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## *Estimating Tax Fraud in the USA's Construction Sector<sup>1</sup>*

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*Smart Cities Prevail conservatively estimates a one-year tax revenue gap of **\$2.6 billion** from two specific types of fraud: (1) unreported construction worker employment and (2) employer misclassification of construction workers as independent contractors. We do not estimate unpaid city income taxes nor unpaid unemployment and workers' compensation insurance premiums. We also do not estimate tax fraud on the part of construction proprietors who under-report business income<sup>2</sup> or who pay a portion of employees' wages in cash. Work remains to be done to fully describe the potential gains from improved tax law compliance by construction contractors.*

### **Estimating unreported workers**

Unreported construction workers are indicated by the difference between 2017 employment estimates of two federal Department of Commerce statistical agencies: The [Bureau of Economic Analysis](#) and the U.S. Census Bureau. Researchers have used this difference to estimate the number of underground, informal jobs.<sup>3</sup> While [the Census Bureau reports](#) a total of 9.9 million private wage & salary employees and self-employed workers in the construction industry, [the BEA reports](#) only 8.7 million. This discrepancy suggests that *approximately 1.2 million construction workers are employed informally and are unreported for tax purposes.*

### **Estimating employees who are misclassified as independent contractors**

Academic and government [studies](#) have estimated construction sector misclassification rates for specific states. Averaging across the studies' findings, about 19 percent of self-employed construction workers nationwide are misclassified as independent contractors. The [Bureau of Economic Analysis statistics](#) record nearly 1.6 million self-employed independent contractors in 2017, therefore our calculations are based on an estimate of *300,000 construction workers improperly classified as self-employed independent contractors in 2017.*

### **Estimating liabilities for Federal and State Income Taxes, Social Security, and Medicare**

Unreported workers: We assume, similar to past studies, that actual incomes of unreported workers are less than or equal to incomes of the 25<sup>th</sup> percentile of private construction workers. The U.S. Census Bureau's Annual Social and Economic supplement to the Current Population Survey (CPS-ASEC) provides household- and individual-specific estimates of federal and state net income tax liabilities,<sup>4</sup> and Federal Insurance Contributions Act (FICA) liabilities for Social Security and Medicare.<sup>5</sup> Based on 2015-2018 microdata, we estimate average annual income tax and FICA liability of \$1,400 per construction worker in the low-income range. The conservatively estimated one-year *income tax and FICA revenue gap from unreported construction work therefore is approximately \$1.64 billion a year.*

Misclassified workers: We compare the average of incomes of the middle quintile (40th - 60th percentiles) of self-employed, unincorporated construction workers to the average for the middle quintile of construction employees and found a gap of approximately 22 percent. We conservatively treat this gap as a reflection of

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<sup>2</sup> The IRS estimated in 2007 that non-farm proprietor income is underreported in the aggregate by 57 percent.

<sup>3</sup> Liu, Yvonne Yen et al. 2014. *Sinking Underground: The Growing Informal Economy in California Construction*. Economic Roundtable; Cooke, Oliver et al. 2016. *The Underground Construction Economy in New Jersey*

<sup>4</sup> Census-estimated Federal income tax liabilities take into account earned income and child tax credits.

<sup>5</sup> We analyzed [CPS-ASEC variables](#) for 2015-2018 distributed by IPUMS-CPS, University of Minnesota, [www.ipums.org](http://www.ipums.org).

income underreporting by employees misclassified as independent contractors.<sup>6</sup> We then calculate average gaps of Census-estimated income tax and FICA liabilities per construction worker for the two groups. Based on an estimated gap of about \$3,500, employers and workers would pay *approximately \$940 million a year in additional Federal and State income taxes and FICA contributions* if the workers were properly classified as employees.

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<sup>6</sup> A multivariate regression analysis of U.S. construction workers' annual incomes suggests that self-employed workers report approximately 30 percent less pay than employees.