ESTIMATED PREVALENCE OF WAGE THEFT IN THE CONSTRUCTION INDUSTRY IN HENNEPIN AND RAMSEY COUNTIES

A Report Prepared for the Labor Advisory Council
Co-chaired by Hennepin County Attorney Michael O. Freeman and
Ramsey County Attorney John J. Choi

Prepared by J. Kyle Makarios

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This report puts statistics behind what workers know to be true day to day. As our economy changes, the ways wage theft appears also changes. This research and reporting is long overdue and is needed to continue to fully understand the extent of this critical issue. Wage theft is prevalent not in only in the construction industry, but across all industries—particularly segmented and subcontracted industries. We are so excited that this innovative collaboration is forming and look forward to the continuation of these reports.

– Chelsie Glaubitz Gabiou, President Minneapolis Regional Labor Federation, AFL-CIO

J. Kyle Makarios provides compelling research that documents the shocking scope of worker abuse in the construction industry in Hennepin and Ramsey Counties. The report details the methods used by abusive employers and the costs borne by workers themselves and by our communities. The Advocates for Human Rights has heard these stories across industries and across the state and this report finally provides concrete numbers that demonstrate the problem extends beyond a few bad actors. Only by strengthening our systems for holding abusive employers accountable and ending a culture of impunity for violations of workers' rights, can we ensure workers both in and outside the construction industry are paid what they are owed.

– Madeline Lohman, Senior Researcher, The Advocates for Human Rights

J. Kyle Makarios effectively synthesizes academic research and public data in his report about the estimated prevalence of wage theft in the construction industry in Hennepin and Ramsey Counties. His report provides members of the Labor Advisory Council to Hennepin County Attorney Michael O. Freeman and Ramsey County Attorney John Choi with a framework for a shared understanding of the prevalence of payroll fraud, worker misclassification, and wage theft in the construction industry. It also shines a light on the negative economic impacts that these illegal practices may have on construction workers in Hennepin and Ramsey Counties. Finally, through a discussion of the Minnesota Fair Labor Standards Act and the Minnesota Wage Theft Law, Makarios discusses some instances of worker misclassification and wage theft that merited remedies available through both civil and criminal proceedings, and demonstrates how the work that the County Attorneys are undertaking in partnership with a shared Labor Advisory Council could be especially impactful in disrupting patterns of criminal behavior that exploit workers.

– Kera Peterson, President Saint Paul Regional Labor Federation, AFL-CIO

This report succinctly captures and summarizes illegal employment practices that are growing stronger in Minnesota. Makarios relies on sound academic studies to support the prevalence of illegal misclassification, which masquerades as an acceptable business model when it is often theft and exploitation. Cash-only construction work is also revealed as a shadow economy used by employers that rob the public coffers and jeopardize the safety and legal protections of the workers.

The civil enforcement silos used to address these problems have not worked in the past and this report supports the idea of using criminal investigations to address crimes against our local workforce.

– Mike Wilde, Executive Director of the Fair Contracting Foundation of Minnesota

I. Overview

Wage theft occurs when an employer fails to pay an employee all wages earned. It is illegal in Minnesota. Common illegal wage-theft practices include:

1. paying less than the minimum wage,
2. not paying time-and-a-half for overtime,
3. requiring work off the clock without pay,
4. misclassifying employees as independent contractors, and
5. making unauthorized paycheck deductions.

In May 2019, the Minnesota Legislature passed the Minnesota Wage Theft Prevention Act to create additional protections for workers, including adding criminal penalties for employers who commit wage theft.

Reports of wage theft are particularly common in the construction industry, where price pressures and competitive bidding incentivize contractors to minimize labor costs. This report, prepared for the Labor Advisory Council created by Hennepin County Attorney Mike Freeman and Ramsey County Attorney John Choi, estimates the prevalence of wage theft in the construction industry by examining topical national, regional, and state studies and data.

Wage theft happens in a variety of ways, but recent scholarship has focused on what is commonly referred to as worker misclassification or payroll fraud. Terri Gerstein, the Director of State and Local Enforcement Project at Harvard Law School's Labor and Worklife Program, defines these topics[1]:

> When employers wrongly treat workers as independent contractors instead of as employees, this is known as misclassification. When employers pay workers in unreported cash "off the books," this leads to payroll fraud. Both practices result in employer failure to pay unemployment insurance taxes or buy required workers' compensation insurance; they are often also accompanied by various forms of wage theft. Misclassification and payroll fraud harm workers, deprive public coffers of revenue, and hurt honest employers who struggle to compete with lawbreakers.

[1] Terri Gerstein, "How district attorneys and state attorneys general are fighting workplace abuses" (2021) Endnote 3. https://www.epi.org/publication/fighting-workplace-abuses-criminal-prosecutions-of-wage-theft-and-other-employer-crimes-against-workers/

In their 2020 national study, *An Empirical Methodology to Estimate the Incidence and Costs of Payroll Fraud in the Construction Industry,*[2] Professors Ormiston, Belman, and Erlich define payroll fraud this way:

> One of the most pervasive and caustic of these illegal practices is payroll fraud. This encapsulates two types of employer actions: (a) misclassifying employees as independent contractors and (b) paying workers "off-the-books" in cash-only arrangements. Employers exploit these practices to evade their legal responsibilities of paying workers overtime rates and contributing to social insurance programs.

Most studies on illegal employment practices in the construction industry focus on this problem rather than wage theft *per se*. However, it is clear that payroll fraud and worker misclassification are frequent ways that employers in this industry commit wage theft, although wage theft also regularly impacts traditional employees as well.

In the Minnesota construction industry, we see misclassification and payroll fraud play out in a couple of common scenarios. When workers are misclassified as independent contractors, a prime contractor on a construction site, such as the company hired to install drywall on the project, pays their workers as if they were each an independent business. While the prime contractor tells the workers what to do, how to do it, sets the schedule, and dictates the rate of pay, they pretend (on paper, at least) that they don't have any construction employees, but rather contract with independent companies. They are then paid with a company check with no deductions, as if this were a business-to-business transaction. The prime contractor does not pay for workers' compensation or unemployment insurance, does not pay the employer share of Social Security or Medicare taxes, and does not provide any benefits. In theory, the workers would cover themselves as independent businesses. According to a 2007 evaluation report by the Minnesota Office of the Legislative Auditor, a drywall company who misclassifies workers as independent contractors instead of employees saves 26% on labor costs compared to a company who pays workers as employees.[3]

However, the relationship between a contractor and its workers as employees or independent contractors is defined by law (Minn. Stat. § 326B.701), not by how they are

[2] Russell Ormiston, Dale Belman, and Mark Erlich, "An Empirical Methodology to Estimate the Incidence and Costs of Payroll Fraud in the Construction Industry" (2020), p. 2. https://stoptaxfraud.net/wp-content/uploads/2020/03/National-Carpenters-Study-Methodology-for-Wage-and-Tax-Fraud-Report-FINAL.pdf

[3] Office of the Legislative Auditor, State of Minnesota, "Evaluation Report: Misclassification of Employees as Independent Contractors (2007) P.10. https://www.auditor.leg.state.mn.us/ped/pedrep/missclass.pdf

paid. For this arrangement to be legal, each independent contractor would need to register with the State's Department of Labor and Industry as a construction company, and it would have to maintain its actual independence as a separate business entity as defined by nine factors in the law (has a federal tax ID, operates under contract, is responsible for the completion of the services for which they're under contract, etc.).[4] Violations of this statute carries civil penalties.

A more common scheme is for workers to be paid "off the books" in cash or by personal check. Generally, the prime subcontractor has no employees on their payroll, but hires a "labor-only subcontractor" or "labor broker" to bring workers to the site. The prime subcontractor pays the labor broker, who usually operates under an LLC, with a business check. The labor broker then pays the workers with cash or personal check with no withholdings. But in both scenarios, the prime subcontractor orders all of the materials, manages the project, is responsible for bidding and performance, and controls the daily flow of work for the workers on the project.

Workers in both of these arrangements are generally paid straight time for all hours worked and thus are denied overtime pay, denied sick time and paid leave, have no unemployment insurance or workers' compensation coverage, and are forced to pay both the employer and employee portions of Social Security and Medicare taxes (often they simply ignore this obligation altogether).

II. Recent Studies

A number of studies have been published that measure the prevalence of worker misclassification or payroll fraud in recent years. Most of them are state-specific. For instance, The Harvard Law School Labor and Worklife Program published a study in 2019 analyzing workers' compensation audits performed in Washington State for fiscal years 2008 through 2017. Across all industries, the study found that the prevalence of misclassification rose from 5% of employers engaging in misclassification in 2008 to 14.4% in 2017. They determined that the construction industry had the most misclassification, with 19% of firms audited over the period committing misclassification.[5]

In 2007, the Minnesota Office of the Legislative Auditor conducted an evaluation report on the misclassification of employees as independent contractors and found that one in seven Minnesota employers misclassified at least one employee as an independent

[4] For a list of the nine factors that all independent contractors must meet, see https://www.dli.mn.gov/business/independent-contractor/contractor-registration-nine-factor-test
[5] Lisa Xu and Mark Erlich, "Economic Consequences of Misclassification in the State of Washington", December 2019. https://lwp.law.harvard.edu/files/lwp/files/wa_study_dec_2019_final.pdf

contractor, and analyzed unemployment insurance audits in various industries. Twenty percent of audits in the construction industry found misclassification.[6]

The Midwest Economic Policy Institute published a study in January 2021, comparing household survey data from the U.S. Census Bureau with payroll records submitted to state unemployment insurance programs. In this study, they use the terms "wage theft" and "payroll fraud" interchangeably to describe workers who are misclassified as independent contractors or paid "off the books" in cash.[7] Their study focuses specifically on Minnesota, Wisconsin, and Illinois using 2018 data.

They found that across the three-state region, one in five construction workers experience some form of wage theft. In Minnesota, about 30,100 construction workers, or 23% of the construction workforce, are misclassified or are paid off the books. The study also found that these workers earned 36% less ($29,700 annually) in wages and benefits than regularly-employed workers and that this fraud costs Minnesota $136 million annually in state tax revenues ($65 million in income taxes, $13 million in unemployment insurance contributions, and $58 million in workers' compensation premiums).

In 2019, Wisconsin Governor Tony Evers issued an Executive Order creating a Joint Task Force on Payroll Fraud and Worker Misclassification, chaired by the Department of Workforce Development Secretary Caleb Frostman. The Task Force issued a report[8] analyzing the State's unemployment insurance audits from 2013 through 2019. Of the 2,820 audits performed of construction companies, 40% of them resulted in at least one worker being reclassified as an employee. In all, 8,416 workers were reclassified.

The most comprehensive recent attempt to quantify this problem is a national study released in January 2020 by three academics and is titled, *An Empirical Methodology to Estimate the Incidence and Costs of Payroll Fraud in the Construction Industry*.[9] One of the goals of the study was to develop accessible empirical methodologies that can be used to estimate the size of the underground construction economy attributable to payroll fraud, as well as its costs to taxpayers.

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[6] Office of the Legislative Auditor, State of Minnesota, "Evaluation Report: Misclassification of Employees as Independent Contractors (2007) P.20.

[7] Nathaniel Goodell and Frank Manzo IV, "The Costs of Wage Theft and Payroll Fraud in the Construction Industries of Wisconsin, Minnesota, and Illinois: Impacts on Workers and Taxpayers". January 14, 2021. https://midwestepi.files.wordpress.com/2020/10/mepi-ilepi-costs-of-payroll-fraud-in-wi-mn-il-final.pdf

[8] State of Wisconsin Department of Workforce Development, "Task Force on Payroll Fraud and Misclassification Report", 2020. https://dwd.wisconsin.gov/misclassification/pdf/2019-2020-misclassification-task-force-report.pdf

[9] Ormiston, *et al*.

Using 2017 data, the study compares household surveys, such as the American Community Survey and the Current Population Survey (where workers answer questions about their employment), to aggregate payroll records submitted by employers to state unemployment insurance programs that are published via the Quarterly Census of Employment and Wages and the Bureau of Economic Analysis (legal wage-and-salary construction employment). In an average month of 2017, between 12.4% and 20.5% of the construction industry workforce were either misclassified as independent contractors or working "off-the-books." These represent national rates and do not rule out substantial differences across states and regions. Overall, these results suggest that between 1.3 and 2.16 million workers were misclassified or working in cash-only arrangements in an average month of 2017.

The study also includes a table[10] that contains 22 prior national, state, and local-level studies that the authors claim corroborates their estimates. Several of those studies have been cited in this paper.

The report also estimates the cost savings that unscrupulous employers gain from payroll fraud due to the non-payment of federal and state income taxes, workers' compensation premiums, unemployment insurance, wage theft (through paying straight time instead of overtime or premium pay), and the offloading of the "employer share" of Social Security and Medicare onto workers. Using conservative income assumptions and the most conservative estimate of the number of workers affected (1.3 million nationwide), these employers stole $811.1 million from workers and illegally shifted $2.98 billion to them in Social Security and Medicare taxes in 2017.

III. Application to Hennepin and Ramsey Counties

According to the U.S. Census Bureau's 2019 American Communities Survey, 188,532 Minnesotans work in the construction industry, representing 6.3% of our state's workforce.[11] Of those, 27,901 live in Hennepin County and 11,399 live in Ramsey County. This represents 3.95% of all workers who live in these counties. Given the nature of these counties, the number of commuters, and the downtown cores, it is highly likely that many more live in outlying counties and commute into Hennepin and Ramsey Counties for work.

Using the most conservative estimates from the Ormiston study, we can estimate that 12.4% of these workers are victims of payroll fraud and wage theft, or 4,872 residents of

[10] *Ibid*, p. 62-64

[11] https://data.census.gov/cedsci/table?q=DP03&g=0400000US27_0500000US27053

the two counties. Using the most conservative income assumptions from that study (that these workers are paid $30,000 per year), we can estimate that the amount stolen from them is $3.04 million per year in overtime and premium pay, and that construction employers illegally shift $11.2 million in Social Security and Medicare taxes onto them. Again, these numbers are likely low because we're using the most conservative estimates for the percentage of construction workers impacted (12.4%) and for the annual wages of those workers ($30,000) as well as only taking into account workers who live in Hennepin and Ramsey Counties.

Table 1: Estimated Number of Construction Workers in Hennepin and Ramsey Counties Who Are Victims of Payroll Fraud

Construction Payroll Fraud in Hennepin and Ramsey Counties	***Total Construction Workers***	***Victims of Payroll Fraud***
Hennepin County	27,901	3,459
Ramsey County	11,399	1,413
Combined	39,300	4,872

Table 2: Estimated Wage Theft of Construction Workers in Hennepin and Ramsey Counties

Wages Stolen from Construction Workers Annually	***Unpaid Overtime and Premium Pay***	***Social Security and Medicare Illegally Shifted***
Hennepin County	$2.158M	$7.93M
Ramsey County	$882,000	$3.24M
Combined	$3.04M	$11.17M

IV. Civil and Criminal Offenses

Complaints of and investigations into the workplace offenses detailed in this report have generally been conducted by civil enforcement agencies, primarily the State's Department of Labor and Industry, and to a lesser extent, municipal enforcement agencies such as the Minneapolis Civil Rights Department. They document and enforce offenses related to the Minnesota Fair Labor Standards Act (Minn. Stat. §§ 177.21-.35), including unpaid overtime and premium pay, violations of the state's construction contractor registration statutes (Minn. Stat. § 326B.701, which addresses misclassification and some types of payroll fraud), and some violations of the Minnesota Wage Theft Law (amended provisions of Minn. Stat. chs. 175, 177, 181, 16C, 609.

There is, however, often criminal activity that occurs in these situations, such as labor trafficking, workers' compensation fraud, creating conditions causing predictable, preventable workplace fatalities and serious injuries, failure to pay unemployment insurance taxes, retaliation and witness intimidation, among others.[12] The Minnesota Wage Theft Law also applies a criminal penalty if wage theft occurs with an intent to defraud.

Hennepin County Attorney Michael O. Freeman has successfully prosecuted two such criminal cases. In 2019, construction labor broker Ricardo Batres pleaded guilty in Hennepin County to felony counts of labor trafficking and insurance fraud. And in 2020, the co-owners of Merit Drywall, a Twin-Cities construction company, pleaded guilty to theft-by-swindle for fraudulently misclassifying workers as independent contractors in order to reduce workers' compensation insurance premiums.

V. Conclusion

Payroll fraud, the misclassification of employees as independent contractors, and wage theft are prevalent throughout the construction industry in Hennepin and Ramsey Counties. Thousands of workers are having millions of dollars of their wages stolen from them on a regular basis. Despite increased funding for civil enforcement of the problem through the Minnesota Department of Labor and Industry and the enactment of the Minnesota Wage Theft Prevention Act, the practice continues to run rampant. It is clear that greater deterrence of this illegal activity is needed through an increased focus on criminal prosecution of the most serious cases.

[12] Gerstein, p. 3