

## IV. Misclassified and Unreported Workers in the U.S. Construction Industry — State-Level Studies

---

### Employee Misclassification in New York Construction — Economic and Fiscal Costs

JAMES A. PARROTT  
*Fiscal Policy Institute*

#### Abstract

Some employers, particularly in construction, misclassify workers as independent contractors in order to circumvent employer liability for payroll taxes and social insurance premiums, particularly workers compensation. This paper estimates the magnitude of employee misclassification in the New York City construction industry and the associated economic and fiscal costs. In 2005, 50,000, or nearly one in four, New York City construction workers were misclassified or employed completely off the books. Employers misclassifying workers or employing workers off the books shifted a total of \$500 million in fiscal and economic costs to workers, taxpayers, social insurance systems, and other employers.

#### Independent Contractor Employee Misclassification Is Often Intentional

There is considerable evidence that many employers are treating workers as independent contractors when they are actually employees in order to circumvent employer liability for payroll taxes and social insurance premiums. Employee misclassification creates significant problems for workers. Misclassified workers are not covered by workers compensation, unemployment insurance, or state temporary disability insurance. They then become liable for the full Social Security and Medicare payroll tax (15.3 percent)<sup>1</sup>, and if the payroll tax is not paid, the amount of Social Security benefits for which they are eligible may be reduced. Such workers also lose overtime pay and access to employer-provided health and other benefits, such as retirement benefits and paid time off. They also lose many employment rights, including the right to organize and form a union, and protections against discrimination.

Independent contractor misclassification is found in many industries throughout the economy, but particularly in construction. The project nature of most construction and the relatively high cost of workers compensation in construction are two factors that account for the greater incidence in construction. In recent congressional testimony, Deputy Labor Secretary Seth Harris noted that while the term “misclassification” seems to suggest a technical violation or a paperwork error, ... much worker classification is intentional” and “no mere technical violation. It is a serious threat to workers” (Harris 2010).

Over decades, government established a series of employment standards and social insurance systems to protect workers and responsible businesses from unchecked competition that degrades working conditions and the economic well-being of workers and that disadvantages responsible businesses. Regulation of labor standards largely falls to state governments. Until recently, state governments have failed to act to curb the spread of illegal misclassification of workers as independent contractors.

---

Author’s address: 11 Park Place, Suite 701, New York, NY 10007

In September 2007, New York's Governor Eliot Spitzer characterized the misclassification problem as "rampant" and an "epidemic" and pledged to curb misclassification through tougher enforcement. Spitzer issued an Executive Order establishing a Joint Enforcement Task Force on Employee Misclassification. Upon signing the Executive Order, the governor stated that it would "protect worker rights while leveling the playing field for law-abiding employers so they are not at a competitive disadvantage to employers who refuse to play by the rules as they exploit hard working New Yorkers" (New York State Office of the Governor 2007).

Misclassification generates a host of economic and fiscal costs that markets on their own do not force businesses to "internalize." It is not just workers who are forced to shoulder these displaced costs. As Deputy Labor Secretary Harris noted,

[Worker misclassification] shortchanges workers, employers, states and the federal government. Workers are not paid the wages to which they are entitled. Law-abiding, responsible employers are denied a level playing field in a hyper-competitive business environment. And the revenues flowing into federal and state treasuries are diminished when employers that should be treating workers as employees avoid paying unemployment taxes, workers compensation premiums, and (unless the workers pay them) payroll taxes. When the misclassified workers themselves do not pay some or all of the employment taxes, for self-employed workers, the Social Security trust funds suffer a permanent loss." (Harris 2010)

When workers are paid off the books, the occurrence of an illegality is readily understood.

Misclassification accompanied by the submission of a 1099 form to the IRS seems to be an order of magnitude less severe an infraction. However, from the point of view of the worker, competing employers, and state social insurance funds, there is little or no difference between misclassification and labor that is paid entirely "off the books." Misclassification occurs deep in the underground economy.

This paper discusses an effort to quantify the magnitude of employee misclassification in construction in New York City and the associated economic and fiscal costs. An initial effort to explore the magnitude of misclassification in New York was undertaken by the Fiscal Policy Institute (FPI) to investigate the underpayment of state workers compensation premiums. This analysis was prepared in late 2006, as then governor-elect Spitzer undertook serious negotiations to reform New York's workers compensation system, efforts that culminated in the passage of reform legislation in March 2007 (Fiscal Policy Institute 2007b).

## **Widespread Underpayment of Workers Compensation Insurance Premiums**

A study prepared for the U.S. Labor Department in 2000 noted that employer avoidance of responsibility for workers compensation premiums was the number one reason employers sought to misclassify workers as independent contractors (Planmatics 2000). The lack of labor standards enforcement in New York in the late 1990s and in the period from 2000 to 2006 was so endemic that employer non-compliance with the state's workers compensation program mushroomed. Not only was there almost no enforcement against worker misclassification, there was no serious effort to ensure any compliance with workers compensation.

Many companies did not provide workers compensation coverage for their workers, thereby limiting the insurance pool of workers covered, depriving their workers of coverage, increasing the premium costs for other employers, and shifting the costs of medical care for injured workers to the injured workers themselves, taxpayers, and other employers.

The FPI study identified two sources of shortfall in the New York State workers compensation system: fall-off from coverage under unemployment insurance (i.e., many fewer workers appeared to be covered by workers compensation than were covered under the unemployment insurance system); and a growing number of workers who were misclassified by their employers as independent contractors to evade employer responsibility for payroll taxes and social insurance premiums, including both workers compensation and unemployment insurance.

In New York, with very limited exceptions (usually self-insured governmental units), all workers who are covered by unemployment insurance should also be covered by workers compensation. Yet, in 2003 the total annual payroll of workers covered by workers compensation was only 80 percent of the unemployment insurance payroll, meaning that roughly one in every five New York workers was not covered by workers compensation. Given limitations in the quality of the workers compensation payroll data, it was possible that the coverage fall-off was less. It was also possible it was more. However, it is unlikely that poor data explain away all or most of the coverage shortfall.

Additionally, analysis of trends in payroll employment and other economic data allowed some estimate to be made of the number of New York workers who are being misclassified by employers as independent contractors. Such workers typically are not covered by either unemployment insurance or workers compensation.

Combining these two sources of shortfall in workers compensation coverage, very conservative estimates of the coverage shortfall suggest that from 500,000 to one million New York workers who should be covered by workers compensation were not covered. Premium payments on behalf of these workers were not being made as required by New York law. The total annual payroll for these uncovered workers ranged from about \$25 billion to \$50 billion (Fiscal Policy Institute 2007b).

These numbers translate into a substantial shortfall in revenues that should have been paid into the workers compensation system. Since workers compensation premiums in 2006 averaged roughly \$1,000 per worker, this coverage shortfall amounts to from \$500 million to \$1 billion in premiums and assessments that were lost to New York's workers compensation system annually. All of these estimates cover a very broad range because New York State has not audited the payroll coverage data to ensure its reliability (and has not even compiled the total workers compensation payroll before) and there has been insufficient effective compliance enforcement.

## **Estimating the Magnitude of Misclassification**

Several studies have used unemployment insurance (UI) employer audits as a basis for estimating the magnitude of employee misclassification. The 2000 Planmatics study for the U.S. Department of Labor examined audit data for nine states and concluded, "The percentage of audited employers with misclassified workers ranged from approximately 10 percent to 30 percent" (Planmatics 2000). In a mid-2010 report, the National Employment Law Project identified 13 state studies published between 2004 and 2010 that estimated misclassification using UI audits or state tax data. These studies found that from 11 to 40 percent of employers misclassified workers as independent contractors (Leberstein 2010).

Where such studies separately examine the construction industry, they invariably find a higher incidence of misclassification. In New York State, for example, a 2007 study by researchers at the Cornell University Industrial and Labor Relations School used UI audits to estimate that 10.3 percent of all employees were misclassified as independent contractors. The Cornell study estimated that about 705,000 New York workers were misclassified. In the construction industry, misclassification affected over 45,000 workers—14.8 percent of all construction workers (Donahue, Lamare, and Kotler 2007).

Since most of these studies rely on UI employer audits, they tend to understate the extent of employer non-compliance with UI and workers compensation programs since such audits rarely capture information on employers who fail to report any worker payments to state authorities and who pay workers completely off the books.

In their study of the misclassification in the Michigan construction industry, Belman and Block found that construction employers were much more likely to engage in non-reporting fraud than to misclassify workers as independent contractors. All told, they found that 26 percent of construction employers misclassified workers or paid them off the books (Belman and Block 2008).

### Another Approach: Estimating Misclassification and Off-the-Books Employment in the New York City Construction Industry

We were first drawn to more closely examine the underground economy—encompassing workers misclassified as independent contractors and those employed off the books—in the New York City construction industry by a striking anomaly in data for the residential construction industry. While the number of residential units covered by building permits issued in New York City between 2000 and 2005 more than doubled—increasing from 15,050 to 31,599 (110 percent)—Labor Department data indicated that residential construction payroll employment increased by only 16 percent over that period. At the same time, Current Population Survey (CPS) data suggested that “self-employment” among all construction workers in New York City increased by 146 percent from 2000 to 2005. The magnitude of the increase in CPS-reported construction self-employment was nearly three times the magnitude of the increased residential construction payroll employment (Fiscal Policy Institute 2007d).

To take a closer look, we turned to the more extensive microdata from the Census Bureau’s American Community Survey (ACS) for 2005, which had recently become available.<sup>2</sup> According to the ACS data, there were 200,000 persons working in the construction industry in New York City in 2005. This includes 155,100 residents of New York City working within the city, 28,400 persons who reside in the New York suburbs and elsewhere in New York State but work in the city, and 16,200 people who work in New York City but live in New Jersey, Pennsylvania, or Connecticut.<sup>3</sup> These estimates are summarized in Table 1.

TABLE 1  
Persons Employed in Construction in New York City, 2005

American Community Survey	Employees	Self-employed	Total by area	
NYC residents	126,939	28,208	155,147	
Residents of NYS outside of NYC	25,434	2,951	28,385	
Residents of NJ, PA, or CT	14,621	1,628	16,249	
Total by employment status	166,994	32,787	199,781	

  

Estimates by industry segment	Payroll employment	Self-employment	Misclassified workers or employed off the books	Total by segment
Residential construction *	38,500	14,250	29,000	81,750
Non-residential construction	71,500	18,550	28,000	118,050
Total construction **	110,000	32,800	57,000	199,800

\* Residential construction: Payroll employment from Quarterly Census of Employment and Wages, NYS Department of Labor; for other categories see FPI 2007d.

\*\* Total construction: Payroll employment from Quarterly Census of Employment and Wages (QCEW), NYS Department of Labor; total for both segments and self-employment total set equal to ACS 2005 total for persons working in New York City; misclassified and employed off the books estimated as the residual between the ACS and QCEW series.

Sources: FPI analysis of American Community Survey microdata and QCEW employment for 2005.

This 200,000 figure is much greater than the 2005 payroll employment level of 110,000 for city construction establishments reported by the New York State Department of Labor. The payroll figures do not include the self-employed or the workers who are misclassified as independent contractors or employed “off the books” on a strictly cash basis. The ACS identifies 32,800 persons working in the construction industry in New York City as self-employed. Almost 57,000 other workers who identify themselves as wage and salary workers must, in effect, be “misclassified” (some workers who should be considered “employees” but who are paid as “independent contractors”) or workers who are employed off the books.<sup>4</sup>

While this burgeoning underground economy in construction is heavily populated with immigrant workers, it is not an immigrant problem. It is a problem created by businesses cutting corners at the expense of workers, and by government standing by while that happens.

Where markets fail, as they clearly were in the case of the sharp expansion in payroll fraud in the New York construction industry, government needs to step in. But until very recently, there was little government enforcement against illegal employment practices in the New York City construction industry.<sup>5</sup> In a market economy, unions can be an effective counterweight to illegal employment practices. However, while New York City remains one of the most unionized large cities in the country, the extent of unionization in the construction industry has fallen considerably compared to 15 years ago.

Union density is measured as the number of union members as a percentage of the estimated total number of construction trades workers in New York City. The denominator *excludes* the self-employed and the non-trades portion of the industry (i.e., managerial, professional, and administrative workers), but it *includes* the 50,000 misclassified as independent contractors and those working off the books. While the number of unionized construction trades workers increased from 66,000 in the early 1990s to 76,000 for the period from 2004 to 2006, the number of non-union workers more than doubled over this period. The number of non-union construction trades workers in the early 1990s was 38,000, but that grew to 94,000 in 2004–2006. Union density in the New York City construction sector fell from 63 percent in the early 1990s, to an estimated 45 percent in the period from 2004 to 2006.<sup>6</sup>

### **Other Government Data Corroborating an Increase in Employee Misclassification**

An increase in employee misclassification in New York in the 2000s is also suggested by the rapid growth in a government data series that likely counts many misclassified workers—the non-employer series compiled by the Census Bureau. Workers paid as independent contractors receive an IRS 1099 form for tax purposes rather than the W-2 form at the end of the year that they would receive if they were treated as a payroll employee. The Census Bureau counts workers paid on 1099 forms as “non-employer establishments.” Many people counted as non-employer establishments may indeed be truly consultants or independent contractors. However, the growth in the non-employer series has been so much greater than the growth in the payroll employment series that it likely reflects an increase in misclassification.

From 2000 to 2005, the non-employer series for New York State increased by 240,500 (20 percent). On the other hand, the Labor Department reported that private payroll employment increased by only 33,500 (0.5 percent) in New York State between 2000 and 2005. This enormous discrepancy strongly suggests an explosion in the misclassification of workers. Several industries showed large increases in “non-employers,” including construction, health care, social assistance, educational services, real estate, information, accommodation and food services, arts and entertainment, and administrative services (Fiscal Policy Institute 2007c).

### **After 2007, New York State’s Enforcement Data Begin to Demonstrate the Extent of Misclassification**

New York’s spring 2007 legislation to reform workers compensation dramatically beefed up penalties for employer non-compliance. And in September 2007, Governor Spitzer issued an Executive Order establishing a Joint Enforcement Task Force on Employee Misidentification. In its early years, the enforcement effort was spearheaded by Patricia Smith, New York’s Labor Commissioner (Smith is now the solicitor at the U.S. Department of Labor)

From the passage of reform legislation in 2007 through the end of 2009, the New York Workers Compensation Board issued 4,000 stop-work orders in cases where investigators had determined that an employer did not have a workers comp policy or had unpaid compliance penalties. In the vast majority of these cases, the subject businesses were not paying into the UI system either. During this period, the board collected more than \$32 million in penalties (Beloten 2010).

From its inception in September 2007 through the end of March 2010, the New York State Joint Enforcement Task Force on Employee Misclassification conducted 67 enforcement sweeps across the state, identified nearly 35,000 instances of employee misclassification, discovered over \$457 million in unreported

wages, identified more than \$13.2 million in UI taxes due, and discovered over \$14 million in unpaid wages. In reporting this enforcement record, Colleen Gardner (Patricia Smith's successor as New York labor commissioner) noted, "We have only scratched the surface of the problem in New York. There is much more work to be done" (Gardner 2010).

Commissioner Gardner noted the Cornell study's estimate that approximately 14.9 percent of the construction industry workforce was misclassified and observed, "Our own field experience has shown that the level of worker misclassification in New York may be even higher than what the Cornell study shows because of the high incidence of off-the-books work" (Gardner 2010).

## **Estimating Economic and Fiscal Costs**

Employee misclassification and off-the-books activity not only drive down the compensation of workers but also lead to several other adverse fiscal and economic effects. Employers who misclassify workers or employ workers off the books may shave their costs but only at the expense of government, which loses tax revenue and sees increased demands made on various government programs, and at the expense of other employers who operate within legal requirements regarding payroll taxes and social insurance protections. Employers engaging in misclassification and off-the-books activity do not really save costs; they just shift them onto workers, other businesses, government, and society at large.

From the point of view of labor protections and wage levels, there is not a huge difference between employers who misclassify workers as independent contractors and those who employ workers off the books. Both types of employers are breaking the law, and neither makes payroll tax payments or social insurance premium payments on behalf of such workers. In New York State, private employers are required to provide coverage for all three social insurance programs (workers compensation, unemployment insurance, and disability insurance). Generally, employers who do not make payroll tax or social insurance premium payments deprive workers of coverage under these programs. Since Social Security and Medicare are general safety-net programs, most workers will be eligible for at least minimum benefits, regardless of the payroll taxes paid in on their behalf.

Workers injured on the job can qualify for workers compensation benefits even if their employer has not made premium payments on their behalf. Such workers are paid out of a special fund financed through an assessment on premiums paid by employers providing regular workers compensation coverage. In any case, there is a fiscal cost, or revenue loss, to government that results from employers not making payroll tax or social insurance premium payments and a shifting of responsibility from underground contractors to responsible contractors.

There is also likely to be cost shifting involving health care costs, which results from employers who illegally employ workers. Since the affected workers will not have employer-provided health insurance, the workers are left to fend for themselves. Given their low wages, such workers likely would qualify for Medicaid coverage; however, many will not avail themselves of that. If they cannot qualify for Medicaid and are injured on the job or otherwise require medical assistance, emergency rooms will provide uncompensated health care services. Medicaid and uncompensated care both involve the shifting of costs from employers illegally employing workers to taxpayers and employers providing health coverage to their employees.

Medicaid costs per non-elderly adult average \$6,000 annually in New York City. The cost of uncompensated health care services provided affordable housing construction workers was estimated by FPI at \$2,500 per worker receiving uncompensated care.<sup>7</sup>

Under New York State's Health Care Reform Act (HCRA), employers providing health insurance to their employees, such as union construction employers, are mandated to pay a surcharge on certain medical expenses to help cover the cost of uncompensated health care, including the health care for employees of employers not providing health insurance. Thus, under this perverse state provision, responsible employers providing health insurance to their employees, in effect, pay several hundred dollars per worker to cover medical costs for the employees of their competitors who do not provide health coverage.

The analysis of the New York City construction industry described earlier estimated that in 2005, 50,000 construction workers—nearly one in four—were either misclassified as independent contractors or employed by construction contractors completely off the books. The costs associated with the illegal

underground construction industry are substantial. For 2005, the fiscal costs were estimated to be close the \$500 million. Three categories of costs were estimated for 2005 (Fiscal Policy Institute 2007a):

- \$272 million in unpaid legally mandated payroll taxes for Social Security and Medicare, and social insurance premiums covering workers compensation, unemployment insurance, and disability insurance.
- \$148 million in health care costs shifted onto the workers themselves, taxpayers, and other employers who provide employee health insurance.
- \$70 million in lost personal income taxes because there is no withholding for underground economy workers and/or they are paid off the books.

The *fiscal costs* estimated here do not include the *economic costs* borne by the workers themselves. These include abysmally low wages for the dangerous work performed, not being covered by social insurance protections (Social Security, Medicare, workers compensation, unemployment or disability insurance), not having pension coverage or family health insurance, no paid time off, and not having the right to join a union.

### **Another Distortion Related to Misclassification**

Payroll employment data are one of the key indicators analyzed by economists seeking to understand current and past trends in the economy. Along with the monthly unemployment survey, no other indicators are more important in gauging the economy's health. Yet, employee misclassification is widespread enough that it taints the accuracy of reported payroll employment. Labor standards enforcement varies considerably by state, and over time within states. Even though enforcement efforts often are severely constrained by very limited resources, in some states we might be starting to see a signaling effect that is putting more law-breaking employers on notice that the likelihood and costs of getting caught are increasing. There is some anecdotal evidence in New York that recent significant increases in restaurant employment may, in part, reflect recent enforcement sweeps targeting that industry.

### **Endnotes**

<sup>1</sup> The combined employer and employee payroll tax rates for Social Security and Medicare total 15.3 percent of gross wages.

<sup>2</sup> The American Community Survey (ACS) is conducted annually by the U.S. Census Bureau and is the government's largest annual survey of socioeconomic conditions. Among other data, the ACS provides information on place of work and place of residence, allowing a detailed look at all of the workers engaged in the New York City construction industry.

<sup>3</sup> These figures do not include the 25,000 workers in construction occupations who work outside of the construction industry (e.g., carpenters and electricians working for the public school system or the Metropolitan Transit Authority). See Fiscal Policy Institute 2006.

<sup>4</sup> Because of significant growth since 2005, there were probably 225,000 to 240,000 total workers in New York City construction at the end of 2007. It is very likely that the estimated number of workers misclassified or working off the books is correspondingly higher at the end of 2007 than in 2005. In addition, the Current Population Survey for the period from 2004 to 2006 indicates an even greater gap with the payroll employment data than in the ACS.

<sup>5</sup> For a discussion of labor standards enforcement efforts, see Fiscal Policy Institute 2007d. When Governor Spitzer signed his Executive Order to prevent employee misclassification, State Labor Commissioner Patricia Smith noted that the Joint Enforcement Task Force on Employee Misidentification would "reverse several years of lax enforcement" (New York State Office of the Governor 2007).

<sup>6</sup> FPI estimates based on 1990–2006 Current Population Survey and 2005 American Community Survey. Non-union total for 2004–2006 includes several thousand misclassified independent contractors and workers employed completely off the books. Estimates are for trades workers in the New York City construction industry.

<sup>7</sup> Articles consulted in developing this estimate include Bovbjerg et al. 2006 and Waddoups 2001.

## References

- Belman, Dale L., and Richard Block. *The Social and Economic Costs of Employee Misclassification in the Michigan Construction Industry*. School of Industrial Relations, Michigan State University, 2008.
- Beloten, Robert E., Chair of the New York State Workers' Compensation Board. "Testimony before the New York Assembly Labor Committee on Misclassification and the Underground Economy." January 27, 2010.
- Bovbjerg, Randall R., et al. "Caring for the Uninsured in New York," Urban Institute, October 2006.
- Donahue, Linda H., James Ryan Lamare, and Fred B. Kotler. *The Cost of Worker Misclassification in New York State*, Cornell University ILR School, February 2007.
- Fiscal Policy Institute. *The New York City Construction Labor Market, A Labor Market Profile*. Prepared for the NYC Employment and Training Coalition and NYC Workforce Investment Board. New York: 2006.
- Fiscal Policy Institute. *Building Up New York, Tearing Down Job Quality. Taxpayer Impact of Worsening Employment Practices in New York City's Construction Industry*. New York: 2007a.
- Fiscal Policy Institute. *New York State Workers Compensation: How Big Is the Coverage Shortfall?* New York: 2007b.
- Fiscal Policy Institute. *The State of Working New York 2007*. New York: 2007c.
- Fiscal Policy Institute. *The Underground Economy in the New York City Affordable Housing Construction Industry*. New York: 2007d.
- Gardner, Colleen C., Commissioner, New York State Department of Labor. "Leveling the Playing Field: Protecting Workers and Businesses affected by Misclassification." Testimony before the U.S. Senate Committee on Health, Education, Labor and Pensions, June 17, 2010.
- Harris, Seth. Deputy Secretary of the U.S. Department of Labor, "Statement before the Committee on Health, Education, Labor, and Pensions." U.S. Senate, June 17, 2010.
- Leberstein, Sarah. "Independent Contractor Misclassification Imposes Huge Costs on Workers and Federal and State Treasuries." Unpublished paper, June 2010.
- New York State Office of the Governor, "Governor Spitzer Signs Executive Order to Prevent Employee Misclassification." Press Release, September 7, 2007.
- Planmatics, Inc. *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs*, Prepared for the U.S. Department of Labor, Employment and Training Administration. 2000.
- Waddoups, C. Jeffrey. "Employer Sponsored Health Insurance and Uncompensated Care: An Updated Study of the University Medical Center in Clark County (Las Vegas)," July 2001.