

The Underground Construction Economy in Washington State: A Review of the Literature and Preliminary Findings

Presented to the Joint Task Force on the Underground Construction Economy

September 26, 2007

Jim Mayfield

Washington State Institute for Public Policy

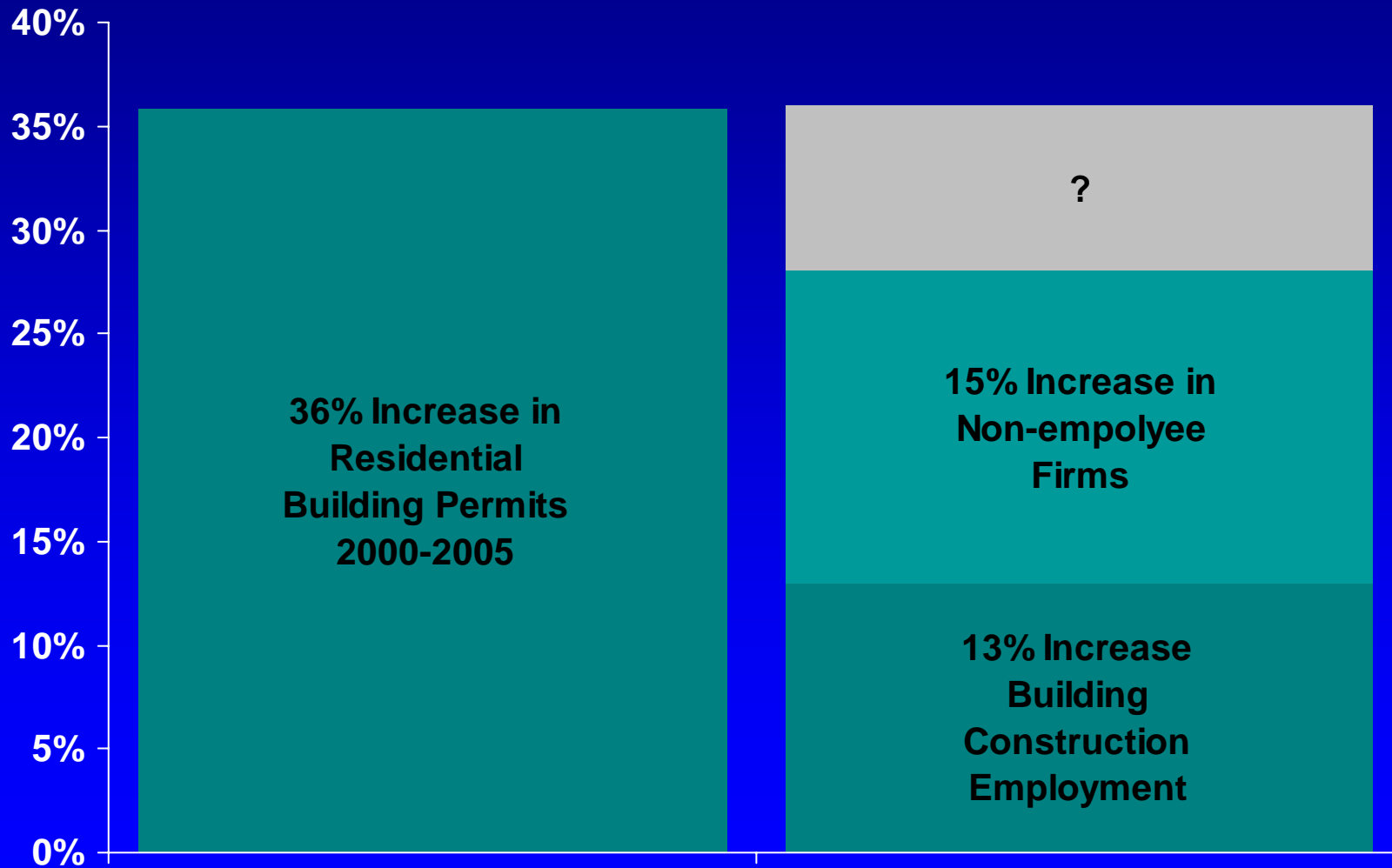
mayfield@wsipp.wa.gov

360-586-2783

Topics

- Review of the Underground Economy Literature
- Update to the Washington State Unregistered Business Study
- Worker Misclassification

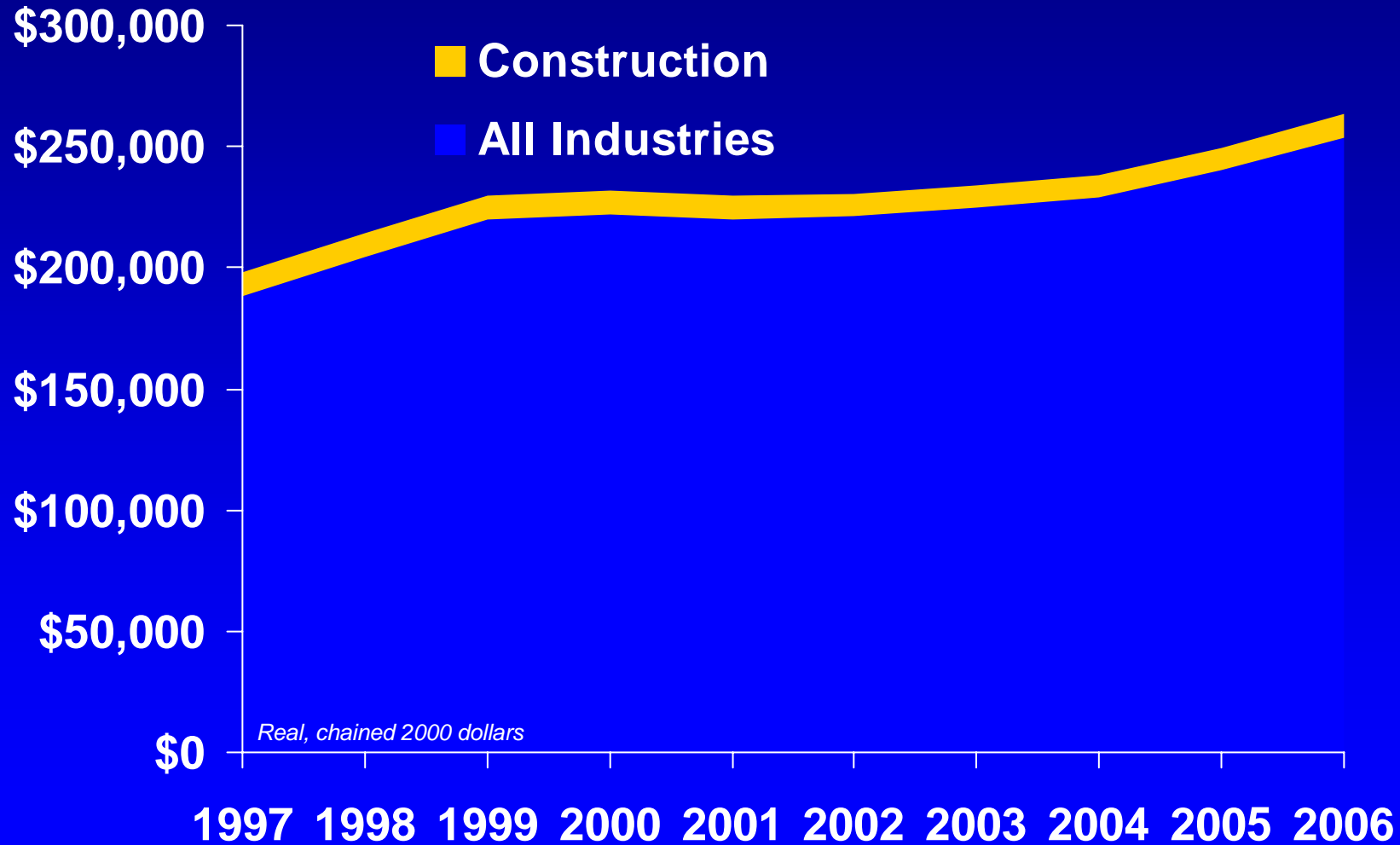
Washington State Construction Activity and Employment: Keeping Pace?



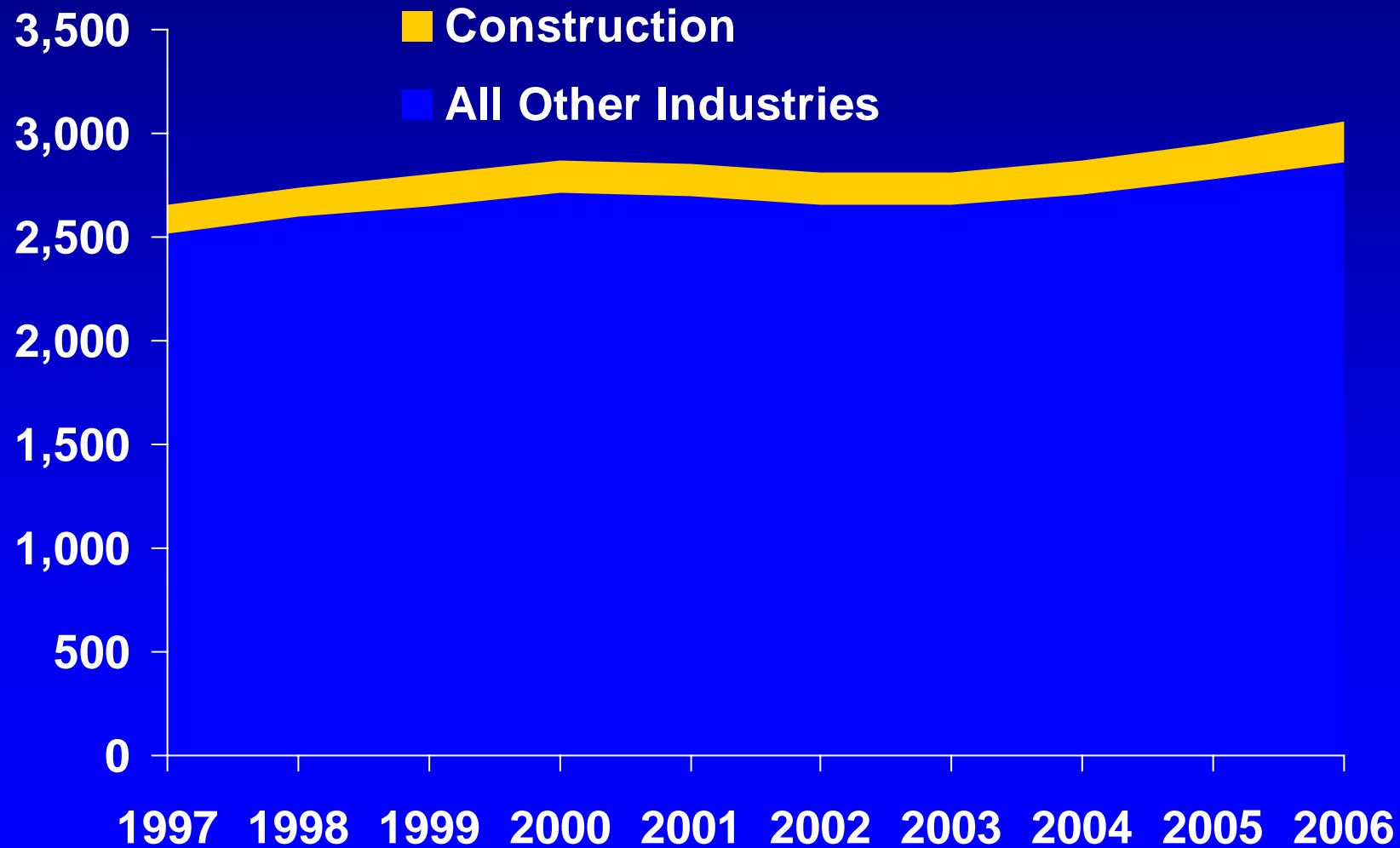
A Taxonomy of Economic Activities



Washington State's Construction Economy and the Gross State Product (Millions of Dollars)

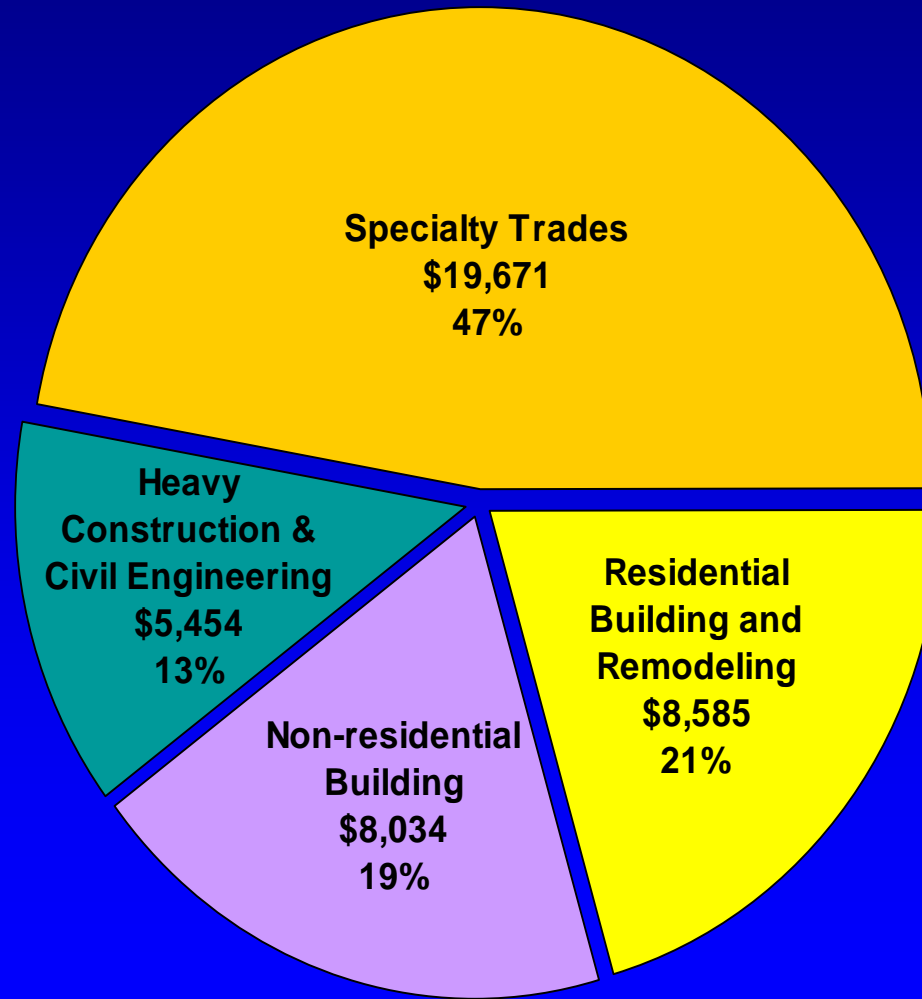


Washington State's Construction Economy and Statewide Employment (Thousands)

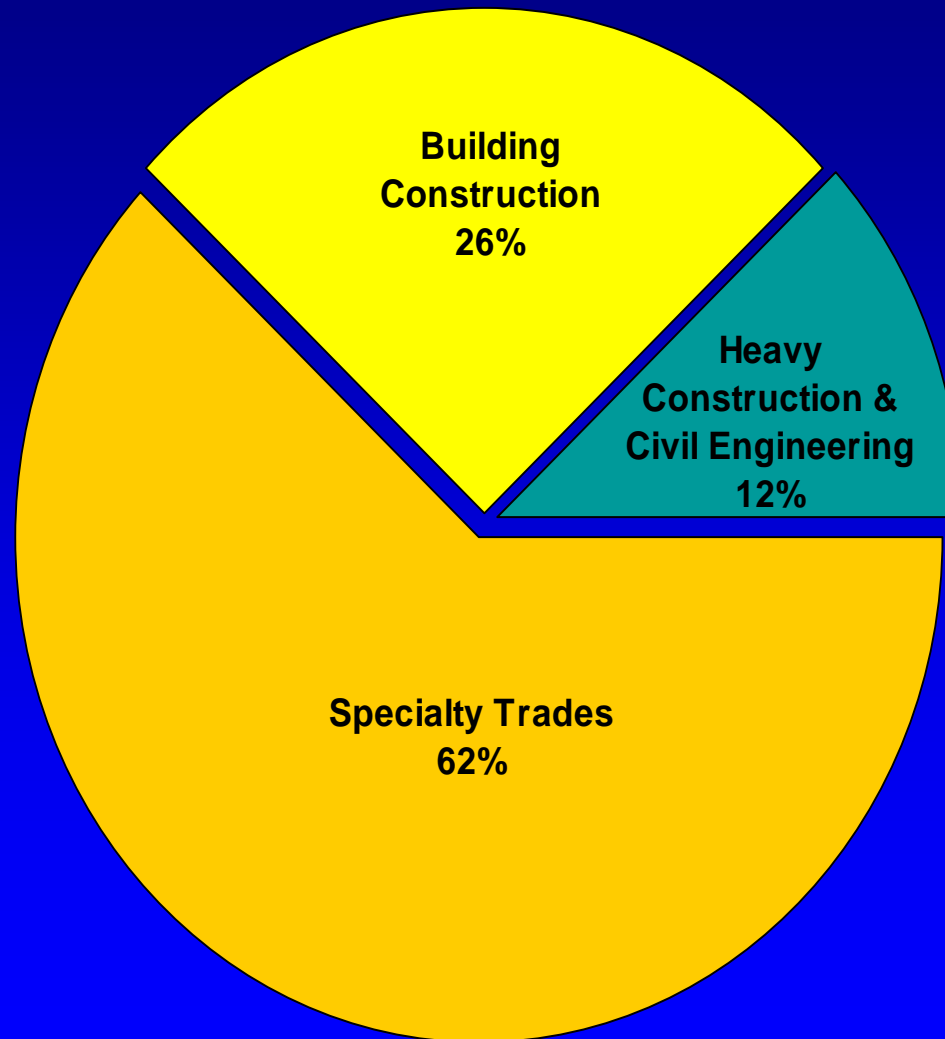


Employer Gross Income: Washington State Construction by Sub-sector

(Millions of Dollars in 2006)



Employees: Washington State Construction by Sub-sector



Underground Economy: Literature Review

- Searched library data bases, the Internet, reviews, and other sources for published reports describing the underground economy and employee misclassification.
- Collected 106 reports, journal articles, book chapters, government studies, research reports, and other information published since 1980.
- Reviewed the reports and recorded results of those that attempted to measure the underground economy using generally recognized approaches.

A listing of the reports reviewed for this study is available at www.wsipp.wa.gov.

The Underground Economy: Pros and Cons

Pros

- Adaptive and competitive
- A route to the formal labor market
- A “trial run” for startup firms
- Alternative to criminal activity
- Develops and sustains social networks
- Provides lower-priced goods and services

Cons

- Reduces tax revenue
- Reduces wages
- Distorts economic data
- Increases volatility
- Creates an unfair playing field
- Reduces tax equity
- Promotes unregulated activities
- Erodes health and safety standards
- Contagious

Measuring the Underground Economy

Direct Methods:

Based on surveys or audits.

Indirect Methods:

National Accounting Approach. Based on discrepancies between national accounting of income and expenditures.

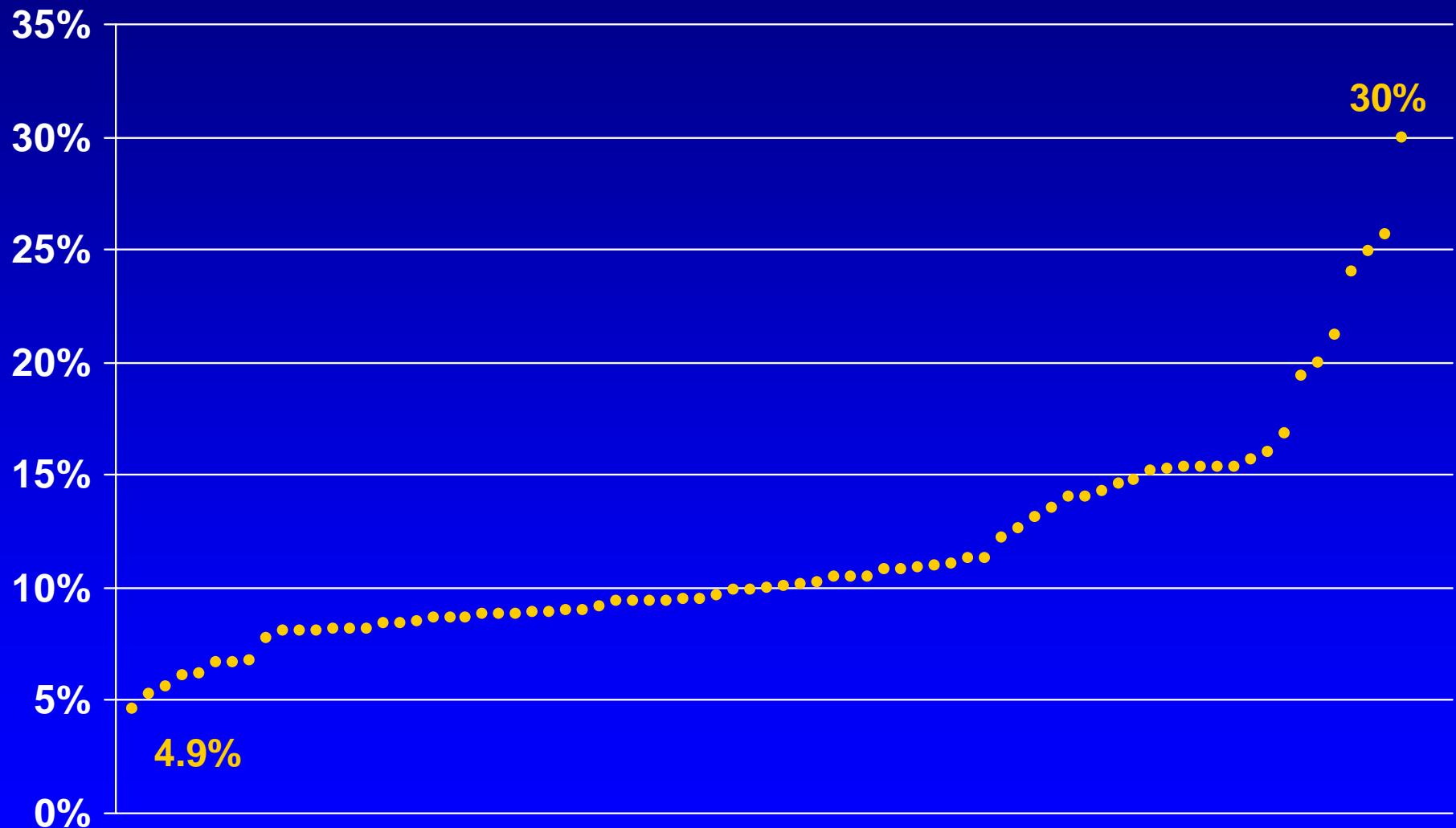
Monetary Approach. Based on the volume of monetary transactions in the overall economy or the demand for cash.

Labor Force Statistics Approach. Based on discrepancies between labor market and production trends.

Physical Input Approach. Based on the consumption of energy or other inputs to production.

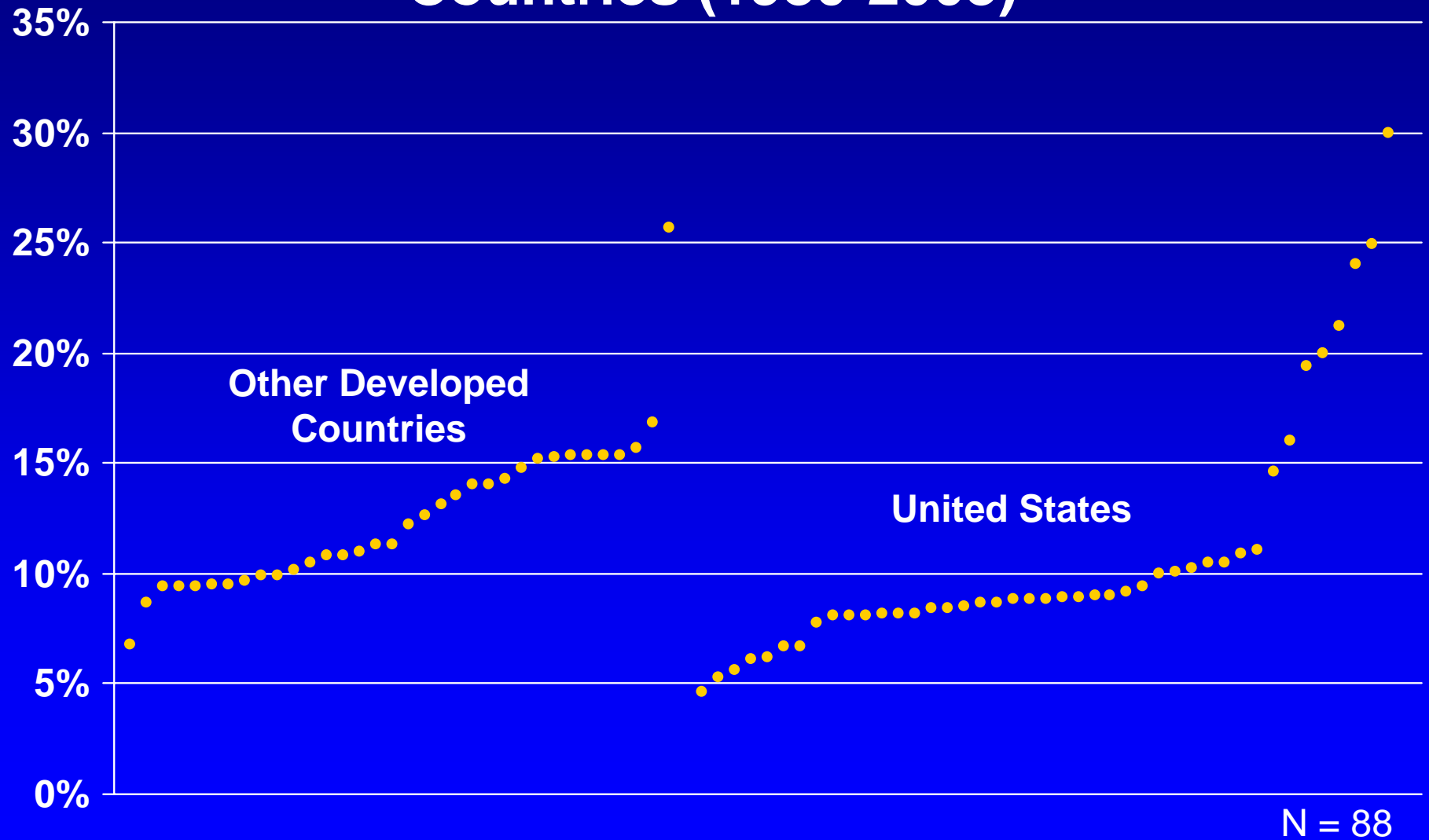
Behavioral Approach. Statistical models based on variables assumed to influence or reflect the underground economy (tax burden, regulation, etc.)

Measurements of the Underground Economy as a Percentage of Gross Domestic Product (GDP): Estimates for Developed Countries (1980-2003)



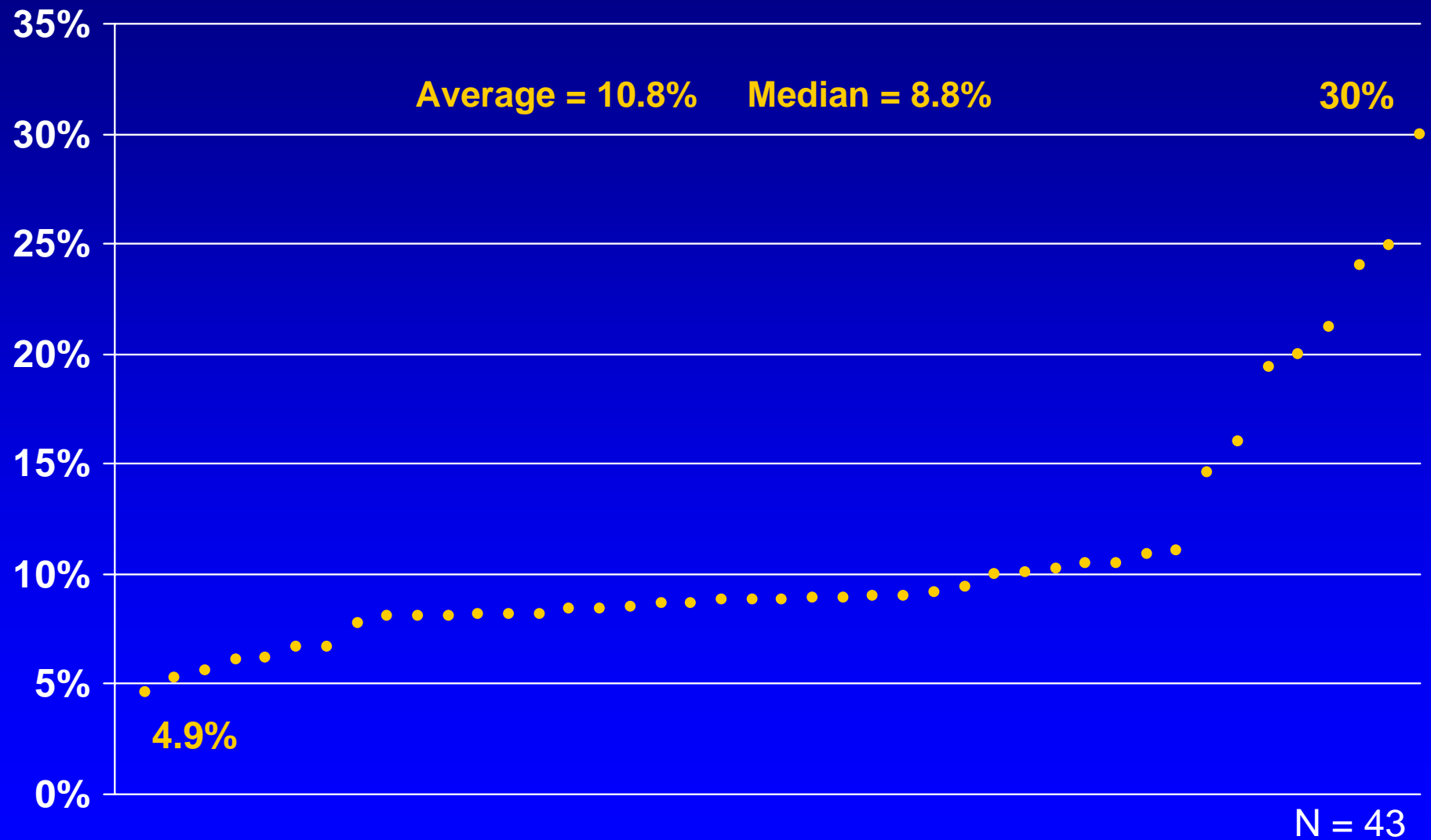
Number of estimates = 88

Measurements of the Underground Economy as a Percentage of GDP: Estimates for Developed Countries (1980-2003)

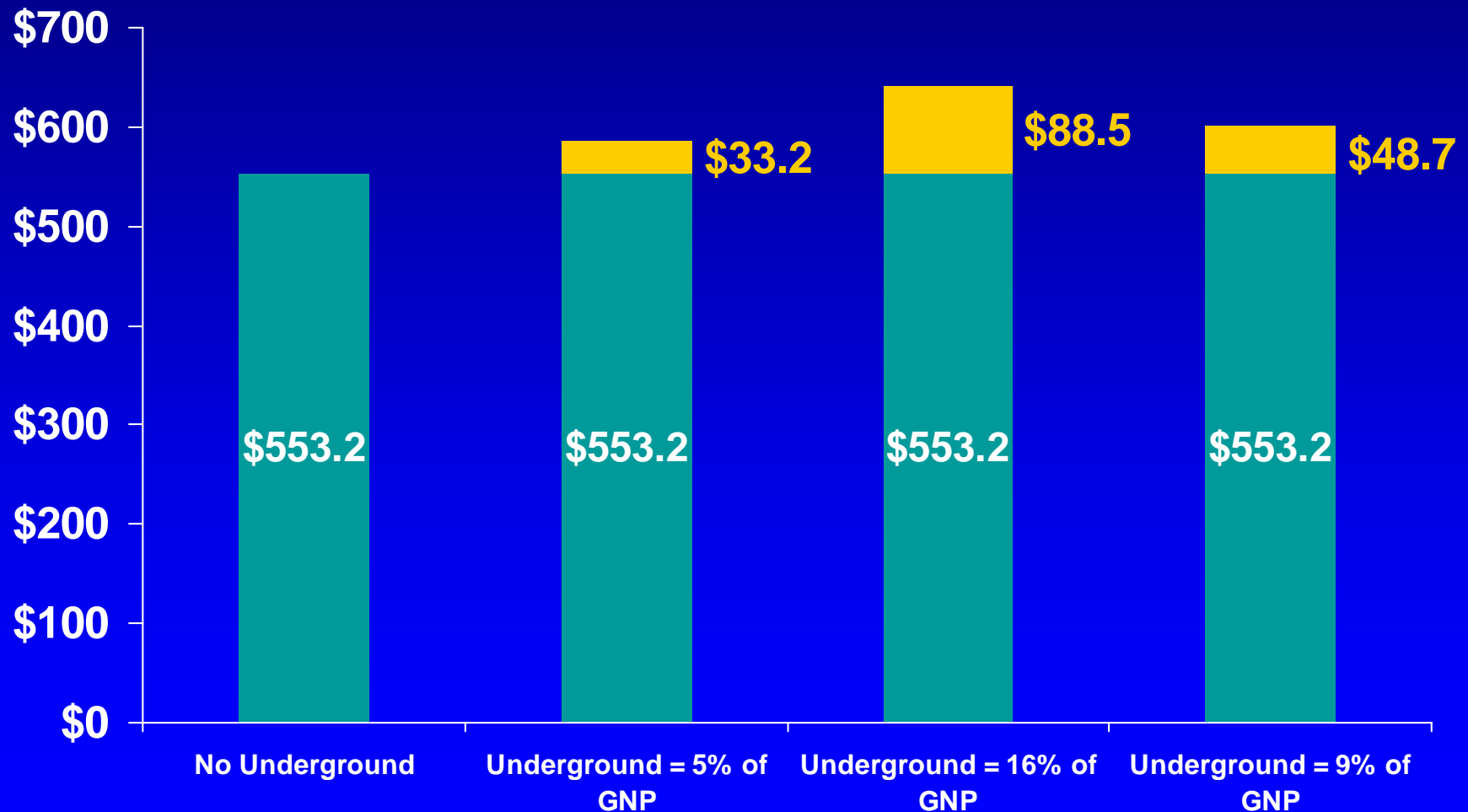


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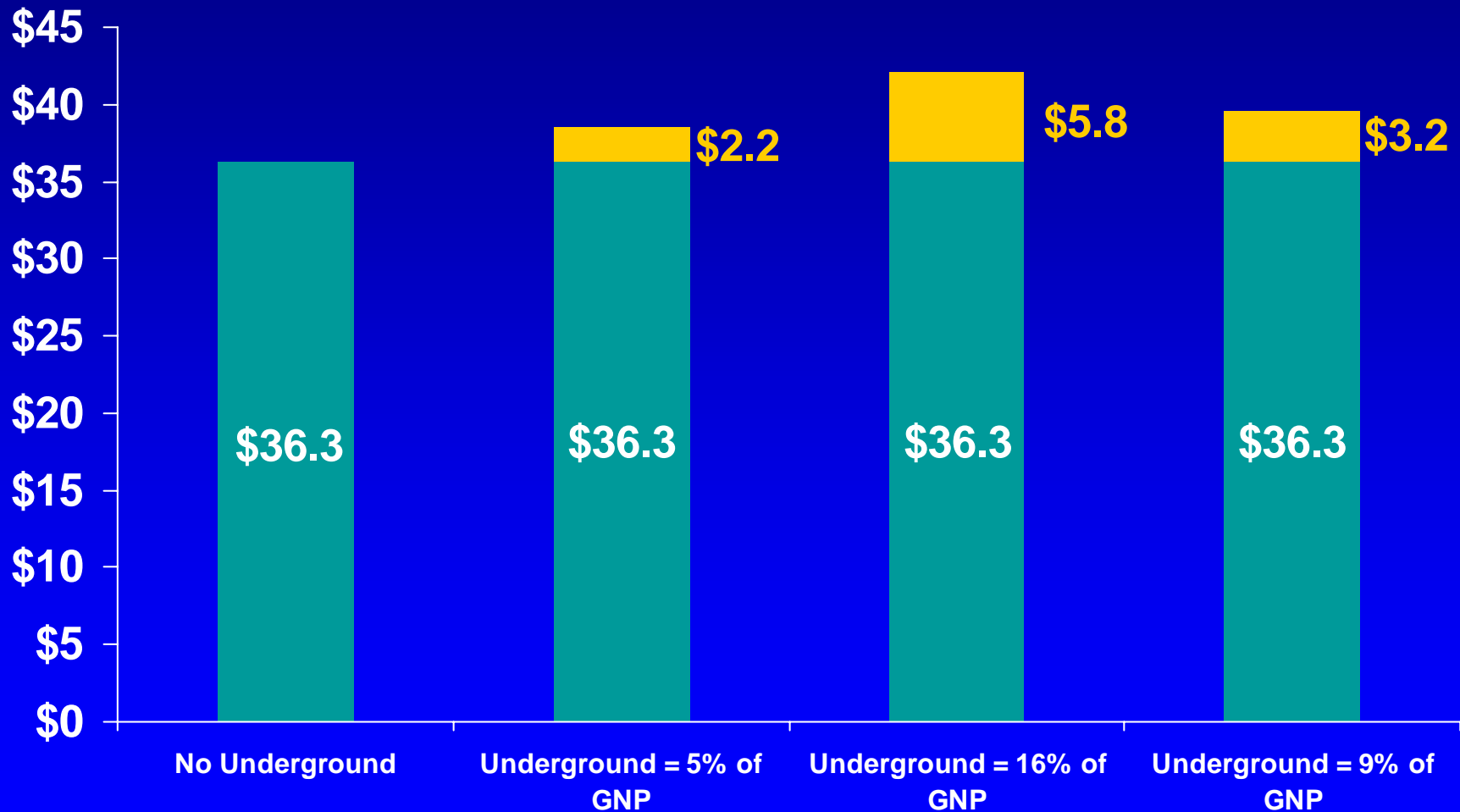
Measurements of the Underground Economy in the United States as a percent GDP (1980-2003)



Washington State's Underground Economy Based on Estimates of the US Underground Economy: 2006 Gross Business Income (A Preliminary Estimate in Billions of Dollars)



Washington State's Underground Construction Economy Based on Estimates of the US Underground: 2006 Gross Business Income (A Preliminary Estimate in Billions of Dollars)



Washington State Unregistered Business Study*

Estimated taxes owed by firms conducting business but not registered in Washington State. The study examines taxes owed to three state agencies:

- Department of Revenue (sales and business and occupation taxes)
- Department of Labor and Industries (worker compensation tax)
- Employment Security Department (unemployment insurance tax)

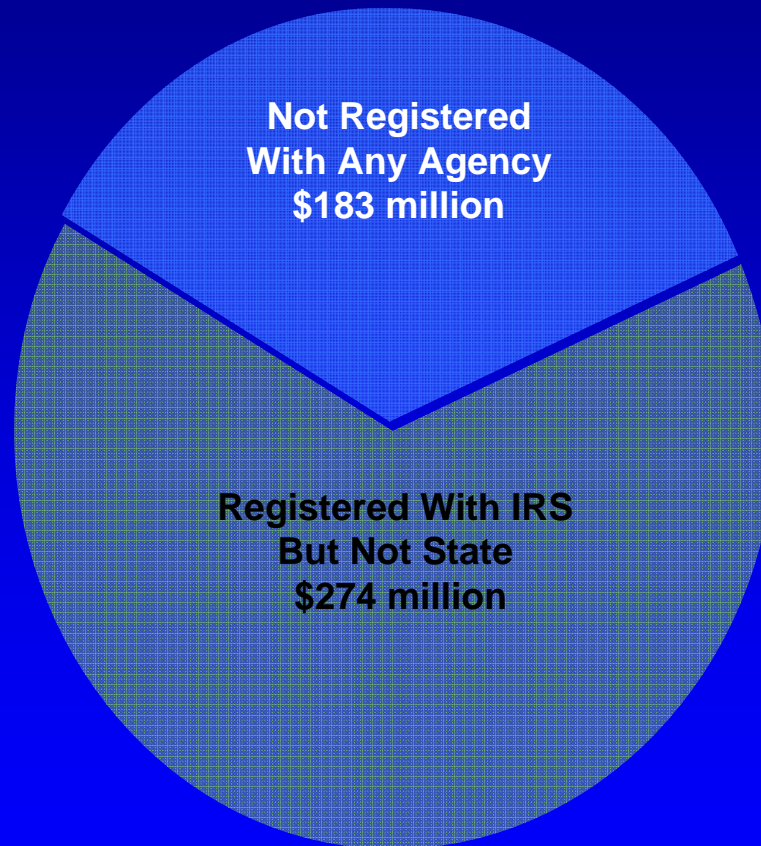
Washington State Unregistered Business Study

Estimated taxes owed by 99,000 firms that file with the IRS but are not registered in Washington State and taxes owed by the 65,000 firms not registered with any agency.

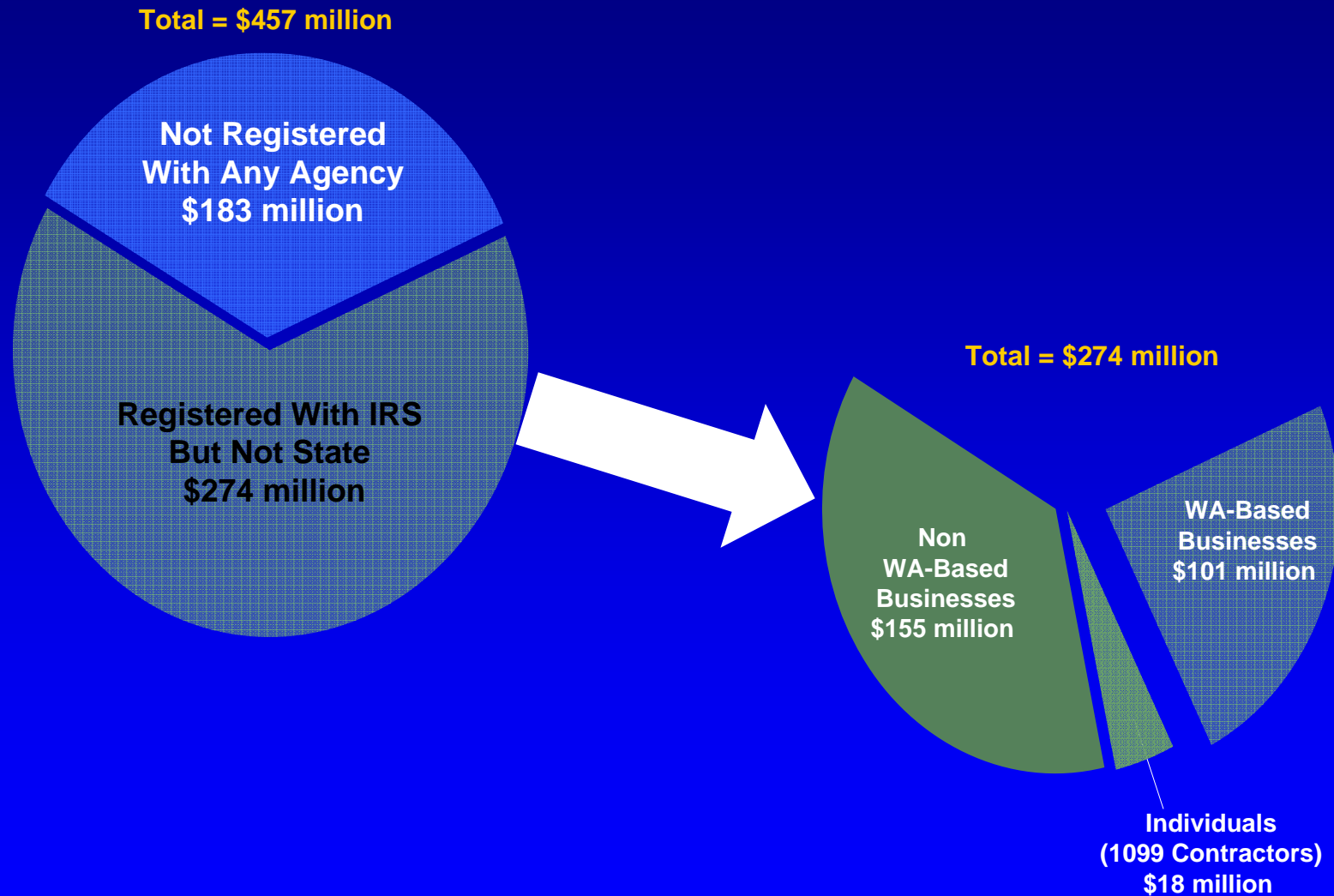
- Cross-matches with IRS and state agency data identified businesses filing with the IRS but not with Washington State.
- National estimates from the IRS Tax Gap Study were used to approximate the taxes owed by firms not registered with any agency.
- The study does not fully capture taxes owed due to underreporting the cash-in-hand economy.

Washington State Unregistered Business Study: Total Taxes Owed for the Study Year

Total = \$457 million

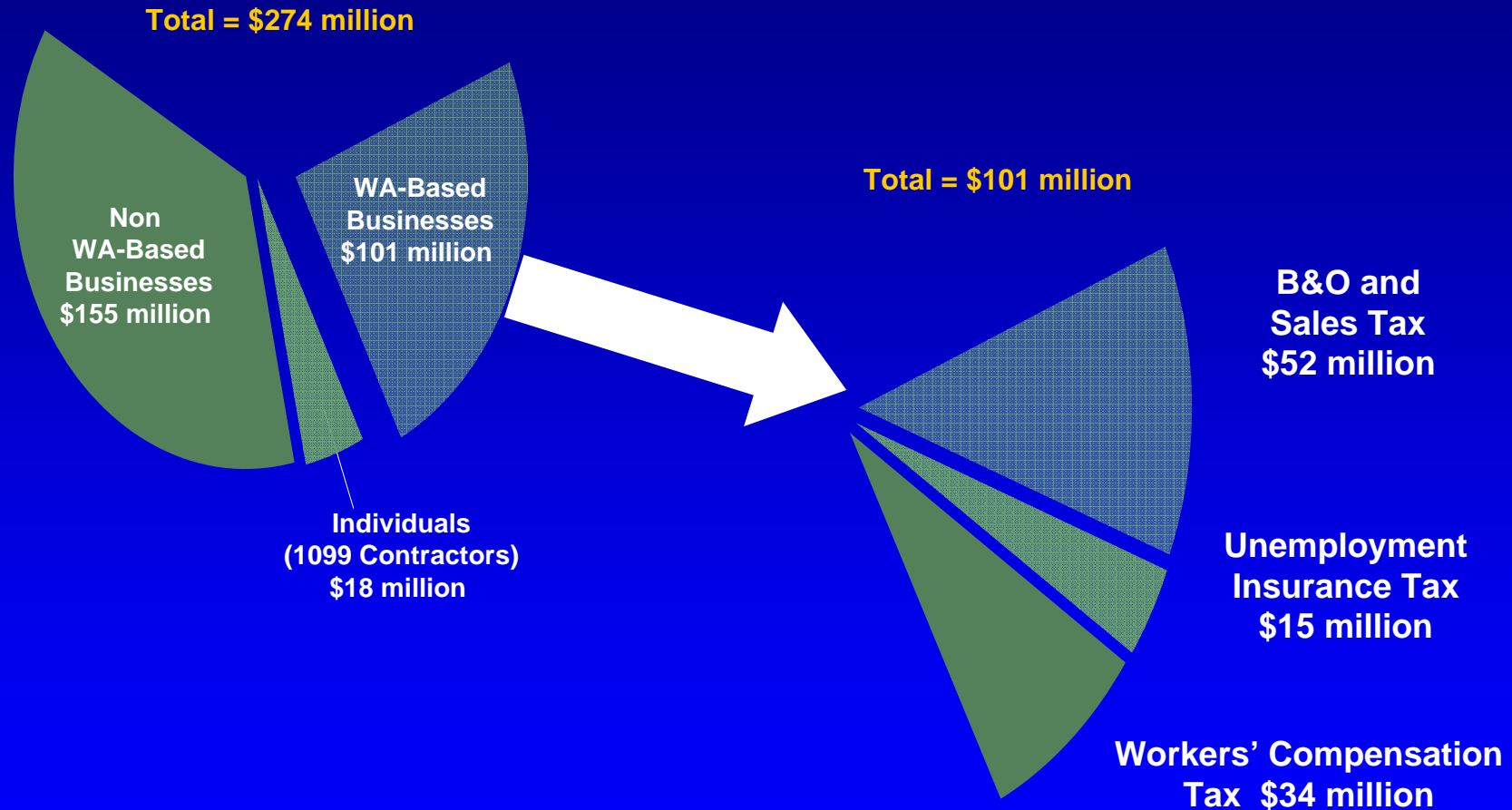


Washington State Unregistered Business Study: Taxes Owed by Businesses Filing With IRS



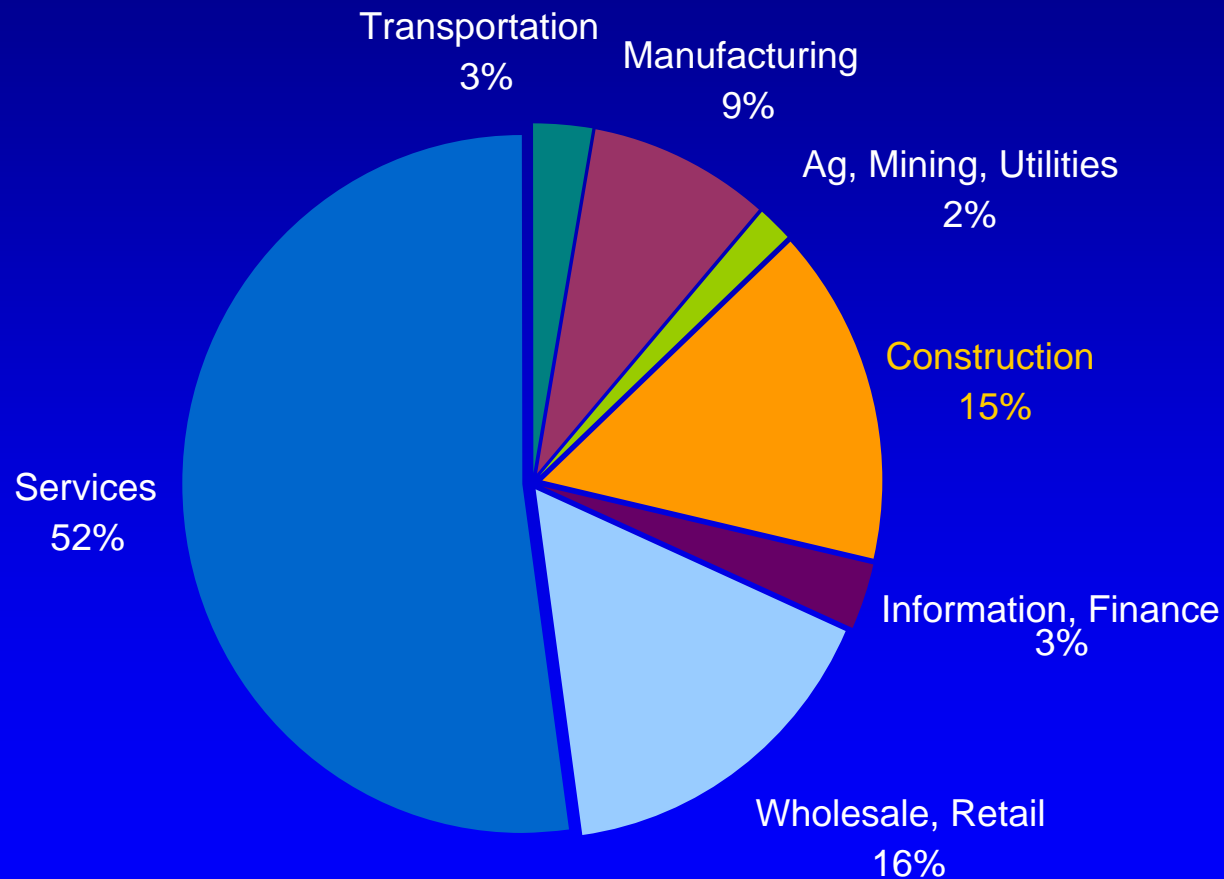
Source: State of Washington GMAP Presentation, September 12, 2007 (Department of Revenue, Employment Security Department, and the Department of Labor and Industries)

Unregistered Business Study: Taxes Owed by Washington-based Businesses Filing With IRS



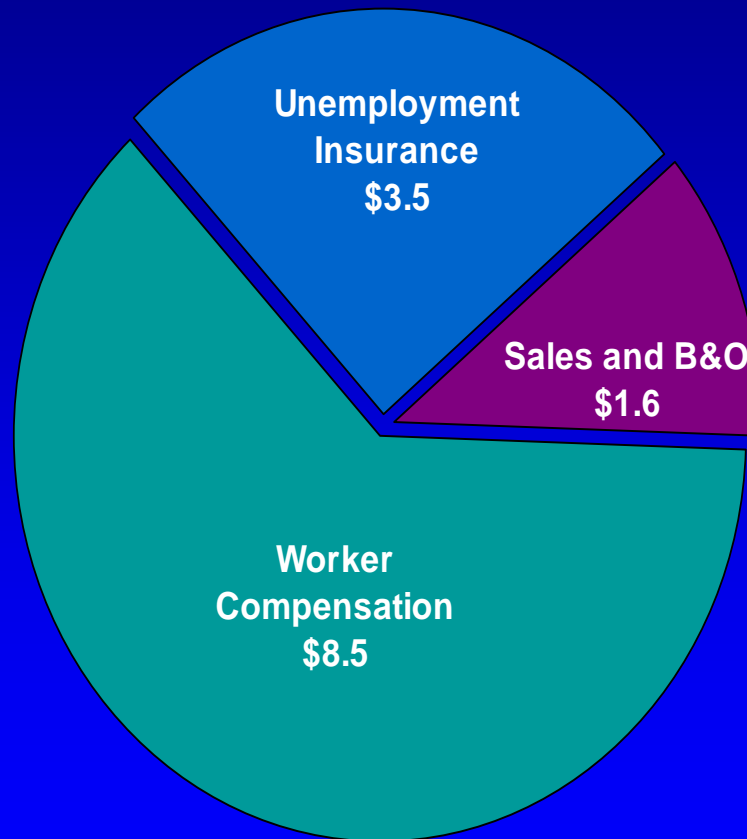
Unregistered Business Study: Taxes Owed by Washington-based Businesses Filing With IRS by Sector

Total = \$101 million



Unregistered Business Study: Taxes Owed by IRS-Filing Construction Firms Operating But Not Registered in Washington State (Millions of Dollars)

Total = \$13.6



Does not include taxes owed by 1099s or out-of-state firms with Washington nexus that did not register with any state agency.

Classification of Independent Contractors

- **Legitimate:** Independent contractors according to state legislation receiving IRS form 1099-Misc for receipt of *non-employee* compensation.
- **Misclassified:** Employees, according to state definitions, who should receive IRS form W-2 for *employee compensation* but receive a 1099-Misc instead.
- **Underground:** Employees and independent contractors who do not receive either a 1099-Misc for non-employee compensation or a W-2 from their employer.

Some Reasons to Hire Independent Contractors and/or Misclassify Employees

- Greater flexibility in hiring and firing
- Avoid worker compensation premiums and other taxes
- Test out new potential employees
- Avoid regulations based on firm size
- Avoid costs associated with labor laws and worker protection.

Worker Misclassification in Washington State

The 2000 Planmatics Study:

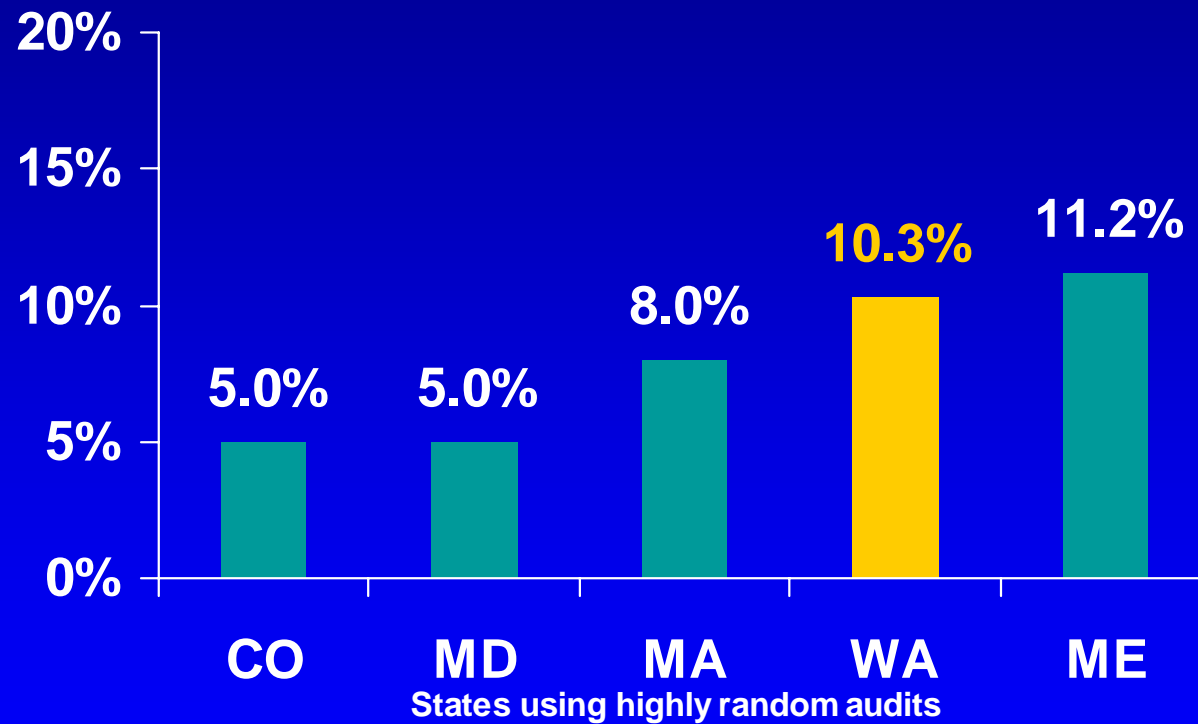
- Percentage of employers with misclassified workers 10.3%
- Percentage of workers misclassified 3.2%

Estimates Based on Employment Security Department Audits 2002-2005:

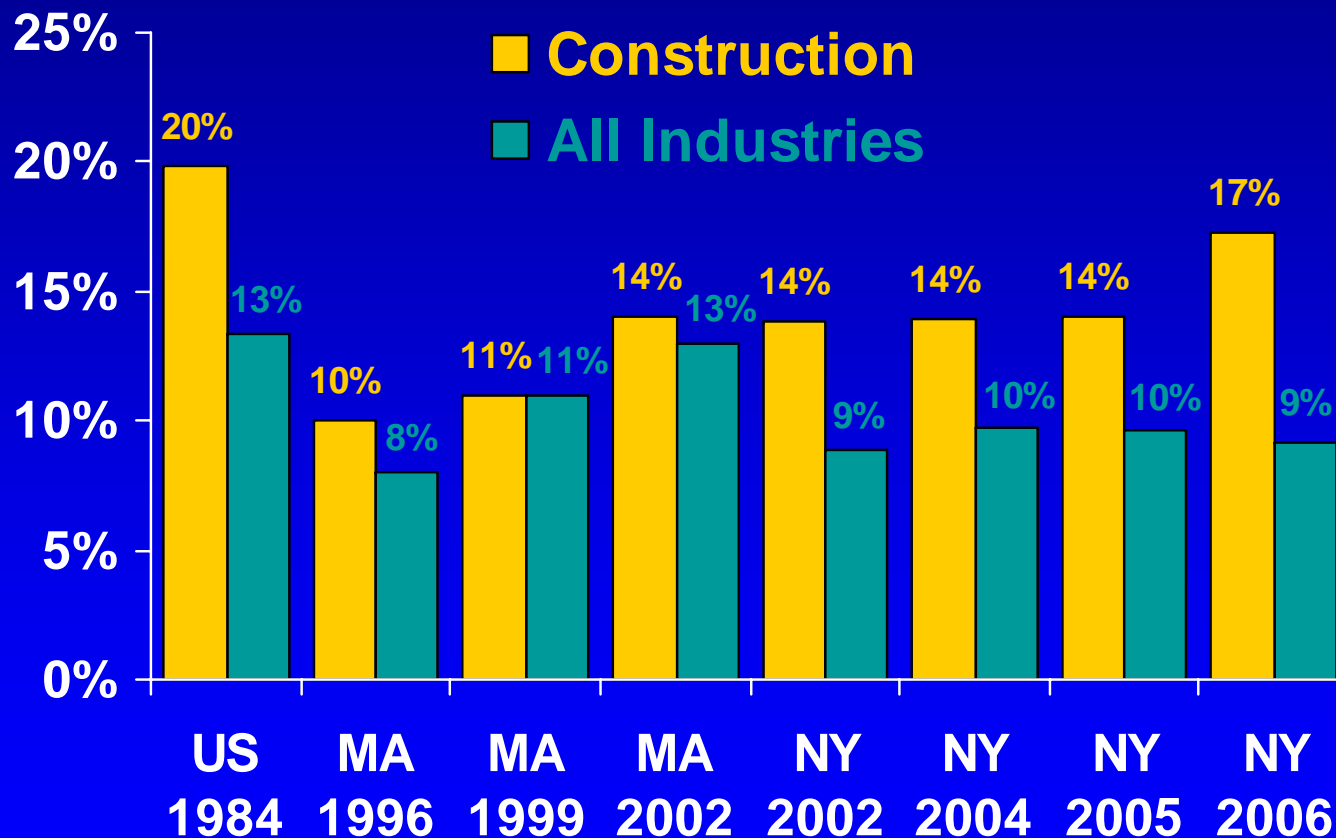
- Number of employees misclassified 118,000/year
- Gross wages underreported \$723.5 mil/year
- Unemployment Insurance tax owed \$12.3 mil/year

Percentage of Employers Misclassifying Employees: Selected States

(based on audits observations from 1998 to 2001)



Misclassification is More Common in the Construction Industry: Percentage of Employers With Misclassified Workers



Employers in the construction industry are 1.4 times more likely to misclassify workers.

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End of Presentation

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