

# SINKING UNDERGROUND

THE GROWING INFORMAL ECONOMY IN CALIFORNIA CONSTRUCTION



Yvonne Yen Liu, Daniel Flaming, Patrick Burns

Economic Roundtable

*A Public Benefit Research Organization*

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“Safeguarding working people and providing a level playing field for honest employers to prosper is essential for the vitality of California’s economy. A just day’s pay for a hard day’s work should be a reality in every workplace. Information from this report identifying abuses in the construction industry is a valuable tool for protecting workers as well as employers who play by the rules.”

— **JULIE A. SU**, California Labor Commissioner

“To make the informal economy more formal requires innovative strategies to eliminate bad business practices, improve working conditions, and create better opportunities for mostly immigrant day laborers. One cannot happen before the other — these strategies must take place simultaneously to ensure the integration of this workforce into a better economic situation. This report provides us with the detailed analysis of the informal construction industry for us to be able to engage in such an innovative process of strategy development.”

— **VICTOR NARRO**, Project Director, UCLA Labor Center

“Excellent report that helps shine the light of day on the pernicious practice of employee misclassification. The problem is by no means limited to California, as much the same occurs in Texas and every other state in the country. It is high time we enforce the law. Misclassification cheats workers of overtime, workers comp, unemployment insurance, social security and just about every other workplace protection, but the harm to society is larger still. Honest employers are driven toward bankruptcy by unfair competition, states are robbed of needed revenue, and a little more of the middle class is worn away each day we allow it to continue unchecked.”

— **RONNY CONGLETON**, Texas Workforce Commissioner

“This research study proves what we in the industry have all know for decades. This valuable information will raise awareness regarding the problem of the underground economy and help in the efforts towards cracking down on violators.”

— **MARK FOWLER**, Executive Vice President, Western Wall and Ceiling Contractors Association

“The abuses uncovered in this report are both unfair and very costly for America. In addition to chopping away the rights of workers, unreported work and misclassified work steal away the revenue needed to fund public investments like Medicare, education and infrastructure that build our economy and security in the long-run. Employers who commit these abuses are stealing not just from their workers, but from the nation at large.”

— **ROBERT MCINTYRE**, Director, Citizens for Tax Justice

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2014

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# SINKING UNDERGROUND

## The Growing Informal Economy in California Construction

### Executive Summary

Construction is a bellwether for California's economic well-being because of its size and role as a leading indicator of economic trends. The \$152 billion industry employed 895,000 workers in 2012 and is projected to grow 26 percent by 2020. However, a growing number of workers in construction are not reported by their employers or are misclassified as independent contractors—characteristics of the informal economy. In 2011, more than 143,900 construction jobs fell into the informal sector, which is one out of six construction jobs in the Golden State. This total represented more than 104,100 unreported wage and salary jobs and 39,800 workers misclassified as independent contractors.

The Economic Roundtable examined labor force statistics over a 40-year period, from 1972 to 2012, to chart the size of informal employment in construction. Less than 6 percent of jobs were estimated to be informal in 1972. The ranks of the informal increased over the years, particularly during economic recessions, when formal sector jobs were cut from the industry. In California, four years after the Great Recession, the industry only recovered 66 percent of jobs lost in the formal sector. Informal jobs, however, rebounded quickly to pre-recession levels by 2009 (the last year of the recession).

The net impact of the growing informal economy is that families and communities are cheated of revenue. Construction workers in the informal economy earn about half what their formal counterparts bring home. As a result, more households with an informal construction worker live in poverty rather than in the middle class. Governments are cheated of revenue from employer and employee contributions to federal and local social insurance funds.

California's construction industry is hurt by the informal economy because growing numbers of workers are low-skilled and transient. The industry has a high turnover rate, especially among young workers. Construction has an aging workforce of higher skilled and paid craft workers, the bulk of whom are Baby Boomers approaching retirement. High-road contractors, like higher skilled workers, are pushed out of the industry by low-road competitors who don't report employees and commit payroll fraud to win contracts. Informal employers rely on a contingent and immigrant workforce, populations most at risk for labor violations. The future for construction in California is jeopardized by this informal turn.

Informalization of construction is not inevitable in California. A solid foundation helps a building withstand seismic shocks. Likewise, a solid regulatory foundation of labor law compliance, rewards for high-road employers, sanctions for cheaters, and encouragement of formal sector entrepreneurship will revitalize the construction industry.

### Major Findings

- More than 143,900 jobs in California's construction industry were informal in 2011. That's one out of six construction jobs in the Golden State or 16 percent. More than 104,100 jobs were

unreported by employers in 2011. More than 39,800 employees were misclassified as independent contractors.

- Construction employers were twice as likely not to report their workers than to misclassify them.
- The share of workers unreported on payrolls or misclassified as independent contractors increased by 400 percent from 1972 to 2012.
- Informal construction workers earn half of what their formal counterparts bring home. For every dollar earned by a worker in the formal sector, an unreported worker makes 52 cents and a misclassified worker 64 cents. The total informal wage gap was \$1.2 billion in 2011.
- Specialty trades, such as drywall, have the highest level of informality, over 25 percent employed informally in 2012. Building construction was next, with 20 percent estimated to be informal. Little evidence of informality was found in heavy and civil engineering.
- Construction has difficulty recruiting and retaining young workers. Many younger, lower paid workers are churned, entering and then leaving the industry after short stints. The median age for those who stayed in the industry was 38 while those leaving and entering were 4 to 6 years younger.
- From 1968 to 2012, an annual average of 20 percent of construction workers were not employed. Between 1988 and 2013, half of the unemployed lost their jobs involuntarily.
- Informal construction contributes to the hollowing out of the middle class. Thirty percent of households with an income earner working informally in construction earned below-poverty wages. Households supported by an informal construction worker were three times more likely to live in poverty than households supported by a formal construction worker.
- The informal tax gap in 2011 was estimated to total over \$774 million. The federal government lost \$301 million in taxes and California lost \$473 million. California unemployment insurance was cheated of \$63 million, state disability \$146 million, and workers' compensation \$264 million. These are conservative estimates, which only include unpaid payroll taxes and not income taxes.
- If the wage floor for informal construction was raised to the level of formal workers, California would benefit from \$1.5 billion in economic stimulus. The federal government would receive \$120 million in additional tax revenue, state and local government \$100 million. Unemployment insurance, workers' compensation, and state disability would receive \$1.6 million.

## Recommendations

- Enforce labor, tax, employment, licensing, and payroll laws and support collaborative enforcement efforts.
- Seek legislative or regulatory reforms that focus on the parties that enable the growth of the underground economy.
- Conduct an aggressive and sustained media campaign to expose violators.
- Establish a wage floor, so informal workers are paid at the same level as those in the formal sector.
- Expand policy initiatives that support high-road contractors.



# SINKING UNDERGROUND

## The Growing Informal Economy in California Construction

### Introduction

Construction is a \$152 billion industry in California, employing 895,000 workers.<sup>1</sup> The industry is projected to grow nationally at double the rate for the entire economy through 2022.<sup>2</sup> Because of its size and role as a leading indicator of economic trends, construction is a bellwether of California's economic well-being. Over the past 30 years, a growing share of construction employment has slid into the underground economy, undermining the quality of construction jobs and portending declining labor law compliance throughout California.

The informal economy is difficult to quantify because, by its definition, it is the nonobserved economy (see Defining Informal Economy). Although data availability is improving, largely through the efforts of the International Labour Organization (ILO), most of those efforts are concentrated in the developing

#### *Defining informal economy*

The informal economy is defined here as workers who are not protected legally or socially in their employment arrangements. Also known as the underground economy, off-the-books economy, extra-legal economy, shadow economy, parallel economy, or unofficial economy. These are jobs that would otherwise be considered legal, but are not effectively regulated. Employers in the informal economy break the law by not complying with tax and labor law requirements. This shortchanges public revenue and creates an unfair advantage for employers who take the low road.

The informal economy first became an area of study in the 1970s by developmental economists and anthropologists who documented subsistence labor done by marginal populations to survive in the global south.<sup>3</sup> Often informal workers were migrants from rural areas to cities, making a living in the periphery of an industrial economy. The underlying assumption was that the workers and their activities would eventually be incorporated into the formal sector.

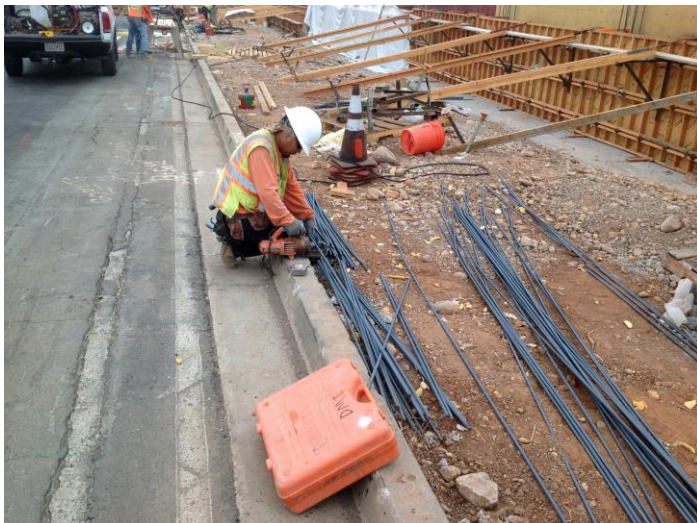
Since the 1980s, the academic literature has shifted to seeing informality as a permanent feature of a post-industrial economy and manifested in both developed and developing nations, alike.<sup>4</sup> Informal employment arrangements in developing countries afford a flexible labor force for small, decentralized microenterprises struggling to compete in the global market. The World Bank published a holistic model in 2007 which proposed that some workers and employers are informal by choice; they exited out of the formal sector because the costs outweigh the benefits of regulation and tax institutions.<sup>5</sup> The solution, according to the authors, was to strengthen the role of the state in enforcement and social protection.

nations, leaving the United States with few reliable estimates, particularly at the state, regional, or industry levels.<sup>6</sup>

Researchers have attempted to estimate the size and scope of the informal economy through indirect means.<sup>7</sup> Economists Fredrich Schneider and Dominik Este aggregated various methods to arrive at an estimate of 9 percent for the informal economy in the United States in 2000.<sup>8</sup> Other calculations by Edward Feige and Richard Cebula produced estimates based on income not reported to the Internal Revenue Service (IRS) that 18 to 19 percent of total income in the nation was earned in the informal economy, totaling \$2 trillion a year.<sup>9</sup>

The Economic Roundtable examined labor force statistics available through federal and state governmental data sets to arrive at an estimation of both the size of the informal economy in construction and its impact on workers and the state economy. Our findings fall into three areas:

1. Estimates of informal employment in the construction industry
2. Wage and worker attrition
3. Impact on poverty and public revenue



We use the following descriptors for informal workers:

- Wage and salary: Individuals that work for wages, salaries, or tips from an employer.
- Self-employed: Individuals that work for themselves instead of an employer.
- Hands-on: Front-line workers in the industry, excluding managerial, administrative, and office staff.

A building needs solid ground and a strong foundation to withstand the tremors of earthquakes. Similarly, the construction industry requires stable footing to maintain equilibrium in a dynamic economy. Unfortunately, the labor market foundation for construction has slowly been sinking over the 40-year period from 1972 to 2012, undermining the industry and making the workers and families who depend on construction jobs increasingly vulnerable and pushed out of the middle class.

## Profile of Mateo Rivera: *A Beautiful Trade*

Mateo Rivera\* followed his father's footsteps into construction. At just 18 years old, he learned carpentry skills from his dad and started working in construction sites. Now 33, Mateo worked hard and surpassed his father by becoming a supervisor, overseeing a construction project from start to finish. His earnings helped his family buy a house in the Inland Empire with four bedrooms to accommodate his children, two toddlers and two in elementary school. His ambitions were to one day become the proprietor of his own business.

Mateo loves what he does. "It's a beautiful trade," he said, "I love being outside, working with my hands." However, the industry was not always kind to Mateo. He couldn't find work during the recession, despite his years of experience. He worked for high-road contractors for 11 years, but had to look to the informal economy for employment during the downturn. "That's when companies started to take advantage of workers, because we have to eat, we have to provide for our families," Mateo explained, "We have to work for these companies."

*"It was hard during the recession, work was slow. Everyone was looking for work. That's when companies took advantage of workers."*

He was relieved to work again, but his family's financial situation didn't improve. Mateo looked for a side job to pay for food and housing because his paycheck didn't cover the bills. On the advice of a colleague he looked closely at his pay stubs and found that he was not being paid for the full number of hours he worked. Out of a 40-hour week he was compensated for just 25 hours. The company varied the amount withheld from Mateo's paycheck from week to week, but what was constant was the fact of wage theft.

*"It's a beautiful trade, I love what I do. As long as the owners are doing the right thing by paying people the wages and not being too greedy. I've seen owners screwing people over. . . . It has a lot of consequences; they hurt a lot of families. They don't care if you lose your house, don't have electricity, or don't have anything in the fridge."*

Mateo left the job with the low-road contractor but found it difficult to find other work. The bills piled up—for the mortgage, to clothe the children for school. The family lost their home and moved into a two-bedroom rental, tight quarters for a family of six. Mateo remembers this period as a difficult time in his life. "Never in my life did I have to get food stamps. I had to do that for my four children," he said, "they're little, they don't wait, when they're hungry, they have to eat. . . . It was hard for me to provide for them." That year, there were no presents under the Christmas tree. Mateo brought his family to his father's house for turkey, because he couldn't afford to buy food for Thanksgiving.

Mateo doesn't want his children to follow his footsteps into construction, as he had followed his father. He encourages his children to pursue other interests to avoid the challenges he faced in the industry. He's concerned about the consequences when companies exploit their workers. "I see owners screwing people over," Mateo said, "They hurt a lot of families, they don't care if you lose your house, don't have electricity, or don't have anything in the fridge."

*\*Mateo's name has been changed to protect his identity.*

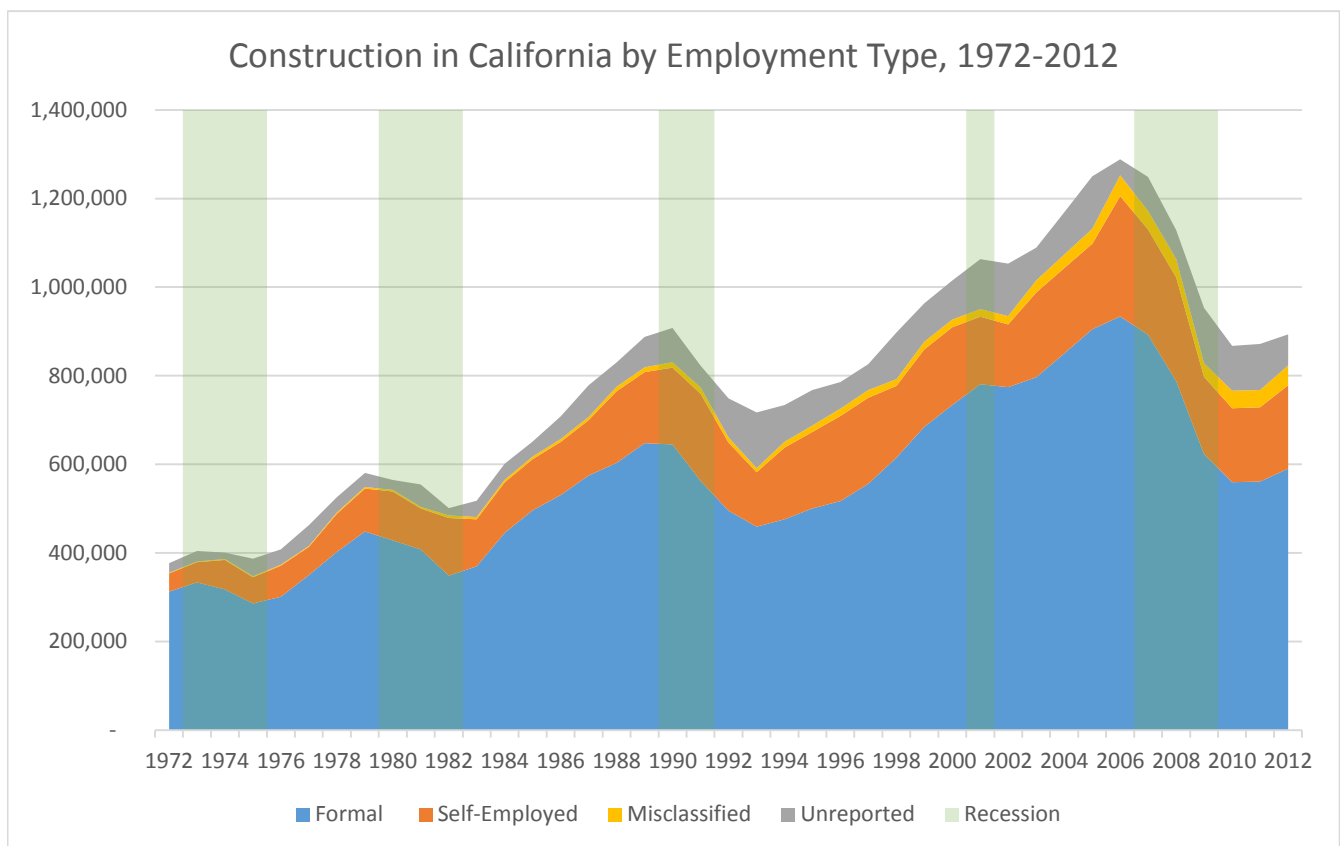
## Chapter 1

# Estimates of Informal Employment

**W**e identified two types of workers within the informal economy: unreported workers who are missing from wage and salary records and independent contractors who are misclassified. Unreported wage and salary workers do not receive an IRS form W-2 reporting receipt of employee compensation. Often, unreported workers are paid in cash or by personal check.<sup>10</sup>

Misclassification occurs when an employer wrongly identifies an employee as an independent contractor. The IRS and state labor departments determine whether a worker is an employee or independent contractor based on the degree of control and independence the worker has in carrying

Figure 1



Sources: U.S. Bureau of Economic Analysis Regional Economic Information System, U.S. Census Bureau decennial census and American Community Survey, U.S. Census Bureau and the U.S. Bureau of Labor Statistics Current Population Survey, California Employment Development Department Industry Employment & Labor Force Report 2012 benchmark, National Bureau of Economic Research Business Cycles, and Economic Roundtable analysis

out his or her job.<sup>11</sup> For example, if an employer tells the worker how, when, and where to work, then the worker is an employee.<sup>12</sup> It is misclassification when an employer wrongly classifies a wage and salary worker as being self-employed and gives the employee an IRS form 1099.

Informal employment has grown by 400 percent in California's construction industry in 40 years (see Figure 1). Less than 6 percent of workers were estimated to be employed informally in construction in 1972. The number of informal workers rose in the late twentieth century to constitute 10 percent of the construction industry. By 2011, over 104,100 or one out of six wage and salary jobs in California went unreported by employers. This represented 16 percent of wage and salary construction jobs unreported by employers.

*One out of six  
construction jobs in  
California was  
informal in 2011.*

More than 39,800 workers were estimated to be misclassified as independent contractors in California's construction industry in 2011. This represented 19 percent of self-employed construction workers.

Combining both unreported and misclassified workers, there are an estimated 143,900 informal workers in California's construction industry, accounting for 17 percent of the state's total construction labor force (see Table 1).<sup>13</sup> Construction employers were more than twice as likely not to report employment than to wrongly classify an employee as an independent contractor.

Table 1

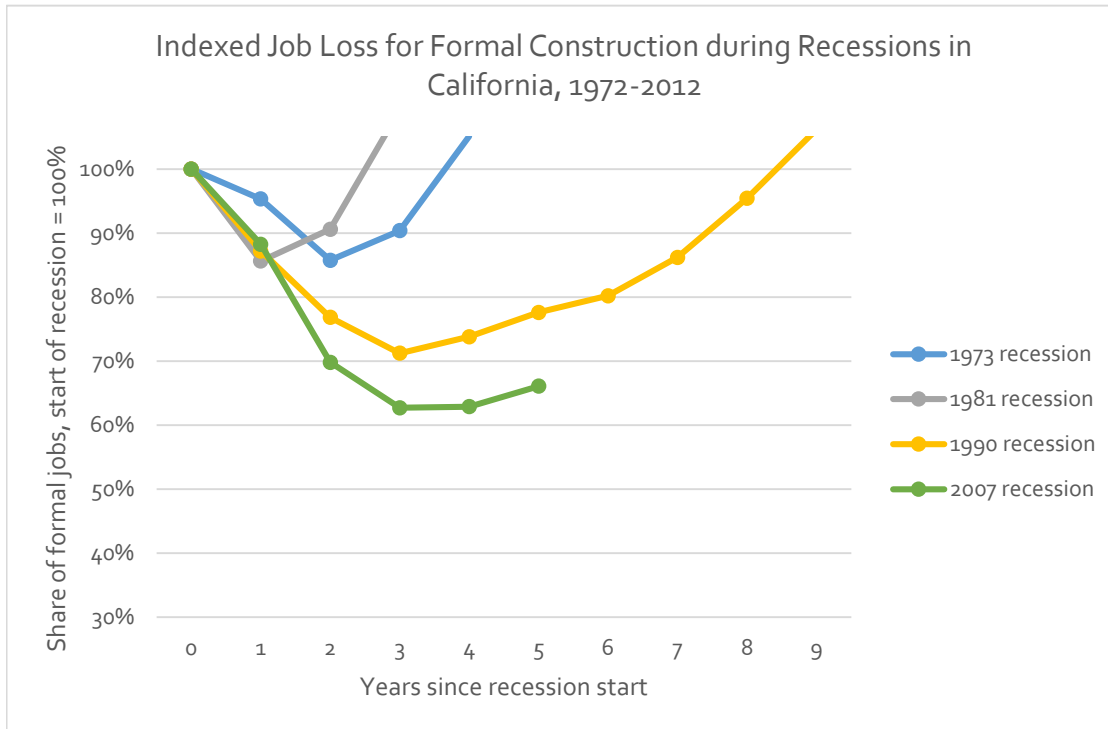
### Estimated Construction Workers Employed in California's Economy in 2011

Labor Force Group	Total	Wage & Salary	Self-Employed
All workers currently employed	872,000	665,400	206,600
All workers informally employed	143,900	104,100	39,800
Hands-on workers currently employed	609,500	461,400	148,100
Hands-on workers informally employed	108,800	76,900	31,900
Percent informal construction industry workers		16%	19%
Percent informal hands-on construction workers		17%	22%

Sources: U.S. Bureau of Economic Analysis Regional Economic Information System, U.S. Census Bureau decennial census and American Community Survey, U.S. Census Bureau and the U.S. Bureau of Labor Statistics Current Population Survey, California Employment Development Department Industry Employment & Labor Force Report 2012 benchmark, and Economic Roundtable analysis.

Hands-on workers, which excludes managerial and administrative support positions, had higher rates of informality than the rest of the industry. In 2011, 17 percent of hands-on workers, totaling 76,900, were unreported by their employers. Twenty-two percent of hands-on workers, totaling 31,900, were misclassified as self-employed.

Figure 2



Sources: U.S. Bureau of Economic Analysis Regional Economic Information System, U.S. Census Bureau decennial census and American Community Survey, U.S. Census Bureau and the U.S. Bureau of Labor Statistics Current Population Survey, California Employment Development Department Industry Employment & Labor Force Report 2012 benchmark, National Bureau of Economic Research Business Cycles, and Economic Roundtable analysis.

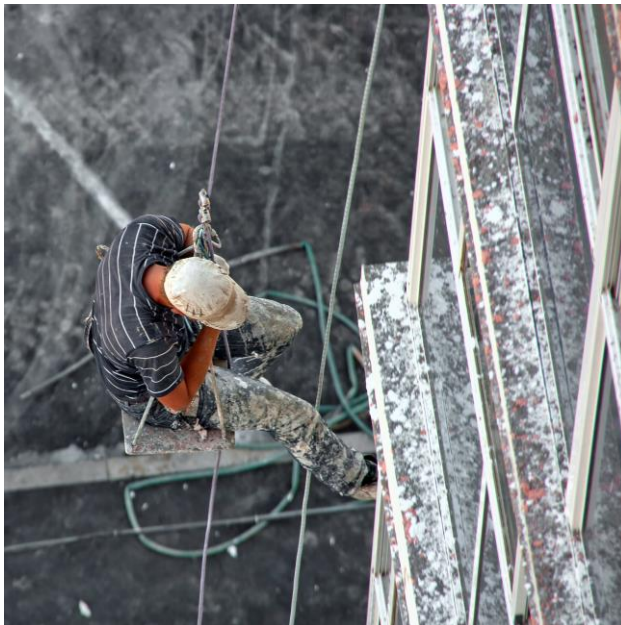


Photo by 2HAPPY.

Employment, overall, is on the rise in construction. However, the numbers are subject to cyclical variation. Construction industry data is used as a leading economic indicator to foretell coming booms or busts. This includes employment in both the formal and informal sectors. The ranks of formal sector construction workers decrease during times of recession (see Figure 2). Over the 40-year period of our analysis, we see that formal employment decreased during the recessions starting in 1973, 1980, 1990, 2001, and 2007. Research by the nongovernmental organization Women in Informal Employment: Globalizing and Organizing (WIEGO) showed that informal workers face increased competition from unemployed workers previously employed in the formal sector who cross over into informality during economic downturns.<sup>44</sup>

## 1.1 Unreported Workers

Many wage and salary workers are missing from the accounting of California's employed labor force. Over time, these unreported workers have grown in number as the working-age population has increased across the state and noncompliance with labor and tax laws have become more widespread. We relied on discrepancies between three data sets to arrive at estimates of unreported jobs. The entire employed population is captured by the Bureau of Economic Analysis (BEA). The BEA draws on many sources of data, including administrative records collected from numerous federal agencies and social insurance programs, including state unemployment insurance and Social Security.<sup>15</sup> The BEA produces estimates of annual employment for states and counties, disaggregated by industry sector. For construction, this estimate represents the entire universe of those employed each year in the industry.<sup>16</sup>

The California Employment Development Department (EDD) provides estimates of the wage and salary jobs reported by employers. This represents the formal economy of employers complying with labor laws. The EDD receives information on employment and wages based on employer filings for unemployment insurance. The compiled data, also known as the Quarterly Census of Employment and Wages Program (QCEW) or ES-202, provides monthly and annual employment estimates for the state and counties, disaggregated by industry.



Photo by TOMAS ADORNAITIS.

Between these two data sources, we noticed a large discrepancy in estimated employment. In the three-year period from 2010 to 2012, the BEA estimated that there were, on average, more than 877,000 construction jobs statewide. However, only 570,000 were identified in EDD data for the formal economy. We concluded in our 2005 report *Hopeful Workers, Marginal Jobs* that the difference in employment numbers indicated the presence of unreported, informal jobs.<sup>17</sup>

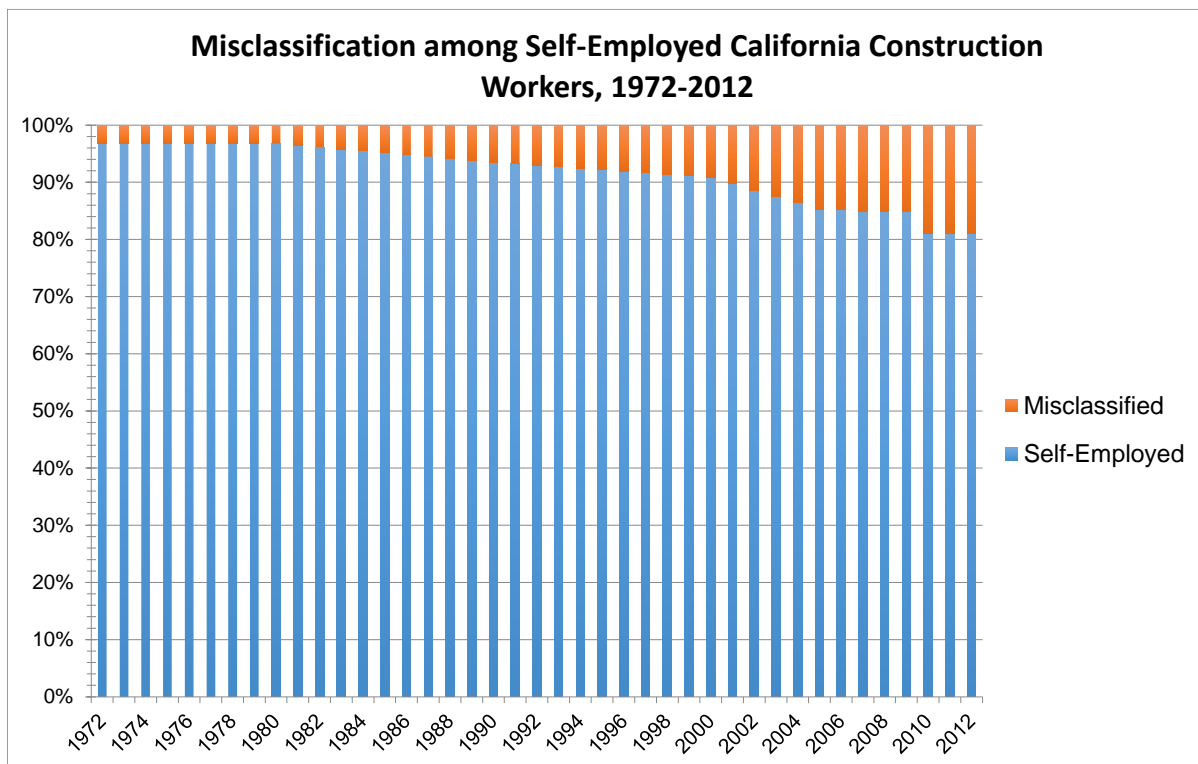
We then removed the portion of self-employed to isolate the number of unreported wage and salary jobs. The U.S. Census and Bureau of Labor Statistics (BLS) collaborate on the annual Current Population Survey (CPS) of approximately 60,000 households across the nation through personal and phone interviews.<sup>18</sup> Unlike the BEA and California EDD, the CPS data captures persons who are self-employed or not working. The rate of self-employment reported in CPS data helped us distinguish informally employed wage and salary workers from wrongly classified workers.

## 1.2 Misclassification

Misclassification is growing as a source of informal employment in construction. Some employers seek a fig leaf of legal compliance while avoiding payment of payroll taxes and benefits by misclassifying hourly workers as independent contractors. Employers are not required to pay Social Security tax, unemployment insurance, disability insurance, worker's compensation insurance, overtime, or the minimum wage for independent contractors. Misclassifying workers can decrease payroll costs for employers by 30 percent.<sup>19</sup> A 2009 study commissioned by the California Department of Insurance's Fraud Assessment Commission found the number of employees either under- or misreported by employers increased when workers' compensation premiums increased.<sup>20</sup> Employers underreported 1 to 4 percent of their payroll when premium levels were low, but misreporting increased when premiums were increased in 2000.

Estimates of the scope of misclassification range from 14 to 38 percent of construction workers who are reported to be self-employed. A 2000 study issued by the Department of Labor estimated that almost 30 percent of unemployment insurance audits in 1998 yielded misclassified cases across all industries.<sup>21</sup> Construction had the second highest rate of misclassification among California industries.<sup>22</sup> A 1984 study by the IRS reported that 19.8 percent of construction employers misclassified their employees.<sup>23</sup>

Figure 3



Sources: U.S. Census Bureau and the U.S. Bureau of Labor Statistics Current Population Survey and Economic Roundtable analysis



Other studies estimated a misclassification rate in the construction industry of:

- 14–24 percent in Massachusetts (2004)<sup>24</sup>
- 14 percent in Maine (2005)<sup>25</sup>
- 19.5 percent in Illinois (2006)<sup>26</sup>
- 14.8 percent New York state (2007)<sup>27</sup>
- 17.8 percent in New York City (2007)<sup>28</sup>
- 38 percent in Austin, Texas (2009)<sup>29</sup>
- 11–21 percent, includes unreported workers, in Tennessee (2010)<sup>30</sup>
- 16.8 percent in Indiana (2010).<sup>31</sup>

There were an estimated 39,800 misclassified California workers in 2011, or 19 percent of construction workers who reported being self-employed (see Figure 3). A decade earlier, only 18,000, or less than half as many, self-employed workers were misclassified. In the 40 years since 1972, the number of misclassified construction workers has increased by 42,700.

### 1.3 Informal Wage Gap

Construction workers who are not reported by their employers earned about half of what their formal counterparts brought home (see Figure 4). Informal workers who worked full-time but were not reported by their employers earned a median income of \$15,473, whereas those properly reported by their bosses made \$30,000. That means for every dollar earned by a worker in the formal construction sector, an unreported worker made 52 cents. For part-time workers, the gap between informal and formal earnings was even wider. Part-time workers who were not reported earned 42 cents for every dollar paid to their counterparts in the formal sector.

Figure 4

#### Median annual income for full-time California construction workers, 2011



Formal



Misclassified



Unreported wage and salary

Sources: U.S. Bureau of Economic Analysis Regional Economic Information System, U.S. Census Bureau decennial census and American Community Survey, U.S. Census Bureau and the U.S. Bureau of Labor Statistics Current Population Survey, California Employment Development Department Industry Employment & Labor Force Report 2012 benchmark, National Bureau of Economic Research Business Cycles, and Economic Roundtable analysis

Misclassified workers also suffered an earnings penalty. Full-time construction workers who were correctly identified as independent contractors earned an annual median income of \$22,282, whereas misclassified full-time workers made \$7,427 less. For every dollar a self-employed worker earned in the formal economy, a wrongly classified worker earned 67 cents when working full-time or 64 cents if part-time.

The total informal wage gap equaled \$1.2 billion for nearly 144,000 informal construction workers in California in 2011. In other words, if the informal sector in construction were to receive the same wages as their counterparts in the formal economy, California workers would benefit from \$1.2 billion more in wages. The economic impact of raising informal wages to the level of the formal economy is discussed in Chapter 3.

*If informal workers received the same wages as their formal counterparts, California would benefit from \$1.2 billion more in wages.*

#### 1.4 Construction Subsectors

The construction industry is composed of three subsectors: construction of buildings, heavy and civil engineering, and specialty trade contractors. There is overlap between the first and third subsectors, in that both work on residential and commercial buildings. However, building contractors are typically responsible for the entire project and then subcontract with specialty trade contractors for a particular craft, such as electrical, mechanical, or interior systems including drywall.<sup>32</sup> Heavy and civil engineering, as the name suggests, focuses on infrastructure projects, such as the construction of highways or dams.

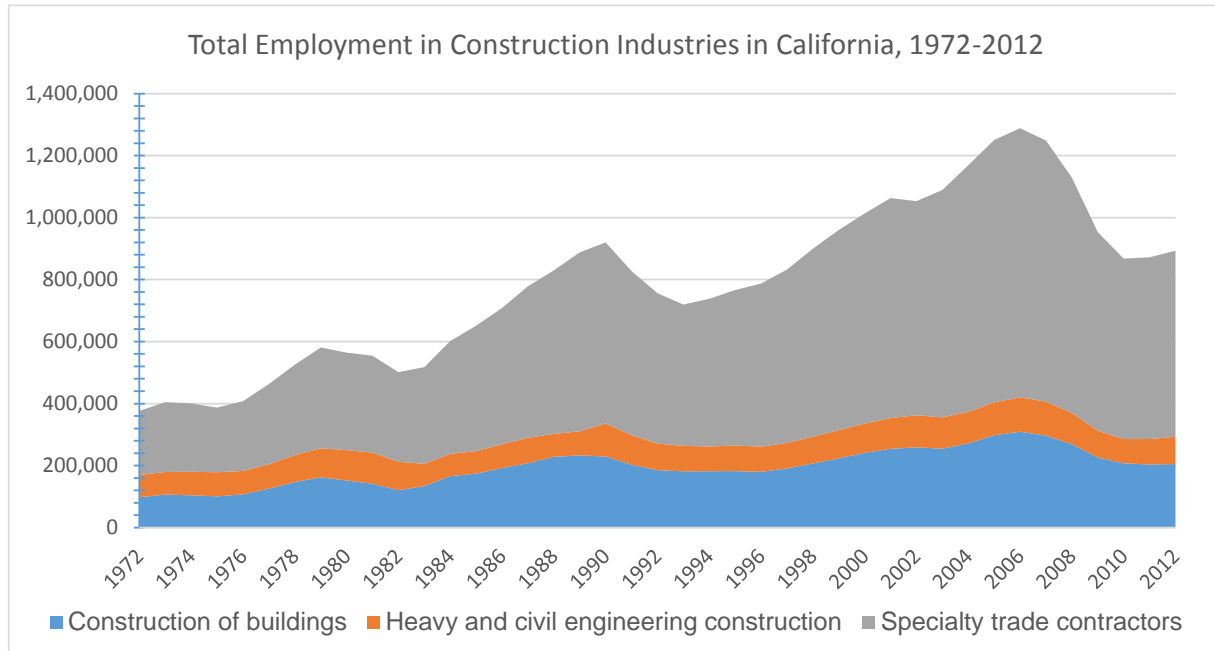
Specialty trades is the largest of the three subsectors, employing two out of three construction workers in California in 2010–2012 (see Figure 5).<sup>33</sup> In 2011, more than 586,000 workers were employed in specialty trades, whereas 82,000 and 203,000 worked in the civil engineering and building subsectors, respectively.



Photo by TOMAS CASTELAZO.

Despite the size of the specialty trades subsector, some industry analysts express concern about the shortage of adequately skilled workers.<sup>34</sup> The industry group Associated General Contractors reported that 74 percent of construction firms had trouble finding qualified craft workers.<sup>35</sup> However, economists, such as Dale Belman, responded that there are no signs of a tightening job market.<sup>36</sup> Typically, a labor shortage is accompanied by low unemployment and increasing wages

Figure 5



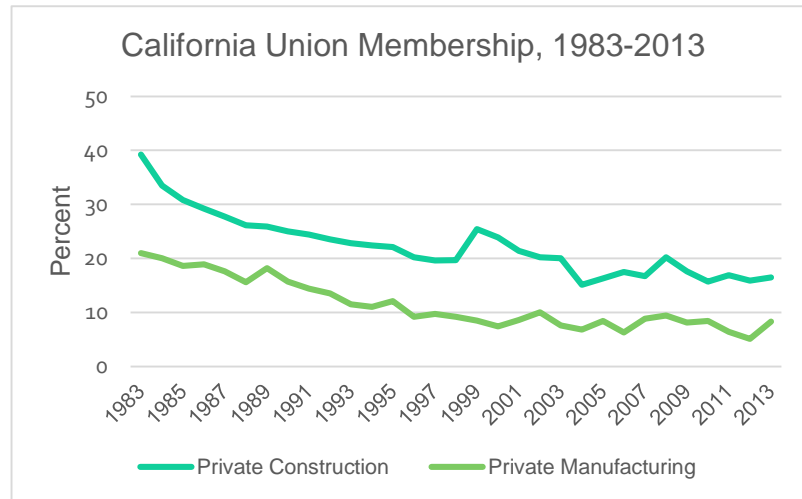
Source: U.S. Bureau of Economic Analysis Regional Economic Information System

due to greater demand for workers. Neither of these two things have occurred five years after the Great Recession ended.<sup>37</sup> We address this in more depth in Chapter 2.

We found the highest levels of informality in the specialty trades, with over 25 percent of the subsector estimated to be employed informally in 2012. In building construction, we found nearly 20 percent informality. In heavy and civil engineering, on the other hand, we found very little evidence of informal employment. Heavy and civil engineering projects are subject to greater governmental regulation and scrutiny, reducing but not eliminating opportunities for informal labor practices. Economist Steven Allen pointed out that heavy and highway subsectors retained union membership through the 1970s and '80s, preserving wages set by collective bargaining and/or project labor agreements.<sup>38</sup>

"There isn't a nail driven in this area that isn't driven by a union man with a union card in his pocket," said a Carpenters' Union officer in 1969.<sup>39</sup> The construction industry had 100 percent union density in the 1960s, according to sociologist Ruth Milkman's calculations. However representation dropped precipitously across the Golden State. By 1985 membership was at 59 percent. The decline continued inexorably through the 1990s, with membership dropping to 24 percent in 2000. By 2013, the union nail was a rarity, with membership at 16 percent in construction (see Figure 6).

Figure 6



Source: *Union Membership and Coverage Database from the CPS (Unionstats.com)*, Barry T. Hirsch & David A. Macpherson, 1983-2013.

The National Labor Relations Board ruled to allow double-breasting in 1973.<sup>40</sup> Contractors who were bound to a collective bargaining agreement were allowed to open to nonunion affiliates. This decision opened the floodgates for open shops to underbid unionized firms by offering cheaper prices. Nonunion workers earned 30 to 42 percent less than union workers between 1967 and 1975.<sup>41</sup> Unions were forced to accept concessions in their contracts throughout the 1980s. By the late 1970s, 300 contractors in Los Angeles withdrew from collective bargaining agreements and subcontracted to nonunion firms.<sup>42</sup>

Construction unions were undermined during the Vietnam War, a decade before membership declined in other industries, according to legal scholar Marc Linder. He argued that tactics used to curb construction unions were later applied to other sectors in the late 1970s. For example, double-breasting spread beyond construction to become common in manufacturing.<sup>43</sup>

## 1.5 Construction Occupations

There is a wide range of informality among hands-on construction occupations in California. Construction helpers had the highest rate of informality—28 percent among employed workers—followed by painters and laborers at 23 percent, carpet installers at 22 percent, and roofers at 20 percent (see Figure 7).

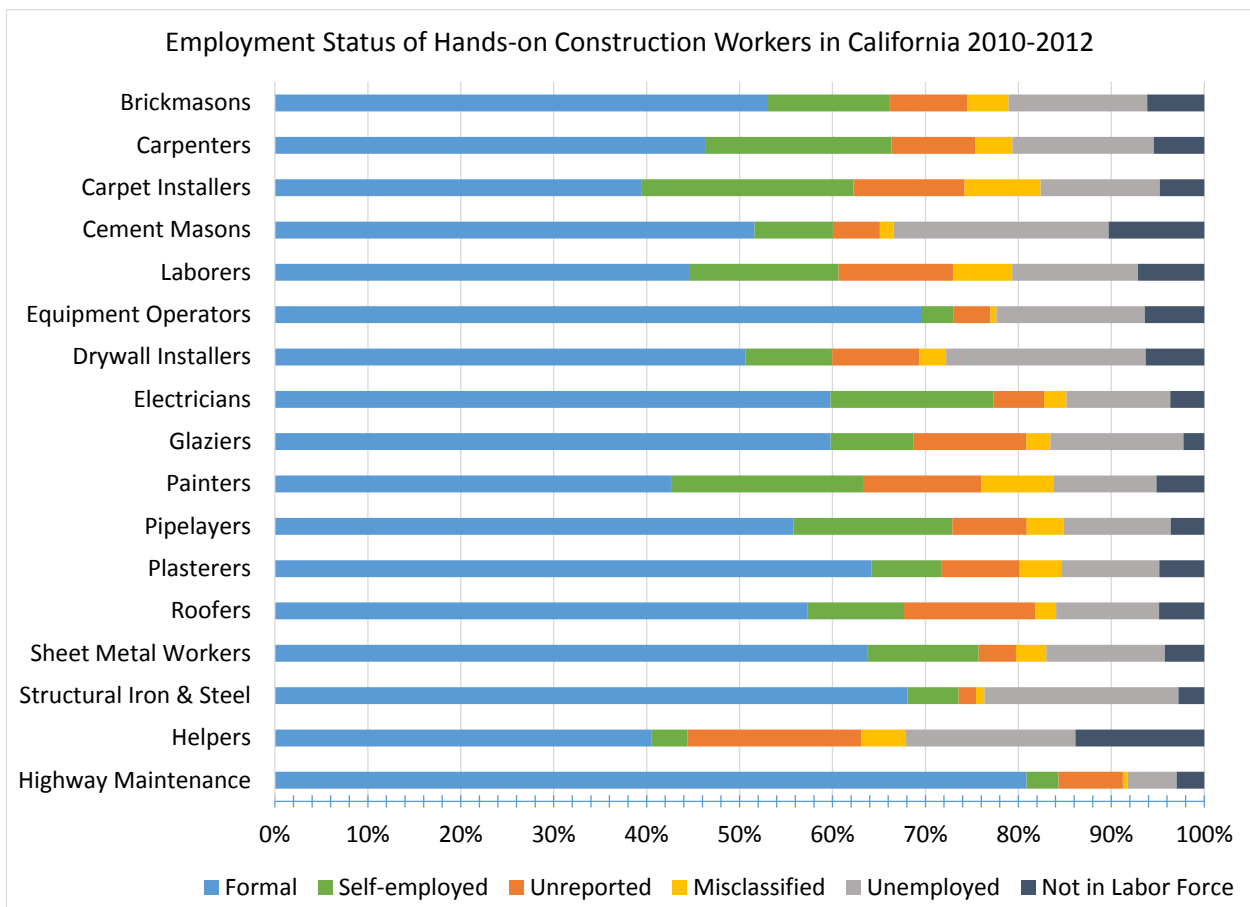
The lowest rates of informality for employed workers were found among structural iron and steel workers and also

*According to the Bureau of Labor Statistics, helpers assist craft workers with a variety of basic tasks, such as carrying tools and materials or setting up equipment. Laborers also perform a wide range of tasks, but their main one is preparing and cleaning up construction sites.*

equipment operators at 6 percent, sheet metal workers as well as highway maintenance workers and glaziers at 9 percent, and electricians at 10 percent.

More than 47,000 laborers were estimated to be informally employed, followed by 16,300 painters and 15,100 carpenters. Because of their size, these three occupations are estimated to account for 70 percent of all informal employment among hands-on construction workers.

Figure 7



Source: U.S. Census Bureau American Community Survey 2010-2012 and Economic Roundtable analysis. California construction workers in hands-on occupations with \$500 or more earned income in the previous year.

Note that the figure includes workers who are unemployed and not in the labor force as well as those who are employed.

### Profile of Cindy Mitchell: *Do the Right Thing*

Cindy Mitchell grew up always knowing she wanted to own and run her own business. She graduated from college with a business administration degree and cut her teeth running an auto repair shop. Then, she followed an opportunity in tile installation, opening her business, Citadel Premium Design, in West Sacramento in 1989. Her company provides tile installation for commercial developments and major home construction projects in Northern California and Nevada. Cindy sat at the helm of her business for 25 years and has weathered three recessions. She has stuck to the high road, even when a growing number of owners are choosing to cheat.

*“Cheaters pay in cash, they don’t pay payroll taxes or workers’ compensation. Even if they do have people on payroll, they’ll underreport people for worker’s compensation. Or, they won’t pay the prevailing wage to workers and will avoid getting caught. Cheaters turn to these practices out of desperation—when you have a mortgage payment and a family to feed, unfortunately some people turn to the dark side instead of working harder or cutting costs.”*

Cindy sees cheating on the rise during the economic downturn. “After the previous recession, cheaters were out there, but there weren’t so many. They stopped what they were doing when building picked up. But this time, it’s different. The cheaters really feel that they’ve found a good way to make money.” The Great Recession hurt Cindy’s business in a way that the prior two hadn’t. She started her business on the tail end of the 1990 recession, when home building slowed down but commercial development didn’t. The same was true with the 2001 downturn, which affected the construction industry two years before it hit the rest of the economy. “We never felt the recession and kept building until the crash that began in 2006. It was ugly, it’s still ugly.”

Cindy had to cut costs to keep her business afloat during the recession. She moved the office into a smaller space to save on rent. However, contractors who take the low road have a competitive advantage over responsible owners, such as Cindy, in winning bids on construction projects. “We’re a good-sized business and we know that our pricing is competitive. We know how many square feet an installer can complete in a day. We also know what it would cost, when you add the cost of labor and materials together. When the winning bid is under the total cost, it’s a cheater.”

Cindy is worried about what the next 25 years will bring for the construction industry, given the favorable climate for cheating. “Disreputable businesses will not be around in 25 years to warranty their work. Cheaters are unscrupulous by nature, there’s more of a likelihood that their work is not up to par. They may not be using the products they say they’re using. Cheaters always cheat, they’re dishonorable people and will take it as far as they can.”

The tide can turn for the industry, according to Cindy, if government regulation stepped up. “The solution is to catch more cheaters and make an example of them. Let it be known which cheaters are being caught and which of the different agencies are catching them, whether it’s the Employment Development Department or the Franchise Tax Board. I wish it was advertised more publicly that cheating is happening and that there were more consequences for cheaters. Ultimately, it’s the government and the consumer that suffer. We don’t need unsafe buildings because of cheaters.”

# Wage and Worker Attrition

Low wages, marginal employment conditions, and an aging labor force are resulting in an inadequate supply of skilled construction workers in California. This shortage is not attributable to a shortfall in the number of construction apprentices who are enrolled and trained, but to a failure to retain skilled workers in the industry. The number of active California apprentices in construction occupations averaged 3 percent of total construction employment in the 1990s and 4 percent from 2000 through 2011.<sup>44</sup> Despite the increased rate of training, there are indications that a significant number of skilled workers are leaving construction and moving to other industries.

An average of 40 percent of construction workers in hands-on jobs moved into or out of the industry each year from 1968 to 2013 (see Figure 8). We referred to the population of workers employed in construction in the previous and current year of the survey as *stayers*. *Joiners* were employed in a different industry the previous year but found work in construction in the year surveyed. *Leavers* were employed in construction the prior year but working in another industry in the year surveyed.

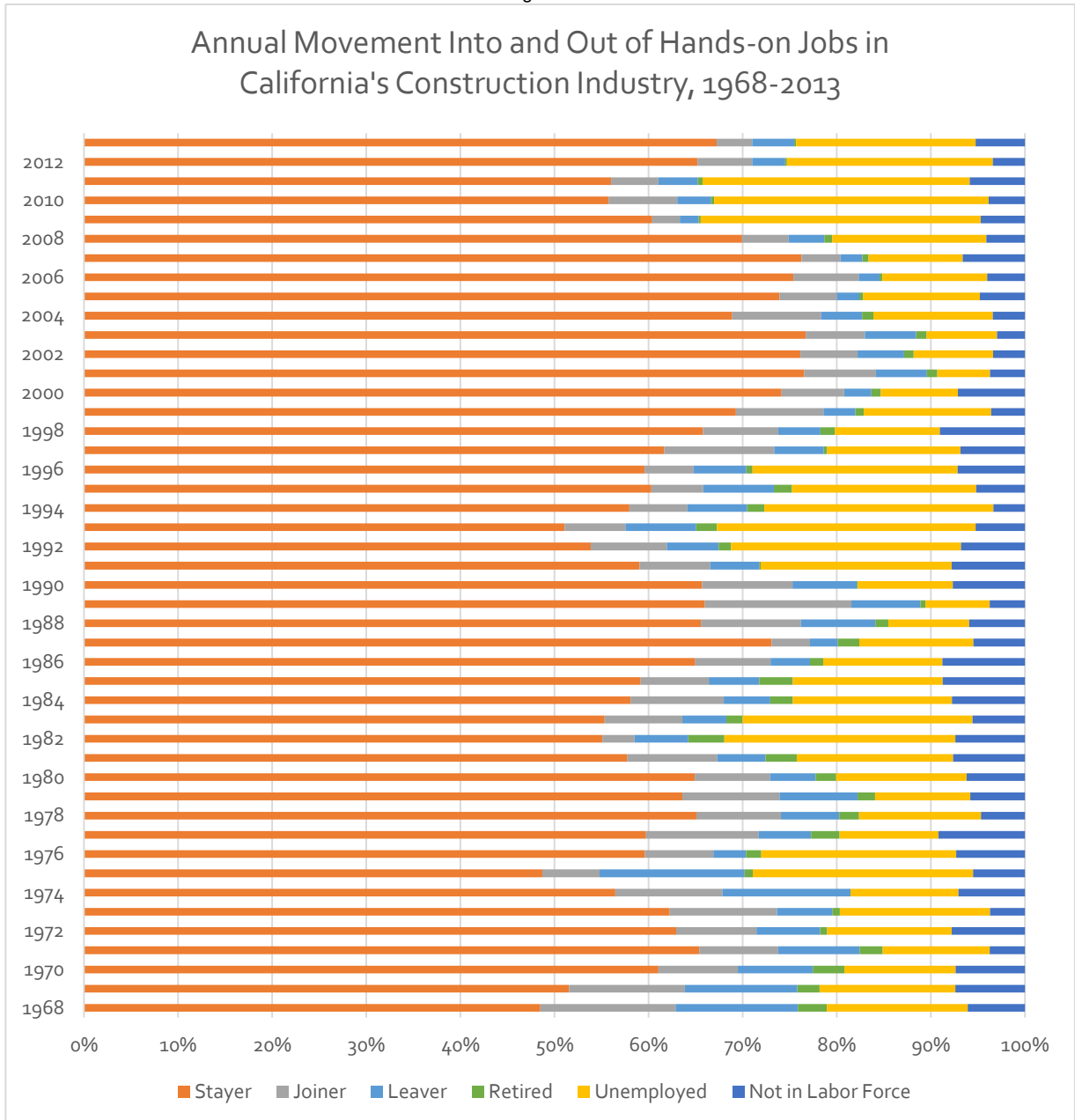
Construction has one of the highest job turnover rates of any industry. Nationally, 4 percent of the workforce in the construction industry were separated from their job in January 2014.<sup>45</sup> This meant that in a single month, 248,000 construction workers terminated their employment arrangement, either voluntarily by quitting or involuntarily by being laid off or discharged. The turnover rate is 13 percent higher for construction than for the overall private sector.

Hands-on workers leave the construction industry for three reasons. The first is job loss during downturns. Workers who left the formal construction sector either turned to the informal sector out of necessity, were under- or unemployed, or dropped out of the labor force. Second, the skilled workforce in the industry is aging, and a generation of craft workers are retiring. Third, few incentives exist to retain joiners who are new to the industry. The demographic profile of joiners differs from stayers, as do their wages. Construction jobs available to joiners often



place them in a secondary labor tier with lower wages. This secondary tier threatens to become the dominant model for the industry.

Figure 8



Sources: U.S. Census Bureau and the U.S. Bureau of Labor Statistics Current Population Survey and Economic Roundtable analysis.



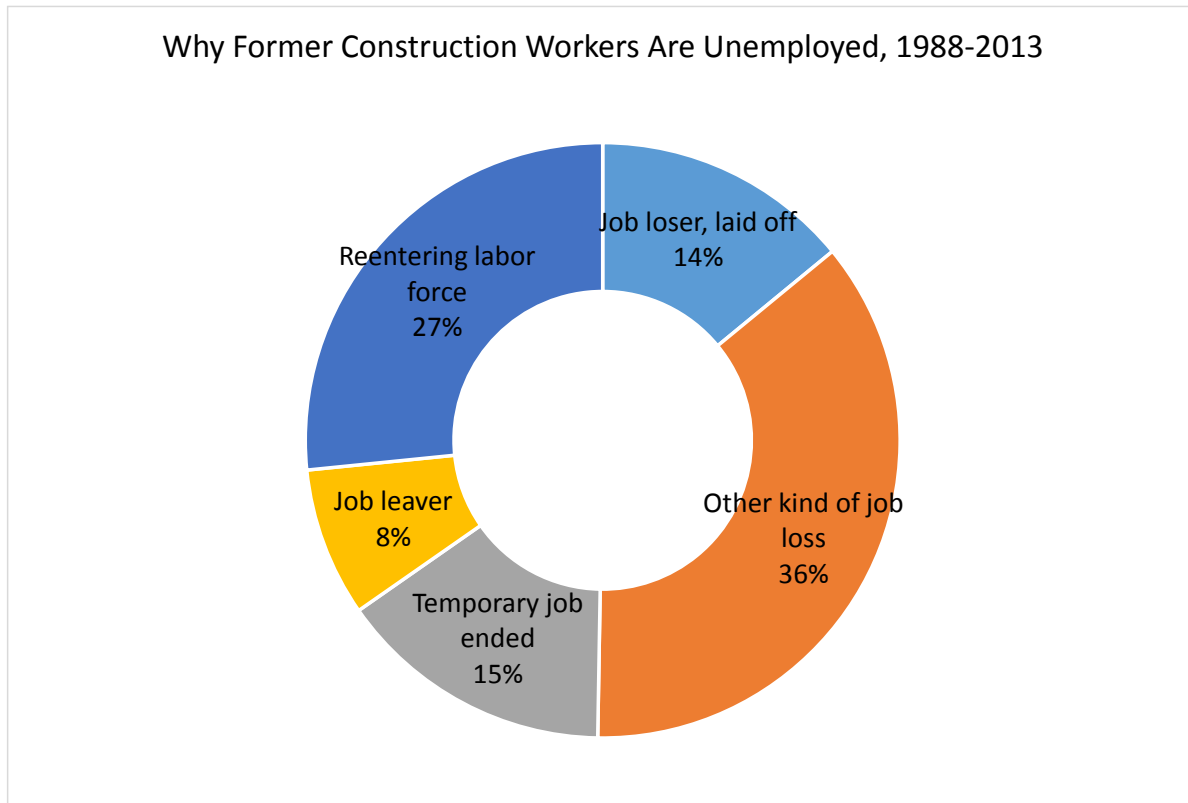
## 2.1 Job Loss

Over a 44-year period, from 1968 to 2012, an annual average of 20 percent of construction workers were not employed (see Figure 9). The numbers of unemployed increased significantly during recessions. Half of out-of-work construction workers lost their jobs involuntarily over a 25-year period (see Figure 10). Fourteen percent were terminated from employment, and 36 percent experienced some other kind of job loss. On average, more than 34,500 left the construction industry annually and found employment in other areas of the economy. Twenty-seven percent left the labor force, including discouraged and marginally attached workers, but were now looking for work.

The time-limited nature of construction jobs and the need for most construction workers to invest continuing effort in searching for the next job make the industry especially vulnerable to labor force attrition when employment conditions within the industry are not competitive with those in other industries.

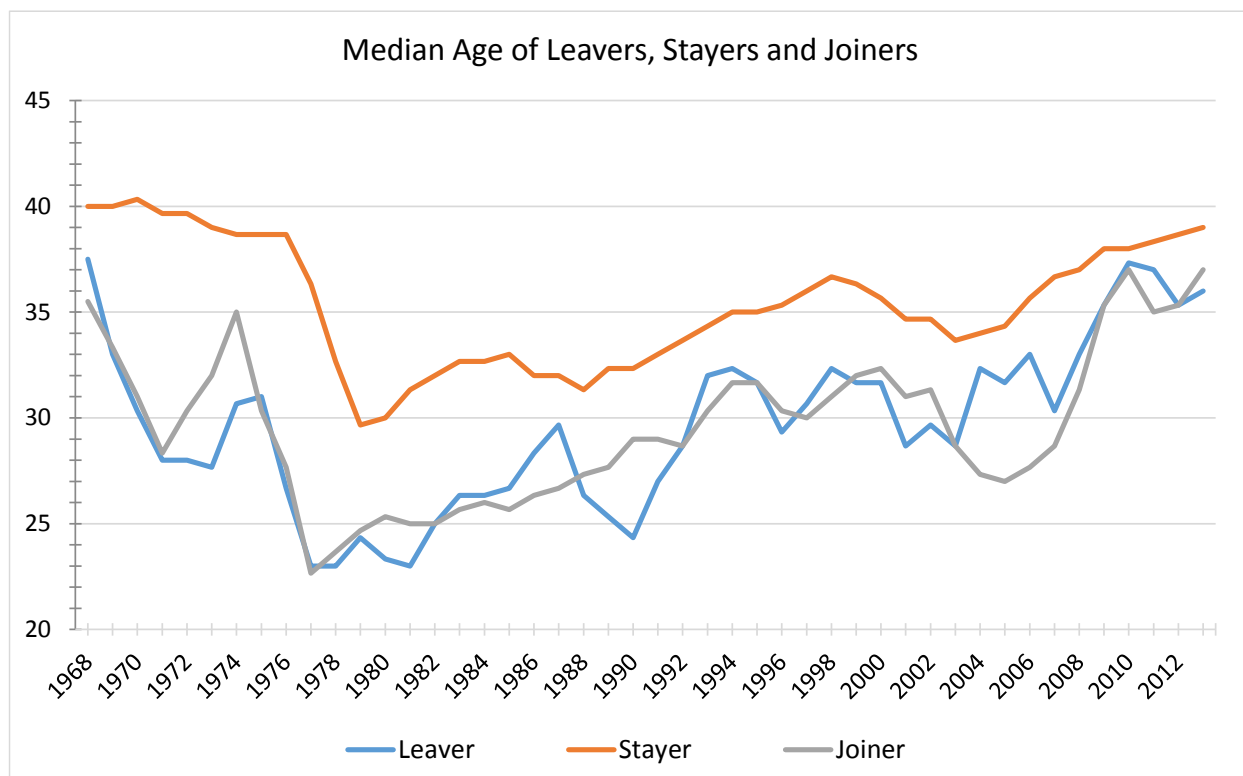
With seven unemployed construction workers for every job opening in the nation in 2014,<sup>46</sup> there are anecdotal reports of construction workers moving from the formal to informal sector out of economic necessity (see Chapter 1's Profile of Mateo, *A Beautiful Trade*). We cannot confirm this movement with the data that is available, but it should be further investigated.

Figure 9



Sources: U.S. Census Bureau and the U.S. Bureau of Labor Statistics Current Population Survey and Economic Roundtable analysis

Figure 10



Sources: U.S. Census Bureau and the U.S. Bureau of Labor Statistics Current Population Survey and Economic Roundtable analysis. Age data is a 3-year moving average of annual median age of each cohort.

## 2.2 Aging Workforce

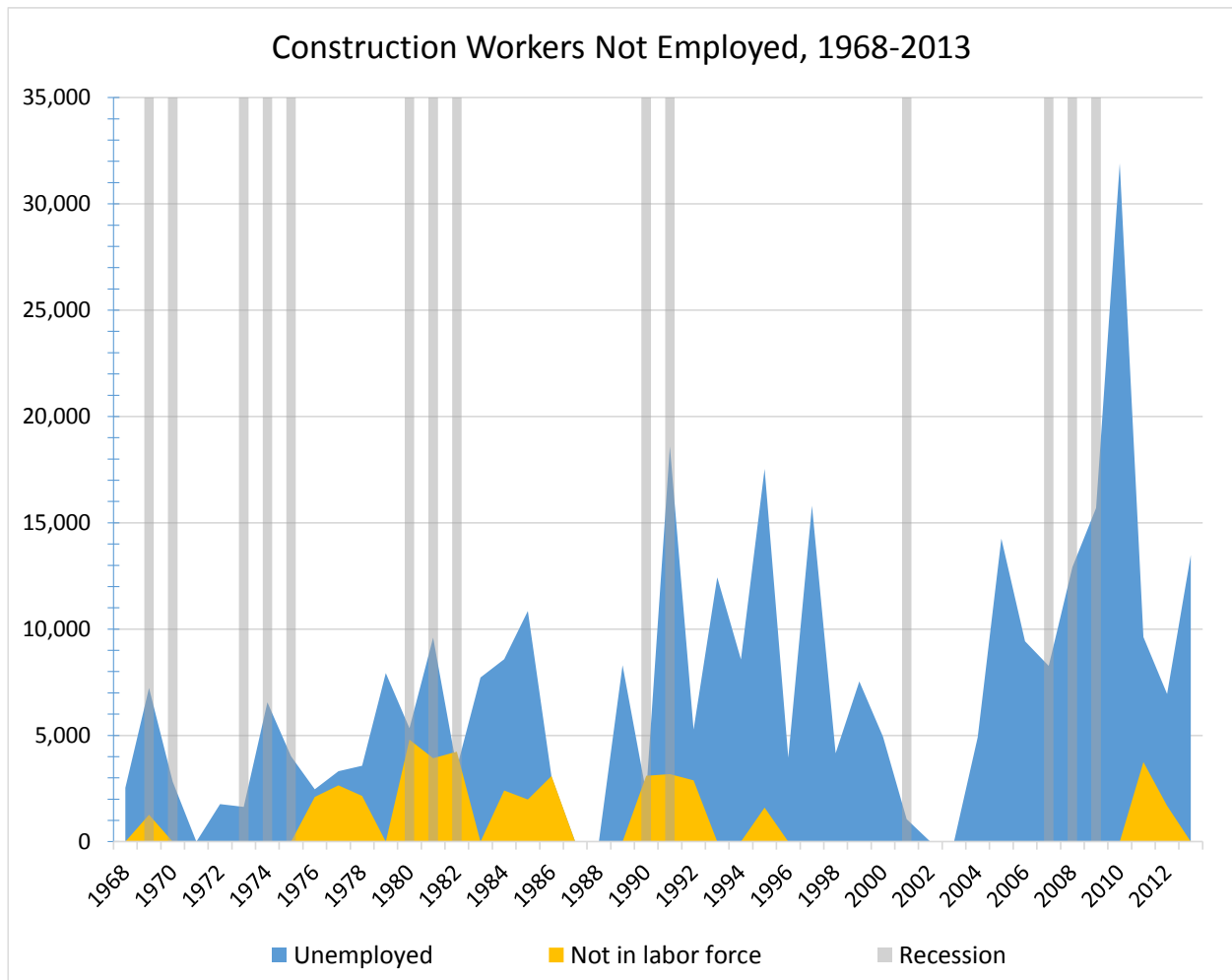
A significant portion of workers leaving the construction industry are retiring Baby Boomers. More than 40 percent of construction workers employed in 2010 were born between 1946 and 1964.<sup>47</sup> The median age of California construction workers in 2011 was 38. For some occupations, including carpenters, equipment operators, and electricians, the median age was older than 41.<sup>48</sup> The graying of the workforce raises alarms for industry analysts, who point to a shortage of skilled craft workers.

The workers who stay in the industry from one year to the next are older than the ones who leave (see Figure 11). In 2011, the median age for stayers was 38; half of leavers were 4 years younger and half of joiners 6 years younger. This suggests that a younger contingent of workers is seeking a sustaining foothold in construction and leaving for other industries after failing to find it.

Industry analysts reported that construction has difficulty attracting and retaining entrants to the labor force. "We don't like construction work because it's dirty work. Your clothes get dirty, your hands get dirty, everything is dirty," students told Hilton Smith, director of equal opportunity and college recruitment at the Turner Corporation, a large general contractor.<sup>49</sup>

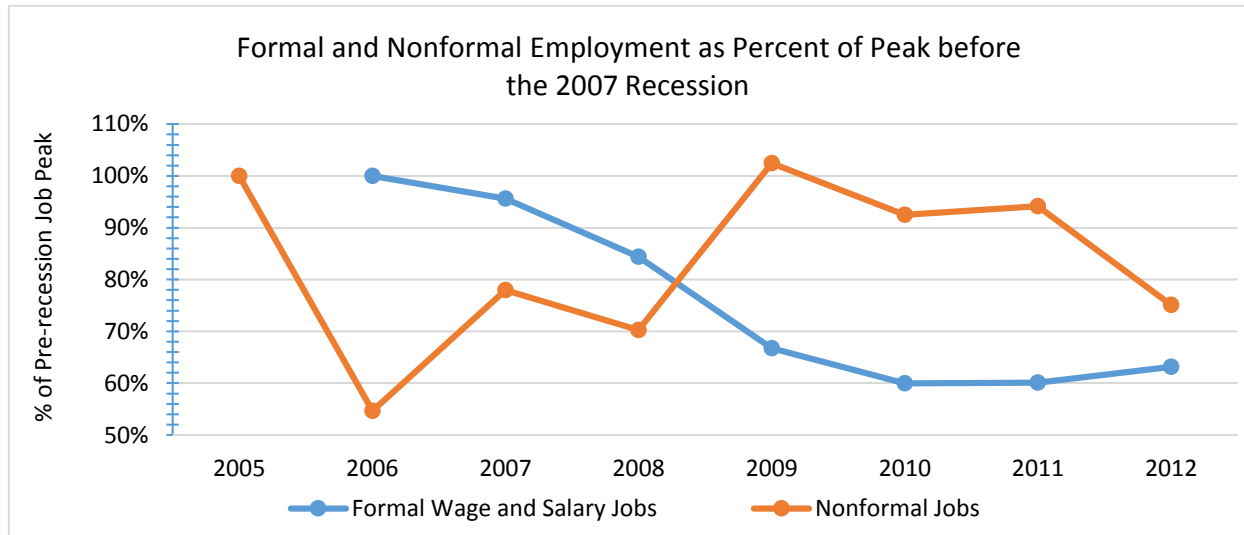
Given that informal workers make significantly less than their formal counterparts, industry observers link informality with labor shortages in construction.<sup>50</sup> Low wages deter young workers entering the labor market from pursuing careers in the skilled trades, according to labor researcher Jeffrey Grabelsky.<sup>51</sup> High school students who were surveyed by the *National Business Employment Weekly* ranked construction 248 out of 250 possible career choices.<sup>52</sup>

Figure 11



Sources: U.S. Census Bureau and the U.S. Bureau of Labor Statistics Current Population Survey, National Bureau of Economic Research Business Cycles, and Economic Roundtable analysis

Figure 12



Sources: U.S. Census Bureau and U.S. Bureau of Labor Statistics Current Population Survey and Economic Roundtable analysis

### 2.3 Two-Tier Workforce

With each economic contraction, the construction industry recovered slowly. During the Great Recession, more than 380,000 California construction jobs were lost by 2010. The bulk of the jobs lost, more than 87 percent, were in the formal sector, leaving mostly lower-paid informal work and less opportunity to advance into the middle class. In 2012, four years after the onset of the recession, the industry still had not recovered the number of jobs lost.

The informal sector has been a harbinger of construction trends in the recent recession. Informal employment peaked in 2005, and job losses among informal workers began two years before the start of the recession in 2007. Informal workers were also the first to be rehired, with employment reaching the pre-recession peak in 2009 (see Figure 12).

Formal wage and salary employment peaked in 2006 and reached bottom in 2010, with only a hint of recovery in 2010 and slight job gains in 2012. Hiring has been far more robust in the informal sector than in the formal sector as construction employers sought to minimize labor costs. A related trend is increasing reliance on self-employed workers, including misclassified workers, as shown earlier in Figure 1.

Construction is moving toward a two-tier system, in which workers are demarcated by skill and wage levels.<sup>53</sup> Tier one workers are lower skilled or have limited industry experience. They are brought to projects to focus on particular tasks with maximum supervision. Tier two workers have more skills and autonomy. Accordingly, tier two workers earn more than tier one workers.

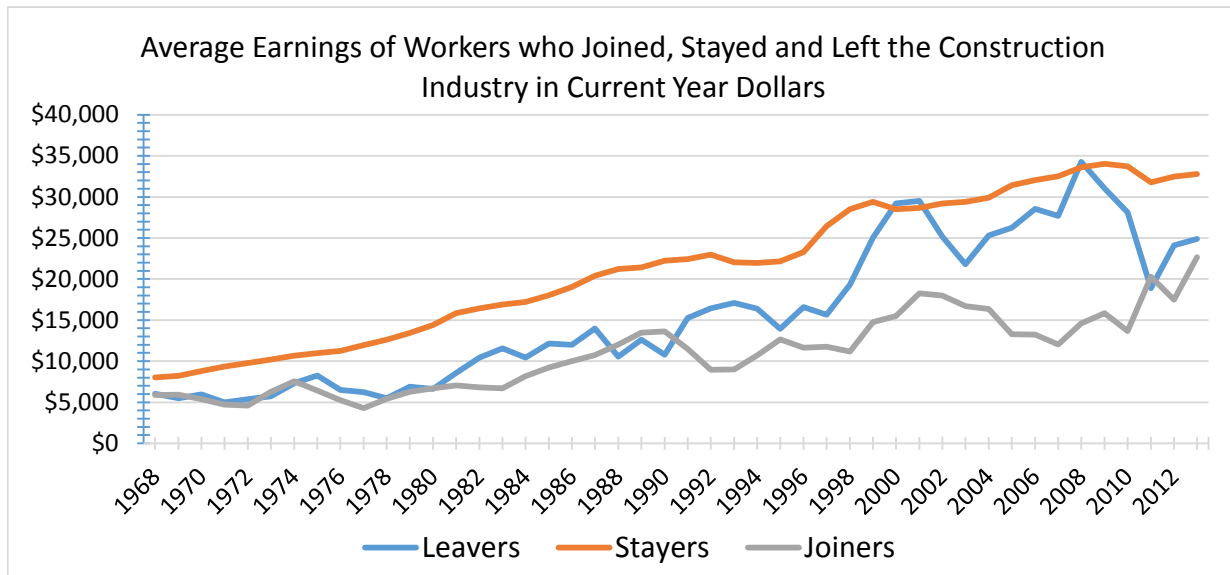
Critics of bifurcating the workforce, such as economists Barry Bluestone, demonstrated that newer, lower-paid employees have a high turnover rate.<sup>54</sup> We can see this trend emerging in California

construction, with tier one leavers and joiners, exiting and entering the industry, and tier two made up of stayers. Most recently, the average annual salary for stayers was \$32,800, whereas joiners and leavers earned significantly less: \$22,700 and \$24,900, respectively. In other words, for every dollar earned by a stayer, a leaver makes 76 cents. Joiners make even less: 69 cents (see Figure 13).

Labor researcher Ken Jacobs noted that two-tier structures have negative effects on an industry.<sup>55</sup> Eroded worker morale and lowered productivity are among the consequences. More troubling are the outcomes when stayers retire, leaving tier one workers to populate the construction industry. "Two-tier systems are inherently unstable," wrote Jacobs, "[As] workers turn over and are replaced, the [lower] tier becomes the new baseline."<sup>56</sup>

## 2.4 Contingency

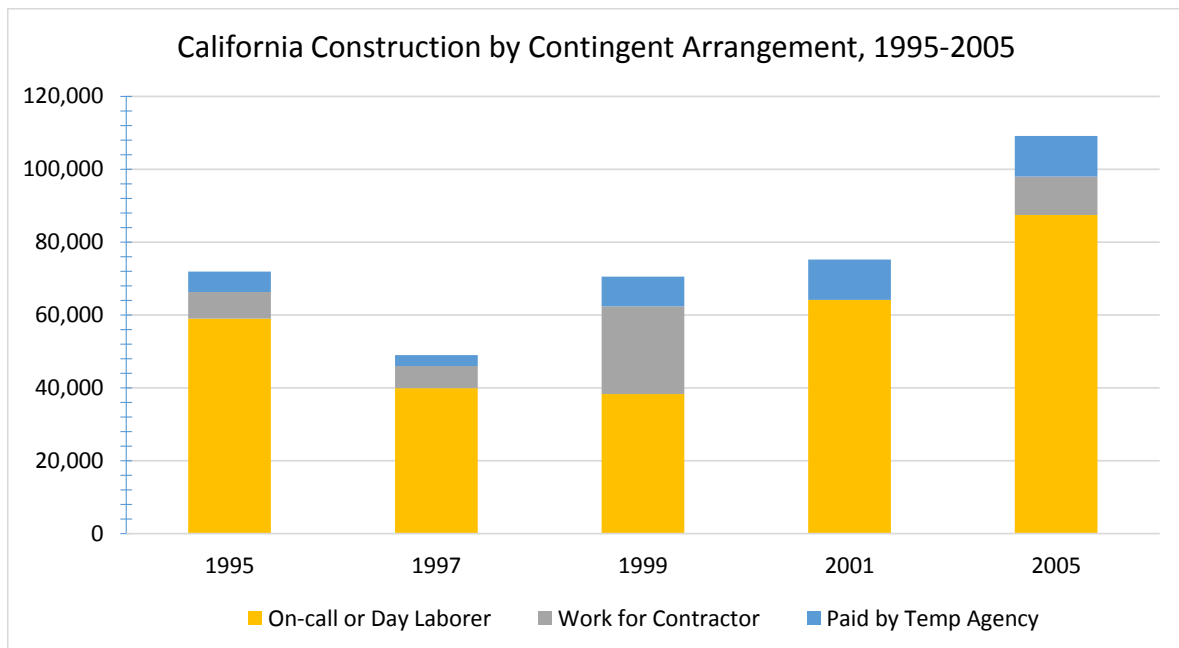
Figure 13



Sources: U.S. Census Bureau and U.S. Bureau of Labor Statistics Current Population Survey and Economic Roundtable analysis. Earnings data shown in graph is 3-year moving average.

Contingent workers are persons who do not expect their jobs to last or who reported that their jobs are temporary.<sup>57</sup> These workers are not employed in full-time wage and salary positions, nor are they engaged in a standard employer–employee relationship.<sup>58</sup> Employers of these workers are often labor brokers who serve as employment intermediaries for larger employers who comply with narrow interpretations of labor and tax laws, but create job conditions similar to informal employment in that workers are precariously employed and paid low wages. From 1995 to 2005, approximately 10 percent of construction workers fell within the contingent classification.<sup>59</sup> Close to 130,000 California construction workers were contingently employed in 2005.

Figure 15



Source: U.S. Census Bureau and the U.S. Bureau of Labor Statistics Current Population Survey special supplement

Contingent and nonstandard work arrangements have been used by some researchers, including Françoise Carre and James Heintz, as proxies for informal employment in developed nations.<sup>60</sup> Contingent and nonstandard workers lack direct relationships with employers, and the length of their employment is temporary and unpredictable. Similar to informal employment, contingent workers are subject to fewer social and regulatory protections. Sociologist Annette Bernhardt and others called this the *gloves-off economy*, in which workers are vulnerable to unfair and substandard employment conditions by corporate employers.<sup>61</sup>

Construction work has had a contingent dimension since the nineteenth century in that employment was limited to the length of time needed to complete a project.<sup>62</sup> However, three aspects of contingent work arrangements were introduced in the late twentieth century: temporary employment agencies, labor contractors, and on-call or day laborers. These developments accompanied industry shifts in the 1970s and '80s, according to sociologist Ruth Milkman.<sup>63</sup> The Census Bureau has collected information about the contingent workforce in a supplement to the Current Population Survey. Using this data, we found an increase in the number of contingent workers in California construction in the 10 years from 1995 to 2005, growing from 84,000 to 129,000 workers (see Figure 15). Contingent workers accounted for more than 10 percent of those employed in the construction industry.

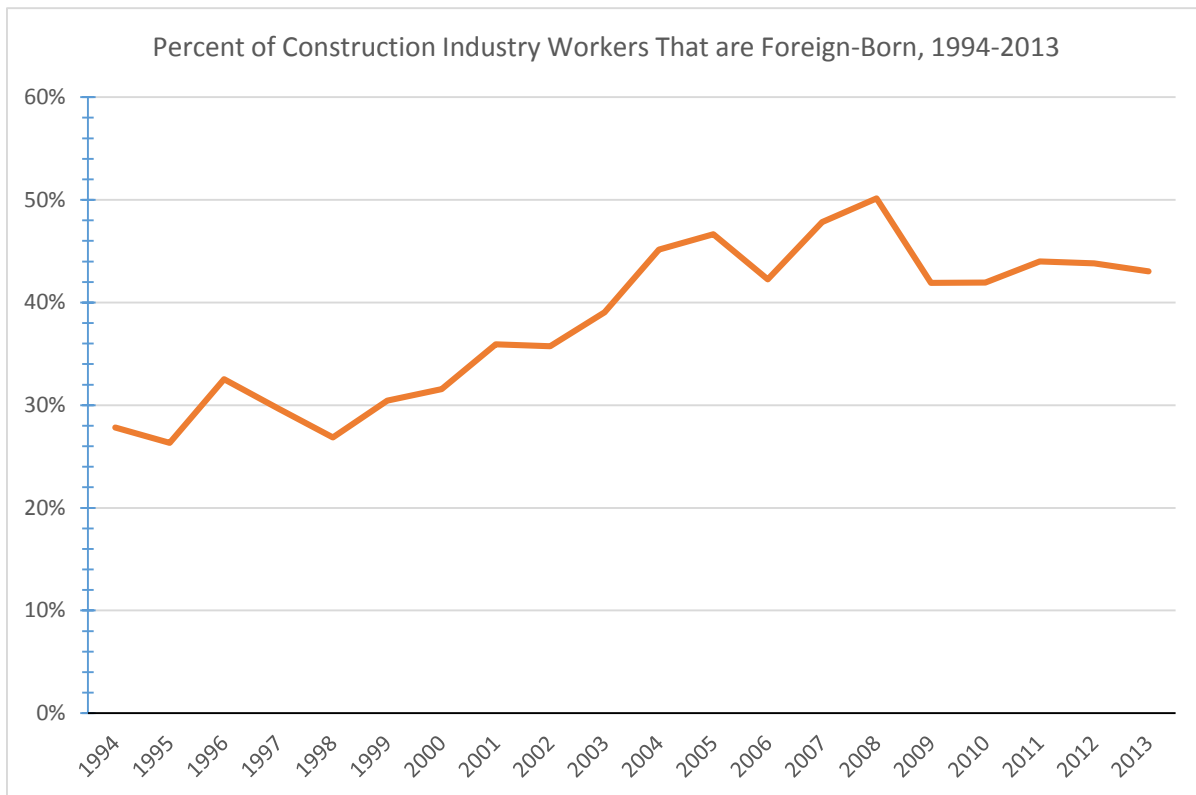
On-call or day laborers were the largest subpopulation within the contingent labor force, accounting for 7 percent of California construction or 87,000 workers in 2005. Day laborers don't have an established schedule for reporting to work but are called in when needed.<sup>64</sup> Urban planner Abel Valenzuela and

others reported, based on the results of a national survey, that most day laborers wait for employment at informal hiring sites, such as the street in front of a home improvement store.<sup>65</sup> Ninety percent of day laborers surveyed were employed in residential construction, performing low-skilled, manual labor for a homeowner or a contractor.<sup>66</sup> The median hourly wage for day laborers was \$10, but employers often withheld earned wages. One in five of those surveyed were injured while working.<sup>67</sup>

## 2.5 Immigrant Workers

California has the most undocumented immigrants of any state, according to the Pew Research Center.<sup>68</sup> An estimated 2.45 million lived and worked in the Golden State in 2012—more than 20 percent of the nation's undocumented population. Approximately 1 in 10 workers in California is an undocumented immigrant.<sup>69</sup> The number of immigrant workers increased in construction between 1994 and 2013 (see Figure 16). Less than 28 percent of the workforce was born outside of the United States in 1994. Immigrants grew to more than half of the industry by 2008. Their share of the construction labor force dipped to 43 percent in 2012, corresponding to a statewide decline in the foreign-born population beginning in 2008.<sup>70</sup>

Figure 16



Sources: U.S. Census Bureau and the U.S. Bureau of Labor Statistics Current Population Survey and Economic Roundtable analysis

A 2009 report found that undocumented immigrants were most at risk for labor violations.<sup>71</sup> Foreign-born workers were almost twice as likely as their U.S.-born counterparts to be paid below the minimum wage. In particular, foreign-born Latinos had double the rate of minimum wage violations as did U.S.-born Latinos and six times the rate of U.S.-born whites.<sup>72</sup> Eighty-five percent of undocumented immigrants experienced overtime violations.<sup>73</sup>

Contractors and real estate developers use labor brokers to hire undocumented immigrants, insulating themselves from responsibility for unlawful labor practices and tax evasion.<sup>74</sup> Labor brokers, according to Milkman, are Latino entrepreneurs, themselves former craft workers, who recruit through social and familial networks.<sup>75</sup> A trend in the industry before the Great Recession were labor brokers employing and moving large groups of immigrant workers across state lines to work on projects.<sup>76</sup> Even after the recession, the use of labor brokers continues.<sup>77</sup>

In 2012, Tennessee-based broker Mike Nobles pled guilty to workers' compensation fraud. He didn't report workers, most of them undocumented immigrants, to insurance companies. He boasted to a *Denver Post* reporter in 2003 that his \$6 million company classified its workers as independent contractors. His workers lived in overcrowded hotel rooms, earning \$4 to \$10 less an hour than the prevailing wage of \$19.70.<sup>78</sup> They worked 56 hours a week and weren't paid for overtime. Nobles was given a 9-year suspended sentence, 10 years on probation, and weekends in jail for one year. He was ordered to pay \$1.2 million in restitution to insurance carriers.

*"You don't have to worry about workman's comp payments with Mexicans because they are afraid to go to the hospital. They're not going to file a big claim and sue you like the Americans are. That's what this boils down to. We have these people intimidated."*

*-- Mike Nobles, labor broker*

Labor researcher Jeffrey Grabelsky wrote that contractors apply labor violations broadly across the industry, whereas before these abuses were concentrated toward undocumented immigrants.<sup>79</sup> Practices such as paying by piece rate, with cash, cutting corners on safety, or hiring underage workers on dangerous jobs are the norm in construction for workers, regardless of immigration status.

In summary, increasing use of low-wage and contingent workers combined with an aging labor force of skilled workers point toward increasing reliance on a two-tier workforce. This model minimizes project-by-project labor costs, but the overall impact is to make construction less attractive and less able to retain skilled workers, who are able to compete successfully for work in other industries with more desirable employment conditions. The reliance on a contingent and low-wage construction labor force is a model now replicated across other industries. Since the Great Recession ended in 2009, almost one-fifth of total job growth has been in the contingent sector.<sup>80</sup>



## Profile of Valentin Perez

### *I Couldn't Stand Up Straight Anymore*

Valentin Perez's mother gave birth to him in Mexico and brought him to the United States when he was 11 years old. His father worked as a farmworker in the berry fields of the Central Coast, supporting Valentin, his six brothers, and four sisters. The family lived in the cramped confines of a three-room apartment. Eventually, the whole family found employment in the fields.

Valentin was still in school when he started to pick grapes, but he had aspirations. He wanted to become a mechanical engineer. He enrolled in a local university, intending to pursue an engineering major, but his mother pulled him out of school to work as a long haul truck driver to contribute income to the family. "My back was always swollen, when I worked cutting grapes," Valentin said, "I started to look for a better job and got a driver's license to drive trucks, but I was never home."

A friend told him about a job hanging drywall. Construction attracted Valentin; no longer would he have to spend the day bent over picking grapes or strawberries. He would also work closer to home. For many in his community, construction was seen as a step up, a way to improve wages and working conditions. Farmworkers who pick fruit are paid a piece rate for the number of pounds harvested. Unfortunately, informal construction contractors sometimes take advantage of this by paying workers a piece rate. Valentin earned \$15 a day for 10 hours of work hanging drywall at the outset.



*"I saw injuries like people falling down, breaking the bench or scaffolding. The crew leader would be more worried about the bench breaking than the people. Companies started to not buy their own equipment, so crew leaders had to buy and bring their own benches. I also saw several benches cracked but not replaced until someone fell and broke it."*

He stayed in the industry, advancing from a journeyman hanger to a supervisor of a crew working on residential remodeling projects. In his five years in the industry, Valentin never received formal training on workplace safety and health. Construction is a very hazardous industry, according to the Occupational Safety and Health Administration. Workers engage in multiple activities that expose them to danger, such as falling from rooftops, getting caught in unguarded machinery, being struck

by heavy construction equipment, being electrocuted, and inhaling silica or dust. Crew leaders taught Valentin skills in installing drywall and metal framing, but not how to avoid injuries.

When Valentin was 27, he worked for Drywall Dynamics, who assigned him to a project with another worker new to the trade. They had two days to hang 60 sheets of dry wall, a task that requires twice that time. The inexperience of Valentin's assistant made progress slow. Valentin tried to compensate by working quickly and shouldering more weight himself. "The pressure was on, instead of picking up one drywall sheet, I picked two at a time, which weigh about 200 pounds," he explained, "When I put the sheets on the ground, I felt something in my back running all the way to my feet." He didn't know what it was and told the general contractor that he felt pain in his feet. Valentin was told to continue working and finish the job. He completed a full day of work, finishing at 1 a.m. the next morning.

Valentin continued to work the following day but experienced severe pain. "I couldn't bend my back anymore," he remembered, "I saw myself in a reflection in a window, I was so crooked, I looked like an old man, I couldn't stand up straight anymore." His supervisor took him to an unlicensed health clinic. These types of clinics serve communities where immigrants live and work—the only recourse to health care for many. This particular clinic lacked the proper equipment to give Valentin an accurate diagnosis. He was told to take the day off from work to rest and return to work the next day.

*"I couldn't work, because I couldn't walk. I felt like I had legs made of rubber, with no muscle, but they made me work for a month after my surgery. They said you have to show up or you'll get fired. They threatened me."*

The next day, when Valentin woke up, he couldn't get up. "I wasn't able to move at all." He tried to receive care at a hospital emergency room, but was turned away because he claimed the injury was work-related. "I kept calling work, no one called me back or answered my calls." Finally, 20 days after his injury, he reached his boss, Jay Scott Silva, at home by calling at night. Silva agreed to file a worker's compensation claim for Valentin, but misreported the day of the injury as the date the claim was filed. Valentin was diagnosed with two herniated discs and treated with surgery. Two weeks after surgery, he returned to work against his doctor's orders.

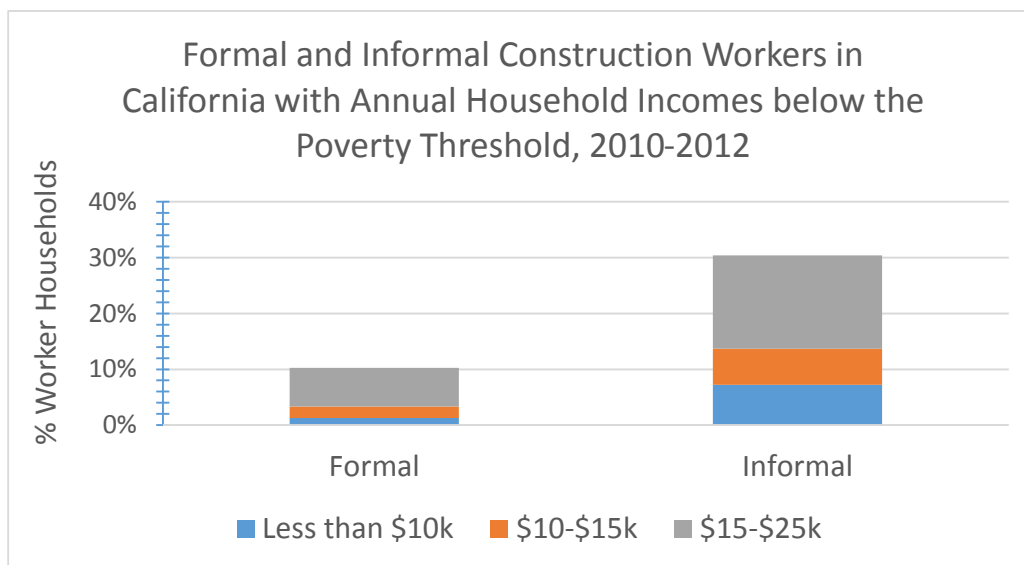
Eventually, Valentin was fired. The California Department of Insurance investigated Silva for fraud and found that Valentin and his co-workers were incorrectly reported to the state compensation fund. The company also owed its workers close to \$500,000 in unpaid wages, of which \$100,000 is still owed to Valentin. As of June 2014, Valentin and his co-workers were still waiting to be paid. After being ordered by the state Labor Commissioner's Office to pay the workers their wages, Silva had filed for bankruptcy and opened a new business under another name.

## Chapter 3

# Impact on Wages and Tax Revenue

California was nicknamed the Golden State to commemorate the discovery of gold in the mid-nineteenth century. In the early twenty-first century, however, California is now a signifier of vast income inequality: three Californian cities rank among the nation's highest in inequality and cost of living.<sup>81</sup> Economists Alberto Chong and Mark Gradstein proposed in a 2006 paper that inequality is a significant determinant of the presence and size of the informal economy.<sup>82</sup> The higher income inequality is, the more likely individuals living in poverty will seek opportunities in the informal sector. A third factor that determines the size of the informal sector is the quality of institutions; strong governments and regulation make for smaller informal economies.<sup>83</sup>

Figure 17



Sources: U.S. Census Bureau American Community Survey 2010-2012 and Economic Roundtable analysis

Thirty percent of households with a hands-on income earner working in the informal economy made less than the federal poverty threshold for a family of four persons. This is three times the poverty rate for formal workers (see Figure 17). Not only does informality sink more Californian families into poverty, it also brings down the wage level for formal sector workers as high-road contractors struggle to compete with cheaters. There were 52,300 households in which an income earner working in the informal sector earned less than \$25,000 a year in 2010 to 2012. The federal poverty level for a household with four persons was \$22,350 in 2011.<sup>84</sup> An alternative to the federal poverty guideline, the self-sufficiency standard, calculates living costs for households in California for basic needs and services.<sup>85</sup> A family of two adults, one preschooler, and one school-aged child needed to earn \$63,000 a

year in 2010–12 to make ends meet, according to the self-sufficiency standard. Using this alternative metric, more than 76 percent of households with a hands-on earner informally employed struggled to fulfill economic needs in 2010–12.

### 3.1 Payroll Fraud

The informal economy not only impoverishes workers and their families, it also deprives government of tax revenue. The IRS estimated that \$450 billion in taxes were not paid on time in 2006.<sup>86</sup> Most of the tax gap, approximately \$399 billion, was due to underreported and nonreported income. Many studies have estimated the specific loss due to misclassification of workers. A 2000 report commissioned by the Department of Labor calculated that for every 1 percent of workers who are misclassified, the unemployment insurance fund lost \$198 million per year.<sup>87</sup> Nine years later, the Government Accountability Office released an estimate that \$2.72 billion wasn't paid in federal taxes because of misclassification.<sup>88</sup> In 2010, the Congressional Research Service calculated that more stringent rules for worker classification would result in \$8.71 billion more in federal tax revenue in 2012–21.<sup>89</sup>

Several studies have looked at the impact to states. Estimates range from \$342 million in New York State<sup>90</sup> to \$400 million in Illinois due to misclassification.<sup>91</sup> In California, a number of agencies, including the Employment Development Department, are charged with monitoring and deterring employers from committing payroll fraud. The state conducted 4,290 audits in 2012 and discovered 89,063 unreported employees, leading to \$230 million in assessments. The Joint Enforcement Task Force, charged with identifying and deterring the informal economy, found 13,226 workers who went unreported for payroll taxes and assessed \$9 million.<sup>92</sup>



Researchers attempted to estimate the loss to state programs. A 2009 study commissioned by the California Fraud Assessment Commission produced a mid-range estimate that in 1997 to 2005, the annual amount of payroll that employers didn't report was approximately \$37 billion.<sup>93</sup> The amount fluctuated based on the premium rates for workers' compensation; the higher the premium, the higher the rates of payroll fraud. For example, average premium rates were \$6.11 in 2004, \$3.81 higher than the lowest rate in the span of time studied. Employers may have failed to report as much as \$61 billion in payroll that year.<sup>94</sup> The result was inflated premium rates for high-road employers who reported their workers, doubling their rates compared to what they would be if there were no fraud.

Table 2

**Estimated Tax Gap in California due to Informal Construction, 2011**

<b>Tax Program</b>	<b>Rate</b>	<b>Employer Contribution</b>	<b>Employee Contribution</b>	<b>Total Contributions</b>
<b>Federal Social Security</b>	6.2% of wages	\$117,453,383	\$117,453,383	\$234,906,767
<b>Federal Medicare</b>	1.45% of wages	\$27,468,936	\$27,468,936	\$54,937,873
<b>Federal Unemployment Insurance</b>	\$84 max per employee	\$12,042,574	-	\$12,042,574
<b>California Unemployment Insurance</b>	\$434 max per employee	\$62,219,966	-	\$62,219,966
<b>California Employment Training Tax</b>	\$7 max per employee	\$1,003,548	-	\$1,003,548
<b>California State Disability Insurance</b>	\$1,016.36 max per employee	-	\$145,709,411	\$145,709,411
<b>California Workers' Compensation</b>	13.94% of wages	\$264,080,672	-	\$264,080,672
<b>Total</b>		<b>\$484,269,079</b>	<b>\$290,631,731</b>	<b>\$774,900,810</b>

Sources: U.S. Bureau of Economic Analysis Regional Economic Information System, U.S. Census Bureau decennial census and American Community Survey, U.S. Census Bureau and the U.S. Bureau of Labor Statistics Current Population Survey, California Employment Development Department Industry Employment & Labor Force Report 2012 benchmark, and Economic Roundtable analysis. Tax rates obtained from the Internal Revenue Service, California Employment Development Department, and California Department of Insurance. Worker's compensation premium rate calculated as an average of construction industry rates obtained from the 2014 advisory pure premium rates by Workers' Compensation Insurance Rating Bureau of California. Note: Workers' compensation is not a tax. It is a mandatory protection for workers that is paid to an insurance carrier, which

Testimony submitted to the Little Hoover Commission reported that the tax gap in unemployment insurance payments ranged from \$672 million to \$1.13 billion.<sup>95</sup> SAS Institute researcher Carl Hammersburg produced this estimate based on a total tax base of \$6.729 billion for unemployment insurance in 2013. A conservative estimate of fraud, 10 percent, would place the annual gap in unpaid unemployment insurance premiums at \$672 million. The estimate of 16.9 percent from the IRS would mean \$1.13 billion annually in unpaid unemployment insurance premiums.

We estimate that the tax gap in 2011 due to informal construction in California totaled more than \$774 million (see Table 2). This is a conservative number because the figures don't include the income tax gap, only payroll.<sup>96</sup> Our calculations are based on our estimates of informal employment numbers in the industry across the Golden State and the earnings paid to these workers (see Chapter 1). We estimate that over 143,900 workers went unreported or were misclassified by their employers in 2011. This sector earned over \$1.8 billion in income. The federal government lost more than \$302 million in taxes, \$234 million toward Social Security, and \$54 million to Medicare. State government was cheated out of even more, \$473 million, of which \$62 million should have replenished unemployment insurance, \$145 million state disability, and \$264 million workers' compensation.

### 3.2 Wage Floor

Earlier, we estimated that the total wage gap equaled \$1.2 billion for the 143,900 informal construction workers in California in 2011. We calculated the economic effects of raising informal wages to the formal level using economic simulation models for California and Los Angeles County developed by IMPLAN. The input-output model estimated induced effects to the economy from household spending of increased wages that would be paid to informal construction workers if they were fairly paid, that is, if informal workers were paid wages comparable to those of formal workers. As these workers bring home their fair-pay earnings, their household spending benefits rental property owners, doctors' offices, restaurants, and grocery stores. With fair pay, each household has increased spending power, which circulates into the economy.

*Every \$1 million in fair wages paid to informal workers would create 7.9 jobs in California.*

The total economic stimulus to the economy created by paying fair wages to informal construction workers would be \$1.5 billion in California (see Table 3). There would be 9,500 new jobs created in the businesses that serve these workers and the supply chain industries for those businesses. Every \$1 million in fair wages would create 7.9 jobs in California.

The ripples of added income in the pockets of the informal workers would increase public revenue. The federal government would benefit from \$196 million in tax revenue, and there would be \$377 million in new revenue for state and local government. Unemployment insurance would receive \$62 million in premium payments, workers' compensation \$168 million, and state disability insurance \$145 million (see Table 4).

**Table 3**

#### **Economic Impacts of a Fair Wage for California's Informal Construction Workers**

Geography & Sector	Unpaid Wages	Economic Stimulus	Jobs Created	Added Federal Taxes	Added State Taxes
California, Construction Industry	\$1,208 million	\$1,501 million	9,536	\$196 million	\$377 million
California, Wage & Salary, Hands-on Construction Workers	\$645 million	\$802 million	5,096	\$137 million	\$231 million
California, Self-Employed, Hands-on Construction Workers	\$267 million	\$332 million	2,114	\$56 million	\$95 million

Source: IMPLAN version 3.1 software with IMPLAN data for California and Los Angeles County in 2012. Impacts are shown in 2014 dollars.

Table 4  
**Tax Impact of a Fair Wage for California's Informal Construction Workers**

California, Construction Industry

Tax Program	Employer Contribution	Employee Contribution	Total Contributions
Federal Social Security	\$74,942,803	\$74,942,803	\$149,885,605
Federal Medicare	\$17,526,946	\$17,526,946	\$35,053,892
Federal Unemployment Insurance	\$12,042,574		\$12,042,574
California Unemployment Insurance	\$62,219,966		\$62,219,966
California Employment Training Tax	\$1,003,548		\$1,003,548
California State Disability Insurance		\$145,709,411	\$145,709,411
California Worker's Compensation	\$168,500,430		\$168,500,430
<b>Sum</b>	<b>\$336,236,266</b>	<b>\$238,179,159</b>	<b>\$574,415,425</b>

California, Wage & Salary, Hands-On Construction Workers

Tax Program	Employer Contribution	Employee Contribution	Total Contributions
Federal Social Security	\$52,969,683	\$52,969,683	\$105,939,366
Federal Medicare	\$12,388,071	\$12,388,071	\$24,776,142
Federal Unemployment Insurance	\$6,459,600		\$6,459,600
California Unemployment Insurance	\$33,374,600		\$33,374,600
California Employment Training Tax	\$538,300		\$538,300
California State Disability Insurance		\$78,158,084	\$78,158,084
California Worker's Compensation	\$119,096,352		\$119,096,352
<b>Sum</b>	<b>\$224,826,606</b>	<b>\$143,515,838</b>	<b>\$368,342,444</b>

California, Self-Employed, Hands-On Construction Workers

Tax Program	Employer Contribution	Employee Contribution	Total Contributions
Federal Social Security	\$21,973,120	\$21,973,120	\$43,946,239
Federal Medicare	\$5,138,875	\$5,138,875	\$10,277,749
Federal Unemployment Insurance	\$2,679,600		\$2,679,600
California Unemployment Insurance	\$13,844,600		\$13,844,600
California Employment Training Tax	\$223,300		\$223,300
California State Disability Insurance		\$32,421,884	\$32,421,884
California Worker's Compensation	\$49,404,078		\$49,404,078
<b>Sum</b>	<b>\$93,263,573</b>	<b>\$59,533,878</b>	<b>\$152,797,451</b>

Sources: U.S. Bureau of Economic Analysis Regional Economic Information System, U.S. Census Bureau decennial census and American Community Survey, U.S. Census Bureau and the U.S. Bureau of Labor Statistics Current Population Survey, California Employment Development Department Industry Employment & Labor Force Report 2012 benchmark, and Economic Roundtable analysis. Tax rates obtained from the Internal Revenue Service, California Employment Development Department, and California Department of Insurance. Worker's compensation premium rate calculated as an average of construction industry rates obtained from the 2014 advisory pure premium rates by Workers' Compensation Insurance Rating Bureau of California.

## Profile of Carlos Barajas Garcia, *Workers Deserve Respect*

Carlos Barajas Garcia worked in a family auto repair shop business. He fixed cars and put them up for sale. Profits during the economic downturn slowed down, first to a trickle, then a drought. His family lost the business due to mounting debts, and Carlos found a job as a plasterer at JDS in San Diego in February 2014. He was paid \$140 in cash for a day of work. Carlos worked 10-hour days, six days a week. Sometimes he worked more than 10 hours, but his earnings didn't increase.

Payday was on Fridays. However, Carlos wouldn't receive all of his earnings, only a portion. He had to complain to the owner, Jeffrey E. Jensen, to receive the remainder. He had to do this repeatedly, up to three times, until Jensen paid him the total wages. The other workers at JDS did the same. Carlos brought home \$840 a week, which wasn't enough to pay for his family's needs. He supported his wife and three children as the sole breadwinner. The financial stress led Carlos and his wife of 10 years to separate.

*"I'm separating from my wife, in part, because of the stress from JDS. She would complain that I wasn't working, I was doing something else. Why else was I bringing in just a little money here and there? Why wasn't I bringing in a steady stream of money?"*

Eight of Carlos's colleagues who worked alongside him as drywall hangers and plasterers slept overnight in their trucks, parked on JDS's land. Most of these workers, according to Carlos, were immigrants with visas but no work permits. They crossed over the border from Tijuana, Mexico, to earn money to support their families. There was no kitchen or shower facilities for the workers to use on the property. There was one restroom, but it was often closed for repair, so the workers had to drive off the property to look for a bathroom. The workers prepared meals by grilling on an outdoor barbecue. Because the workweek was six days long, Carlos's colleagues would stay in the United States for 15 days, and then return to their families for a one-day holiday. His co-workers also had to complain to the owner to be paid their wages in full.

Jeffrey E. Jensen, the president of JDS, has a history of prevailing wage violations for public works projects. California's Department of Industrial Relations debarred Jensen from bidding on or performing any construction projects funded by public monies from 2011 to 2013. However, that did not preclude him from working on commercial and residential contracts. The impetus to make things better in the industry, according to Carlos, will come from comprehensive regulation.

*"The owners have to respect the workers. This way the workers would get what they are owed. Government needs to have more inspectors and eyes on companies to verify and see how they operate. If there's nobody to monitor companies, they will do whatever they can get away with."*



# Conclusions

The \$152 billion construction industry employed 895,000 workers in 2012. In addition to its breadth, construction anticipates shifts in business cycles before the impacts are felt by the rest of the economy. The deregulation of the industry and loss of union membership occurred a decade earlier than the attack on other sectors, such as manufacturing, in the Golden State. Other practices, such as misclassifying employees as independent contractors or double-breasting, had a foothold first in construction before spreading to other industries. For these reasons, we need to understand where construction is going to anticipate the future direction of California's economy. In particular, the growing informal economy in the construction industry is a grave risk.

One out of six construction jobs in 2011 fell into the informal sector. The share of workers unreported by their bosses on payrolls or misclassified as independent contractors increased by 400 percent from 1972 to 2012. Economic recessions increase the number of informally employed workers, as formal sector workers turn to the underground economy for jobs. Informal construction expanded by 7 percent from 2008 to 2009, as close to 60,000 joined the ranks of the informally employed. Informal construction workers earn half what their counterparts in the formal sector bring home. For every dollar earned by a formal sector employee, an informal worker in construction makes 52 cents. The public treasury is cheated out of needed revenue; in 2011, informal employment in California was responsible for a revenue gap of over \$774 billion, \$302 billion in federal revenue and \$472 billion in state revenue.



## Enforce Standards for Workers

**Enforce labor, tax, employment, licensing, and payroll laws.** Many laws protect workers and consumers from unscrupulous employers and must be enforced vigorously. Multiple state, local, county, and federal agencies hold purview over these laws, including the Division of Labor Standards Enforcement, the Contractors State License Board, the Office of the Attorney General, the Franchise Tax Board, the Board of Equalization, county district attorneys, the Employment Development Department, the California Department of Insurance, the U.S. Department of Labor, the U.S. Department of Justice, and the Internal Revenue Service. Innovative strategies are also needed to maximize agency resources for strong enforcement.

**Support collaborative enforcement efforts.** Enforcement agencies often operate in jurisdictional siloes. Information is not shared, and there is no participation in joint enforcement actions with other agencies. Over the years, California has experimented with various task force models, including the recent Revenue Recovery and Collaborative Enforcement Team (RRCE), the Tax Recovery and Criminal

Enforcement (TRaCE), and the Contractors State License Board's Statewide Investigative Fraud Team (SWIFT). These efforts are necessary and need to be supported. In addition, cooperation between county district attorneys and state enforcement agencies needs to continue. California's Department of Insurance provides grant funding for county district attorneys to investigate and prosecute workers' compensation fraud.

**Seek legislative or regulatory reforms that focus on the parties that enable the growth of the underground economy.** Frequently, enforcement actions affect only the subcontractor, leaving the general contractor or developer who has enabled the unlawful practices to take place to be free to subcontract to another lawbreaker. Many property owners, developers, or general contractors take unrealistic low bids and bear little or no risk for doing so; at the same time, they exercise a significant degree of control over the subcontractor's workforce, making them joint employers. Enforcement agencies need to adopt or use joint employer criteria to place accountability up the contract chain to discourage illegal employment practices and the use of law-breaking subcontractors or labor brokers.

**Improve detection of law-breaking construction employers.** This includes looking at what other states (such as Louisiana and Washington) have done to establish fraud detection technology to cross-reference information in state agencies to identify employers likely to be breaking the law. Relevant data can be imputed to make those systems more effective and detect reports of payments made by the users of construction services to construction service providers. This would be similar to current IRS 1099 MISC reporting, but it would be superior because it would require reporting of payments made to incorporated entities and not just the unincorporated.

## Educate the Public and Construction Industry Stakeholders

**Educate and publicize violators.** Many stakeholders are affected by employers who violate labor and employment laws. Contractor associations, organized labor, community advocacy groups, health care institutions, and construction clients need to be reached out to and educated about the negative impacts of informal activity, as well as how to prosecute cheaters. Increased publicity around cheaters is an effective deterrent. Enforcement agencies need to publicize the identity of cheaters through press releases and by capturing the media's attention.

## Lift Wages and Reward High-Road Contractors

**Establish a wage floor.** The presence of informality is linked to inequality and poverty. The higher the level of income inequality, the more likely it is that individuals living in poverty will seek employment in the informal sector. Thirty percent of households with an earner employed informally in construction were below the federal poverty level in 2010–12. Raising wage standards for informal workers to the level paid in the formal sector would add a total of \$1.2 billion in income to households in California. Our models estimated that the effects of added income would multiply across the economy to create a stimulus of \$1.5 billion. Almost 10,000 new jobs would be created; every \$1 million in raised wages would create close to eight jobs.

Lifting 52,300 households in the Golden State out of poverty would help ensure California's future growth. Economists including Martin Ravallion make the case that poverty hinders economic development.<sup>97</sup> Others, such as Arindrajit Dube, found that raising wages effectively reduced poverty and boosted living standards for families and communities.<sup>98</sup>

**Encourage the use of responsible contractor policies to foster a more positive contracting environment.** Action steps for accomplishing such goals can include a requirement to disclose prior labor violations; financial and technical ability to complete the work; and efforts to train apprentices, hire local workers, and pay good wages.

**Facilitate the entry of informal entrepreneurs into the formal sector.** In many cases the employers of informal workers are informal entrepreneurs. Researcher Benedict Delloit proposed that the informal economy is a "hotbed of entrepreneurialism," an incubation space for the growth of formal, fully fledged enterprises.<sup>99</sup> Aided by online platforms, such as Ebay and Etsy, individuals are starting businesses before (or without) writing a business plan. Delloit advocated "a stepping-stone model [to help] entrepreneurs make their journey from informality to formality, helping them to become aware of their obligations and to do simple things like set up bank accounts, register for income tax."<sup>100</sup>

**Enact comprehensive immigration reform.** Evidence suggests that noncitizen immigrants are a major component of the informal labor force because jobs in the formal economy are not open to them. Many of these workers have been productive residents of California for decades, helping build the state's economy. The status and future of undocumented workers with a path to citizenship must be addressed as part of an overall strategy for curtailing the informal economy. Research shows that legal status and citizenship not only emboldens undocumented workers to demand enforcement of labor laws,<sup>101</sup> but also benefits the economic health of the nation through increased tax revenue and household spending.<sup>102</sup>

**Create a high-road contractors guide for consumers.** A high-road labor index should be created based on the company's labor practices and compliance with labor law. The rating system could be used by consumers and by public procurement agencies to select contractors who have sustainable employment practices. Similar to existing rating systems for certifying the environmental sustainability of buildings, the high-road labor index would certify that a contractor's employment practices are sustainable for both workers and the community.



Photo by TOMAS CASTELAZO.

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