

The California Commission on Health and Safety and Workers' Compensation



“Split” Class Codes: Evidence of Fraudulent Payroll Reporting

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Introduction

In the 1980s, workers’ compensation premiums were rising rapidly, eventually reaching what were then historic highs in the early 1990s. The construction industry, with traditionally high premium rates, was especially hard hit. In addition, within the construction industry, union employers felt they were particularly disadvantaged relative to non-union employers in the same industry with whom they competed for contracts.

Union employers saw this disadvantage as a consequence of several factors:

- Workers’ compensation premiums are calculated as a percent of an employer’s payroll.
- Union employers typically paid substantially higher wages under collective bargaining agreements than were paid by non-union contractors.
- For the same number of hours worked, a union employer paid more in workers’ compensation premiums, even though the workers were not exposed to any greater period of occupational risk.
- Unions and union contractors also contended that because of better training, longer tenure, and a better safety environment, union workers experienced fewer injuries.
- Union contractors pay benefits (e.g., group health and pensions) into accounts for each worker. These benefits are paid directly to joint union-management health and welfare trusts based on hours worked by each worker. Consequently, there was virtually complete payroll and employment reporting by union contractors. Non-union contractors were thought to under-report a substantial fraction of payroll and employment. Non-union contractors might also misreport payroll between high-rate and low-rate classes, something that is unlikely within the union building trades sector.

This combination of factors meant that the union contractors were paying higher premium rates than experience justified, simply because they were pooled with non-union contractors. Experience rating, while common for the construction industry, only offsets a fraction of the impact from the low-wage, under-reporting, non-union sector.

The construction industry and building trades unions requested the Workers’ Compensation Insurance Rating Bureau (WCIRB) “split” class codes used for the construction industry based on the hourly wage paid to the worker. The Bureau examined industry data and determined class codes with bi-modal distributions in the wages paid that represented good candidates for split classification.

In 1986, the first segregated classes were developed for carpentry, electrical wiring, sheet metal, painting and plumbing. In 1992, additional split classes were added for masonry, concrete/cement work, wallboard, glaziers, plastering, roofing, excavation, sewer construction, and water main construction. In 1995 and 1996 automatic sprinkler installation, steel framing—

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residential, and steel framing—commercial were added. Subsequently, the Bureau has investigated other classes; however, none were found suitable for segregation based on wage.

The splitting of classes was meant to establish more equitable premium rates for employers that pay very different wages. It was also meant to make union labor and employers more competitive with the lower-wage, non-union sector. However, there have been ongoing concerns by union employers that non-union employers are fraudulently misclassifying low-wage workers into high-wage classes in order to pay lower premiums. This could also lead to inappropriately higher premium rates for higher- wage employers if injuries and related costs are also assigned to the inappropriate class.

In connection with a larger study of fraudulent reporting by employers, the Commission on Health and Safety and Workers’ Compensation (CHSWC) asked the authors to examine evidence of abuse of split class codes by dishonest employers. This supplement to the main report examines that issue.

Split Class Premium Rates

Splitting class codes has resulted in substantially different premium rates for similar work but different underlying wage rates. The “low-wage” classes have higher premium rates, often more than double the rates for the “high-wage” class. Examples in the table below reflect the Bureau’s recommended pure premium rates for 2002 (at the end of our study period when rates were relatively high) and the current rates (July 2007).

<i>Table 1: Examples of Pure Premium Rates for Split Classes</i>				
	July 2002 Pure Premium Rates		July 2007 Pure Premium Rates	
Craft	High wage	Low-wage	High wage	Low-wage
Plumbing	\$6.12	\$13.67	\$2.64	\$5.32
Carpentry	\$11.16	\$31.64	\$4.31	\$13.00
Painting	\$10.50	\$16.58	\$3.11	\$6.95
Masonry	\$9.69	\$21.60	\$4.45	\$6.95
Roofing	\$18.12	\$45.19	\$8.73	\$22.25
Wallboard	\$7.85	\$18.00	\$3.45	\$7.17
Electrical	\$6.34	\$11.45	\$2.79	\$3.35
Glaziers	\$11.91	\$20.45	\$5.28	\$7.66

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It is clear from *Table 1* that the difference in premium rates offers a significant incentive for low-wage employers to misreport payroll, shifting it from low-wage classes into the high-wage classes.

It should be noted that, while split classes are often thought to be synonymous with union and non-union labor, this is not completely true. Apprentices often earn a wage just below the split-wage threshold in the initial training period, meaning some union workers will have wages included in the low-wage class. Some non-union workers are paid at a level that places them in high-wage classes. In addition, non-union contractors when working on government contracts are usually required to pay the “prevailing” wage, which places workers in the high-wage class.¹

Methodology

The approach used for examining the extent of abuse of split class codes is very similar to the method described in the main report, “Fraud in Workers’ Compensation Payroll Reporting: How Much Employer Fraud Exists and What is the Impact on Honest Employers?” by Colleen Donovan and Frank Neuhauser. Only the specific modification required to study split classes is discussed in detail.

For both reports, wages reported by workers in a large, monthly survey, the Current Population Survey (CPS) conducted by the U.S. Bureau of the Census, are compared with payroll reported by insurers to the WCIRB. A class code is assigned to each employed worker in the CPS based on reported industry and occupation. For the split class analysis, we also assign the worker to the high-wage or low-wage class. This is done by calculating the hourly wage and assigning workers appropriately. The wage thresholds for each year are attached at the end of this report.²

Also, for the split class analysis, we pool the data across the classes and years, resulting in two sets of payroll data, that for high-wage classes and that for low-wage classes. This is done because the survey samples for any individual class and year are small and subject to a large amount of random variation. Hence, the aggregate under/over reporting for the high-wage and low-wage classes as a group over the period 1996-2002 is reported.

Conclusion: Evidence of Abuse

The study presents evidence that payroll for low wage workers is:

- Being systematically under-reported in the low-wage class codes; and
- Some of that payroll may be misreported, shifted from the low-wage class to the high-wage class to avoid the higher premium rates in the low-wage classes.

1 Prevailing wage rules are often referred to as Davis-Bacon wage determinations after the authors of the original federal legislation. For more information see: <http://www.gpo.gov/davisbacon/index.html>

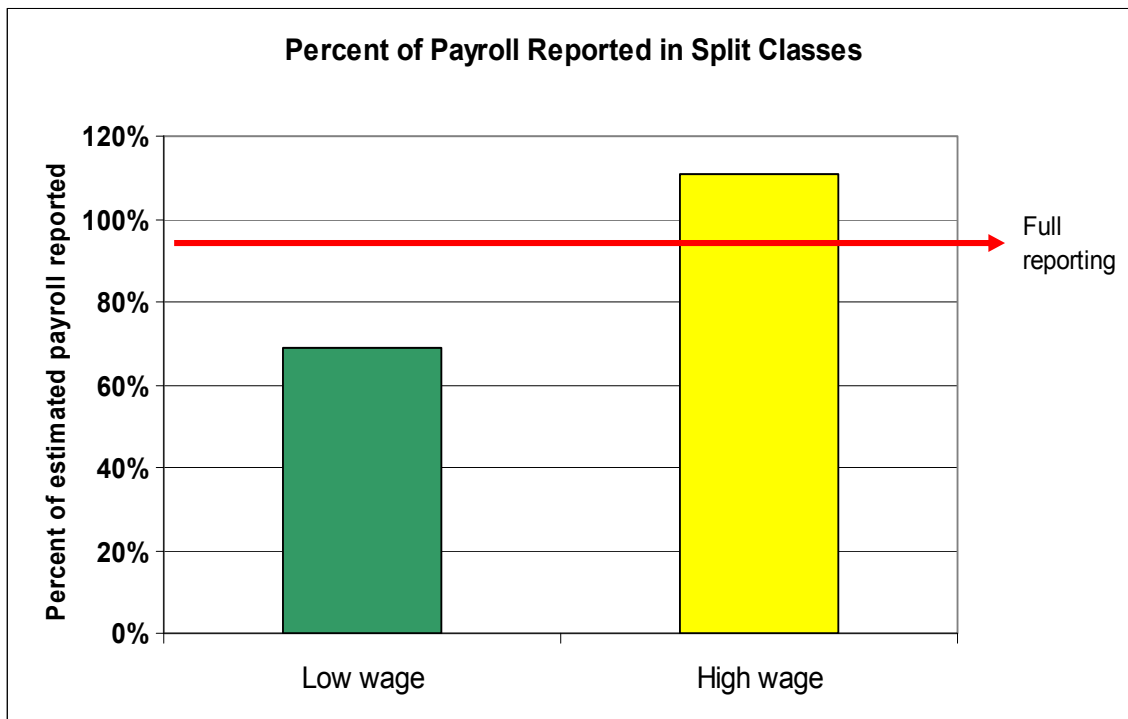
2 Union status is reported in the CPS, but only for about 25% of the sample that receives a special supplemental set of questions. Hence, it was not possible to segregate the data by union status for this study.

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Chart 1 below summarizes the data. First, note that across all low-wage classes, aggregate payroll reported reflects only about 65% of the payroll that would be expected to be observed based on wages reported by workers in the survey. As discussed in the main report, payroll reported to the Rating Bureau is not expected to equal wages reported by workers. Some wages are excluded from reporting for premium calculations (e.g., over-time and shift premiums). Overall, payroll reported to the Rating Bureau for insured employers is expected to be about 92%-96% of actual payroll. This still suggests that 25%-30% of low-wage payroll is being under-reported or misreported.

On the other hand, more payroll is observed being reported in the high-wage classes than is observed for all of the high-wage workers in the survey. Reported payroll is about 10% higher than actual payroll and 14-18% higher than expected reporting for premium purposes.

Chart 1



This evidence is consistent with misclassification of low-wage payroll in high-wage class codes. It is expected that high wage payroll will be nearly perfectly reported because the union employers have an obligation to pay hourly premiums to the health and welfare trusts. However, we observe that reported payroll exceeds even this high expectation.

The misclassification of payroll gives low-wage employers an unfair competitive advantage relative to high-wage employers by reducing their premium costs. It may result in an additional disadvantage to high-wage employers if injuries and related costs are also misclassified into high-wage classes. If injuries are misclassified, premium rates in the high-wage class would most

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likely be inappropriately high (for high-wage workers). In the main report, we show evidence that reporting can skew the premium rates for classes more generally. This happens because, if an injury is reported to the workers’ compensation insurer, the occupation of the worker is likely to be accurately reported by the doctor in the First Report of Injury. It is less clear whether the injury will be misclassified in the case of split classes. If the worker is paid indemnity benefits based on actual wages, it is more likely that the injury will be correctly sorted into the correct wage classification. The impact of misreporting on premium rates for high-wage classes is unclear.

Caveats

The main report discusses concerns and caveats about the data and methods used in these studies. Readers can refer to that report for a more detailed discussion. However, here it should be pointed out that those concerns are particularly important for this subgroup of class codes, because they focus on employment in the construction industry where employment relationships can be less well-defined. For example, two previous studies discussed in the main report highlight the degree to which independent contract status is fraudulently used to avoid workers’ compensation premiums and possibly required payroll taxes and deductions. The CPS is thought to do a good job of capturing wage reporting for the “grey economy.” However, observers are uncertain about how accurately survey respondents report their employment relationship, for example, independent contractor vs. employed by a firm.

Consequently, the comparison for the wages reported for the low-wage class codes may be too high or too low, depending on how accurately workers understand their employment status. We are more confident that the data for the high-wage classes indicates fraudulent misclassification of low-wage employment as high-wage workers. Union employment and payroll are well tracked as discussed above, and workers are more likely to accurately understand their employment relationship because union workers typically have longer tenure with employers and more consistent employment. The 14%-18% over-reporting in this category is likely a reasonably accurate estimate of misreporting.

Wage Threshold History

Table 2: Classifications Segregated in 1986

Threshold	1986	1991	1993	1996	1997	2000	2002	2003	2004	2005	2007
Carpentry	\$17	\$18	\$19	\$20	-	\$21	\$22	\$23	-	-	\$24
Electrical Wiring	\$18	\$19	\$20	\$21	-	\$22	\$23	\$24	\$25	-	\$26
Sheet Metal	\$16	\$17	\$18	\$19	-	\$20	\$21	-	\$22	-	\$23
Painting	\$17	\$18	-	-	\$19	-	-	\$20	-	\$21	\$22
Plumbing	\$17	\$18	\$19	\$20	-	\$21	\$22	-	\$23	-	-

Table 3: Classifications Segregated in 1992

Threshold	1992	1997	2000	2002	2004	2007
Masonry	\$17	\$18	\$19	\$20	\$21	\$22
Concrete or Cement Work	\$17	\$18	\$19	\$20	\$21	\$22
Wallboard Application	\$19	\$20	\$21	\$22	\$23	\$24
Glaziers	\$19	\$20	\$21	\$22	\$23	\$24
Plastering	\$18	\$19	\$20	\$21	\$22	\$23
Roofing	\$17	\$18	\$18	\$20	-	\$21
Excavation	\$21	\$22	\$23	\$24	\$25	
Sewer Construction	\$19	\$20	\$21	\$22	\$23	\$24
Water Main Construction	\$19	\$20	\$21	\$22	\$23	\$24

Table 4: Classification Segregated in 1995

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<u>Threshold</u>	<i>1995</i>	<i>2000</i>	<i>2002</i>	<i>2004</i>	<i>2007</i>
Automatic Sprinkler Installation	\$21	\$22	\$23	\$24	\$25

Table 5: Classifications Segregated in 1996

<u>Threshold</u>	<i>1996</i>	<i>2000</i>	<i>2002</i>	<i>2004</i>	<i>2007</i>
Steel Framing Lt. Gauge Residential	\$20	\$21	\$22	\$23	\$24
Steel Framing Lt. Gauge Commercial	\$20	\$21	\$22	\$23	\$24