

March 18, 2002

MEMORANDUM FOR: EMILY STOVER DeROCCO
Deputy Assistant Secretary
for Employment and Training

Elliot P. Lewis

FROM: ELLIOT P. LEWIS
Acting Deputy Inspector General
for Audit

SUBJECT: Unemployment Insurance Field Audit Program:
Followup on the Results of Blocked Claim Audits for CY 2001
Report No. 03-02-007-03-315

During Calendar Year (CY) 2001, we followed up with the State Employment Security Agencies to determine what effect revisions to the Employment Security Manual (ESM) had on states' successes in identifying hidden or unreported wages and collecting related tax contributions from employers through field tax audits.

The Employment and Training Administration (ETA) made the ESM revisions in February 1999 in response to a finding in our audit report entitled *Improvements are Needed in the Evaluation of Audit Quality and the Reporting of Blocked Claim Audits*, Final Letter Report No. 03-98-008-03-315, issued September 25, 1998. Briefly, the audit found that many states were discouraged from conducting blocked claim audits, which is one of the more effective ways to identify hidden wages, because they did not meet the definition of a reportable audit (output) through ETA's 581 Contributions Operations report. ETA's revision of the definition allowed states to get credit for conducting blocked claim audits beginning in CY 1999.

Results of ESM Revisions

In our CY 2001 followup, 30 states reported that they (1) identified more than 18,507 employees who had been misclassified by their employers, and (2) recovered more than \$7.2 million of Unemployment Insurance (UI) tax contributions as a result of blocked claim audits conducted during CY 2001 that would not have been conducted without the ESM revisions.

Based on the information provided by the states, the Office of Inspector General (OIG) believes that ETA's revision of the ESM has maintained a significant positive effect on the performance and results of state field tax audit programs.

Background

Unfortunately, not all employers voluntarily report all UI-covered wages or pay their fair share of UI taxes as required by law. When employers classify employees as independent contractors, employers reduce their tax liability by not having to pay state and Federal UI and social security taxes. Employers also avoid the costs of withholding income taxes or providing fringe benefits as they do for employees. Other incentives for not treating workers as employees include the costs associated with minimum wage laws, workers' compensation insurance, and collective bargaining. Thus, when an employee is misclassified, tax revenues and benefits are lost.

In our 1998 audit, states ranked the search for hidden wages (blocked claims) as their primary concern. They contended that the most common reporting error was the misclassification of workers as independent contractors. A blocked claim is a claim for benefits for which employment status or wage credits are questioned. If not resolved by claim representatives, such claims are referred to the field audit staff for investigation and resolution. The investigation may result in a field audit.

Our audit found that some states were not performing blocked claim audits and others were performing blocked claim audits but could not report the results because of the ESM definition contained in ESM Appendix E, Part V, Section 3670-3693. ETA's response to our report concurred that the ESM policy should be revised. On February 5, 1999, Office of Workforce Security (OWS) issued Manual Transmittal Letter (MTL) 1473 permitting states more flexibility in converting field investigations into audits.

Results of Followup

We worked with the OWS to gather from the states the results of blocked claim audits that would not have been conducted before the implementation of ESM changes.

The OIG, in agreement with OWS, developed a method to gather CY 1999, and subsequently CY 2000 and CY 2001, blocked claim audit results to determine the impact of the above-mentioned ESM changes on blocked claim audits and the potential future impact on states' audit programs. We requested states to provide, on a Quarterly Electronic Worksheet, the results of blocked claim audits that they would not have conducted prior to ESM Appendix E, Part V, Section 3670-3693, modification resulting from UI Program Letter 03-99 and MTL 1473.

Specifically, we asked the states to provide the following information:

- total underreported and overreported contributions resulting from blocked claim audits, and
- total number of misclassified employees resulting from blocked claim audits.

Our CY 2001 followup for the 53 reporting entities (50 states and 3 territories) determined:

- 30 states (or 57 percent) reported results from blocked claim audits that would not have been performed before the ESM changes
 - 18,507 misclassified employees were identified
 - \$7,213,474 in net contributions were recovered
- 2 states plan to report blocked claim audit results in CY 2002
 - 1 state plans to begin performing and reporting blocked claim audits in CY 2002 after a new audit program or automated tax system has been completed
 - 1 state plans to begin reporting blocked claim audit results in CY 2002 after installation of a new automated UI Tax system.
- 21 states do not plan to change their practices of performing blocked claim audits
 - 6 states performed blocked claim audits before the ESM changes and are not counted in the above figures for the 27 states
 - 14 states do not conduct blocked claim audits as part of their audit program
 - 1 state is without an operating audit program

The following chart summarizes the results by quarter from blocked claim audits that would not have been performed before the ESM changes for CY 1999, CY 2000, and CY 2001.

CY 1999 CY 2000, and CY 2001 by Quarter	Number of States Reporting			Misclassified Employees Identified			Net Contributions Recovered*		
	1999	2000	2001	1999	2000	2001	1999	2000	2001
First Quarter	12	26	30	3,164	3,619	5,337	\$422,675	\$1,362,106	\$2,167,224
Second Quarter	15	27	30	3,389	5,547	5,185	525,286	1,332,986	2,703,172
Third Quarter	21	27	30	2,789	6,035	3,961	726,668	1,245,202	1,376,222
Fourth Quarter	23	27	30	3,908	5,019	4,024	868,920	2,062,676	966,856
Totals	23	27	30	13,250	20,220	18,507	\$2,543,549	\$6,002,970	\$7,213,474

* We were unable to determine the amount of unreported (hidden) wages identified by the states that resulted in the recovery of the net UI contributions reported above.

In summary, the chart above shows the benefits derived by 30 states that took advantage of the MTL 1473 permitting states more flexibility in converting field investigations into audits. Based on the results of our Quarterly Electronic Worksheet, some states still are not willing to change their audit program's policy. Specifically, 15 (or 28 percent) of the 53 states and territories do not, and have no plans to, perform blocked claim audits.

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Thank you for the excellent cooperation provided to us by Ms. Grace Kilbane, Administrator, OWS, and Mr. Rett Hensley, and their staff in this audit.

This letter report is for your information and requires no response. If you have any questions about this letter report, please contact Michael T. Hill, Regional Inspector General for Audit, in Philadelphia at (215) 656-2300.