

Size and Cost of Misclassification Fraud and Unreported Pay: Survey of National and State Studies

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Employers “misclassify” workers to avoid withholding income taxes, paying employment taxes, overtime and workers compensation premiums. Misclassification fraud comes in two forms. First is the intentional reporting of employees as independent contractors to state and federal authorities or workers’ compensation carriers. Second, there are employers who operate in the underground economy—they don’t bother to report all or a sizable portion of their workers. As will be seen, many studies of the problem do not quantify the degree or cost of the underground economy.

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.

Frequently, employers say misclassification is unintentional, because the rules defining employment are numerous and subjective. Except for small remodeling projects, that is not the case in the construction industry. It is difficult to imagine hundreds of independent contractors building large housing projects, commercial buildings, chemical refineries, bridges and power plants. The need for safety, productivity and protection from liability requires a degree of control that makes true independent contractor status difficult. In many places the industry has descended into the hands-down fraud of unreported-cash pay. It is the worst kept secret in construction, with many looking the other way as they pocket the profits. Misclassification in our industry is not a mistake—it is fraud as a business plan.

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

¹ *Tax Administration: Issues in Classifying Workers as Employees or Independent Contractors*, Statement of Natwar Gandhi, GAO/T-GGD-196-130, p. 13 (June 20, 1996).

² *Ibid*, p 1.

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 A different estimate by the Government Accountability Office put the IRS' 1984 number in 2006 dollars for a tax loss of \$2.72 billion.⁵

*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.⁶

*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.⁷ Reforms were enacted in 2003 to reduce costs and toughen enforcement.

***Massachusetts study 2004:**⁸

	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.	91 million	7 million
Total	\$278 million	\$17.8 million

This study does not include the degree of unreported pay in the underground economy.⁹

***2005 Maine study:**¹⁰

	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>

³ *Ibid.* pp. 4-5.

⁴ *Ibid.*

⁵ *Employment Arrangements: Improved Outreach could Help Ensure Proper Worker Classification*, GAO-06-565, p. 2 (July 2006).

⁶ *Projection of the Loss in Federal Tax Revenues Due to Misclassification of Workers*, by Coopers & Lybrand, p. 3 (June 1994).

⁷ *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).

⁸ *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).

⁹ Massachusetts Study, p. 1.

¹⁰ *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)

Total \$21.4 million

This study does not include the degree of unreported pay in the underground economy.¹¹

***2007 New York state study:**¹²

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

***Illinois 2006:**¹³

	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>
Total	\$400 million	\$54.6 million

This study does not include the degree of unreported pay in the underground economy.¹⁴

***Minnesota 2007 study:**¹⁵

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

Within construction, the study found that 31% of drywall employers misclassify their employees as independent contractors.¹⁶

This study does not include the degree of unreported pay in the underground economy.¹⁷

***Vermont 2007 study**

The Vermont Department of Labor, assisted by the Department of Banking, Insurance, Securities & Health Administration studied (1) the feasibility of having an on-line proof of coverage database through the National Council of Compensation Insurance (2) the extent and nature of class code and independent contractor misclassification and (3) the

¹¹ Maine Study, p. 1.

¹² *The Cost of Worker Misclassification in New York State*, Cornell Univ., ILR School, by Donahue, p. 2 (February 2007) (New York Study).

¹³ *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.

¹⁴ Illinois Study, p. 2.

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

¹⁶ *Ibid.*, p. 20.

¹⁷ Minnesota Study, p. 15.

effectiveness of current Vermont law to counter misclassification.¹⁸ Most of the answers came from a survey of the top 9 workers' compensation insurers in the state.¹⁹ They concluded that it is feasible to have an on-line proof-of-coverage open to the public.²⁰ Also, they found that insurance companies don't believe that class-code misclassification is a serious problem.²¹ They do believe that independent contractor misclassification is a problem and that it is a particular problem in the construction industry.²² The insurers say that misclassification of class codes and especially employees as independent contractors raises premium costs.²³ Regarding current statutes, the Department of Labor recommends a uniform definition of independent contractor for its unemployment and workers compensation codes.²⁴

***Washington 2007 study:**²⁵

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 workers comp.	14.8	14.8	3.4
	34.5	34.5	8.7
Total	\$274.3	\$101.3	\$13.1

The study cites 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.

***Pennsylvania 2008 study**

9 percent, 580,000, workers are misclassified as independent subcontractors annually, costing the unemployment compensation trust fund over \$200 million a year in lost

¹⁸ Vermont Department of Labor Study Required by Act 57 (S>196) 2007 Legislative Session: *The Misclassification of Workers in Vermont's Workers' Compensation System*, p. 3 (December 2007).

¹⁹ *Ibid.* p. 21.

²⁰ *Ibid.* at p. 3.

²¹ *Ibid.* at pp. 3 and 15.

²² *Ibid.* at pp. 4 and 15-16

²³ *Ibid.* at p. 15.

²⁴ *Ibid.* at pp. 4-5 and 9-10

²⁵ *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).

revenue.²⁶ The cost to the worker's compensation system is \$81 million in lost premiums.²⁷

This study does not include the degree of unreported pay in the underground economy.²⁸

***Michigan 2008 study**

A review of state unemployment tax audits found significant losses to the trust fund.²⁹ The review found \$23.3 million in misclassified wages from 2003 to 2007.³⁰

*The **nationwide rate of misclassification** in all industries has not been static; it grew by 42 percent from 2001 to 2002.³¹

***Most studies do not include the extent of unreported pay** in the underground economy.³² 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."³³

*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 construction activity data to construction employment from 2000 to 2005.³⁴ Conservatively, New York City had 82,000 residential construction workers in 2005. 30,000 of those construction workers were employed illegally.³⁵ (13,000 may have been misclassified and the other 17,000 were completely off the books.³⁶) 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.³⁷

²⁶ Testimony of Patrick T. Beaty, Deputy Secretary for Unemployment Compensation Programs, Pennsylvania Department of Labor and Industry, before the House of Representatives Commonwealth of Pennsylvania, Labor Relations Committee on HB 2400, The Employee Misclassification Prevention Act, p. 3 (April 23, 2008) (hereinafter *Beaty*).

²⁷ Testimony of Timothy L. Wisecarver and Bruce Decker, Pennsylvania Compensation Rating Bureau, Summary of Testimony before the House of Representatives Commonwealth of Pennsylvania, Labor Relations Committee on HB 2400, The Employee Misclassification Prevention Act, p. 3 (April 23, 2008).

²⁸ *Beaty*, p. 3.

²⁹ *Interagency Task Force on Employee Misclassification: Report to Governor Jennifer M. Granholm*, p. 2 (July 1, 2008).

³⁰ *Ibid.*, pp. 2, 11.

³¹ Illinois Study, fn. 1, p. 2.

³² Massachusetts Study, p. 1, Maine Study, p. 1, Illinois Study, p. 2, Minnesota Study, p. 15.

³³ *The Underground Labor Force is Rising to the Surface*, Bear Stearns Asset Management, by Justich and Ng, p. 3 (January 3, 2005).

³⁴ *The Underground Economy in the New York City Affordable Housing Construction Industry*, Fiscal Policy Institute (New York City Housing), p. 1, 9. (April 2007).

³⁵ New York City Housing, pp. 1, 10-12.

³⁶ *Ibid.*

³⁷ *Ibid.*, pp. 1, 8-9.

*The **Fiscal Policy Institute also released a study in December 2007 on illegal employment practices in the entire New York City construction market.**³⁸ Like the study of the residential market, this study captures workers who are improperly misclassified as well as those paid unreported compensation.³⁹ The study made the following findings of losses in 2005:⁴⁰

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 **Florida Grand Jury report in 2008** concluded its discussion on money laundering by check cashing businesses engaged in workers compensation premium fraud schemes by writing:

In the short term, it may be prudent for the legislature to inquire of the [construction] industry, when considering this Grand Jury's recommendations, why they have apparently decided over the last few years to move increasingly to an all cash payroll.⁴¹

In **2008 research was done in Kentucky of people with work-place injuries seeking emergency treatment.**⁴² Twenty percent did not have workers compensation coverage, and 92 percent of them also did not have any health insurance.⁴³ Within that number of the uninsured, 54.2 percent were in the construction industry.⁴⁴ The authors conclude:

Hiring practices that allow employers to avoid paying for both WC and health insurance have the effect of shifting the cost of injured workers' care to taxpayer-funded programs such as Medicaid's disproportionate share [sic] hospital funding.⁴⁵

*A **2007 study done for the California Commission on Health and Safety and Workers' Compensation** disclosed that employers in all industries failed to report up to

³⁸ *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).

³⁹ New York City Construction, p. 1.

⁴⁰ *Ibid.*, pp. 1, 20.

⁴¹ *Eighteenth Statewide Grand Jury Case No. SC 07-1128, Second Interim Report of the Statewide Grand Jury: Check Cashers: A Call for Enforcement*, p. 14 (West Palm Beach, Florida, March 2008).

⁴² *Disparities in Work-Related Injuries Associated With Worker Compensation Coverage Status*, Valerie, J. Nicholson, et. al. *American Journal of Industrial Medicine* (Author Proof document) (May 2008).

⁴³ *Ibid.*, pp. 2-3.

⁴⁴ *Ibid.* p. 3.

⁴⁵ *Ibid.* p. 4.

23 percent of their payroll to workers' compensation carriers, resulting in \$100 billion in underreporting.⁴⁶ 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.⁴⁷

⁴⁶ *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).

⁴⁷ *How Much Employer Fraud Exists*, pp. 1-3.