

## **Regulatory impact statement: Clarifying labour inspectors' ability to investigate whether workers are employees**

### **Agency disclosure statement**

1. This regulatory impact statement has been prepared by the Ministry of Business, Innovation and Employment.
2. It provides an analysis of options to clarify labour inspectors' ability to exercise their investigative powers (which consist of powers to enter premises, interview people, and obtain relevant documents), to ascertain whether or not workers are employees, and therefore in scope of the protections of the employment legislation.
3. The issue this work responds to has been identified as one that is suitable to be addressed in the Regulatory Systems Bill (No 2). Regulatory Systems Bills offer an opportunity to make smaller regulatory fixes to a number of pieces of legislation at once, supporting the effectiveness of those systems. For inclusion in a Regulatory Systems Bill any policy changes must be minor, and for this reason, options that would fundamentally rewrite the powers of labour inspectors were not considered.
4. The proposed change to the Employment Relations Act 2000 has not been widely consulted, but the New Zealand Council of Trade Unions and Business NZ have both indicated their support for the intent of the proposal. This indicates the proposal is likely to be uncontroversial.

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## Summary

5. To enable labour inspectors to perform their function of monitoring and enforcing compliance with employment standards, inspectors are given statutory powers to enter premises, interview persons, and require the production of documents.
6. These investigative powers may generally only be exercised in respect of employers and employees, and at premises where people are employed or where the inspector has “reasonable cause to believe” that a person is employed. This means that inspectors do not have a clear ability to proactively inquire into whether a worker is an employee or not.
7. There have been instances where firms deem workers to be contractors, to avoid the costs and obligations that attach to employment relationships. The status quo means that some workers in these situations, who are entitled to, but denied, the protections afforded by the employment legislation, may be beyond the reach of the regulator empowered to enforce those protections.
8. We have assessed two options – the status quo, and a legislative change clarifying inspectors’ ability to investigate whether a worker is an employee or not – against criteria drawn from the Treasury’s Best Practice Regulation principles: effectiveness, costs of implementation for all parties, proportionality, and transparency and certainty. The analysis in this RIS identifies the legislative clarification as the preferred option, because it would:
  - Enhance the effectiveness of inspectors’ investigative powers, by ensuring inspectors can obtain sufficient information to ascertain whether workers should be treated as employees; and by removing ambiguity in the current legislation, improve transparency and certainty both for businesses and the regulator
  - Improve the overall proportionality of inspectors’ powers to the objective these powers serve, and introduce only minor costs (no more than necessary to enable the regulator to perform its functions), which are outweighed by the benefits identified.

## A. Status quo

### Overview of current legislative framework

#### Different rights and obligations for employees and contractors

9. The rights and protections afforded to employees by employment legislation do not apply to contractors. This includes the right to be paid at least the minimum wage, and the right to various types of leave and leave pay. In most cases, contractors are also responsible for meeting their own tax, ACC and social policy obligations (eg student loan and child support), whereas for employees the compliance costs associated with these obligations are borne by their employers.
10. The potentially greater direct and compliance costs and obligations that apply to employment relationships may incentivise some firms to purchase certain services from contractors, rather than hiring employees. These same incentives may also drive firms to deem workers to be contractors, even where the workers are in substance employees.

## Legal distinction between employees and contractors

11. Section 6 of the Employment Relations Act 2000 (ER Act) is designed to prevent firms from disguising employment relationships by unilaterally labelling workers as contractors and thereby avoiding the rights and obligations that apply to employment relationships. Whilst the term “employee” is not defined in detail in the Act, when deciding if an employment relationship exists courts must “determine the real nature of the relationship” between the parties, without treating as determinative any statement by the parties that describes the nature of their relationship.
12. Determining employment status is a fact-based exercise for the courts, guided by a number of tests that have developed in the common law (including the degree of control exercised by the employer or principal, and an assessment of whether the worker is performing services as someone “in business on his or her own account”). Inland Revenue also applies these common law tests when determining the status of a worker for tax purposes.

## General approach to enforcement of the employee-contractor distinction

13. Under section 223A of the ER Act, labour inspectors have the function of “monitoring and enforcing compliance with employment standards”.
14. To enable labour inspectors to perform this and its other functions, section 229 of the ER Act provides them with a range of investigative powers, including the ability to enter premises, interview persons, and require the production of documents. Consistent with the Inspectorate’s proactive functions, the powers are couched so as to allow proactive investigations of the employment conditions in businesses. Inspectors do not need to have any belief that wrongdoing has occurred in order to enter premises and gather information (provided that this is for the purpose of performing one of the inspector’s statutory functions).
15. Where a labour inspector believes that a worker who has been categorised as a contractor by the business owner/operator should have been treated as an employee, and believes that the worker’s employment standards (eg minimum wage) have been breached, they can and do take enforcement action, such as taking a case to the Employment Relations Authority (the Authority) for a determination. Where the Authority determines in the inspector’s favour the worker will be entitled to be paid arrears for any entitlements they missed out on previously, and penalties may also be awarded. The breaches would relate to the failure to provide employment entitlements, rather than the miscategorisation in itself.
16. While it is not possible to quantify the scale of issues with the misuse of contractor status, it is clear that there are pockets of poor practice in the labour market. For example, in a snapshot of activities by the Labour Inspectorate in September 2016 there were 16 open cases in which inspectors believed workers had been misclassified as contractors (and were in fact employees), with a majority of these cases being in the construction sector.

## B. Problem definition

17. Although labour inspectors’ investigative powers may be exercised proactively (in the sense that no suspicion of wrongdoing is required), these powers may also generally only be exercised in respect of employers and employees, and at premises where people are employed or where the inspector has “reasonable cause to believe” that a

person is employed. This means that inspectors do not have a clear power to proactively inquire into whether a worker is an employee or not.

18. In the context of reactive investigations, where a worker alleges they have been improperly classified as a contractor and denied their minimum employment entitlements, inspectors are likely to have “reasonable cause to believe” that the person is an employee, because the complainant will have testified as to the real nature of the working relationship. An inspector’s existing powers are sufficient in this complaints-driven context.
19. Forming a view on whether someone is, in reality, an employee – and therefore entitled to minimum wage protection and other statutory entitlements – can only be done by applying the common law employment status tests to the facts of a working relationship. To do this effectively would require the inspector to have access to relevant information, which could include:
  - a. discussions with the workers and the firm about their working conditions
  - b. documents such as payslips, invoices and contracts.
20. Increasingly, the Inspectorate is seeking to discharge its function of monitoring compliance with employment standards by undertaking proactive investigations and auditing in target sectors. This approach is hampered by the lack of a clear power to gather information proactively to assess whether workers are subject to the employment jurisdiction. This could place a number of workers entitled to, but denied, the protections afforded by the employment legislation beyond the reach of the regulator empowered to enforce those protections.

## **C. Regulatory impact analysis**

### **Objectives and criteria**

21. The specific objective of the present work is to confirm that labour inspectors can use their investigative powers (entering premises, interviewing people, and viewing/copying documents) to obtain information that would allow them to ascertain whether particular workers, who are not being treated as employees, should in fact be treated as such.
22. This is connected to the overall objective of the powers of labour inspectors, which is to enable inspectors to perform the functions conferred upon them by employment legislation. Labour inspectors are responsible for “monitoring and enforcing compliance with employment standards” (section 223 A of the ER Act), which requires them to assess whether workers are being provided with the minimum employment entitlements such as the minimum wage and annual holidays. Forming a view on whether a worker is an employee, and therefore subject to the employment jurisdiction, is often a necessary precursor to assessing compliance with employment standards. Intrusive powers are justified because without such powers it would not be possible for inspectors to perform this function effectively.
23. At the same time, the powers granted to inspectors must be proportionate to the outcomes sought, and intrusive powers should be exercisable only for the purpose of monitoring compliance or detecting breaches of the legislation.
24. The objectives above are reflected in a set of four criteria, drawn from Treasury’s Best Practice Regulation principles, which have been used to assess the identified options:

- a. Effectiveness: The approach allows labour inspectors to obtain information in order to form a view on what the “real nature” of a given working relationship is.
- b. Costs of implementation: Any changes are relatively easy and cost effective to implement for the government/regulator, and avoid unnecessary compliance costs for business.
- c. Proportionality: The burdens imposed on the regulated community are proportionate to the benefits that are expected to result. The powers granted to the regulator are consistent with:
  - i. the scope of the regulator’s jurisdiction
  - ii. the powers granted to comparable regulators in other jurisdictions and other regulatory systems.
- d. Transparency and certainty: The regulated community has certainty about its legal obligations and rights; the regulator acts in a transparent and predictable way; and there is consistency with other regulatory regimes where appropriate.

## Options

25. Because the problem identified relates to the way in which the powers of labour inspectors are expressed in legislation, there are no non-regulatory options; nor are there a wide range of feasible legislative approaches to address the problem and fit within the constraint of being suitable for inclusion in a Regulatory Systems Bill. We have assessed the following two options:

### **Option 1: Status quo**

For the purpose of performing one of the inspector’s statutory functions, an inspector may (subject to further requirements in relation to dwellinghouses)

<b>Power</b>	<b>Main conditions attached to power</b>
Enter premises	Where any person is employed (ie an employee), or where the inspector has reasonable cause to believe that any person is employed.
Interview any person at premises	Linked directly to the power of entry.
Obtain and make copies of relevant documents	No explicit threshold, which generates some uncertainty. However, it is likely that documents must relate to workers whom an inspector “reasonably believes” to be employees.

**Option 2: Legislative clarification to clarify that inspectors may proactively inquire into whether a worker is an employee or not**

For the purpose of performing one of the inspector's statutory functions, an inspector may (subject to the existing requirements in relation to dwellinghouses):

<b>Power</b>	<b>Main conditions attached to power</b>
Enter premises	Where work is performed, or where the inspector reasonably believes work is performed (removing any requirement for the employment status of persons to be known in advance).
Interview any person at premises	Linked directly to the power of entry.
Obtain and make copies of relevant documents	Clarify that inspectors' ability to obtain documents extends to documents associated with the engagement of persons to perform work (without limitation by employment status).

**Analysis of options against criteria**

26. The option identified as a possible alternative to the status quo has been assessed against the above criteria with either 1-3 crosses 'x' or 1-3 ticks '✓' to indicate the degree to which the option meets the relevant criterion, as compared to the status quo.

Option	Criteria for assessment of options				Conclusion / net outcomes
	Effectiveness	Costs of implementation	Proportionality	Transparency and certainty	
<p><b>Option 1: Status quo</b></p> <p>Labour inspectors' investigative powers comprise powers to proactively enter premises, interview people, and require the production of documents. These powers may generally be exercised only if the inspector knows, or has reasonable cause to believe, that persons are <u>employed</u> (ie subject to employment law).</p>	<ul style="list-style-type: none"> <li>Where the status of workers as employees is clear and undisputed, labour inspectors' investigative powers are sufficient to allow them to monitor firms' compliance with employment standards. The existing powers are also effective in situations where inspectors are acting on information or a complaint that gives them "reasonable cause to believe" that persons are, in reality, employees (though not being treated as such).</li> <li>However, where the Inspectorate is undertaking a proactive investigation, inspectors cannot clearly rely on their investigative powers to help form a view on the employment status of workers. This limits inspectors' ability to "monitor compliance with employment standards" in situations where workers are being treated as contractors rather than employees.</li> </ul>	<ul style="list-style-type: none"> <li>Labour inspectors' current powers (as amended on 1 April 2016) are now implemented as BAU.</li> <li>Any business whose compliance with employment legislation is assessed by the Labour Inspectorate will incur some compliance costs in interacting with the regulator. The costs of answering questions and providing documents are not high, and are justified by the need for regulatory oversight of firms' compliance with employment standards.</li> </ul>	<ul style="list-style-type: none"> <li>The investigative powers are generally commensurate with the range of functions inspectors must perform.</li> <li>Inspectors do not have powers beyond the minimum necessary to perform these functions (eg inspectors do not have powers to search premises, which would be unnecessary).</li> <li>Consistent with other regulators, inspectors' powers may only be exercised for the purpose of performing one of the inspector's statutory functions.</li> <li>The uncertainty with current settings potentially leaves some non-compliance unable to be detected, with adverse consequences for firms overall.</li> </ul>	<ul style="list-style-type: none"> <li>There is some uncertainty as to the reach of the Inspectorate's current powers. The requirement for inspectors to reasonably believe workers to be employees is only stated explicitly in relation to the power to enter premises.</li> <li>This means there is a degree of uncertainty for the regulated community, and the regulator itself, as to the Inspectorate's role in enforcing employment standards with respect to workers who are being treated as contractors.</li> </ul>	<p>Labour inspectors' current powers are broadly in keeping with their mandate to "monitor and enforce compliance" with employment legislation.</p> <p>However, inspectors' ability to assess whether workers are receiving their correct entitlements, especially in the context of proactive investigations, may be compromised by the lack of a clear power to obtain information to assess whether workers are in fact employees (and therefore subject to the employment jurisdiction). This reduces the overall effectiveness and proportionality of inspectors' powers; and the lack of clarity around the ability of inspectors to gather information, in respect of workers who are allegedly not employees, introduces some uncertainty for the regulator and the regulated community.</p>
<p><b>Option 2: Legislative clarification to confirm inspectors may proactively inquire into whether a worker is an employee or not</b></p> <p>This would be achieved by:</p> <ul style="list-style-type: none"> <li>Making inspectors' ability to enter premises (and interview people) conditional on the premises being somewhere that work is performed (without requiring advance knowledge of the nature of the working arrangement)</li> <li>Clarifying that inspectors' ability to obtain documents for compliance purposes extends to obtaining documents associated with the engagement of persons to perform work (including, for example, remuneration records and the contract under which contractors are engaged).</li> </ul>	<p>✓✓✓</p> <ul style="list-style-type: none"> <li>Labour inspectors would have a clear ability to investigate whether workers are employees or not – including in proactive investigations and audit activities. The powers of inspectors would enable them to obtain sufficient information to perform this function (as a necessary preliminary step to "monitor and enforce compliance" with employment legislation).</li> </ul>	<p>✗</p> <ul style="list-style-type: none"> <li>For the Labour Inspectorate, a legislative change would in the short term generate some minor costs in training inspectors and communicating changes.</li> <li>For firms that engage contractors as part of their workforce, this option may create some additional compliance costs (by obliging firms to answer inspectors' questions, and provide existing documents in respect of workers who are alleged to be non-employees). We consider these costs to be minor and no more than necessary to enable the regulator to perform its functions.</li> </ul>	<p>✓✓</p> <ul style="list-style-type: none"> <li>For some firms, there is a marginal increase in regulatory burden; however this is proportional to the benefits gained for firms overall in improving compliance.</li> <li>Retains the core requirement that the powers may be exercised only for the purpose of performing "functions and duties" under relevant legislation.</li> <li>Improves consistency with other regulatory regimes – for example, health and safety (where the regulator's power of entry applies to any "workplace").</li> </ul>	<p>✓✓✓</p> <ul style="list-style-type: none"> <li>Removes the current uncertainty that applies to labour inspectors' ability use their powers to ascertain whether persons are, in reality, employees.</li> <li>The reach of the Inspectorate's investigative powers would be clear for both the Inspectorate and the regulated community.</li> </ul>	<p>Overall, this option improves the clarity of labour inspectors' investigative powers (i.e. to enter premises, interview people, and obtain documents), in situations where workers are not being treated as employees. The clarification ensures inspectors' powers effectively support their legislative functions, while retaining appropriate checks. The benefits of this option outweigh the minor costs identified.</p> <p><b>[Preferred option]</b></p>

## **D. Implementation of preferred option**

27. The preferred option would require an amendment to the Employment Relations Act 2000. With Cabinet's agreement, this amendment will be progressed via the Regulatory Systems Bill (No 2), which is included as a category 5 bill on the 2017 legislation programme (category 5: to be referred to a select committee in 2017).
28. Information about the legislative change will be made available through MBIE's usual communication channels, including the website [www.employment.govt.nz](http://www.employment.govt.nz).
29. The Labour Inspectorate will be responsible for implementing the proposed option, in the course of its activities to monitor and enforce compliance with employment legislation.
30. Combating non-compliant business models (a good example of which is firms falsely treating their workers as contractors when they should have all the entitlements of an employee) is one of the Labour Inspectorate's three key priorities. These priorities guide the allocation of reactive investigations as well as targeting for proactive investigations. Given this issue is a priority for the Inspectorate, we would not expect the preferred option would have a large impact on the emphasis the Inspectorate places on employee-contractor issues (where such issues are associated with possible breaches of employment standards), relative to other employment standards issues.

## **E. Impacts of preferred option**

### **Impacts on business and employers**

31. Under the preferred option, firms that engage workers as contractors will clearly be required to provide information to the regulator (under the status quo, these firms can avoid scrutiny by inspectors in some circumstances). This means that inspectors will be able to investigate more firms, and more working arrangements, than currently.
32. We do not envisage that the preferred option would, in itself, impact the number of proactive activities undertaken by the Inspectorate. As stated above, the priority of combating "non-compliant business models" is already being considered in the Inspectorate's decisions about allocation of resource.
33. In the National Survey of Employers for 2015/16 (conducted by MBIE), 11 per cent of employers reported using self-employed workers who worked exclusively for the employer's firm. This provides a broad indication of the proportion of firms with contractors as part of their regular "standing" workforce, which is the group of firms that could be required to provide more information to labour inspectors if they were subject to proactive monitoring.
34. Any business whose employment practices are audited by the regulator will bear some compliance cost in interacting with the regulator, and the reach of labour inspectors' powers has some impact on the extent of this cost. Overall, we consider the impacts on compliance costs for firms to be minor.



35. The potential impacts on different types of firms are summarised below:

Type of business	Status quo	Impact of preferred option
Firm engages employees only	<ul style="list-style-type: none"> <li>Inspectors may enter workplace, interview any person there, require all relevant documents</li> </ul>	Nil
Firm engages employees and other kinds of workers (eg contractors)	<ul style="list-style-type: none"> <li>Inspectors may enter workplace and interview any person there</li> <li>Firm must provide documents relating to engagement of employees</li> <li>Unclear whether firm must provide documents relating to the engagement of other workers (likely only if inspector reasonably believes workers to be employees).</li> </ul>	<ul style="list-style-type: none"> <li>No change to powers of entry / interview</li> <li>Firm clearly must provide inspectors with documents relating to workers who are not treated as employees.</li> </ul>
Firm engages workforce that is alleged to be entirely contractors	<ul style="list-style-type: none"> <li>Inspectors may not exercise powers unless they reasonably believe workers to be employees.</li> </ul>	<ul style="list-style-type: none"> <li>Inspector may exercise all investigative powers.</li> </ul>

36. Clarifying that labour inspectors may proactively investigate whether particular workers are employees has the potential to be of overall benefit to businesses, because it could reduce the ability for some businesses to gain an unfair competitive advantage by deeming employee-like workers to be self-employed contractors. The success of the option in this regard will depend on the resourcing and capability of the regulator (including its ability to successfully target non-compliance).

### Impacts on workers

37. The option will benefit workers by ensuring labour inspectors can intervene in situations where employees are wrongly being treated as contractors (or another type of worker), and being denied the employment rights that stem from employee status.
38. The benefits of effective enforcement action are most likely to be experienced first-hand by vulnerable groups of workers who have been more at risk of not receiving their correct entitlements. These groups include migrant workers, temporary workers, labourers, young people and older workers, Māori, Pasifika, women, those working in rural areas and those with lower qualifications. The proposed clarification has the potential to enhance enforcement outcomes for workers in industries where there have been anecdotal reports of vulnerable workers being miscategorised as contractors, e.g. the construction sector, cleaning, security, and labour on hire.

## Wider impacts

39. As well as contributing to a more level playing field for business, the preferred option could (if it leads to a reduction in the misuse of contractor status by firms) have flow-on benefits of better compliance with tax, ACC and social policy obligations in at-risk sectors.

## F. Consultation

40. Business NZ and the New Zealand Council of Trade Unions have been consulted on the proposal to clarify labour inspectors' ability to investigate whether workers are employees or not. Both have indicated their support for the intent of this proposal.
41. The planned release of an exposure draft of the Regulatory Systems Bill (No 2) in October 2017, and the select committee process, will provide opportunities for further public consultation.
42. The following agencies have been consulted on the policy proposal discussed in this Regulatory Impact Statement: The Treasury, Inland Revenue, Te Puni Kōkiri, and the Ministries of/for Justice, Women, Pacific Peoples, Social Development, Health, and Education. The Department of Prime Minister and Cabinet has been informed.

## G. Monitoring, evaluation and review

43. The effect of the preferred option in improving the Inspectorate's ability to perform its statutory functions will be assessed as part of general reporting on the Inspectorate's activities. The Labour Inspectorate's two key outcomes are:
  - a. employers who exploit their workers or operate non-compliant business models and gain an unfair competitive advantage are found out and prosecuted; and
  - b. workers receive their entitlements.
44. A monitoring and evaluation framework is applied to the Labour Inspectorate's outcomes and this is assessed against four key impacts:
  - a. effective enforcement of employment standards;
  - b. public have confidence in the regulatory system;
  - c. employers understand their obligations; and
  - d. people know about labour standards.
45. Key performance metrics are regularly reviewed by senior managers and the Minister. While the proposed change is minor and (all other things being equal) not expected to have a large impact on the Inspectorate's performance measures, we would expect any notable issues, benefits and challenges stemming from the proposed legislative clarification to be reported through this monitoring approach.