ICERES
Institute for Construction Employment Research

RESEARCH BRIEF *JUNE 2025*

Worker Misclassification Disadvantages Honest, Law-Abiding Contractors: A Project-Based Analysis

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Abstract

A collaboration between three labor economists specializing in the construction industry and an experienced construction cost estimator has produced an innovative research methodology capable of estimating the illegal cost "savings" attributable to worker misclassification on construction projects across the United States. As one example, the authors obtained architectural plans for a 67-unit, multi-story residential complex in Ann Arbor, Michigan. Developing a detailed cost estimation strategy using RSMeans—the industry-standard data and software program used by construction cost estimators—the authors conclude that worker misclassification would allow unscrupulous contractors to underbid law-abiding contractors by 4.9% off the total cost of a project by evading hundreds of thousands of dollars in legally-required tax and insurance payments. These actions not only harm workers who lose out on their earned benefits, but also makes it difficult, if not impossible, for honest employers to compete in a cutthroat industry where submitting the lowest bid is the key to economic survival.

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Introduction

Worker misclassification is rampant in the U.S. construction sector. Industry stakeholders and researchers alike have long understood that contractors have increasingly relied on the blatant and intentional misclassification of employees as independent contractors—and off-the-books, cash-only payments to workers—to evade their tax and insurance obligations under state and federal law (e.g., Carre and Wilson, 2004; Canak and Adams, 2010; Liu et al., 2014; Ormiston et al., 2020; Juravich et al., 2021; Ormiston and Juravich, 2022; Gutierrez et al., 2023). These actions directly harm workers who lose rights to legal benefits such as overtime pay, Social Security and Medicare payments, unemployment insurance, and workers compensation insurance coverage if they get injured on the job.

But the actions of these unscrupulous contractors also put honest, law-abiding contractors in a bind as it is difficult, if not impossible, for many high-road employers to successfully compete in a cutthroat, low-bid industry when their competitors are reducing their costs by illegal means. While this argument has been reiterated by many over the years, the claim has never been supported by research-based findings about *how much* worker misclassification disadvantages fair-minded contractors on specific projects. This absence of specificity has hindered both policy and research initiatives surrounding the problems caused by worker misclassification.

Analysis

To address this issue, three established construction labor economists partnered with an experienced construction cost estimator in potentially a first-of-its-kind collaboration to analyze how these illegal labor practices affect the total cost of construction. To start, the authors secured the architectural plans for a multi-story, 67-unit residential project recently erected in Ann Arbor, Michigan. The cost estimator used his decades of experience and RSMeans, the industry-standard data and software program, to develop cost estimates of each detailed component of the construction process—from the cost of architect's fees to the material cost of interior doors and everything in-between—including the cost of labor for each component. The labor economists then further decomposed these labor costs, identifying the potential illegal cost "savings" derived from classifying workers as

independent contractors (or paying them off-the-books) instead of regularized W-2 employees.

Using the architectural plans and detailed labor conditions in Michigan, the researchers estimated that the project would cost $13,449,363 if completed by non-union contractors that paid all of their employees legally. However, the estimates suggested that the same project would cost $12,795,020 if completed by non-union contractors that were illegally misclassifying their entire workforce, thus evading their legal responsibilities to provide workers compensation insurance and the employer share of Social Security and Medicare. This equates to an estimated cost "savings" of $654,343—or 4.9% of total project costs and 16.1% of labor costs—generated by what amounts to tax and insurance fraud on the part of the lower-cost contractor. This calculation does not include the additional problem of wage theft which extends beyond tax evasion and is more common on projects where workers are paid off-the-books.

Research and Policy Implications

The primary goal of this research was to attach a specific number of the "cost" of worker misclassification as it relates to the total cost of construction. More than anything, this highlights how the deck can be stacked against honest, law-abiding contractors when operating in competitive, low-bid markets featuring unscrupulous competitors who are willing to break labor laws in order to win a project. Further, it is reminded that these cost savings have real-life consequences for workers (e.g., no workers compensation insurance in a dangerous industry) and taxpayers (e.g., underfunded Social Security and Medicare systems).

Beyond the practical implications of these findings, this research offers important context for researchers and policymakers. For instance, Hinkel and Belman (2022) estimate that prevailing wage laws in California add between zero and six percent to the cost of affordable housing construction in the state. But what was previously unknown was whether any increase in construction costs was attributable to the prevailing wages themselves or because such laws come with greater government oversight of contractors. This government vigilance—in the form of requiring contractors to submit certified payroll records—makes it more difficult for contractors to commit wage and tax fraud. The current research highlights that a large proportion of any cost differential resulting from policies like prevailing wage laws may, in fact, be the result of stamping out payroll fraud which would benefit workers, taxpayers, and law-abiding contractors.

Future Directions

This research collaboration could potentially yield other important benefits for industry stakeholders, policymakers, and researchers. The authors developed the methodology used in this research brief using the 67-unit residential construction project in Ann Arbor, Mich., as a proof of concept. But this methodology—and the flexibility of RSMeans data and software—would allow the costs of worker misclassification to be quickly computed if the same project had been in any major city in the United States (important given differing labor

and policy environments in different markets). Similarly, the process can be utilized to estimate misclassification costs for any project—from new school buildings to multi-story parking garages—in nearly any location in a bespoke manner given the availability of architectural plans.

Conclusion

This unique collaboration between labor economists and a construction cost estimator has yielded an innovative research approach demonstrating how worker misclassification provides a substantial competitive advantage to contractors willing to break the rules over honest, law-abiding employers in the U.S. construction market. On a 67-unit, multi-story residential construction project in Ann Arbor, Mich., the authors conclude that worker misclassification would allow a non-union contractor acting illegally would be able to underbid a comparable, law-abiding contractor by 4.9%. One limitation of the current research, however, is that the data-building methodology applied by RSMeans substantially clouds any direct cost comparison between union and non-union contractors, thus making it difficult to assess the cost differential between union employees and off-the-books non-union workers. Regardless, it is hoped that this finding—and the methodology that opens the door for additional analyses of projects across the country—will help inform construction research and advance policy initiatives that directly or indirectly address worker misclassification issues and labor standards in the U.S. construction industry.

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