



Office of the Controller City of Philadelphia

Financial and Policy Analysis Unit

The Underground Economy in Philadelphia

Executive Summary

Philadelphia's construction sector has experienced a recent boom, pushed upward by a strong housing market, tax abatements on new construction, and national recognition of Philadelphia's renaissance. With the benefits of a burgeoning economy come growing pains; in the case of Philadelphia's construction industry those growing pains come in the form of an informal construction economy that costs the city in a number of ways.

Like many other localities throughout North America, Philadelphia has recently come to the realization that much of its labor is performed by workers who are either undocumented or are misclassified by their employers. Forming a significant portion of the "informal economy", these workers typically do not pay income taxes (or they pay less than they should), while their employers skirt some costs of doing business by avoiding payment of payroll taxes and social insurance programs (such as unemployment insurance, worker's compensation, health insurance, etc).

Misclassified construction workers are prevalent throughout the country, representing about 15-25% of the overall construction workers in the places where it has been studied. Due to the nature of the work and the structure of employment, the construction industry has higher incidences of misclassification than other sectors of the economy. Research in Washington State found that construction firms were 1.4 times more likely to misclassify workers than firms in any other industry, while a similar report in New York State found that 15% of the construction workers there are misclassified compared to 10% of workers in all other sectors.

The costs of worker misclassification come in a number of forms. Direct costs to governments come from lost tax revenue and social insurance premiums. Indirect (and therefore much harder to measure) costs come from increased risk to workers, demand for city services, and costs-of-doing-business passed on to legitimate employers.

A very rough estimate of direct costs to the City of Philadelphia from lost wage taxes amounts to between \$2.1 million and \$7.4 million.

Policies that have been suggested in other studies fall under two categories: enforcement and regulation. On the enforcement side, suggestions include increasing efficiency and efficacy by joining state and local efforts, as well as by incorporating industry-based policing. Regulation suggestions include clarifying or changing the legal definitions of worker class and requiring a prevailing wage for all government-sponsored construction.

The Problem: Worker Misclassification

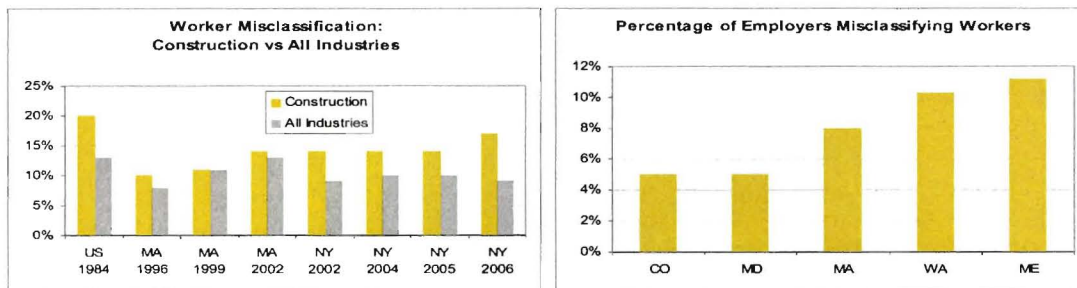
As the economy of Philadelphia has transitioned from manufacturing to service sectors, informal economies have thrived, as they have in most cities of the US. Filling the gap of services to low-income consumers, low-margin businesses compete, at least in part, by skirting regulation costs. At the opposite end of the underground economy, the rise of condo- and office-towers downtown spurred a rise in the demand for skilled labor on myriad job sites. Meanwhile, between the upper and lower floors of the local economy lie smaller job sites, employing fewer workers per job, but with far more individual jobs. If other cities are any indication, much of the work being performed on these sites is being done by misclassified and undocumented workers.

Worker misclassification is the intentional or unintentional classification by an employer of a worker as an independent contractor rather than as a salaried or waged employee. Misclassification generally happens for one of two reasons: the employer does not correctly understand the difference between the types of worker, or because the employer hopes to avoid various costs of an employee (such as payroll taxes and social insurance programs).

Employers of misclassified workers typically submit the appropriate paperwork to government agencies, allowing them to claim that they're following the law. On the subject of taxes and other required payments, employers will say that these are the responsibility of the contractor. Much less common, undocumented workers are workers who are not declared to any government agency, and therefore are not taxed at all.

The Extent of the Problem

The issue of misclassified workers in the construction industry has been studied in just a handful of places: New York City, New York State, Maine, Massachusetts, Washington State, and Ontario. Based on these reports, an average of about 15% of construction workers are either undocumented or misclassified. In New York City, which has been experiencing a construction boom over the past decade, the number jumps to about 25%. Comparing misclassification in the construction industry to other industries, the study in Washington State found that "employers in the construction industry are 1.4 times more likely to misclassify workers."¹ In New York City, for example, informal workers represent about 10% of the overall workforce, whereas in the construction industry they make up about 15% of the workforce.



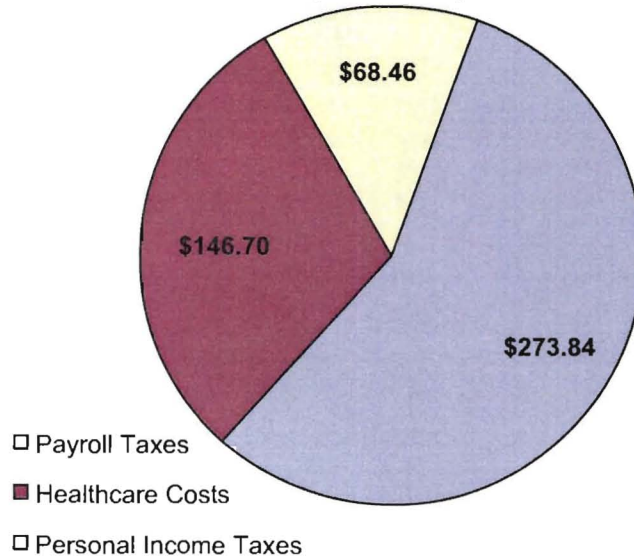
The costs associated with misclassified workers, as found in the places that have been studied, are significant. In New York City, the informal construction economy cost the city about \$489M in 2005, and was expected to rise by approximately 114% over 3 years. Of this total, 56% came from payroll taxes, 30% were from increased healthcare costs, and 14% were from lost personal

¹ Findings & Recommendations Joint Legislative Task Force on the Underground Economy in the Construction Industry, 15 Feb. 2008

Appendix IV: Study on the Underground Economy in Philadelphia

income taxes. While indirect costs that stem from misclassified workers are inherently difficult to quantify, there is a "strong correlation between construction fatalities and the characteristics of the underground economy."² Of the 51 construction fatalities that occurred in 2006 and 2007 in New York City, 75% of the employing firms were non-union, 50% were very small, and "failure to provide safety training was cited in over half of the cases."³

Underground Economy Costs to NYC, 2005
(in millions)



Research Scope

While the construction sector represents a minority of the overall informal economy, it is a reasonable focus of study for a number of reasons. To start, the construction industry represents the kind of "low-hanging-fruit" that makes sense to study. Construction projects, regardless of the status of the workers, are typically well documented with permits, loans and other paperwork. Construction projects are easily found on the street and do not move, whereas informal retail and other businesses typically blend into surrounding areas or are portable. Compared to other areas of the overall informal economy, the construction sector is relatively visible and immobile, and therefore easy to study.

Based on findings in other places, the construction industry is also a cohesive and significant portion of the overall informal economy. Construction firms are more likely than other types of businesses to misclassify workers, which is likely due to the nature of the work. While jobs are inherently immobile, workers leap from one job to the next, following the work throughout the city. Small residential firms, typically employing a handful of people, will hire independent contractors for days, weeks or months at a time. Meanwhile construction firms have to compete for work, with time- and cost-estimates their only real way to stand out amongst the other bidders. The two factors, of cost-sensitive employers and workers with no job security, collide to

² *Building Up NY, Tearing Down Job Quality* Fiscal Policy Institute, 5 Dec. 2007

³ *Ibid*

Appendix IV: Study on the Underground Economy in Philadelphia

create an atmosphere in which proper worker classification is too expensive, too slow, and too inconvenient for workers or employers to bother with.

The construction industry is unique among other industries for the scale of its impact on the city's present and future. Unlike retail and restaurants, construction firms leave a significant physical mark on the landscape of the city. Cutting corners in construction projects can present immediate dangers to the workers, to nearby businesses and residents, and to passerby. Unlike in other businesses, worker's errors also have lasting effects that may not be detected for years, and which may present serious, unseen risks to people and property.

For these reasons, the Office of the Controller has focused its study on the construction industry. The combination of relative ease of study, size of impact, and the safety implications make the informal construction industry a strong subject of study. Additionally, lessons learned during the course of compiling data for this report may be applicable to studies of other sectors of the informal economy in the future.

Research Methods

Studying informal economies is an exercise in comparative analysis. This study will require a series of audits, comparing one set of data to another to find discrepancies. Data sets to compare may include:

Growth in 1099 filings	Vs. Growth in private payroll employment
Registered company names	Vs. Advertisements for businesses of that type
Unemployment insurance claims	Vs. Unemployment insurance payments
Industry estimates from BLS, ACS, etc	Vs. Industry estimates from PA Dep. Of Labor
Declared income of workers	Vs. Industry audits
Growth in utility usage	Vs. Growth in economic indicators
Growth in building permits	Vs. Growth in industry employment
IRS filings	Vs. State/Local tax filings
Quarterly Census of Employment & Wages	Vs. Current Population Survey employment data
US. Bureau of Economic Analysis regional accounts data	Vs. Similar county data

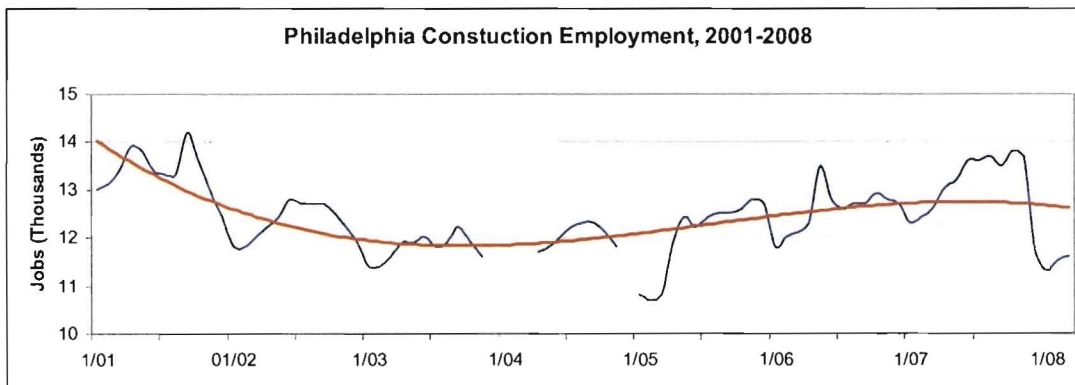
Following the collection of the data, analysts will estimate the direct costs of the informal construction economy, using procedures outlined in similar studies. A simple, albeit imprecise method of estimating costs to government of informal workers is to multiply the estimated number of misclassified workers by the estimated average per-worker cost to the government (which is arrived at by comparing revenue from employees to revenue from independent contractors). Similarly, applying the city's wage tax rate to an income estimate for the number of misclassified/undocumented workers will give a rough idea of their cost to the city. While the estimates provided by these methods will not be precise, they will provide an idea of the costs that the City of Philadelphia is incurring due to informal employment in the construction sector.

An example of a more complicated and exact measure is found in the New York City study, where researchers devised a five-step method of estimating costs in which workers were grouped by wage and compliance status. For each group, per-worker estimates of payroll and social insurance premiums led to industry-wide estimates of lost taxes and insurance premiums for the non-compliant groups, followed by estimates of lost income taxes and of the costs that are shifted to other entities. Numbers provided by this method will be somewhat more precise than those of the simpler methods.

Concurrent to the collection of the economic data, researchers have explored policies in other cities and states to identify a set of best practice recommendations. Most of the research that has been done on this subject has been performed at the state level, so most of the existing policy recommendations involve state law rather than local ordinances. Given this, the policy recommendations will involve, at least in part, a call for increased state/local communication and cooperation and lobbying the state for classification standards.

Findings

Based on existing research of the informal construction economies of other places, this office expects that the local informal construction economy will represent approximately 15-25% of the overall construction sector. In New York City, the bulk of the underground construction economy is found in residential construction, where most of the construction businesses are small, with only 4-10 full-time employees compared to 15-25 for non-residential construction companies. Approximately 66% of the affordable housing sector in NYC is underground (which represents about 20% of the entire underground construction economy). While Philadelphia is obviously much smaller than New York, this office expects to find proportionate similarities in our construction industries. New York, like Philadelphia, has enjoyed a construction boom since 2000, with the "biggest surge in residential construction activity since the 1970s." Additionally, both New York and Philadelphia's real estate markets and their construction economies have remained fairly strong relative to the nation.



Prior to performing the audits, this office ran up a very rough estimate of the local informal construction economy. Comparing numbers from the US Bureau of Economic Analysis, the Census Bureau and the Bureau of Labor Statistics, we estimated that the Philadelphia construction economy represents between 11,000 to 20,000 jobs. Based on proportions from other reports, a very rough estimate of the number of misclassified workers in Philadelphia gives a range of 1,650 to 5,000 workers. Multiplying these numbers by the median wage from the Census Bureau (about \$35,000), and again by the wage tax rates, and the very rough estimate of lost income taxes is between \$2.1M and \$7.4M. While this rough estimate is exactly that, it

Appendix IV: Study on the Underground Economy in Philadelphia

does give us an idea of the expected breadth and depth of the informal construction economy in Philadelphia.

Recommendations

"Government has an obligation to curb the underground economy, enforce long-standing employment laws, ensure compliance with essential social insurance protections and eliminate the unfair competitive advantage from contractors in the underground economy"

In the existing body of policy papers on this subject, the most common recommendation is to ensure that all agencies use the same criteria to determine the appropriate classification for workers. Following this, most of the policy recommendations include a call to presume worker classification as employees, putting the onus on the employer to prove that the worker is an independent contractor. In a number of states, bills have been passed that presume employment status or require that the employer prove the independent status of a worker.

On the municipal level, policy recommendations are to work with the state to increase enforcement, to require prevailing-wage labor on all government-sponsored projects, and to ensure that enforcement efforts are even-handed and fair, taking into account "an often vulnerable workforce that includes many black and Hispanic workers long shut out of opportunities for good-paying jobs, skill development and advancement, or who are recent immigrants."

By far the most effective way for local government to reduce the scale of the underground construction economy is through projects that, in any form, receive assistance from local government. Whether through funding (in part or in whole), zoning variances, or tax incentives, Philadelphia offers various types of assistance to developers. By the nature of the construction industry, responsibility for the many functions of development is handed down through a number of firms. Holding all involved contractors of city-assisted projects to a prevailing-wage standard will go a long way towards reducing the effect of the informal construction economy in Philadelphia. In an FPI report studying misclassified workers in New York City's affordable housing construction, the authors call for municipalities to "take responsibility for the working conditions" by working with the state to "begin enforcing labor standards and addressing working conditions and the poor pay and benefit practices"⁴ that exist in government-assisted construction.

Beyond increasing enforcement of existing laws, Philadelphia should work with surrounding municipalities and the state to update these laws. In a number of states, laws have been enacted that presume worker employee status; in Massachusetts, for example, employers must prove that workers meet three criteria to be determined independent. In some states, there are bills that amend the definition of independent contractor so that various state agencies (for example the unemployment and workers' compensation bureaus in Maine) will use one definition. Increased civil and criminal penalties are also parts of a number of states' reactions to the informal construction economy. Pennsylvania's most recent attempt (2005-06 HB 1215) to deal with the informal construction economy did not pass the House. Philadelphia and surrounding municipalities should work together to lobby for increased enforcement, a clear and consistent definition for "independent contractor", and stiff penalties for employers who knowingly misclassify workers.

⁴ The Underground Economy in the New York City Affordable Housing Construction Industry Fiscal Policy Institute, 17 Apr. 2007