

**Size and Cost of Misclassification Fraud
and Unreported Pay:
Survey of National and State Studies**
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By Matthew F. Capece
Representative of the General President
United Brotherhood of Carpenters and Joiners of America
101 Constitution Ave., NW
Washington, DC 20001

Employers who misclassify workers as independent contractors avoid withholding income taxes, paying employment taxes, overtime and workers compensation premiums. In the construction industry misclassification fraud gives irresponsible employers a 30 percent or more advantage in labor costs. And in a competitive industry like construction that means responsible employers who play by the rules (and their employees) lose work. Misclassification in construction is more common than in other industries, because of competitiveness, mobility of employers and the workforce, the temporary nature of the work and the multiple layers of contractors and subcontractors.

Below are brief descriptions from numerous national and state studies of the size and cost of misclassification fraud:

***A 1984 study by the Internal Revenue Service** found that 19.8 percent of construction employers misclassified their employees.¹ The rate for all industries was 15%.² The total income, unemployment and Social Security tax loss was \$1.6 billion.³ Moreover, the IRS estimated that the loss of Social Security and unemployment taxes alone would be \$2.3 billion in 1987 and \$3.3 billion in 1992.⁴

***In 1994 Coopers & Lybrand** estimated that the federal government would lose \$3.3 billion in revenues in 1996 due to misclassification, and from 1996 to 2004 misclassification would cost the government \$34.7 billion.⁵

***A 2001 Florida study** reported that in 1997 \$912 million in workers compensation premiums were paid by construction industry employers, and that an additional \$1.3 billion was lost due to employer premium fraud and the state's exemption policies.⁶ Reforms were enacted in 2003 to reduce costs and toughen enforcement.

¹ *Testimony of US General Accounting Office before subcommittee on Oversight, Committee on Ways & Means*, by Gandhi, p. 13 (June 20, 1996) (GAO 1996 Testimony).

² *Ibid*, p 1.

³ *Ibid*. pp. 4-5.

⁴ *Ibid*.

⁵ *Projection of the Loss in Federal Tax Revenues Due to Misclassification of Workers*, by Coopers & Lybrand, p. 3 (June 1994).

⁶ *A Study on the Magnitude of Loss of Workers' Compensation Premiums in 1997 due to Employer Fraud and Exemptions in the Florida Construction Industry*, by Construction Concepts, Coble Ph.D, Hinze Ph.D. P.E., pp. 27-28 (March 2001).

***Massachusetts study 2004:⁷**

	All Industries	Construction
Degree employers who misclassify	up to 19%	up to 24%
Unemployment taxes lost	\$ 35 million	\$ 3.9 million
State income taxes	152 million	6.9 million
Workers comp prem.	<u>91 million</u>	<u>7 million</u>
Total	\$278 million	\$17.8 million

***2005 Maine study:⁸**

	All Industries	Construction
Degree employers who misclassify	11%	14%
Unemployment taxes lost	not quantified	\$ 0.3 million
State income taxes	nq	4.3 million
Workers comp prem.	nq	6.5 million
FICA	nq	<u>10.3 million</u>
Total		\$21.4 million

***2007 New York state study:⁹**

	All Industries	Construction
Degree employees misclassified	10.3%	14.8%
Unemployment taxes lost	\$176 million	nq

***Illinois 2006:¹⁰**

	All Industries	Construction
Degree employers who misclassify	17.8%	17.8% est
Unemployment taxes lost	\$ 53.7 million	\$ 2.5 million
State income taxes	248.4 million	17.3 million
Workers comp prem.	<u>97.9 million</u>	<u>34.8 million</u>

⁷ *The Social & Economic Cost of Employee Misclassification in Construction*, Construction Policy Research Center, Labor & Worklife Program, Harvard Law School & Harvard School of Public Health, by Bernhard and Herrick, p. 1 (December 2004) (Massachusetts Study).

⁸ *The Social & Economic Cost of Employee Misclassification in the Maine Construction Industry*, Construction Policy Research Center, Labor & Worklife Program, Harvard Law School & Harvard School of Public Health, by Bernhard and Herrick, pp. 1-2 (April 2005) (Maine Study)

⁹ *The Cost of Worker Misclassification in New York State*, Cornell Univ., ILR School, by Donahue, p. 2 (February 2007) (New York Study).

¹⁰ *Economic Costs of Employee Misclassification in the State of Illinois*, Dep. Of Economics, Univ. Missouri-Kansas City, by Kelsay, Sturgeon and Pinkham, pp. 4 to 8 and 15 (December 2006) (Illinois Study). The rate of misclassification in construction used here is the rate of misclassification for all industries. The Illinois study was unable to quantify exactly the construction rate, because the state did not provide industry specific audit data. It is fair to assume that construction rate is at a minimum the same as the overall rate, and that it is probably higher, because the Illinois data is based only on random audits, and the data from the other states shows a greater incidence of misclassification in construction.

Total \$400 million \$54.6 million

***Minnesota 2007 study:**¹¹

	All Industries	Construction
Degree of employers who misclassify	14%	15%

***Washington 2007 study:**¹²

In-state and out-of-state business registered with the IRS but not with Washington in 2004 cost the state \$274 million in unpaid taxes (that includes taxes for workers compensation coverage). Unpaid taxes for Washington employers are \$101.3 million. Industry breakdowns for these employers are available.

In 2001, and additional \$183 million of unpaid taxes can be added for business that are neither registered with the IRS and Washington. Industry breakdowns for these employers are not available.

Breakdown in millions:

	In&Out of State All Industries	In-State All Ind.	In-State Construction
State income tax	225.0	52.0	1.0
State unemplmnt	14.8	14.8	3.4
workers comp.	34.5	34.5	8.7
Total	\$274.3	\$101.3	\$13.1

The study sites construction as an area where the number is probably higher, because they don't have an industry breakdown of the employers who aren't registered (don't pay taxes) to either the federal and state. Construction is cited as a focus for enforcement.

***The nationwide rate of misclassification** in all industries has not been static; it has grown by 42 percent from 2001 to 2002.¹³

***Most studies do not include the extent of unreported cash pay** in the underground economy.¹⁴ A **Bear Stearns 2005** report estimated that the United States is losing \$35 billion a year due to the number of jobs that are now "off the books."¹⁵

***A sense of the size of unreported-cash pay in the underground economy** can be found in the **Fiscal Policy Institute's study of the residential construction market in New York City**. They compared residential building permits and FW Dodge

¹¹ *Misclassification of Employees as Independent Contractors*, Office of the Legislative Auditor, State of Minnesota, pp 15 and 18 (November 2007).

¹² *Unregistered Business Study: Joint Report of the Washington State Dept. of Revenue, Washington State Dept. of Labor and Industries and the Washington State Employment Security Dept.*, pp. 2, 3-7, 11-17 and 19 (November 2007).

¹³ Illinois Study, fn. 1, p. 2.

¹⁴ Massachusetts Study, p. 1, Maine Study, p. 1, Illinois Study, p. 2, Minnesota Study, p. 15.

¹⁵ *The Underground Labor Force is Rising to the Surface*, Bear Stearns Asset Management, by Justich and Ng, p. 3 (January 3, 2005).

construction activity data to construction employment from 2000 to 2005.¹⁶ Conservatively, New York City had 82,000 residential construction workers in 2005. 30,000 of those construction workers were employed illegally.¹⁷ (13,000 may have been misclassified and the other 17,000 were completely off the books.¹⁸) That means that a minimum of 21 percent of New York City residential construction workers received unreported pay. The numbers were worse in the city-funded affordable-housing construction market, where up to two thirds of the 13,350 construction workers were employed illegally.¹⁹

***The Fiscal Policy Institute also released a study in December 2007 on illegal employment practices in the entire New York City construction market.²⁰** Like the study of the residential market, this study captures workers who are improperly misclassified as well as those paid cash.²¹ The study made the following findings of losses in 2005:²²

Total number of construction workers:	200,000
Number misclassified or paid off the books:	50,000
Health care cost shifting:	\$148 million
Fed income tax lost:	43.5
Fed employment tax/comp. premium lost:	271.6
New York state income tax lost:	15.2
New York City income tax lost:	<u>11.0</u>
Total cost:	\$489.3 million

FPI further estimates that fraud in New York City will cost the \$557 million in 2008.

***A 2007 done for the California Commission on Health and Safety and Workers' Compensation** disclosed that employers in all industries failed to report up to 23 percent of their payroll to workers' compensation carriers, resulting in \$100 billion in underreporting.²³ Because carriers shift costs to customers that do pay what they should, responsible employers who have workers in dangerous occupations are paying eight times more than they should be paying.²⁴

¹⁶ *The Underground Economy in the New York City Affordable Housing Construction Industry*, Fiscal Policy Institute (New York City Housing), p. 1, 9. (April 2007).

¹⁷ New York City Housing, pp. 1, 10-12.

¹⁸ *Ibid.*

¹⁹ *Ibid.*, pp. 1, 8-9.

²⁰ *Building Up New York, Tearing Down Job Quality: Taxpayer Impact of Worsening Employment Practices in New York City's Construction Industry*, Fiscal Policy Institute (New York City Construction) (December 2007).

²¹ New York City Construction, p. 1.

²² *Ibid.*, pp. 1, 20.

²³ *Up to One Fifth of California Payroll Not Reported*, WorkCompCentral, by Jim Sams (April 30, 2007). This study was of all employers, and not just construction. *Fraud in Workers' Compensation Payroll Reporting: How Much Employer Fraud Exists and How are Honest Employers Impacted: Report for the Commission on Health and Safety and Workers' Compensation*, by Frank Neuhauser and Colleen Donovan, University of California, Berkeley (August 2007).

²⁴ *How Much Employer Fraud Exists*, pp. 1-3.

"INDEPENDENT CONTRACTOR" The term shall mean an individual who meets all of the following conditions:

*The individual has the right to and can demonstrate by credible evidence the right to direction and control over the performance of services.

*Maintains a separate business location that is separate from the location of the person for whom services are being performed, with the individual's own office, equipment, materials, and other facilities; provided that an office may be maintained in the individual's residence and is licensed to perform the specific kind and quality of work required by the agreement specified below by all state and local licensing authorities and can demonstrate the same by credible evidence.

*Holds, or has applied for, a federal employer identification number or AND has filed and provides verified copies of business or self-employment income tax returns with the federal Internal Revenue Service based on that work or service in the previous year if the independent contractor claims to have been in operation at any time in the past . In the event an application for a Federal Employer ID Number is Claimed, a verified copy of the official issuance of that number shall be provided within ninety (90) days of the claimed date of application or this requirement shall be conclusively presumed to not have been met.

*Operates under contracts which are in writing and are submitted by the Independent Contractor within 48 hours upon request by any agency of the Commonwealth or any of its political subdivisions or by any Labor Organization or Federation of Labor Organizations representing employees in the Commonwealth which contracts are to perform specific services for specific amounts of money and which contracts articulate, plainly, the precise terms of payment for work performed, the scope of work to be performed, and a specific prohibition on the employment by the independent contractor of any other person or persons to perform any part of the work described in the said agreement.

*Incurs the main expenses related to the work and can demonstrate the same by credible evidence.

*Is responsible for the satisfactory completion of the work and is liable for a failure to complete the work and can demonstrate the same by credible evidence.

*Realizes a profit or loss under contracts to perform work and can demonstrate the same by credible evidence.

*the success or failure of the individual's business depends on the relationship of business receipts to expenditures and can demonstrate the same by credible evidence.

*the individual supplies the necessary tools, supplies, and materials and can demonstrate the same by credible evidence.

*Makes services available to general public through business advertising, solicitation, or other marketing efforts reasonably calculated to obtain new contracts to provide similar services and can demonstrate the same by credible evidence.

*Has the ability to hire employees without the approval of the person whom services are being rendered to and can demonstrate the same by credible evidence.

*Has continuing or recurring business liabilities or obligations and can demonstrate the same by credible evidence.

* Is a United States citizen or is authorized under Federal law to work in the United States, as defined under Section 274A of the Immigration and Nationality Act (66 Stat. 163, 8 U.S.C. § 1324a) and can demonstrate the same by credible evidence.

* When an individual registered or claiming to be an independent contractor under this definition is determined to not be, or have been, an independent contractor as that term is defined herein, then and in that event, any person who solicited such an individual's representation as being an independent contractor shall be presumed to have committed fraud pursuant to the Laws of this Commonwealth.