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The Underground Construction Economy in New Jersey

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KEY FINDINGS

- New Jersey construction companies that follow the law are forced to compete with contractors who use off-the-books labor, misclassify employees as independent contractors, and avoid paying taxes and social insurance costs. Construction leaders warn that the so-called underground economy is damaging the $20 billion industry.

- Differences in counts of New Jersey construction industry workers, the small size of the state's construction firms, and declining hourly wages all point to evidence of an underground economy operating within the state's construction industry.

- New Jersey's total underground economy is estimated to be between $7.3 billion and $16.3 billion in economic activity.

- Estimates of the size of the construction industry's underground economy vary based on methodologies used, with an average estimate being $640 million. But research suggests it is likely to range from $528 million to $1.2 billion and involve 35,000 workers operating off-the-books or as misclassified independent contractors.

- Estimates of wages paid in underground activity also vary, averaging $284 million. The upper range of estimates is $528 million in underground wages.

- Lost state income taxes not being paid to the state because of underground activity is estimated to be up to $11 million in off-the-books employment and nearly $9 million from employment of misclassified workers. An estimated $3.1 million to $6.7 million in unemployment insurance goes unpaid.

- About 10,000 companies are registered to work on public construction projects put out in New Jersey by nearly 600 school districts, 565 municipalities and county and state agencies. The N.J. Department of Labor and Workforce Development (NJLWD) has 25 general enforcement field staff (seven are dedicated to misclassification). Field staff conducted 35,136 inspections in 2014-15 and assessed $2.6 million in penalties. Because those penalties fund inspection staff, more inspections could fund increased NJLWD staff.

- The NJLWD currently has 14 field staffers dedicated to prevailing wage violations. Staff conducted 844 inspections in 2014-15 and assessed $535,900 in penalties.

- Analysis of national data provided by the U.S. Department of Labor shows the number of compliance actions taken on federal construction projects in New Jersey ranged between 80 and 140 a year in recent years.

- Research shows that other states have more aggressive policies than New Jersey in battling the underground economy, particularly misclassification. Recommendations based on best practices include coordination with the USDOL and other states, a joint task force to attack misclassification, an updated legal definition of independent contractors, tougher laws, penalties, and enforcement, and criminal prosecution.

EXECUTIVE SUMMARY

The William J. Hughes Center for Public Policy was contracted to study the underground commercial construction economy in the state of New Jersey for the Bricklayers and Allied Craftworkers Labor Management Committee of New Jersey and the Carpenter Contractor Trust. This research takes a multi-pronged approach in exploring policy and best practices, presenting a data-driven analysis of the underground economy in New Jersey, and allowing construction leaders to speak freely about their experiences in the industry. Rather than list all references at the end of this paper, references and citations are listed separately at the end of each major section to make it easier for readers to follow up on specific resources.

The term “underground economy” refers to unreported income, off-the-books work and unpaid taxes from employment or business activity. Labor unions have sounded the alarm that they face unfair competition from underground construction activity that illegally undercuts companies that follow the rules. In addition, the government misses out on tax payments, and social insurance programs such as worker compensation and unemployment insurance go unfunded in the underground economy.

The New Jersey Department of Labor and Workforce Development’s Office of Research and Information/Bureau of Labor Market Information reported that in 2014, New Jersey’s construction industry averaged 141,900 jobs statewide. In this state, the construction sector includes specialty trade contractors, construction of buildings, and heavy and civil engineering.

New Jersey labor law sets out a number of requirements for construction industry employers. Most businesses must register with the state. Employers must file quarterly reports on wages paid, and the first $32,600 reported are subject to taxes to fund state unemployment insurance, disability insurance, workforce development and family leave. Businesses must maintain specific worker and payroll records for four years. These records can be audited to check whether appropriate wages and taxes are being paid. Most employers are required by the state to carry worker compensation insurance or to have a state-approved self-insurance program to protect workers who are injured on the job. Penalties for failure to provide worker compensation coverage include up to $5,000 for the first 10 days of non-coverage and up to $5,000 for each subsequent 10-day period. In the case of a work-related injury or death, the employer can be liable for medical expenses, temporary disability, permanent disability or dependency benefits as well as potential civil penalties.

Employers are also subject to federal Fair Labor Standards Act requirements as regulated by the U.S. Department of Labor, including the requirement to pay a minimum wage of $7.25 an hour. However, New Jersey’s state-mandated minimum wage of $8.38 an hour is higher. The FLSA requires overtime to be paid at 1.5 times the regular pay rate. Employers are also covered by federal anti-discrimination and equal-opportunity laws.

The “underground economy” is an umbrella term for business behaviors to evade mandatory taxes and employment laws and regulations. The products produced and sold are legal (unlike the “black market”). It is often thought to include three categories.

Misclassification is when a worker is classified as an independent contractor rather than as an employee. They receive a 1099-MISC tax form rather than a W-2 form. They are treated as if they are self-employed. Businesses that misclassify fail to pay mandatory payroll taxes such as Social Security (FICA), Medicare, unemployment insurance, workers compensation and, in New Jersey, paid family leave insurance. Instead, the independent contractor is responsible for these. Businesses that misclassify may also evade labor laws such as minimum and prevailing wages, overtime payments, and laws that protect collective bargaining rights.

Unregulated work is work that escapes regulation by employment and labor laws. Much unregulated work is performed in the home, for example, in the home health care industry. Day laborers in the construction industry are another example. Employers here tend to violate the Fair Labor Standards Act and underpay workers; they may not pay the minimum wage, pay for the full number of hours worked, or pay overtime for work more than 40 hours per week, also called "wage theft."

Working for cash or barter, also called working under the table, is another way of avoiding tax obligations and employment legislation. In this case, there are zero records for employees, not even a 1099-MISC form. It is as if the worker was never there.

One common violation involves pay for government construction or public works projects at the state and federal levels. "Prevailing wages" are minimum pay packages including wages and benefits for workers on publicly funded construction projects. This minimum prevailing rate must be paid to construction workers such as carpenters, plumbers, electricians, equipment operators, and others whether they belong to a union or not. The value of each pay package depends on the type of craft work being done and on the geographic area. The requirement to pay prevailing wage rates is triggered when the cost of a construction project exceeds a set amount. The Davis-Bacon Act applies to public works projects awarded by a federal agency, including military bases. The New Jersey Prevailing Wage Act applies to public construction projects awarded by state, county or municipal governments, school districts or other boards and agencies.

Under the state law, public works contractors must register with the labor department and must pay the prevailing wage to all covered workers. Rates determined by the labor commissioner most be posted where workers have access. If a builder subcontracts out work, the subcontractors must also pay the prevailing wage rate. The contractors and subcontractors must submit certified payroll records showing payment of the rate to the agency that hired them.

About a dozen bills have been proposed in the N.J. State Legislature regarding the prevailing wage. Supporters have proposed to: expand the prevailing wage law to additional types of work or additional agencies; strengthen reporting requirements and employee protections; to increase criminal penalties against violators; and to allow stop-work orders against repeat violators. Opponents have proposed: exempting the N.J. Board of Public Utilities and state colleges from paying prevailing wage rates; suspend prevailing wage law requirements for work repairing storm damage; or outright repealing the prevailing wage law. As of this report, none of the bills have reached the floor of the General Assembly or state Senate. Most had not yet received a vote in a legislative committee. (Page 21)

The state LWD Department investigates complaints concerning the prevailing wage. Violators may face fees and penalties and could be barred from working on future public works projects. Workers also have the option of filing a civil lawsuit to recover wages as well as legal costs and fees.

Supporters of prevailing wage laws argue that they allow construction workers to remain rooted in the middle class and off public assistance rolls. They cycle earnings back into the economy and pay taxes. Others claim that quality may suffer if highly skilled firms that pay living wages are discouraged from bidding against contractors relying on the cheapest labor available. This report also includes interviews with contractors, construction union members and others about how they have been affected by the underground economy.

EXECUTIVE SUMMARY: QUANTIFYING THE UNDERGROUND ECONOMY

The construction sector represents a key component of New Jersey's economy. While the industry's overall contribution to the state's economy has declined over the last several years during the post-housing crisis and recession, the industry's real output in 2014 remained significant at $17.7 billion in 2014, or 3.5 percent of New Jersey's real gross domestic product (GDP).

Employment provides another means of gauging the construction sector's overall contribution to the state's economy, peaking at 175,000 in 2006 (or 4.3 percent of total statewide establishment employment). Construction employment began to decline with the national housing crisis, hitting 129,500 in 2010. This represented a total job loss in the industry of 45,400 (-26 percent). Nationally, construction employment declined by 28 percent over the same period. As of 2015, construction employment remained 27,000 (-15.4 percent) below its 2006 peak. In 2014, wages and salaries paid in New Jersey's construction sector totaled $18.5 billion which represented 7.7 percent of total wages and salaries in the state.

These numbers regarding construction sector employment focus solely on company or payroll employment produced by the U.S. Bureau of Labor Statistics and other agencies. "Residential" or household employment data as from the U.S. Census Bureau's Current Population Survey pertain to individuals and relate to where they live. The Census-based estimate of construction employment is considerably higher than the payroll estimate. One reason is because about 57,000 self-employed construction workers show up in these statistics. Another is because nonprofit or government workers not employed by private companies are also represented. Also, the Census-based numbers show construction workers who live in New Jersey but work in other states.

However, another possible reason for the difference between New Jersey's official payroll construction employment and Census-based employment is underground construction activity in New Jersey. A three-fold increase in this difference between 2005 and 2014 *may* suggest that New Jersey's underground construction sector has grown significantly in recent years. Data show that the monetary value of construction per worker is higher in New Jersey than in other states – 30 percent higher than the national average. This could be another indicator of underground activity in New Jersey's construction sector. Higher-than-average productivity is especially notable in New Jersey's home construction sector.

The Census Bureau's *County Business Patterns* data show nearly 21,000 firms (or establishments) in the state's construction industry in 2014. These establishments employed 139,000 individuals in 2014 and had a collective total annual payroll of $9.2 billion. The average number of employees per construction firm in New Jersey was 6.6, well below the national average of 8.6 as well as averages in Maryland (10.4) and Pennsylvania (8.4). Construction firms with 20 or fewer employees account for 46.7 percent of statewide construction industry employment—a figure well above the national average of 38.6 percent and the other area states. The average annual payroll per construction firm in New Jersey totaled $440,000, a figure that was below the national average ($478,853). These small firms account for a higher percentage of construction industry employment in New Jersey – a state with higher-than-average productivity per worker – than elsewhere. The trend could suggest use of misclassified independent contractors who are not counted as company employees.

Real average hourly construction wages in 2007 in New Jersey were higher than in surrounding states and much of the country. New Jersey companies pay higher average wages than in other states. However, since 2007 hourly wages have dropped by an eye-popping 7.6 percent. Hourly wages increased 2007-2015 in New York and Pennsylvania. New Jersey's decline occurred as homebuilding activity has rebounded since 2009. Some could be attributed to a decline in commercial construction (state-level data were not readily available). A significant increase in underground construction activity in New Jersey over the past several years could also explain some (though not likely all) of the real hourly wage difference. A sharp rise in underground construction hiring in the state, for example, would have likely exerted downward pressure on New Jersey construction workers' real hourly wages.

While each individual finding alone does not prove the existence of an underground economy, taken together they present a collective body of evidence that appear to show underground activity in New Jersey's construction sector.

Various researchers have used different methodologies to estimate the size of underground economies in the United States and in other countries. Schneider and Williams estimated that in 2007, underground activity represented 8.4 percent of gross domestic product, or $1.3 trillion. A recent report by the Organization for Economic Cooperation and Development suggests that many of the methodologies used (including those employed by Schneider and Williams) likely *overstate* the size of underground economies. It should be noted that there is no foolproof method of trying to measure something that by its nature is mostly invisible, and any estimates should not be taken as absolute.

Using the Schneider and Williams model and adjusting for likely overstatement of underground activity, and based on New Jersey's share of national GDP, we can estimate New Jersey's total underground economy at approximately $6.4 billion to $14.2 billion in 2007. Assuming growth similar to the formal economy since 2007, New Jersey's underground economy likely had a range-estimate value of $7.3 billion to $16.3 billion in 2014, approximately 1.3 to 3 percent of the state's nominal GDP of $552 billion in 2014.

With the construction sector's nominal output of $19.9 billion representing 3.6 percent of the state's GDP, we can estimate the size of New Jersey's underground construction economy (page 62. A conservative estimate, assuming underground activity matches the same share of

GDP as the entire sector, is that the underground construction economy ranges from $264 million to $590 million. If we assume that construction has a higher share of underground activity – and there is research to suggest that it does – the estimate ranges from $528 million to $1.2 billion. The average of the estimates is $640 million.

Evidence suggests that the practice of misclassification is widespread and growing. Misclassification is especially relevant because such practices have been found to be rampant in the construction sector. Methods used in a 2000 U.S. Department of Labor study of misclassification suggest 11.4 percent of New Jersey construction payroll workers, or 15,800 workers, were misclassified as independent contractors in 2014. A range of $3.1 million to $6.7 million in unemployment insurance is estimated to have gone unpaid (page 68). Because we believe the underground economy has grown in recent years, this estimate is likely very conservative.

In addition, workers paid "off-the-books" represent another dimension of the underground economy. Unlike misclassification, which produces some documentation (1099-MISCs), "off-the-books" arrangements leave no documentation. Analyzing the numbers of construction workers living in New Jersey compared to companies' payroll workforce, and accounting for New Jersey residents who work in New York, we estimate that nearly 23,000 construction workers are employed off-the-books in New Jersey.

To get a very rough estimate of the total wages this off-the-books activity in the construction sector amounts to, we assume that the average New Jersey off-the-books construction worker works an average of 1,200 hours per year (i.e., 30 hours per week and 40 weeks per year). We estimate the hourly wage based on the low end of the industry's 2015 wage distribution at $10.38 per hour. Were this the case, total wages for these approximately 23,000 workers would amount to $284 million (page 64). This figure would account for approximately 44 percent of underground construction economy activity (which we put at a mid-point estimate $640 million). Using the very highest estimate of underground activity of $1.2 billion, the wages would amount to $528 million. The very lowest wage estimate using the most conservative numbers is $116 million.

Making an estimate of lost income taxes becomes even more arbitrary than earlier estimates. This report estimates there are 22,860 off-the-books New Jersey construction workers making $12,456 annually (1,200 hours at $10.38 per). Assume all of these workers belong to tax-filing units with two-income earners that file jointly and earn an average of $32,400. Based on an ITEP study (see link in body of this report), this New Jersey family had an effective state income tax rate of 0.6 percent. Thus, it should have paid a total of $194 in personal income taxes if all income were on the books. If every one of the 22,860 off-the-books workers were in this same position, the total dollar value of income taxes lost would be approximately $4.4 million.

However, anecdotal evidence suggests that many underground workers in New Jersey earn more than $10.38 an hour. Union officials, day laborers and an activist organization told our researchers that underground construction workers in 2016 often earn $20 an hour and work more than eight hours a day or five days a week. Doubling those workers' hourly wages and increasing the work week could place such a family in an effective state income tax rate of 1.7 percent for total personal income taxes of $748. If half of the 22,860 underground construction workers were in the higher bracket, the total income taxes going unpaid would be $10.8 million. The lost income taxes would also total almost $11 million if all underground workers averaged a wage estimate of $15 an hour (page 74). It should be noted that these estimates apply tax rates to all of the income, while in reality they would apply to taxable income only. Finally, union leaders would argue that the true cost of lost tax revenue should be based on what these workers would earn if strict enforcement required employers to pay legal rates and overtime.

Our midpoint estimate of the number of misclassified construction workers in New Jersey is 11,600. We estimate that misclassified construction workers earn $57,135 but report income of only $39,990. If all of these misclassified construction workers are again members of two-earner families that file taxes jointly and the second worker's annual earnings approximate $20,000, we get families with reported incomes of roughly $60,000. Based on the previously cited ITEP report, such families would pay an average effective income tax rate of 1.7 percent. Combined, these families with a misclassified worker would pay New Jersey personal income taxes totaling $11.8 million versus $20.6 million if all income were reported. The difference suggests there is $8.75 million in lost personal income tax revenue to the state.

Combined, we estimate $13.1 million in lost state personal income taxes due to misclassification and off-the-books activity in the state's underground construction industry. Using a higher estimate of off-the-books workers working longer and earning $20 an hour, the total would be $19.6 million.

Finally, we sum our estimates for off-the-books construction workers (approximately 23,000) and misclassified construction workers (approximately 11,600, which represents the average of our estimates) to arrive at a figure of nearly 35,000 New Jersey construction workers that are likely to be involved in some way in the state's underground construction industry. This would represent 14 percent of total residential construction workers in the state in 2014.

EXECUTIVE SUMMARY: REGULATING NEW JERSEY'S CONSTRUCTION INDUSTRY

The construction industry's activities are regulated at the state level by the N.J. Department of Labor and Workforce Development (NJLWD) and at the federal level by the U.S. Department of Labor (DOL). In New Jersey, the NJLWD receives 7,500-8,000 complaints a year and has 25 general enforcement field staffers who investigate. Included in the general enforcement staff are seven people dedicated to investigating misclassification. Between 5,000 and 6,000 state inspections of New Jersey construction sites are conducted each year. The NJLWD performs more than 3,000 audits a year to determine if employers are paying unemployment compensation taxes and other taxes in full. The state's enforcement activities result in approximately $2.5 million in penalties a year. Those monies fund the budget of the Wage and Hour Division, which does not operate on state revenues (page 75).

Another 14 NJLWD field staffers are dedicated solely to regulating compliance with the state's prevailing wage law. That staff conducts 850-900 job-site inspections on prevailing wage complaints a year, resulting in 700 cases involving violations. About $400,000 to $500,000 in penalties are assessed in prevailing wage cases in New Jersey each year. The penalties fund the enforcement activities. Approximately 10,000 companies are registered to perform public construction work done in the state by nearly 600 school districts, 565 municipalities and county and state agencies.

On the federal level, the agency that contracts out construction work is responsible for enforcing provisions of the Davis-Bacon Act requiring payment of set prevailing wage rates and fringe benefits. That agency is also responsible for enforcing the Contract Work Hours and Safety Standards Act, which ensures that overtime is paid at the rate of 1.5 times the regular wage for hours worked in excess of 40 hours a week on qualifying federal construction contracts. Employers must maintain employee payroll records and submit certified payrolls on a weekly basis. Contractors are responsible for making sure subcontractors abide by the law.

In FY 2014, the DOL's Wage and Hour Division nationally had more than 1,000 investigators, completed 29,483 compliance actions, and obtained agreements to pay over $240 million in back wages for more than 270,000 workers. In 2014-15, 42 percent of investigations were initiated by the division. Although the DOL could not provide state-level statistics, analysis of a DOL database of compliance actions dating back to 2007 shows the construction industry accounted for 8 percent of all actions in New Jersey. Analysis shows that in 2010, 138 wage and hour cases were either started or completed. In 2011, there were 78 wage and hour cases. In 2012, there were 97 federal cases in New Jersey. Totals for all three years were well below the approximately 700 prevailing wage cases reported each year by the NJLWD. The number of New Jersey cases in the federal database dropped significantly after 2012, possibly suggesting incomplete data.

Enforcement actions often start with a complaint to state or federal wage and hour regulators, and construction unions have a vested interest in reporting companies engaged in underground activities. The Northeast Regional Council of Carpenters in New Jersey actively monitors construction sites for evidence of violations. This report provides two examples in which union members observed underground activities at large construction sites and cooperated with the NJLWD to investigate and assess penalties.

EXECUTIVE SUMMARY: MISCLASSIFICATION, BEST PRACTICES

To review, the "underground economy" is an umbrella term for business behaviors to evade mandatory taxes and employment laws and regulations. Misclassification is when a worker is classified as an independent contractor rather than as an employee. They receive a 1099-MISC tax form rather than a W-2 form. They are treated as if they are self-employed. Researchers and policymakers have begun to document the scope of misclassification because it leaves millions of workers uninsured, without benefits and other rights, and without job security. Studies in various states find that 15 to 40 percent of construction workers are misclassified (page 79).

New Jersey defines independent contractors by the three-part "ABC test," the most commonly used criteria of the IRS. All three prongs of the ABC test are required to establish that someone is an independent contractor: the individual has been and will continue to be free from control or direction over the performance of that service, both under his contract of service and in fact; the service is either outside the usual course of the business for which the service is performed, or the service is performed outside of all the places of business of the employer for which the service is performed; and the individual is customarily engaged in an independently established trade, occupation, profession or business.

Beginning in 2011, the U.S. Department of Labor's Wage and Hour Division (WHD) teamed with the U.S. Treasury Department on a multi-agency initiative to develop strategies to reduce employee misclassification. A number of states have signed a federal-state Memorandum of Understanding (MOU) to work in partnership with WHD and the Internal Revenue Service (IRS) on information sharing and coordinated enforcement. New Jersey is notably absent among them. An Advisory Commission on Construction Industry Independent Contractor Reform was formed by Governor Jon Corzine in 2008. It never met and never issued a report.

Policies to reduce the size of the underground economy in the construction industry require cooperation among various state agencies, the federal government, labor unions, employer trade associations, and employers. Best practices in other states can be categorized into five areas (page 82):

1. Measuring the problem and making it a policy priority
2. Updating the legal definition of independent contractor
3. Enhancing enforcement mechanisms
4. Developing or augmenting education campaigns for consumers and employers
5. Increasing cooperation with the federal government and nearby state governments.

Based on the review of best practices in other states, we outline 15 policy recommendations for the State of New Jersey (page 90). Recommendations #1 through #4 are related to the structure and functions of state government entities that have duties related to employee misclassification. Recommendations #5 and #6 deal with the definition of independent contractor. Recommendations #7 through #9 call for increased education. The final five recommendations deal with enforcement issues.

Recommendation #1. The Commissioner of the New Jersey Department of Labor and Workforce Development should sign an MOU with the Wage and Hour Division of the U.S. Department of Labor to collaborate to reduce misclassification.

Recommendation #2. The New Jersey Legislature and governor should create a joint interagency Task Force dedicated to investigating, reporting and prosecuting employee misclassification.

Recommendation #3. New Jersey state government should restructure as necessary to ensure greater information sharing among state agencies to reduce employee misclassification.

Recommendation #4. New Jersey should utilize a one-stop (single entry) portal for businesses to interact with various state agencies, and to handle business registration, licensing, etc.

Recommendation #5. New Jersey government should review its laws and update its definition of independent contractor to model other states such as Washington, Minnesota, and especially New York State, a neighboring state.

Recommendation #6. Since commercial and construction businesses often operate across state lines, New Jersey should work collaboratively with other states and the U.S. government to review state and federal laws and regulations to conform legal definitions of who is a covered worker for unemployment, wage and hours laws, health and safety, etc.

Recommendation #7. New Jersey should embark on a statewide education campaign on employee misclassification in cooperation with trade associations and labor unions. Further, the State should offer seminars and webinars to assist businesses.

Recommendation #8. New Jersey should design a dedicated inter-agency website on employee misclassification. It should be accessible to employers and consumers through a simple, one-click url. Ideally, the website should be maintained by the joint Task Force (see Recommendation #1).

Recommendation #9. New Jersey should publicize data on completed enforcement action and include names of past violators.

Recommendation #10. New Jersey should create and staff a tip line so that businesses and consumers may offer tips of suspicious hiring practices confidentially.

Recommendation #11. New Jersey government should work with industry and employer associations and labor unions on voluntary audit programs within industry. New Jersey should not just rely on the current audit and inspection process.

Recommendation #12. New Jersey should step up efforts to monitor social media for employers seeking workers and construction workers seeking jobs, as this will offer clues for audits and investigations.

Recommendation #13. New Jersey should step up enforcement under existing law, e.g. stop work orders, other penalties and fines, business revocation. Further, New Jersey should ensure that enforcement is fully funded and staffed.

Recommendation #14. New Jersey should conduct a thorough review of current laws and enforcement to increase the costs of avoiding the law. For example, New Jersey should consider: not merely work stoppage orders but asset seizure laws; higher fines than paying back wages and insurance premiums; progressive penalties for repeat offenders; revoking licenses; holding contractors and corporate officers legally responsible for actions of subcontractors; and working with other neighboring states to prevent offenders from relocating to nearby states.

Recommendation #15. New Jersey State government should set an example by ensuring that its own contracts that are awarded to the “lowest responsible bidder” are not low because laws and regulations are being evaded or fudged through subcontracting.