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Testimony of
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Before the

New York State Assembly Standing Committee on Labor Public Hearing on Tax Evasion through Employee Misclassification

January 27, 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, tax and economic development policies, we regularly publish a comprehensive economic and labor market update in our ***The 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.

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[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

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, and protections against discrimination and violations of minimum wage and overtime laws.

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]

In her testimony before the State Senate Labor Committee on January 13, 2010, Jennifer Brad, the Executive Director of the Task Force reported on enforcement efforts from September 2007 through the end of 2009. Over this period, the Task Force identified 31,5000 misclassified workers, uncovered $390 million in unreported wages, and more than $11 million in unemployment insurance taxes due. Investigators found that employers owed more than $14 million in unpaid wages and overtime.[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, 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. State UI audits have determined that a high incidence of worker misclassification occurs in many industries besides construction, including healthcare, educational services, retail, accommodation and food services, arts and entertainment, auto repair and waste management.[4]

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[2] New York State Office of the Governor, "Governor Spitzer Signs Executive Order to Prevent Employee Misclassification," Press Release, September 7, 2007.

[3] Testimony of Jennifer S. Brand, Executive Director of the New York State Joint Enforcement Task Force on Employee Misclassification, New York State Senate Labor Committee, "Employee Misclassification in New York's Underground Economy," January 13, 2010.

[4] *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. 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]

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[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 construction 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 in the construction industry

We looked at <u>three categories of fiscal costs</u> associated with illegally misclassifying workers as independent contractors or off the books: unpaid payroll taxes and social insurance premiums, lost personal income taxes, and health care costs shifted to other payers (including employers who provide their workers with health insurance.) For 2005, we estimated that these fiscal costs were $489 million for the New York City construction industry overall.[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.

Underground economy labor practices are common in residential construction, but also exist in commercial construction, especially in the boroughs outside of Manhattan, and even among some infrastructure projects that are entirely government-funded. While an estimated 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.

- Construction safety reached crisis proportions in 2006 when 29 construction workers were killed on the job in New York City. 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

[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. This estimate of $489 million breaks down as follows: $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; $70 million in lost personal income taxes because there is no withholding for underground economy workers and/or they are paid off the books; and $148 million in health care costs shifted onto the workers themselves, taxpayers and other employers that provide employee health insurance.

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. Adding insult to injury, law-abiding construction contractors pay several hundred dollars per worker to cover medical costs for the employees of underground businesses not providing health coverage.

Estimates of the statewide fiscal cost of employee misclassification

While it is not possible to come up with a precise estimate of the statewide fiscal costs since misclassification is underground, a "ballpark" estimate is possible. Based on Cornell's estimate that there are about 700,000 misclassified New York workers, unpaid workers' compensation premiums total $700 million, and unpaid unemployment insurance premiums come to $215 million. Using very conservative assumptions for the wages of underground misclassified workers, and regarding the portion of workers not paying income taxes on the payments they receive for working as independent contractors, New York State and New York City lose at least $83 million a year in unreported and unpaid income taxes.[12] The amount of foregone income taxes might also come to two, three or four times that sum.

Conclusion and Recommendations

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. Legislative changes to clarify the meaning of employee status and to increase penalties for non-compliance would, hopefully, deter some employers and help the enforcement effort. Also, Federal legislation is needed that would significantly tighten the IRS provision pertaining to employee classification. In this budget season, we should be talking about adding state investigators to clamp down on the "epidemic" of employee misclassification that results in widespread tax evasion.

Thank you for the opportunity to testify today.

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[12] The Federal government would lose roughly $160 million in income taxes.