

Safety Net Snags:

THE EFFECT OF PAYROLL FRAUD ON MINNESOTA WORKERS AND TAXPAYERS

The employer-employee relationship is foundational in the US. Labor protections begin with being recognized as an employee. Funding for many social safety net programs comes from employer and employee contributions.

That foundation is now in jeopardy. Rather than hiring people as employees, deceptive employers are exploiting the system by misclassifying their workers as independent contractors. When this type of payroll fraud occurs, everyone loses. Workers miss out on crucial benefits and worker protections. Employers who play by the rules are placed at a competitive disadvantage, as those engaging in fraud can undercut them. And taxpayers must cover the costs of social safety net programs that fail to receive legally required benefits.

Adding to the concerning nature of misclassification is the fact that we don't know its extent. A study of Minnesota's construction industry estimates that 23% of workers were misclassified, costing each worker roughly \$30,000 annually, along with the state losing out on \$136 million in tax revenue. While helpful, this analysis leaves an open question about the scale and cost of misclassification outside of construction.

To help answer this question, we estimate the proportion of workers experiencing payroll fraud in the state in 2019, how much money was lost to state programs due to that fraud, and how much workers themselves lost in compensation. We find:

- ◆ **Approximately 316,000 private-sector workers experienced payroll fraud in 2019**, representing 9.4% of all private-sector workers in Minnesota.
- ◆ **These Minnesota workers lost between \$2.9 and \$6.2 billion due to payroll fraud**, including lost compensation in the form of paid leave, overtime pay, health insurance, and retirement benefits.
- ◆ **Payroll fraud cost the Minnesota state government an estimated \$506 million to \$1.3 billion in tax revenue.** This total includes \$276 million to \$836 million in unrealized state income tax collections, \$176 million to \$353 million in Workers' Compensation premiums, and \$54 million to \$108 million in state Unemployment Insurance contributions.
- ◆ **We estimate the total public revenue impact of payroll fraud in Minnesota to be between \$1.04 and \$2.1 billion.** This greater financial penalty reflects payroll fraud's impact on other legally required benefits, including money lost in federal Social Security and Medicare contributions. If we assume this level of payroll fraud exists today and adjust it for inflation to put it in real 2024 dollars, the losses rise to an estimated \$1.3 to \$2.6 billion.

Notably, the methodology underlying these estimates utilizes conservative assumptions, meaning our analysis almost assuredly **underestimates** the amount of payroll fraud in Minnesota. A more comprehensive and accurate estimate of payroll fraud in Minnesota will ultimately require greater data analysis from state agencies. Even if we accept these likely underestimated figures as correct, the analysis shows that payroll fraud is widespread in Minnesota and punches significant holes in the state's social safety net.