F I S C A L   P O L I C Y   I N S T I T U T E
11 Park Place, Suite 701, New York, NY 10007
212-721-5624   www.fiscalpolicy.org

Testimony of
James A. Parrott
Deputy Director and Chief Economist
Fiscal Policy Institute

Before the

New York State Senate Standing Committee on Labor

Public Hearing on Employee Misclassification in New York's Underground Economy

January 13, 2010

Mr. Chairman, my name is James Parrott, Deputy Director and Chief Economist of the Fiscal Policy Institute. Thank you for the opportunity to testify today.

FPI has done extensive research and analysis on the changing New York economy and in particular, how the labor market has changed and the effects of those changes on working people. In addition to our work on the state budget, and tax and economic development policies, we regularly publish a comprehensive economic and labor market update in our ***State of Working New York*** series. We have done eight of these reports since 1999. We also prepare briefing reports and studies on specific sectors of the New York City and State economies. These sector and labor market studies have covered the spectrum from social services to hospitality and from movie production to the finance sector. We have also prepared several reports on the construction sector in New York City.

As we have documented in our ***State of Working New York*** reports, in recent years workers' wages have not grown along with their productivity.[1] Wage and income growth was highly concentrated at the top in the expansion from 2003 to 2007, giving New York the dubious distinction of having the greatest degree of income polarization among all states between the rich and the poor and between the rich and the middle class.

[1] Fiscal Policy Institute, *The State of Working New York 2009: Unemployment and Economic Insecurity in the Great Recession*, September, 2009, pp. 40-41.

Misclassification exploits workers, represents unfair competition, and harms taxpayers

But the problem goes beyond that. In a deeply disturbing development, many employers act to unilaterally change the status of workers in a way that pushes New York workers back into the 19th century. By misclassifying workers as independent contractors or paying workers off the books, employers strip workers of the protections of the entire package of social insurance programs that helped lay the basis for a broad middle class in this country. Such workers lose coverage under workers' compensation, unemployment insurance, temporary disability insurance, and Social Security. Workers lose any paid time off, and lose access to any fringe benefits such as health insurance or pension. They also lose many employment rights, including the right to organize and form a union.

Important progress in enforcement

This scourge of employee misclassification afflicts an estimated 10 percent of New York's workers. The problem is particularly severe in the construction industry. In establishing an inter-agency Task Force on Employee Misclassification, former Governor Eliot Spitzer characterized the problem as "rampant" and an "epidemic". Governor Spitzer said the Task Force 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."[2]

The second annual Task Force report was released last July, covering the first sixteen months of enforcement activities. Through the end of 2008, Task Force investigations identified "12,300 instances of employee misclassification and discovered over $157 million in unreported wages." Investigators assessed over $4.8 million in unemployment insurance taxes alone, over $1 million in unemployment insurance fraud penalties, over $12 million in unpaid wages, and over $1.1 million in workers compensation fines and penalties.[3]

The Task Force has conducted joint enforcement sweeps, many of which have been in the construction industry, both downstate and upstate. The Task Force has also coordinated cross agency investigations, referrals of audit results, and fostered greater data sharing methods to aid fraud detection efforts. The state Labor Department's Unemployment Insurance Division also detects worker misclassification through routine employer tax audits and investigations. In 2008, the UI Division identified over 85,000 misclassified workers and unpaid taxes of $27.4 million. The practice of misclassifying employees as independent contractors is not limited to construction. State UI audits have determined that a high incidence of worker misclassification also occurs in healthcare, educational services, retail, accommodation and food services, arts and entertainment, auto repair and waste management.[4]

---

[2] New York State Office of the Governor, "Governor Spitzer Signs Executive Order to Prevent Employee Misclassification," Press Release, September 7, 2007.
[3] *Annual Report of the Joint Enforcement Task Force on Employee Misclassification to David A. Paterson, Governor, State of New York*" submitted by NYS Department of Labor, M. Patricia Smith, Commissioner and Task Force Chair, February 1, 2009, p. 3.
[4] Ibid, p. 24.

Vigorous enforcement against misclassification is essential and New York State has made important progress in this area over the past two-and-a-half years. However, the scale of this problem in New York State calls for an even greater commitment of enforcement resources. And, given the fiscal impact to state taxpayers, the state treasury and social insurance funds (not to mention the value in leveling the playing field among businesses,) a case can be made that enforcement more than pays for itself.

Misclassification is a substantial problem and plagues many industries

A team of researchers from the Cornell Industrial and Labor Relations School examined unemployment insurance audits in 2006 to gauge the extent of employee misclassification in New York. Their study estimated that about 705,000 New York workers were misclassified as independent contractors. For the 2002-to-2005 period of the Cornell study, misclassification affected 10.3 percent of all New York private sector workers. In the construction industry, which was a special focus of the Cornell report, misclassification affected over 45,000 workers, 14.8 percent of all workers.[5]

Given that it is an illegal activity, the growth in employee misclassification is difficult to pinpoint. Still, a significant growth in employee misclassification in New York State is suggested by the phenomenal growth in data series such as the U.S. Census Bureau's annual data on "nonemployer establishments."[6] Many people counted as nonemployer establishments may truly be consultants or independent contractors. However, the fact that the nonemployer series increased by 240,500 (20 percent) from 2000 to 2005 when private payroll employment increased by only 33,500 (0.5 percent) in New York State, strongly suggests an explosion in the misclassification of workers. Several industries showed large increases in "nonemployers," including construction, health care, social assistance, educational services, real estate, information, accommodation and food services, arts and entertainment, and administrative services.[7]

Misclassification and the underground economy in New York City construction

A study prepared for the U.S. Labor Department stated that employer avoidance of responsibility for workers' compensation premiums was the number one reason employers sought to misclassify workers as independent contractors.[8] In the 2007 FPI report on the widespread non-compliance with workers' compensation in New York, we pointed out the prominent role that misclassification played in workers' compensation fraud.[9]

---

[5] Linda H. Donahue, James Ryan Lamare, Fred B. Kotler, J.D., *The Cost of Worker Misclassification in New York State*, Cornell University, ILR School, February 2007.
[6] The Census Bureau counts workers paid on 1099 forms rather than W-2s as "non-employer establishments."
[7] Fiscal Policy Institute, *The State of Working New York 2007*, September 2007, pp. 21-22.
[8] Planmatics, Inc., *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs*, Prepared for the U.S. Department of Labor, Employment and Training Administration, February 2000, p. iii.
[9] Fiscal Policy Institute, *New York State Workers' Compensation: How Big Is the Coverage Shortfall?* January 25, 2007.

The State Labor Department's official employment data for the construction industry vastly understates the number of workers. In a report on the New York City construction industry, we estimated there were at least 200,000 workers in the New York City construction industry in 2005, nearly twice the 110,000 number reported by the state's unemployment insurance system. Some of the difference can be accounted for by self-employed trades workers, but we estimated that about 50,000 workers – one-quarter of all construction workers -- were misclassified as independent contractors or employed by construction contractors completely off the books.[10]

The high fiscal costs of employee misclassification

We looked at three categories of fiscal costs associated with illegally misclassifying workers as independent contractors or off the books: unpaid payroll taxes and social insurance premiums, health care costs shifted to other payers (including employers who provide their workers with health insurance), and lost personal income taxes.

- We estimated that underground economy employment practices generate enormous fiscal costs that get shifted to workers, law-abiding employers in construction and other industries, and to taxpayers generally. For 2005, we estimated that these fiscal costs were $489 million for the New York City construction industry overall, and were likely to reach at least $557 million in 2008.[11] Contractors in the underground economy skirt payment of legally required payroll taxes and workers compensation premiums and shift these and other costs onto taxpayers and their competitors who play by the rules. Three categories of costs were estimated for 2005:
    - $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 that 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 underground construction industry is concentrated in residential construction, but also exists in commercial construction, especially in the boroughs outside of Manhattan, and even among some infrastructure projects that are entirely government-funded. While two-thirds of the affordable housing sector is underground, it accounts for only about one-fifth of the entire underground construction sector.

The taxpayer costs quantified above do not include harder-to-quantify economic costs borne by workers and responsible contractors.

---

[10] Fiscal Policy Institute, *Building Up New York, Tearing Down Job Quality. Taxpayer Impact of Worsening Employment Practices in New York City's Construction Industry*, December 5, 2007.
[11] Fiscal Policy Institute, *Building up New York …*, p. 21.

- Construction safety reached crisis proportions last year when 29 construction workers were killed on the job in New York City. This necessitated a strong government enforcement response and Occupational Safety and Health Administration (OSHA) reports 22 construction fatalities in 2007. OSHA data indicate a strong correlation between construction fatalities and the characteristics of the underground economy: half of the deaths occurred among workers at very small construction companies, three-fourths of the workers involved worked for non-union companies, and failure to provide safety training was cited in over half of the cases.

- Despite the dangerous working conditions, workers in the underground economy are paid very low wages, are denied the protections of universal social insurance programs (workers' compensation, unemployment insurance, disability), do not have health coverage or retirement benefits, are not able to join a union, and rarely are they entitled to paid sick leave, holidays or vacations. Working in the underground construction economy is like working in the 19th century when it comes to labor rights, protections and employment standards.

- An estimated 43,000 New York City construction workers earn less than $11 an hour, not much above the federal poverty guideline for a family of four.

- Contractors operating in the underground economy also disadvantage law-abiding companies by shifting costs and exploiting workers. Among other things, law-abiding construction contractors pay several hundred dollars per worker to cover medical costs for the employees of underground businesses not providing health coverage.

As in the case of environmental pollution, markets on their own do not force businesses to "internalize" all the costs they generate. 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.

Enforcement against worker misclassification is an essential governmental responsibility that had broad and deep benefits to workers, businesses, taxpayers, and the viability of our social insurance systems.

Thank you for the opportunity to testify today.