



Ohio Legislative Service Commission

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Fiscal Note & Local Impact Statement

Bill: [H.B. 523 of the 128th G.A.](#)

Date: December 7, 2010

Status: As Introduced

Sponsor: Reps. Phillips and Driehaus

Local Impact Statement Procedure Required: No — Offsetting revenues

Contents: Requires the Department of Commerce to enforce additional employee classification standards

State Fiscal Highlights

- If the bill results in greater compliance with employee classification requirements, there could be substantial gains in income tax revenue collected by the state, as well as unemployment compensation and workers' compensation premium payments from employers.
- Most (94.35%) of any gain in income tax revenues would be retained by the GRF while the State Insurance Fund and Unemployment Insurance Trust Fund, both custodial funds, would gain the applicable revenue from greater collection of employer premium payments.
- The new employee classification standards would be overseen by the Labor and Wage Section within the Department of Commerce's Division of Industrial Compliance and Labor. Under the current budget, funding for the activities overseen by that section is \$1.5 million from the Labor Operating Fund (Fund 5560). This amount is not sufficient to cover the additional responsibilities under the bill.

Local Fiscal Highlights

- Local governments could realize a substantial gain in revenue if the bill results in greater compliance with employee classification requirements. This is because 5.65% of the increased state income tax revenue would be distributed to the Local Government Fund (Fund 7069) and the Public Library Fund (Fund 7065). These additional amounts would be distributed to counties, municipalities, townships, libraries, and certain other special districts.
- Municipalities and school districts could also see an increase in revenue from local income taxes levied by these political subdivisions.

Detailed Fiscal Analysis

Overview of the bill

The bill attempts to address the misclassification of employees as independent contractors by generally defining an employee as an individual who performs services for compensation for an employer, unless the Director of Commerce determines otherwise. To do so, the bill makes changes to existing law definitions of "employee" under the minimum wage, bimonthly pay, prevailing wage, unemployment compensation, workers' compensation, and income tax laws. Accompanying the bill's new or revised definitions of employee are prohibitions against (1) failing to properly designate an individual as an employee and (2) retaliating against an individual for exercising any rights granted under the bill. Overall, if the bill results in greater compliance with employee classification laws, the revenue gains for several state and local funds could be substantial. However, the bill will also impose new enforcement costs for the Department of Commerce (COM). These fiscal effects are summarized in this introductory section and elaborated upon in the detailed fiscal analysis that follows.

These changes, to the extent they result in increased employer compliance or greater discovery of nonpayment, will result in revenue gains to the GRF, the State Insurance Fund (which receives workers' compensation premium payments), the Unemployment Insurance Trust Fund, the state's local government funds, and the funds of municipalities and school districts. These revenue gains could be substantial. Research conducted by the federal government and the states pegs the annual revenue losses from misclassification in the tens of millions of dollars or more.

COM would incur new costs for enforcing the employee classification requirements under the bill. This would include conducting investigations, performing employer audits, and holding administrative hearings for any apparent violations of the employee classification requirements in the bill. The bill requires the agency to hire additional employees to perform the new enforcement functions. Although the new costs that COM will incur for personnel and overhead are uncertain, they could reach into the hundreds of thousands dollars per year. The Department's current budget of \$1.5 million for the Labor and Wage Section is not sufficient to cover the additional responsibilities under the bill.

Potential for increased tax receipts and employer premiums

As noted above, the bill is likely to increase receipts to the GRF, local general funds, and the applicable workers' compensation and unemployment compensation custodial funds, though the exact magnitude of the revenue gain cannot be reliably estimated. Any effect on revenues would depend on the extent that (1) employer compliance with respect to employee classification increases and (2) increased enforcement efforts lead to the discovery of nonpayment of income tax or workers' compensation or unemployment compensation premiums. The revenue gain, however,

could be substantial. Various audits conducted by the federal government and the states indicate that anywhere from 10% to 30% of employers misclassify employees while 7.5% to 10% of employees are misclassified. Misclassification is quite prevalent in the construction and other industries where the workforce is transient.

A number of studies in recent years have found the effect of misclassification on federal, state, and local government revenues to be significant with annual losses of income tax revenue and workers' compensation and unemployment compensation premiums in the tens of millions of dollars or more. In particular, a February 2009 report from the Office of the Attorney General (AGO) estimated the losses to Ohio from worker misclassification using a number of different methods. Based on extrapolations of Ohio Department of Job and Family Services (ODJFS) audits of 5,300 employers conducted in 2005, annual losses were estimated at up to \$20 million in unemployment insurance premiums, at least \$103 million in workers' compensation premiums, and over \$36 million from underpaid income taxes. Using other methods, such as using the state of Illinois's estimate of 8.5% of workers misclassified, the Attorney General's Office calculated that losses could be a great deal higher: \$100 million in payments for unemployment compensation, over \$510 million in workers' compensation premiums, and nearly \$180 million in income tax revenues.

Political subdivisions also lose significant amounts of revenue from municipal and school district income taxes when workers are misclassified. If the bill results in better compliance with employee classification requirements, municipalities and school districts may also see an increase in the revenue they receive from local income taxes levied. Further, a portion (totaling 5.65%) of the increased state income tax revenue would be distributed to the Local Government Fund (Fund 7069) and the Public Library Fund (Fund 7065). These additional amounts would be distributed to counties, municipalities, townships, libraries, and certain other special districts.

Enforcement – Department of Commerce

The bill requires the Director to hire as many investigators and other personnel as are necessary to enforce the new employee classification standards. The bill authorizes the new personnel to conduct investigations and audits upon receipt of complaints. The Labor and Wage Section within the Division of Industrial Compliance and Labor would be responsible for the new employee classification standards. The Section's current responsibilities are to enforce the prevailing wage, minimum wage, and minor labor laws. These activities are primarily funded through the Labor Operating Fund (Fund 5560) using a FY 2011 allocation of \$1.5 million from appropriation item 800615, Industrial Compliance. The Section currently has nine investigators (with five vacant investigator positions), one attorney, and several employees providing administrative and customer service support. Labor and Wage Section staff members completed nearly 1,300 wage investigations during FY 2010.

The Section does not have the enforcement personnel currently available to investigate worker misclassification complaints, meaning the state would need to hire

additional persons to carry out the bill. Based on the state's pay range classification booklet, each new wage and hour investigator would result in salary and fringe benefit costs starting at around \$53,800 (assuming fringe benefit costs of 30% of wages) while the wage and benefit costs for a new full-time attorney position would likely start at similar levels. The cost for a new, full-time administrative support position, such as a Customer Service Assistant or Administrative Assistant, would start in the \$42,000 to \$44,000 range.

Based on the above salary figures, the staffing costs of a program in Ohio could cost in the hundreds of thousands of dollars annually. Hypothetically, if Ohio were to hire five new investigators, one new, full-time attorney, and one new, full-time administrative support position, the annual payroll and fringe benefit costs would be around \$367,000. In addition to these payroll costs, there also would likely be new overhead costs for information technology and for office supplies and equipment.

For comparative purposes, LSC reviewed the staffing requirements or estimates of recent initiatives in other states attempting to combat employee misclassification. These initiatives, which range in staff from one to ten, are briefly described below. It should be noted that all of the states mentioned below have smaller populations than Ohio.

- The Iowa General Assembly appropriated \$500,000 for FY 2011 to its Department of Workforce Development to enhance efforts to investigate employers that misclassify workers. This appropriation funds 8.1 full-time equivalent (FTE) employees in the Department's Misclassification Unit.
- Pursuant to a Wisconsin law taking effect January 1, 2011, the state's Department of Workforce Development is required to, among other responsibilities, receive and investigate complaints alleging violations of employee misclassification or investigate any alleged violations on its own initiative. A fiscal analysis conducted by the state's Legislative Fiscal Bureau estimated that four investigators and nearly 1.5 other FTEs for support and legal work would be necessary to implement the bill. Such activities were estimated to cost nearly \$450,000 annually in payroll and overhead.
- As noted in a November 2010 Policy Matters Ohio report, Maryland has ten employees working in a Workplace Fraud Unit, including three investigators and two field auditors, though the unit is mainly focused on state contracts. One of Oregon's 15 wage and hour investigators is devoted to misclassification while New Jersey has five such investigators.¹

¹ Schiller, Zach and Sarah DeCarlo, "Investigating Wage Theft: A Survey of the States," Policy Matters Ohio, November 2010, December 6, 2010, <http://www.policymattersohio.org/pdfInvestigatingWageTheft2010.pdf>.

Program Funding

It is unclear how the Department's new responsibilities will be funded, as the bill is largely silent on a funding source to support any new costs. Further, the Department's current budget of \$1.5 million for the Labor and Wage Section is not sufficient to cover the additional responsibilities under the bill. As a result, the ability of the Department to perform the functions required by the bill will depend on additional funding being secured. Even so, some sporadic revenue could be generated from civil penalties assessed by the Department. Specifically, the Director has the power to assess a civil penalty of up to \$1,500 per initial violation and more for subsequent violations within five years of the first violation, or for knowingly violating or obstructing an investigation. Revenue from civil penalties would be deposited into the newly created Employee Classification Fund for use by Commerce in enforcing the bill's requirements.

Civil and criminal remedies

The bill prohibits an employer from failing to properly designate an individual as an employee and prohibits employers from retaliating against an individual for exercising any rights granted under the bill. If a violation is found, the bill provides various criminal and civil remedies. As a result, there may be additional persons successfully prosecuted and convicted and additional civil suits filed. However, court costs and/or fine revenue would offset some of any new costs created in local criminal and civil justice systems.

Employers that are found to be misclassifying employees are guilty of a fourth degree misdemeanor on a first offense and a fifth degree felony on subsequent offenses within five years. A fourth degree misdemeanor carries a fine of up to \$250 and/or a jail stay of up to 30 days while a fifth degree felony carries a fine of up to \$2,500 and/or a prison term of six to 12 months. While local jurisdictions have considerable discretion in the arrest, prosecution, and sanctioning of offenders, it is likely that, based on the low misdemeanor penalty for a first violation, persons so prosecuted and convicted will not serve any appreciable jail time, if any. Local court costs and fines would offset at least some of any new local criminal justice expenses created by the bill, making it likely that any additional cost would not be more than minimal. Any fine revenue would go to the county in which the trial court is located.

At the state level, the Indigent Defense Support Fund (Fund 5DY0) and the Victims of Crime/Reparations Fund (Fund 4020) may experience a minimal gain in state court cost revenue from these penalties. Fund 5DY0 receives \$20 per misdemeanor and \$30 per felony while Fund 4020 receives \$9 per misdemeanor and \$30 per felony. Violators of felonies of the fifth degree typically are not sentenced to prison, as there is a preference against such an action unless the offense involves certain drug offenses. As such, it is not likely that the state will incur incarceration expenses.

In addition to the remedies available through the criminal justice system, aggrieved parties may file suit on their own in the court of common pleas in the county

where the alleged violation occurred or where any individual who is party to the action resides. An action must be brought no later than three years after the last day the aggrieved individual performed services for the employer. An aggrieved party may recover, among other items, the amount of back pay and benefits plus an equal amount in liquidated damages, compensatory damages, and attorney's fees and costs.

Background information

Existing audit programs

COM's investigations and audits of employers would be in addition to existing employer audit programs conducted by ODJFS and the Bureau of Workers' Compensation (BWC.) The Department of Taxation (TAX) may also become involved in the enforcement of proper employee classification through referrals from the Internal Revenue Service (IRS) or from collaborations with ODJFS and BWC pursuant to an information sharing agreement entered into during calendar year (CY) 2009. The sections below provide a brief summary of these programs. Please note that AGO has no formal authority to do misclassification audits except in support of its statutory clients: TAX, ODJFS, BWC, and COM. In the event a client audit determines an employer classification of a worker as an independent contractor is inappropriate, AGO takes action to collect the unpaid taxes due from that employer.

ODJFS

In CY 2009, ODJFS completed 4,975 audits through the Bureau of Integrity Assurance. These audits resulted in 7,297 workers being reclassified and \$10.6 million being identified for reimbursement to the Unemployment Compensation Trust Fund. The table below summarizes ODJFS's various audit initiatives. ODJFS's audit operations are expected to cost up to \$6.2 million during CY 2010, providing for a staff of up to 84, most of which are unemployment compensation compliance auditors.

ODJFS Unemployment Compensation Audit Programs, CY 2009			
Audit Initiative	Audits Completed	Amount Identified for Reimbursement	Workers Reclassified
Tax Performance System (TPS) Regular Audits	4,764	\$632,548	3,267
SUTA Dumping and Tax Avoidance Detection Audits	140	\$9,300,000	0
Worker Misclassification Targeted Audits	71	\$708,000	4,030
Total	4,975	\$10,640,548	7,297

BWC

BWC conducts premium audits of employers each to year to ensure that employers correctly classify employees and are paying the correct amount of premium. These audits are conducted on a semi-random basis, with certain employer groups, such as employers in the construction industry where the high number of contracted employees makes employee misclassification common, being chosen on a more regular basis. BWC conducts approximately 25,000 audits annually (or about 10% of State

Insurance Fund employers), spending roughly \$4.7 million each year. This amount is paid for from the Workers' Compensation Fund (Fund 7023) appropriation item 855407, Claims, Risk, and Medical Management.

TAX

TAX does not typically become involved with worker misclassification issues unless the agency receives a referral from the IRS. The Department will, however, audit an employer if it finds an issue with the employer's income tax withholding, which may reveal employees that are improperly classified. The Attorney General's Employee Misclassification Task Force facilitated an agreement in CY 2009 with TAX, ODJFS, and BWC whereby information is shared between the agencies to help identify employers that misclassify employees or fail to properly report and pay their taxes.