucky. Department of Revenue. Instructions for Form 740-EZ (2010). Page 13.

⁴⁷http://www.taxfoundation.org/files/state_individualincome_rates-2000-2011-20110302.swf

⁴⁸ Employee Misclassification. Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention. United States General Accounting Office. GAO-09-717.

⁴⁹ Treasury Inspector General for Tax Administration. *While Actions have been Taken to Address Worker Misclassification, an Agency-Wide Employment Tax Program and Better Data are Needed*. February 4, 2009. Reference Number: 2009-30-035.

second estimate is based upon the assumption that 50% of the income of misclassified workers is not reported. For our calculations with respect to lost state revenues, we derive the annual earnings of all construction workers in the Commonwealth of Kentucky.⁵⁰

Based upon an estimate that 30% of the income of misclassified workers is not reported, we provided a lower and upper bound estimate based upon an 8.01% misclassification rate of construction workers in Kentucky. Based upon a misclassification rate of 8.01% and that 30% of income is not reported, we estimate, as a lower bound, that the Commonwealth of Kentucky loses \$6.13 million annually from the construction sector in unpaid income taxes. Based upon a misclassification rate of 8.01% and that 50% of income is not reported, we estimate, as a upper bound, that the Commonwealth of Kentucky loses \$11.59 million annually from the construction sector in unpaid income taxes.

Implications of Employee Misclassification for Worker Compensation

Misclassification also impacts worker's compensation insurance. Among other effects the costs are higher for employers that follow the rules, placing them at a distinct disadvantage. It was reported by Planmatics (2000) that the cost of worker's compensation insurance premiums is the primary reason why employers misclassify.⁵¹ Misclassification offers employers an opportunity to avoid paying the high cost of these insurance premiums. This allows those employers who misclassify employees as independent contractors to underbid employers who correctly classify workers as employees. Therefore, in the construction sector, workers compensation premium costs have increasingly fallen on those contractors who classify their employees appropriately. It has also been reported that after an injury has occurred many independent contractors are simply converted to employee status in order to obtain coverage under the company's worker's compensation policy, resulting in payment of benefits even though premiums were not collected.⁵²

⁵⁰We obtained the average annual earnings for all private sector employees and annual earnings for the construction sector in Kentucky from Workforce Kentucky, Detailed LMI. Quarterly Census of Employment and Wages (QCEW)

<http://www.workforcekentucky.ky.gov/cgi/dataanalysis/industryReport.asp?menuchoic=industry>
For the construction sector in Kentucky in 2008, the average annual salary in construction was \$41,991.

⁵¹Planmatics, Inc. For the U.S. Department of Labor – Employment and Training Administration. *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs*. February, 2000

⁵²“Reconversion from IC [Independent Contractor] to employee status also occurs in order to avoid paying high worker's compensation premiums...[in California]...This practice was prevalent in the other states also.” (p. 30); and “...the retroactive use of workers' compensation [when they are injured]...The insurers have to pay benefits for workers they never received premiums for.” (p. 76). Planmatics (2000)

According to the Oregon Workers' Compensation Premium Rate Ranking for Calendar Year 2008, the 2008 index rate for worker's compensation rate premium statewide in Kentucky was \$2.27 per \$100 of payroll. Worker's compensation premiums are much higher in the construction industry. However, within construction, rates are substantially higher. For example, the workman compensation rate for Concrete Construction (Class 5213) was \$12.43 per \$100 of payroll, Carpentry – Detached Dwellings (Class 5645) was 24.42 per \$100 of payroll, and roofing – All Kinds (Class 5551) was \$30.03 per \$100 of payroll.⁵³ When these annual premiums are not paid by those employers who misclassify, it results in raising the premiums that are charged to those employers who do correctly classify their employees.

We present two estimates for worker's compensation premiums in construction trades in Kentucky based upon (1) a rate of \$10 per \$100 of payroll and (2) a rate of \$15 per \$100 of payroll. For the four year period of 2007-2010, we estimate the annual cost shift of premiums to be \$3.4 million annually in the construction sector. Based upon a rate of \$15 per \$100 of payroll, we estimate the annual cost shift of premiums to be \$5.1 million annually in the construction sector. Again, annual premiums not paid by misclassifying employers may result in an increase of premiums paid by employers who classify their employees correctly.

Implications of Employee Misclassification for Social Security and Medicare

For 2007-2010, social security taxes were 6.2% of earnings up to a threshold and Medicare taxes were 1.45% on all earnings.⁵⁴ The total amount of social security and Medicare taxes payable by the employee is 7.65%. The employer is also legally responsible for a like match of 7.65% for a total social security and Medicare tax of 15.30%. Based upon the assumption that 30% of the income of misclassified workers is not reported, we estimate that \$10.8 million in employee contributions for social security and Medicare are not made. Based upon the assumption that 50% of the income of misclassified workers is not reported, we estimate that \$18.0 million in employee contributions for social security and Medicare are not made. In addition to these losses to social security and Medicare, employers are also responsible for the same amounts.

Implications of Employee Misclassification for Federal Income Taxes

⁵³ Oregon Department of Consumer & Business Services. *Oregon Workers' Compensation Premium rate Ranking, Calendar Year 2008*. March 2009.

⁵⁴ The employee portion of social security in 2011 has been reduced by 2.0%.

According to the United States Census Bureau, the median annual income in Kentucky in 2008 was \$41,663. The median annual income in the construction sector in Kentucky was \$41,991 in 2008 which places the sector at the state median.⁵⁵

The Statistics of Income Bulletin published by the Internal Revenue Service provides annual data on income tax returns. The average tax rate for this level of income ranged from 11.84% to 13.77%.⁵⁶ The average tax rate for the two levels reported is 12.81%

Based upon the assumption that 30% of the income of misclassified workers is not reported, we estimate that \$18.1 million in federal tax payments in not made as a result of misclassification in the construction sector annually. Based upon the assumption that 50% of the income of misclassified workers is not reported, we estimate that \$30.2 million in federal tax payments in not made as a result of misclassification in the construction sector annually.

⁵⁵U.S. Census Bureau. American Fact Finder. Kentucky. S1903. Mean Income in the Past 12 Months (in 2008 Inflation-Adjusted Dollars.

⁵⁶ Internal Revenue Service. <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=133521,00.html>

V. Conclusions

Our study is a first step toward illustrating the dimensions of and the negative economic impacts associated with the problem of employer misclassification in the Commonwealth of Kentucky. Our study has confirmed the fact that misclassification in the construction sector is a severe problem which impacts the public and private sectors in Kentucky as well as the revenue streams of the federal government. We have shown that misclassification has direct and significant impacts on workers, employers, taxpayers and markets. Table 3 summarizes the losses to the Commonwealth of Kentucky and the federal government in the construction sector as a result of misclassification in the construction sector. Under Option 1, the estimated annual economic loss in the construction sector for the period 2007-2010 to Kentucky is \$11,280,000; under Option 2, the estimated annual economic loss from the construction sector for the period 2007-2010 to Kentucky is \$18,440,000.

We have also estimated the losses to the Federal treasury from unpaid social security taxes, Medicare taxes, and personal income taxes as a result of misclassification in the construction sector. Under Option 1, the estimated annual economic loss from the construction sector for unpaid social security, Medicare, and personal income taxes is estimate for the period 2007-2010 to Kentucky at \$39,700,000 annually; under Option 2, the estimated annual economic loss from the construction sector for unpaid social security, Medicare, and personal income taxes is estimate for the period 2007-2010 to Kentucky at \$66,200,000 annually.

The estimate of the total economic loss under Option 1 (Commonwealth of Kentucky and Federal Government) is \$50,980,000. The estimate of the total economic loss under Option 2 (Commonwealth of Kentucky and Federal Government) is \$84,640,000.

TABLE 3
Summary of Losses to Kentucky and the Federal Government in the Construction Sector as a Result of Misclassification of Employees

	Option 1 ¹ Annually: 2007-2010	Option 2 ² Annually: 2007-2010
State of Kentucky: Construction Industry		
1. Lost Unemployment Insurance Taxes	\$1,750,000	\$1,750,000
2. Lost State Income Taxes	\$6,130,000	\$11,590,000
4. Lost Worker's Compensation Premiums	\$3,400,000	\$5,100,000
Total Economic Losses: State of Kentucky in Construction Industry	\$11,280,000	\$18,440,000
Loss to Federal Government: Construction Industry		
1. Social Security and Medicare Taxes (Employee Portion)	\$10,800,000	\$18,000,000
2. Social Security and Medicare Taxes (Employer Portion)	\$10,800,000	\$18,000,000
2. Federal Income Taxes	\$18,100,000	\$30,200,000
Total Economic Losses: Federal Government in Construction Industry	\$39,700,000	\$66,200,000
Total Economic Losses from Construction Industry: State of Kentucky and Federal Government	\$50,980,000	\$84,640,000

NOTES:

¹ Option 1 assumes that 30% of income is unreported and that the worker's compensation rate for construction is \$10 per \$100 of payroll.

² Option 2 assumes that 50% of income is unreported and that the worker's compensation rate for construction is \$15 per \$100 of payroll.

The Office of the Inspector General for the U.S. Department of Labor reported on best practices to improve identification of noncompliant employers for state UI field audits.⁵⁷ The Kentucky Office of Employment and Training, Division of Unemployment Insurance, should be lauded for the implementation of certain of these best practices. This has resulted in Kentucky ranking in the top tier of states for return per audit hour. Among these best practices that Kentucky uses are a selective process based upon NAICS code for determining targeted industries and employers. As a result, Kentucky OET is allocating the department's scarce resources toward those industries and/or employers where the problem of misclassification has been shown to be most acute. Certain efficiency measures derived from the audit data reveal that the Kentucky OET is utilizing its scarce resources efficiently (Table 4 & 5). The efficiency measures also illustrate that resource hours are have a greater return from construction sector audits as opposed to audits from all industries in Kentucky. For example, in 2009, the number of misclassified per audit hour in all industries was 0.168, while it was 0.631 in the construction sector, over three times as high.

For all industries in Kentucky, misclassified per audit hour has increased from 0.141 in 20047 to 0.266 in 2010, an 89.3% increase; net underreported taxable wages for misclassified per audit hour has increased from \$1,229.94 in 2007 to \$1,384.52 in 2010, a 12.6% increase. For the construction sector in Kentucky, net underreported taxable wages for misclassified per audit hour has increased from \$2,823.97 in 2007 to \$4,242.59 in 2010, a 50.3% increase.

⁵⁷U.S. Department of Labor, Office of Inspector General. *Adopting Best Practices Can Improve Identification of Noncompliant Employers for State UI Field Audits*. Final Report No. 03-99-006-03-315.

A comparison of the efficiency measures shows that an increase in construction industries audits would be beneficial. For all industries, the average misclassified per audit was 0.189; for the construction sector, the average misclassified per audit was 0.513. For all industries, the average net underreported taxable wages for misclassified per audit hour was \$1,174.53; for the construction sector, the average net underreported taxable wages for misclassified per audit hour was \$3,573.11. For all industries, the average net underreported contributions for misclassified per audit hour were \$20.73; for the construction sector, the average net underreported contributions for misclassified per audit hour were \$82.50.

Table 4 Efficiency Measures for Kentucky Office of Employment and Training Division of Unemployment Security All Industries				
	2007	2008	2009	2010
Misclassified Per Audit Hour	0.141	0.181	0.168	0.266
Net Underreported Taxable Wages for Misclassified Per Audit Hour	\$1,229.94	\$1,471.51	\$612.15	\$1,384.52
Net Underreported Contributions Per Audit Hour	\$21.13	\$30.31	\$18.86	\$12.60

Table 5 Efficiency Measures for Kentucky Office of Employment and Training Division of Unemployment Security Construction Industry				
	2007	2008	2009	2010
Misclassified Per Audit Hour	0.580	0.519	0.631	0.321
Net Underreported Taxable Wages for Misclassified Per Audit Hour	\$2,823.97	\$2,910.81	\$4,315.05	\$4,242.59
Net Underreported Contributions Per Audit Hour	\$90.56	\$93.72	\$95.92	\$82.50

We believe we have shown that workers, businesses, revenue collection agencies, and policy analysts in Kentucky will benefit from better documentation of misclassification in Kentucky. Furthermore, it seems reasonable to suggest that public officials devote special attention to those employers who intentionally and/or repeatedly violate state statutes regarding misclassification.

As a beginning, we recommend the following steps for consideration by policy makers and public officials in Kentucky: (1) the Commonwealth of Kentucky should continue to perform a high degree of "targeted" audits on problem employers like those done in other states,⁵⁸ (2) develop meaningful penalties to deter those employers

⁵⁸Targeted audits are those audits identified where a higher degree of misclassification may be observed. For example, targeted audits might be audits of employers with (1) delinquent filings or (2) multiple delinquent quarters of unemployment insurance due. Planmatics (2000) encouraged states to maintain

who intentionally and/or repeatedly violate state laws on misclassification, (3) review current authorities and procedures for the collaboration among revenue, labor, and enforcement agencies so that violations of state statutes will receive a comprehensive and coordinated response with the intent of recovering all payroll-related funds that are due and of deterring future willful violations, and (4) expand outreach to educate employers and employees about classification rules.

Table 6
Unemployment Insurance Audit Statistics and Audit Definitions for Kentucky

Audit Activity	2007	2008	2009	2010	2007-2010
Audit Activity					
Total Audits	1,686	1,488	1,792	1,850	6,816
Gross Payroll (Pre Audit)	501,802,090	439,968,480	786,437,638	703,139,463	2,431,347,671
Gross Payroll (Post Audit)	512,403,918	448,911,688	799,507,055	716,702,435	2,477,525,096
Hours Spent Auditing	10,577	9,122	10,914	11,942	42,555
Audit Types:(1)					
1. Excess Wage Audit (EA)	1,242	NA	NA	NA	NA
2. Federal Audit (FA)	247	NA	NA	NA	NA
3. Large Audit (LA)	37	NA	NA	NA	NA
4. Random Audit (RA)	124	NA	NA	NA	NA
5. Request Audit (RA)	35	NA	NA	NA	NA
6. Target Audit (TA)	1	NA	NA	NA	NA
Audit Results					
Total Employers Misclassifying Workers	364	342	358	388	1,452
Total Workers Employers Misclassified	1,488	1,654	1,837	3,180	8,159
Misclassified Workers Per Audit	0.883	1.112	1.025	1.719	1.197
Revenue Data from Audited Employers					
Underreported Taxable Wages for Misclassified	\$3,243,797	\$3,863,795	\$4,329,588	\$4,992,176	\$16,429,355
Contributions for Underreported	\$117,915	\$161,328	\$154,796	\$371,256	\$805,296
Over reported Taxable Wages for Misclassified	\$1,138,892	\$1,233,695	\$1,175,256	\$588,663	\$4,136,507
Contributions for Over reported	28,078	22,801	22,217	17,570	90,666

* NOTE: Audit statistics in Kentucky for the period 2007-2010 provided by the Kentucky Office of Employment and Training, Division of Employment Insurance

(1) Audit definitions [per Kentucky Office of Employment and Training, Division of Employment Insurance]

1. Excess Wage Audit (EA) -- Employers whose wage files on system do not match the excess wages that employers reported on their quarterly reports.
2. Federal Audit (FA) -- Employers who reported more in taxable wages on their federal unemployment tax than on the state unemployment tax.
3. Large Audit (LA) -- Employers with more than 100 employees or more than \$1,000,000 in taxable payroll.
4. Random Audit (RA) -- Randomly selected
5. Request Audit (XA) -- Requested by an auditor or supervisor based upon a tip, information discovered while working on another case, information from another agency, etc.

audit selection criteria that reflect potential noncompliance (e.g. high employee turnover, type of industry, and prior reporting history).

Table 7

Unemployment Insurance Audit Statistics and Audit Definitions for Construction Sector in Kentucky

	2007	2008	2009	2010	2007-2010
<u>Audit Activity</u>					
Total Audits	224	220	201	25	670
Gross Payroll (Pre Audit)	60,189,794	66,580,779	84,309,723	15,147,475	226,227,771
Gross Payroll (Post Audit)	62,199,653	68,639,535	86,186,433	16,126,633	233,152,253
Hours Spent Auditing	1,612	1,402	1,293	371	4,678
<u>Audit Types(1)</u>					
1. Excess Wage Audit (EA)	162	NA	NA	NA	NA
2. Federal Audit (FA)	36	NA	NA	NA	NA
3. Large Audit (LA)	3	NA	NA	NA	NA
4. Random Audit (RA)	14	NA	NA	NA	NA
5. Request Audit (RA)	9	NA	NA	NA	NA
6. Target Audit (TA)	0	NA	NA	NA	NA
<u>Audit Results</u>					
Total Employers Misclassifying Workers	66	62	39	10	177
Total Workers Employers Misclassified	334	271	214	62	881
Misclassified Workers Per Audit	1.491	1.232	1.065	2.480	1.315
<u>Revenue Data from Audited Employers</u>					
Underreported Taxable Wages for Misclassified	\$823,632	\$819,490	\$623,135	\$217,318	\$2,483,575
Contributions for Underreported	\$52,162	\$48,920	\$32,517	\$15,923	\$149,522
Over reported Taxable Wages for Misclassified	\$131,926	\$120,801	\$13,025	\$0	\$265,752
Contributions for Over reported	9,428	2,529	360	0	12,317

* NOTE: Audit statistics in Kentucky for the period 2007-2010 provided by the Kentucky Office of Employment and Training, Division of Employment Insurance

(1) Audit definitions [per Kentucky Office of Employment and Training, Division of Employment Insurance]

1. Excess Wage Audit (EA) -- Employers whose wage files on system do not match the excess wages that employers reported on their quarterly reports.
2. Federal Audit (FA) -- Employers who reported more in taxable wages on their federal unemployment tax than on the state unemployment tax.
3. Large Audit (LA) -- Employers with more than 100 employees or more than \$1,000,000 in taxable payroll.
4. Random Audit (RA) -- Randomly selected
5. Request Audit (XA) -- Requested by an auditor or supervisor based upon a tip, information discovered while working on another case, information from another agency, etc.

ESTIMATION METHODS

I. Calculating the Extent of Employee Misclassification (Percentage of Firms with Misclassified Workers).

From the unemployment insurance audit records for 2007-2010, we calculated the percentage of all audited employers who were found to be misclassifying in the construction sector, and applied that rate to the total number of UI-covered employees in Kentucky. Thus, we assumed that the sample of employers selected for auditing was representative of all UI-covered employers in Kentucky.

II. Calculating the Severity of the Impact of Employee Misclassification (Percentage of Misclassified Workers within Employers Found to be Misclassifying Workers as Independent Contractors).

To estimate the severity of misclassification among employees who would otherwise be covered by unemployment insurance, we utilized the unemployment insurance records for the period 2007-2010. Based upon the unemployment insurance records for all industries, we report on the increasing trend in number of misclassified found during audits

Based upon the unemployment insurance records for all industries and the construction sector, we report the number of misclassified workers per audit for the period 2007-2010 for the construction industry and all other industries.

III. Calculating the Extent of Worker Misclassification (Percentage of all Workers Misclassified as Independent Contractors).

In order to calculate the number of misclassified workers in the construction sector in Kentucky, we utilized United State Census Bureau (American Community Service), Internal Revenue Service's Nonemployer Statistics, Quarterly Census of Employment and Wages, and audit data for the period 2007-2010. The American Community Survey reports that there were 139,965 workers in the construction industry in Kentucky. According to the Quarterly Census of Employment and Wages for Kentucky, there were 84,400 construction workers. The Internal revenue Service reports that there were 44,350 non employer firms. The number of misclassified workers in the construction industry was 11,215 [139,965 *minus* (84,400 + 44,350) *equals* 11,215]. The rate of employee misclassification in Kentucky was calculated to be 8.01%

IV. Calculating Economic Loss in Unemployment Insurance Taxes

We calculated an estimated average tax loss per worker as a result of misclassification in the audit results and assumed that these workers could stand as a proxy for all workers in Kentucky. This result was multiplied by the estimated number of workers misclassified in Kentucky.

Most of these figures are taken from the information provided by the Kentucky OET audit records, Workforce Kentucky data, U.S. Census Bureau data, and Internal Revenue Service data and the calculations made for the rate of employee misclassification. Multiplying the estimated number of construction workers in Kentucky that were misclassified times the estimated rate of misclassification in the construction sector of 8.01%, we estimate that 11,215 employees in the construction sector were misclassified. This figure will be multiplied by the average unpaid unemployment insurance tax per employee.

For example, to determine that figure, we divide the 2008 "UI Taxes (net underreported contributions) for Misclassified" by "Total Workers Employers Misclassified". For the period 2007-2010, this results in an average unpaid unemployment insurance tax per employee of \$155.74. We next multiply 11,215 times \$155.74 for the total estimated loss of uncollected unemployment insurance taxes in the construction sector for Kentucky annually for the period 2007-2010 is \$1.75 million.

V. Calculating the Loss in Kentucky Income Tax

In order to calculate the loss in state income taxes for the construction sector in Kentucky, we multiplied the estimated number of construction workers by estimated average annual earnings for construction workers and workers statewide.

For the construction sector, we estimated the number of misclassified construction workers in Kentucky (11,215) and multiplied that by the estimated annual earnings of construction workers in Kentucky in 2008 (\$41,991).

We then provided two estimates of ("income not reported"), using alternative assumptions regarding the amount of income not reported (30% and 50%). We multiply these results by 5.8% minus \$184 (Kentucky Form 740-EZ Instructions)

yielded a range of two estimates for the loss of state income tax revenues for the construction sector and all workers in Kentucky.

VI. Calculating the Revenue Losses on Workers' Compensation Premiums

We present two estimates for lost workers' compensation premiums in the construction sector. Workers' compensation premiums are substantially higher than in other sectors and we, therefore, present estimates based upon (1) \$10 per \$100 of payroll and (2) \$15 per \$100 of payroll. Using the quarterly census of employment and wages for Kentucky, we calculated gross private sector payroll in construction reported in Kentucky. We then calculated the unreported wages as percentage of gross payroll reported in the construction sector audit results and applied this percentage to total wages reported for private sector wages by Kentucky.

VII. Calculating the Revenue Losses from Unpaid Social Security and Medicare Taxes

For the period 2007-2009 social security taxes were 6.2% and Medicare taxes were 1.45% for the employee. The total amount of social security and Medicare taxes for this period is 7.65%. For 2010, the social security tax was reduced by 2%. The employer is legally responsible for an equal percentage. We present two estimates of loss of social and Medicare taxes that were not paid. Based upon the assumption that 30% of the income of misclassified workers is not reported, we multiply the estimated unreported income in the construction sector by the social security and Medicare tax rate of 7.65%. Based upon the assumption that 50% of the income of misclassified workers is not reported, we multiply the estimated unreported income in the construction sector by the social security and Medicare tax rate of 7.65%.

VIII. Calculating the Revenue Losses from Unpaid Federal Income Taxes

According to the United States Census Bureau, the median annual income in Kentucky in 2008 was \$41,663. The median annual income in the construction sector in Kentucky was \$41,991 in 2008 which places the sector at the state median. The Statistics of Income Bulletin published by the Internal Revenue Service provides annual data on income tax returns. The average tax rate for this level of income ranged from 11.84% to 13.77%.⁵⁹ The average tax rate for the two levels reported is 12.81%

⁵⁹ Internal Revenue Service. <http://www.irs.gov/taxstats/indtaxstats/article/0,,id=133521,00.html>

In order to estimate the lost income taxes, we report two estimates. The two estimates are based on the assumption that (1) 30% of the income of misclassified workers is not reported in federal tax payments in not made as a result of misclassification in the construction sector annually and that (2) the assumption that 50% of the income of misclassified workers is not reported. We multiplied the estimated unreported income by the average tax rate of 12.81%.

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