

FISCAL POLICY INSTITUTE

11 Park Place, Suite 701, New York, NY 10007

212-721-5624 www.fiscalpolicy.org

Testimony of

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

Presented to the

Public Hearing on the Cost of Housing Construction and the Availability of Affordable Housing

Before the

New York State Assembly Standing Committee on Housing

February 14, 2008

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

FPI has done extensive research and analysis on the changing New York economy, and in particular, how the labor market has changed and the effects of those changes on working people. Every two years we publish a comprehensive economic and labor market update in our series, *The State of Working New York*. We have done six of these reports since 1999. We also prepare briefing reports and studies on specific sectors of the New York City and State economies. These sector and labor market studies have covered the spectrum from social services and hospitality to movie production and securities. We have prepared several reports on the construction sector, including one on employment practices in the New York City affordable housing construction industry.

Affordable housing is a critical priority for New York City and New York State. The situation has only gotten worse in recent years with the tremendous increase in housing prices and rents, the shrinking supply of affordable rental units, and the relative stagnation in wages for most New York workers. Under Mayor Michael Bloomberg, the City of New York justifiably has undertaken an ambitious ten-year plan to preserve or create 165,000 units of affordable housing. In the context of a state budget tightly squeezed by the emerging economic downturn, Governor Eliot Spitzer is to be applauded for proposing \$400 million for affordable and supportive housing. But the need is much greater than even these ambitious plans.

Part of the affordability problem is on the wage and income side. As we have documented in *The State of Working New York*, workers' wages have not grown along with their productivity. Wage and income growth has been very highly concentrated since 2003, giving New York the dubious distinction of having the greatest degree of polarization among all states between the rich and the poor and between the rich and the middle class.¹

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

This scourge of employee misclassification afflicts an estimated 10 percent of New York's workers. The problem is particularly bad in the construction industry. In establishing an inter-agency Task Force on Employee Misclassification, Governor Spitzer characterized the problem as "rampant" and an "epidemic." The Governor said the task force would "protect worker rights while leveling the playing field for law abiding employers so they are not at a competitive disadvantage to employers who refuse to play by the rules as they exploit hard working New Yorkers."²

The Task Force's first report was released this past Monday, February 11, 2008. In its first four months, task force investigations "revealed 2,078 misclassified workers, \$19.4 million in unreported remuneration paid to workers. Additional unemployment insurance taxes alone amounted to over \$856,000. Many of these investigations resulted from dozens of staff jointly inspecting construction and other sites throughout the state."³

The Task Force report also noted that, by "re-engineering its statistical tracking methods related to the number of misclassified workers found in its ongoing and traditional audits and investigations," the State Labor Department identified 35,410 misclassified workers during the months of September through December 2007, far more than would have been identified under the old method.⁴

¹ Fiscal Policy Institute, *The State of Working New York 2007, Encouraging Recent Gains but Troubling Long-Term Trends*, September, 2007, pp. 27-36.

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

³ *Report of the Joint Enforcement Task Force on Employee Misclassification to Eliot Spitzer, Governor, State of New York* prepared by New York State Department of Labor (M. Patricia Smith, Commissioner and Task Force Chair), New York State Department of Taxation and Finance, New York State Workers' Compensation Board, Fraud Inspector General, New York State Attorney General, and Comptroller of the City of New York, February 1, 2008, p. 3.

⁴ *Ibid*, pp. 5-6.

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

A study prepared for the U.S. Labor Department stated that employer avoidance of responsibility for workers' compensation premiums was the number one reason employers sought to misclassify workers as independent contractors.⁶ In the FPI report on the widespread noncompliance with workers' compensation in New York, we pointed out the prominent role that misclassification played in workers' compensation fraud.⁷

The state Department of Labor's official employment data for the construction industry vastly understates the number of workers. In a December 2007 report on the New York City construction industry, we estimated there were at least 200,000 workers in the New York City construction industry in 2005, nearly twice the 110,000 number reported by the state's unemployment insurance system. Some of the difference can be accounted for by self-employed trades workers, but we estimated that about 50,000 workers—one quarter of all construction workers—were misclassified as independent contractors or employed by construction contractors completely off the books.⁸

And in a study of the affordable housing segment of the New York City construction industry from last April, we found that underground economy employment practices are proportionately greater in residential construction and particularly in affordable housing. Using the best available government data, that study estimated that 37 percent of residential construction workers in New York City were misclassified independent contractors or employed off the books. In the affordable housing segment of the construction industry, we estimated that two thirds of the 13,350 workers in that segment were part of the underground economy, either employed illegally as independent contractors or off the books altogether.⁹

These estimates have been reported widely in the media and presented to various bodies, including a distinguished group of regional economists and fiscal experts, a national group of construction labor economists, staff of the City's Department of Housing and

⁵ Linda H. Donahue, James Ryan Lamare, Fred B. Kotler, J.D., *The Cost of Worker Misclassification in New York State*, Cornell University, ILR School, February 2007.

⁶ Planmatics, Inc., *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs*, Prepared for the U.S. Department of Labor, Employment and Training Administration, February 2000, p. iii.

⁷ Fiscal Policy Institute, *New York State Workers' Compensation: How Big Is the Coverage Shortfall?* January 25, 2007.

⁸ Fiscal Policy Institute, *Building Up New York, Tearing Down Job Quality. Taxpayer Impact of Worsening Employment Practices in New York City's Construction Industry*, December 5, 2007.

⁹ Fiscal Policy Institute, *The Underground Economy in the New York City Affordable Housing Construction Industry*, April 17, 2007.

Preservation and Development, and to City Council staff. FPI invites review of the methodology or data sources used to develop these estimates; we have yet to hear anything critical in this regard.”

This hearing is examining the question of affordable housing costs. I would like to approach the cost issue from two perspectives: first, the fiscal costs related to the predominant way affordable housing is constructed in New York City; and second, the relationship between prevailing wages and the total costs of production.

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

We estimated that underground economy employment practices generate enormous fiscal costs that get shifted to workers, law-abiding employers in construction and other industries, and to taxpayers generally. For 2005, we estimated that these fiscal costs were about \$490 million for the New York City construction industry overall, and that in the affordable housing segment the total is \$85 million. Affordable housing accounts for 17 percent of the total fiscal costs even though it represents less than seven percent of the number of construction workers.¹⁰

The argument is often made that paying construction workers prevailing wages and benefits, or union wages and benefits, is too costly. “Too costly” usually means higher wages and benefits than what non-union or underground economy workers are paid. However, in accordance with basic economic principles, the price of an input to production, in this case, the price of labor (“wages”) is not the same thing as its effect on the cost of producing something, in this case, the cost of producing affordable housing. You can’t tell the effect of labor on the cost of production unless you know what the *productivity* of labor is, that is, the skills and experience of the worker, the degree of supervision required, or, for example, the quantity of construction materials required. Low-skilled construction labor requires more construction materials because work not performed properly the first time has to be ripped out and done over.

Prevailing wage is a labor system that builds in (and self-finances) years of classroom skills training and safety education, and enables apprentices to work under the direction of skilled journey persons. In the workforce development field, the construction industry’s apprenticeship system is held up as the gold standard in terms of a model for how to train highly skilled workers, affording them a lifelong career and one of the most certain paths into the middle class. The construction apprenticeship system overcomes the market failure that would otherwise lead construction employers who work on a project basis to under-invest in worker skill development.

¹⁰ Fiscal Policy Institute, *Building Up New York, Tearing Down Job Quality: Taxpayer Impact of Worsening Employment Practices in New York City’s Construction Industry*, p. 21, Fiscal Policy Institute, *The Underground Economy in the New York City Affordable Housing Construction Industry*, p. 27.

The greater productivity of high-skilled, better paid construction labor makes possible lower production costs than achievable with poorly trained, low-paid workers.¹¹ For example, in an extensive evaluation of highway construction costs covering all 50 states over a 14-year period, the Construction Labor Research Council concluded that the much greater productivity of more highly-paid construction workers in high-wage states resulted in lower production costs per highway mile than the production costs attainable utilizing lower-paid construction workers. The better-paid construction workers, on average, needed 38 percent fewer hours to build each mile of highway.¹²

Considering the productivity advantage of union workers and prevailing wage contractors, and the fact that underground economy producers shift substantial fiscal costs onto others, including prevailing wage producers, it is not at all clear that producing affordable housing on a prevailing wage basis is more costly. More over, there is substantial value to our city's workers and to society in general, in creating a skilled workforce that's part of the middle class.

In conclusion, our research suggests that it would be far preferable for our economy, our workforce and our communities, to build affordable housing on a prevailing wage basis. Prevailing wage would also likely bring a vital ally in the building trades unions into the affordable housing coalition, an addition that can only be favorable to the chances of securing the public and private resources needed to expand affordable housing production.

The prevailing wage economy offers workers a career, economic security and a path into the middle class. The underground construction economy offers none of that, and it puts workers at a far greater occupational risk, and cheats workers, taxpayers, and law-abiding employers on a large scale. Government has an obligation to curb the underground economy, enforce long-standing employment laws, ensure compliance with essential social insurance protections and eliminate the unfair competitive advantage from contractors in the underground economy. Let me hasten to add that enforcement efforts should be pursued in a fashion that benefit an often vulnerable workforce that includes many black and Hispanic workers long shut out of opportunities for good-paying jobs, skill development and advancement, or who are recent immigrants.

Thank you for the opportunity to testify today.

Attachments

Summaries of FPI reports:

- *The Underground Economy in the NYC Affordable Housing Construction Industry*, April 17, 2007.
- *Building Up New York, Tearing Down Job Quality: Taxpayer Impact of Worsening Employment Practices in New York City's Construction Industry*, Dec. 5, 2007.

¹¹ For a compendium of academic research regarding the productivity and other advantages of prevailing wage construction, see Hamid Azari-Rad, Peter Philips and Mark J. Prus, editors, *The Economics of Prevailing Wage Laws* (London: Ashgate Publishing Limited, 2005).

¹² Robert M. Gasperow, *Evaluation of Highway Cost Analysis*, Construction Labor Research Council, February 9, 1995.

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

Executive Summary

This study uncovers a significant underground economy in affordable housing construction. Illegal employment practices are rampant. The size of the underground economy is estimated using the Current Population Survey and by comparing Labor Department payroll data to figures on new construction permits and awards.

Despite the dangerous working conditions in the affordable housing construction industry, most workers earn very low pay and few benefits. Few workers have health insurance. For most workers, employers are not paying premiums for workers compensation or unemployment insurance. For a significant number of workers, no payments are made into the social security or Medicare systems.

These practices have a broad fiscal impact on the city, state and national economies. When employers do not meet their legal responsibility for social insurance premiums, costs are shifted—onto employers that do. Similarly, when employers don't provide health insurance for employees, health care providers give uncompensated care, and costs are passed on to other consumers. Taxpayers in general suffer too, because the government picks up the tab for Medicaid and basic payments for social security and Medicare.

One third of New York City's residential construction is underground:

- New York City has been experiencing a tremendous boom in residential construction since 2000. New residential construction permits and construction awards have more than doubled. Yet there has been only a very slight increase in the Labor Department's official count of New York City residential construction workers.
- Conservatively, it is estimated that the current level of construction activity employs 82,000 New York City residential construction workers, and that construction contractors employ more than one third (30,000) of this number on an illegal basis.
- As many as 17,000 workers may be paid off the books and so do not show up in the official employment numbers. Also, 13,000 of those identified as self-employed in Census Bureau data may be employees who are misclassified as independent contractors by their employers.

In affordable housing construction, two thirds is underground:

- It is estimated that the New York City affordable housing construction workforce numbers 13,350 workers. Of this number, about two thirds, or 9,000 workers, are illegally employed, either as independent contractors or employed off the books.

Most affordable housing construction workers receive very low pay, and few receive benefits:

- Many workers are paid \$10 an hour, an amount that has changed little over the past decade. The low wages paid in affordable housing construction contribute to the 30

percent decline in inflation-adjusted wages for New York City construction workers since 1990.

- Not only do construction contractors pay low wages, they also:
 - Illegally skirt responsibility for the payment of payroll taxes and social insurance premiums for their workers.
 - Deprive their workers of basic employment rights and opportunities for skill development and career advancement.
 - Shift the costs of employee health care onto the workers themselves, taxpayers and other employers that pay taxes and operate within legal requirements regarding payroll taxes and social insurance protections.

Employment practices in the affordable housing construction industry have sizable fiscal costs:

- Together, the shifted costs are estimated to range from \$85 million to \$126 million. The low end of the range represents strictly the costs of employer non-compliance with legal requirements given the wage rates currently paid.
- Current wages are unusually low for most affordable housing construction workers. Thus, the high end of the range of fiscal effects is based on the assumption of a \$14 an hour minimal wage standard. This wage standard equals the hourly equivalent (based on 1,840 annual hours) of 150 percent of the three-person 2007 federal poverty guideline.

The City heavily subsidizes the affordable housing industry and plans to sharply increase the number of subsidized housing starts:

- Under Mayor Michael Bloomberg, the City of New York justifiably has undertaken an ambitious ten-year plan to preserve or create 165,000 units of affordable housing. The ten-year goal includes preserving 73,000 units and building 92,000 new affordable housing units. Through the plan's first four years, the City subsidized about 6,000 new affordable starts per year. This number will have to almost double to 11,373 per year through the remaining six years of the plan to meet the 92,000-unit new construction goal. As the City sharply increases the number of City-subsidized housing starts over the next few years, the affordable housing share of new residential construction likely will increase.

Recommendations:

- New York City government should work with the State of New York to improve working conditions and the poor pay and benefit practices that exist in the affordable housing construction sector. The City has moved aggressively to address hazardous scaffold safety problems in construction. The logical next step is to recognize and begin addressing, together with the State, pervasive noncompliant labor practices. With the passage of several anti-fraud enforcement provisions in the historic workers' compensation reform legislation signed into law in mid-March, the State is also poised to dramatically improve labor standards enforcement.
- Enforcement efforts should be pursued in a fashion that benefits an often vulnerable workforce that includes many minority workers long shut out of opportunities for good-paying jobs, skill development and advancement, and workers who are recent immigrants.

Fiscal Policy Institute, *Building Up New York, Tearing Down Job Quality: Taxpayer Impact of Worsening Employment Practices in New York City's Construction Industry*, December 5, 2007.

Executive summary

The New York City construction industry employs over 200,000 workers—much more than indicated by the official government payroll job numbers. Residential construction activity continues at a high level and together with increased infrastructure and commercial building, the construction sector is soaring to new heights. However, the industry's otherwise bright prospects are marred by worsening wage and employment standards in a large and growing underground segment of the industry.

- As buildings go up in New York City, more and more construction work has gone underground, signifying violation of several employment and tax laws. An estimated 50,000 New York City construction workers—nearly one in four—are either misclassified as independent contractors or employed by construction contractors completely off the books.
- The costs of the illegal underground construction industry to taxpayers are substantial and growing. These fiscal costs were an estimated \$489 million in 2005 and are likely to reach at least \$557 million in 2008. Contractors in the underground economy skirt payment of legally required payroll taxes and workers compensation premiums and shift these and other costs onto taxpayers and their competitors who play by the rules. Three categories of costs were estimated for 2005:
 - \$272 million in unpaid legally mandated payroll taxes for social security and Medicare, and social insurance premiums covering workers' compensation, unemployment insurance and disability insurance.
 - \$148 million in health care costs shifted onto the workers themselves, taxpayers and other employers that provide employee health insurance.
 - \$70 million in lost personal income taxes because there is no withholding for underground economy workers and/or they are paid off the books.

The underground construction industry is concentrated in residential construction, but also exists in commercial construction, especially in the boroughs outside of Manhattan, and even among some infrastructure projects that are entirely government-funded. While two thirds of the affordable housing sector is underground, it accounts for only about one fifth of the entire underground construction sector.

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

- Construction safety reached crisis proportions last year when 29 construction workers were killed on the job in New York City. This necessitated a strong government enforcement response and Occupational Safety and Health Administration (OSHA) reports 22 construction fatalities in 2007. OSHA data indicate a strong correlation between construction fatalities and the characteristics of the underground economy: half of the deaths occurred among workers at very small construction companies, three fourths of the workers involved worked for non-union companies, and failure to provide safety training was cited in over half of the cases.
- Despite the dangerous working conditions, workers in the underground economy are paid very low wages, are denied the protections of universal social insurance programs (workers' compensation, unemployment insurance, disability), do not have health coverage or retirement benefits, are not able to join a union, and rarely are they entitled to paid sick leave, holidays or vacations. Working in the underground construction economy is like working in the 19th century when it comes to labor rights, protections and employment standards.
- An estimated 43,000 New York City construction workers earn less than \$11 an hour, not much above the federal poverty guideline for a family of four.
- Contractors operating in the underground economy also disadvantage law-abiding companies by shifting costs and exploiting workers. Among other things, law-abiding construction contractors pay several hundred dollars per worker to cover medical costs for the employees of underground businesses not providing health coverage.

The underground economy in construction has grown rapidly in recent years as government has failed to effectively enforce employment standards and tax laws. As in the case of environmental pollution, markets on their own do not force businesses to "internalize" all the costs they generate. Over decades, government established a series of employment standards and social insurance systems to protect workers and responsible businesses from unchecked competition that degrades working conditions and the economic wellbeing of workers and that disadvantages responsible businesses.

In particular, state government has failed to act to curb the spread of illegal misclassification of workers as independent contractors. Some businesses do this to skirt employer obligations for payroll taxes, social insurance premiums and other mandated employment costs. In recent years, state government has largely turned a blind eye to this practice that affects an estimated 10 percent of all New York workers, and a much higher percent within construction. In pledging to curb misclassification through tougher enforcement, Governor Spitzer recently characterized the problem as "rampant" and an "epidemic".

Unionization, which could help provide a counterweight to exploitative employment practices, has declined from 63 percent in the early 1990s to about 45 percent in New

York City (calculated as a percentage of all trades workers, including an estimated 50,000 workers misclassified or working off the books). Unfair cost advantages for underground contractors make it increasingly hard for unionized contractors to compete.

The prevailing wage concept was originated decades ago in the construction sector to serve as a check on cutthroat competition among employers based on reducing wages and cheapening working conditions. Unrestrained wage-based competition not only drove down wages but also resulted in a less skilled and less productive workforce and a less safe workplace. This race to the bottom is widespread today in the underground economy with workers squeezed and a host of illegalities involving noncompliance with payment of payroll taxes and noncompliance with social insurance and other essential labor and safety protections. People who do not mind the underground economy are fond of criticizing prevailing wage for allegedly driving up costs. Such a view ignores the full range of implications for construction companies, worker training and well being, safety, and the broader fiscal and economic impacts.

- The underground economy shifts many costs to others while construction companies paying prevailing wage internalize these costs, provide their workers with health insurance and retirement security, and compensate their workers at levels that make possible a middle class living standard.
- Prevailing wage means a more skilled and more productive workforce. Since unit costs are what is important, it is not clear that prevailing wage is more costly when all associated costs are internalized and quality and productivity factors are taken into account.
- And importantly, since prevailing wage carries with it an apprenticeship training requirement, companies paying prevailing wage also fund an extensive program of worker skill and safety training. The result of this mandatory training investment is a highly skilled and more productive workforce and a far safer workplace.

The prevailing wage economy offers workers a career, economic security and a path into the middle class. The underground construction economy offers none of that, and it puts workers at a far greater occupational risk, and cheats workers, taxpayers, and law-abiding employers on a large scale.

Recommendations

The spread of the underground economy in New York City's construction industry has worsened employment practices and reduced real wages. It is a problem and a threat not only in construction, but more broadly. It imposes substantial costs on workers, responsible contractors and taxpayers. Government has an obligation to curb the underground economy, enforce long-standing employment laws, ensure compliance with essential social insurance protections and eliminate the unfair competitive advantage from contractors in the underground economy.

Testimony on the Cost of Housing Construction and the Availability of Affordable Housing

- New York City government should work with New York State to vigorously enforce employment laws, ensure compliance with tax laws and social insurance requirements, and use various leverage points to improve pay and working conditions.
- New York City and New York State should require prevailing wage for all affordable housing contracts and for any construction project benefiting from city and state government funding, subsidy or zoning or other land use action. Taxpayers get better value with prevailing wage. It is an effective anti-poverty program, and an obvious way to address New York's widening income gap between the rich and the poor.
- Enforcement efforts should be pursued in a fashion that benefit an often vulnerable workforce that includes many black and Hispanic workers long shut out of opportunities for good-paying jobs, skill development and advancement, or who are recent immigrants.