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# **JOINT LEGISLATIVE TASK FORCE ON THE UNDERGROUND ECONOMY IN THE CONSTRUCTION INDUSTRY**

## **FINDINGS AND RECOMMENDATIONS FEBRUARY 15, 2008**

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### **Co-Chairs**

Senator Jeanne Kohl-Welles\* and Representative Steve Conway\*

### **Task Force Members**

Asterisk (\*) denotes Executive Committee Members

Senator Janéa Holmquist\*

Representative Cary Condotta\*

Bob Abbott, Labor Member

John Bratton, Business Member

Dave Johnson, Labor Member\*

John Littel, Labor Member

Randy Loomans, Labor Member

Craig Munson, Business Member

Rick Slunaker, Business Member\*

Hilary Stern, Business Member

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# JOINT LEGISLATIVE TASK FORCE ON THE UNDERGROUND ECONOMY IN THE CONSTRUCTION INDUSTRY

February 15, 2008

Members of the Legislature:

We are pleased to present the Findings and Recommendations of the Joint Legislative Task Force on the Underground Economy in the Construction Industry.

During the 2007 interim, the Task Force heard presentations and public testimony on underground construction activity. This information confirmed that the underground economy is costly to the state in lost revenue and unfair to law-abiding businesses and workers.

To address the underground economy in the construction industry, the Task Force recommends legislation for the 2008 session to increase penalties, improve data-sharing and detection by state agencies of underground activity, and blend definitions used for determining whether a person is covered under workers' compensation and unemployment compensation laws. The Task Force is also making budget recommendations, including providing additional funding to the Department of Labor and Industries to increase enforcement and for an expanded social marketing campaign aimed at consumers. Finally, the Task Force expresses its support for current agency activity regarding underground construction activity. These recommendations are further detailed in the report.

It became clear during the Task Force's work that it would not be possible to address all issues during the 2007 interim and the 2008 session. In addition to the recommendations described above, the Task Force identified several items for further discussion during the 2008 interim and possible action during the 2009 session. The Task Force is therefore recommending continuation of its efforts through 2008.

We believe these recommendations will assist in protecting the economic vitality of the state.

Sincerely,



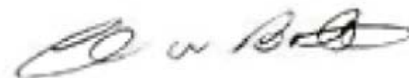
Senator Jeanne Kohl-Welles, Co-Chair



Representative Steve Conway, Co-Chair



Bob Abbott, Business Manager,  
Wash. and North Idaho District Council  
of Laborers



John Bratton, Legislative Policy Chair,  
Building Industry Association of Wash.



Dave Johnson, Executive Secretary,  
Wash. State Building & Construction  
Trades Council, AFL-CIO



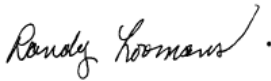
Craig Munson, Owner  
Seattle Floor Service



John Littel, Political Director  
Pacific Northwest Regional  
Council of Carpenters



Rick Slunaker,  
Director of Government Affairs  
Associated General Contractors of Wash.



Randy Loomans  
Government Relations Director,  
International Union of Operating Engineers  
Local 302



Hilary Stern  
Executive Director, CASA Latina

## **PART I BACKGROUND ON THE TASK FORCE**

In 2007, the Legislature enacted Senate Bill 5926 relating to the underground economy in the construction industry.<sup>1</sup> The full text of the bill is attached in the Appendix. The Final Bill Report is available online at <http://apps.leg.wa.gov/billinfo/>. Task Force meeting materials are also available online at <http://www1.leg.wa.gov/Joint/Committees/UECI>.

### **Findings, Declarations, and Intent**

The bill expressed legislative findings and declarations as well as the Legislature's intent in enacting SB 5926. The Legislature found "that some current estimates place the percentage of unreported employment in Washington state's construction industry at between twenty percent and fifty percent, although solid data on this phenomenon is not readily available in Washington." The Legislature also found "that unreported construction employment may result in the loss of a worker's employment rights and protections, including workers' compensation and unemployment insurance compensation." The Legislature further found "that unreported construction employment also could deny the state the revenues it is due, including sales taxes, business and occupation taxes, and other business fees paid to the state." The Legislature declared "that the underground economy in this state may permit unfair conditions to exist against persons working in the construction industry who do follow the employment laws and appropriately pay taxes." The Legislature's intent was "to determine the extent and potential costs to the state of the underground economy in the construction industry."

### **Joint Legislative Task Force**

The bill created a joint legislative task force to formulate a state policy to establish cohesion and transparency between state agencies to increase oversight and regulation of the underground economy practices in the construction industry. See Appendix.

The Task Force was directed to contract with the Washington State Institute for Public Policy to assist in the goals of the Task Force and to determine the extent of and projected costs to the state and workers of the underground economy in the construction industry.

The Task Force was required to report its findings and recommendations to the Legislature by January 1, 2008.

The Task Force consisted of the following members: four legislative members designated as the chairs and the ranking minority members of the Senate Labor, Commerce, Research and Development Committee and the House Commerce and Labor Committee; four members representing the construction business; four members representing construction laborers; and nonvoting agency liaison members from the Employment Security Department, the Department of Labor and Industries, and the Department of Revenue. The Washington State Institute for Public Policy maintained a nonvoting liaison representative to the Task Force as well.

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<sup>1</sup> The companion to SB 5926 was HB 2086 which passed the House Commerce and Labor Committee.

Funding for the Task Force was provided for in the 2007-09 operating budget, SHB 1128. \$56,000 was appropriated for the House of Representatives and \$56,000 was appropriated for the Senate for fiscal year 2008.

## **PART II ACTIVITIES OF THE TASK FORCE**

In 2007, the Task Force studied issues relating to the underground economy in the construction industry. These issues included: an overview of the current oversight of the underground economy in the construction industry as presented by the Employment Security Department, the Department of Labor and Industries, and the Department of Revenue; impediments to collection of taxes and recommendations for improvement; experiences from other states; perspectives on the underground economy from both business and labor representatives; the role of local governments in monitoring the construction economy; current independent contractor laws in this state and other states; laws regarding data sharing among state agencies; enforcement and penalty issues; and contractor registration requirements. (Dates in parentheses are dates of the meetings as which particular issues were discussed.)

### **Organizational Matters**

Before beginning its study of substantive issues, the Task Force addressed the following organizational matters.

Procedures: The Task Force reviewed, revised, and approved its procedures. (July 10) The procedures addressed the organization and conduct of the Task Force, the appointment of Task Force subcommittees; the data request process; and the decision making process. The Executive Committee agreed to meet after Task Force meetings as necessary to make data requests of staff and agencies and to identify agenda items for the next meeting.

Schedule: The Task Force approved its schedule on a meeting by meeting basis. The Task Force planned to have four definite meetings with additional meetings on an as needed basis. Ultimately, the Task Force met six times. (July 10, August 1, September 26, October 31, November 19, and December 13)

Reports: Presentations and reports given to the Task Force by state, agency representatives, the Washington State Institute for Public Policy (Institute), and other presenters are available online at <http://www.leg.wa.gov/Joint/Committees/UECI/>. The Appendix contains a list of all these reports. In addition, the Appendix contains copies of all Institute reports and the August 1, 2007 Joint L&I, ESD, and DOR Presentation to the Legislative Task Force on the Underground Economy. The Institute reports provide estimates of taxes owed from unregistered businesses and the scope of worker misclassification.

Public Comment: Each Task Force meeting included an opportunity for public comment.

Subcommittees and Advisory Committees: The co-chairs created one Subcommittee and two Advisory Committees (subgroups).

Independent Contractor Subcommittee. The Subcommittee was to look into creating a uniform definition of “independent contractor.” The Subcommittee discussed blending the exception tests into one test and circulated a draft. The co-chairs also requested information on whether there were adequate criminal penalties for a contractor who misclassifies his or her workers. The

Subcommittee had met three times as of the date of this report. (November 7, December 3, and December 17)

Local Government Advisory Committee. The Advisory Committee was requested to investigate ways to improve data sharing between the state and local governments and report back to the Task Force. The Advisory Committee met one time. (December 6)

Benchmark Advisory Committee. The Advisory Committee was requested to investigate the establishment of future benchmarks. The Washington State Institute for Public Policy is the lead on this committee which had not yet met as of the date of this report.

## **Substantive Issues**

### Scope and Projected Costs of the Underground Economy

Agency representatives presented information to the Task Force on the projected costs to the state of the underground economy in the construction industry. (July 10)

The Washington State Institute for Public Policy presented a review of underground economy literature, including estimates of taxes owed to the state from unregistered businesses and the scope of worker misclassification. (September 26, November 19)

### Enforcement

Agency representatives presented data on their fraud detection and auditing procedures, the number of auditing and collections staff, issues relating to the hiring and retention of staff, and how these activities are funded. (July 10, August 1, October 31, November 19)

The nature of the underground economy in the construction industry was identified by agency representatives as an enforcement issue; this presents many enforcement challenges, including misclassification of workers as independent contractors to avoid tax liabilities. (August 1)

The agency representatives discussed their authority to access financial records, both corporate and individual, as well as issues involving record retention and subpoena authority. (August 1)

The role of local governments in monitoring the underground construction economy was explored by a panel of building officials representing cities and counties in the state as well as a representative of the Association of Washington Cities who agreed to serve on the local government subcommittee. (September 26, November 19)

The agency representatives presented a report detailing the difficulty of recruiting and retaining auditors. (November 19)

### Penalties and Requirements

Information was presented to the Task Force on the types of penalties that may be imposed and the amount of penalties collected through audits, including financial penalties, taxes recovered, and registration suspensions. (July 10, October 31, November 19)



Changes to penalties under the contractor registration law were discussed. (October 31)

### Education and Outreach

The Department of Labor and Industries presented its FAQ sheet on 2007 changes to the contractor registration law, the application for contractor registration form, information on contractor training days, information on 2007 home shows, and its workshop on contractor registration. (October 31)

The Local Government Advisory Committee recommended expanding and promoting the Get on Board Grant Program created in 2005 to help cities and state agencies remove barriers that may prevent them from participating in the Master License Service. This would help to ensure that new business applicants obtain all of their required licenses and registrations in order to meet both local and state requirements. (December 13)

### Data-Sharing and Detection

Hindrances to sharing data among agencies under state and federal privacy requirements were identified by agency representatives, and staff presented a comparison of state and federal unemployment insurance confidentiality laws. (August 1, September 26, November 19)

The Local Government Advisory Committee recommended the creation of a pilot project between the Department of Labor and Industries and local jurisdictions to explore improving ways of collecting and sharing building permit information. Participation would be voluntary for the local jurisdictions who participate. Ideally, such a pilot should include at least one larger city, a couple of smaller cities, and at least one county. (December 13)

### Other Issues

Agency representatives provided a list of major barriers and impediments to monitoring the underground economy and collecting taxes in the construction industry. These included:

“1. Lack of clear, consistent, cross-agency definitions of ‘worker,’ ‘employee,’ and ‘independent contractor’ and court decisions which have resulted in differing treatment among agencies.” (August 1)

“2. The definition of ‘registered contractor’ and the requirements to become a contractor.” (August 1)

Agency representatives presented information on SHB 1843 from 2007 which modified contractor registration laws. (August 1) The text of SHB 1843 can be found at: <http://apps.leg.wa.gov/billinfo/>.

Reports and legislation in other states addressing various aspects of the underground economy were summarized by staff; these included examples of how states have defined the term “independent contractor” and how this state determines what constitutes an independent contractor who is not covered by workers’ compensation and unemployment compensation. (August 1, September 26, October 31)

Whether independent contractors should be mandated to carry workers' compensation and unemployment insurance was discussed by staff with information provided by agency representatives. (November 19)

## **PART III RECOMMENDATIONS OF THE TASK FORCE**

In its final meeting of 2007, the Task Force identified Legislative, Budgetary, and Agency actions for 2008. Prior to its final meeting of 2007, the Task Force identified a broad range of recommendations for discussion. Task Force members completed a survey that listed these recommendations and indicated which recommendations they supported, the priority level of each recommendation, and whether the recommendation could be accomplished in the 2008 session or later sessions. The Task Force took up for discussion those recommendations that were suggested for the 2008 session, and some of those items were tabled for future discussion.

### **Legislative Action**

The following legislative recommendations were made by the Task Force.

#### Penalties and Requirements

In general, the Task Force recommends that penalties be increased. This could include publicizing the names of those people who have been penalized, or imposing training requirements on those who have been penalized. A specific recommendation was made to explore civil and criminal penalties for falsifying information on a contractor registration form, as well as to explore a prevailing wage strike for willful or repeat violations of workers' compensation reporting or contractor registration laws.

#### Data-Sharing and Detection

The Task Force recommends that legislation be enacted to allow state agencies to share all information regarding workers and employers with other state agencies, regardless of the source of such information.

The Task Force also recommends that legislation be enacted that requires employers using the services of independent contractors to maintain the contractors' Unified Business Identifier (UBI) number on file, as well as compensation paid to the contractor.

Finally, the Task Force recommends that all businesses be required to have a UBI number, even if they are exempt from Department of Revenue reporting requirements.

#### Other Issues- Independent Contractor

The Task Force recommends that the different definitions of covered worker and employment exceptions used by the agencies be blended into one consistent definition in the 2008 session. It was agreed that further discussion of how to define the term "independent contractor" be deferred to the 2009 session.

### **Budget Action**

The following budget recommendations were made by the Task Force.

## Enforcement

The Task Force recommends the addition of three staff members, with one being a working supervisor, to the Department of Labor and Industries' Fraud Audit Infracton and Revenue (FAIR) contractor fraud team. Funding would be provided from an L&I dedicated fund.

The Task Force addressed the issues of adding more auditors to both the Department of Labor and Industries and the Employment Security Department. It was specifically recommended that L&I add three to four auditors with funding to be provided from an L&I dedicated fund. It was further mentioned that in general, funding needs to be increased and used towards enforcement activities. This includes recruiting, retaining, and training auditors, and increasing the pay scale for auditors in all three agencies and that salary changes would need to be worked through the Department of Personnel and the Labor Relations Office processes.

Finally, the Task Force recommends exploring ways to dedicate money to the Attorney General's office for contractor compliance cases. Funding would come through the Attorney General's office but be tied to L&I.

## Education and Outreach

The Task Force recommends funding for 2008 for an expanded social marketing campaign using currently available materials and newly created materials as needed. This campaign should be aimed at consumers and warn them of the risks and potential consequences of hiring unregistered contractors or otherwise assisting in the furtherance of the underground economy. The campaign could include: providing public service announcements, and other similar materials to the media and to community groups, and made available in languages other than English; providing information on violations and penalties; and encouraging legitimate contractors and the public to report fraud.

## Data-Sharing and Detection

The Task Force recommends that the pilot project as discussed by the Local Government Advisory Committee be implemented, with funding to be provided from the General Fund.

## Other Action

The Task Force agreed to the establishment of an Advisory Committee to be organized by the Washington State Institute for Public Policy and with the assistance of the agencies, with a goal of establishing benchmarks for future monitoring of activities recommended by the Task Force. Benchmarks should measure the effect of Task Force recommendations to determine their efficiency and effectiveness and to determine if additional approaches should be explored. Establishment of these benchmarks along with a more concerted effort to develop data which answer the baseline question of the magnitude of the problem could be discussed in a legislative extension of the Task Force. It was further recommended that the Institute provide a preliminary report to the Senate Labor, Commerce, Research and Development Committee and the House Commerce and Labor Committee by December 31, 2008.

## **Agency Action**

The Task Force stated its support for current agency activity including work in the areas of education and outreach and data-sharing and detection. See comment under enforcement.

### Enforcement

The Task Force supports the Department of Labor and Industries' evaluation of potential needs regarding additional enforcement, focusing on the following areas: Audit staff (statewide), contractor compliance, and whether another Assistant Attorney General is needed for criminal cases.

### Education and Outreach

For 2008 and ongoing, the Task Force supports the work of the agencies in enhancing both contractor and consumer education. These efforts include changes to the contractor registration form to provide information that will increase the contractor's understanding of the laws, risks, and responsibilities relating to his or her registration. The agencies also will approach the UBI Board to discuss potential changes to the master business application to increase the applicant's understanding of the laws, risks, and responsibilities relating to the master business license.

### Data-Sharing and Detection

The Department of Labor and Industries will complete a secure database for Internal Revenue Service (IRS) data-sharing and finish a feasibility study for a comprehensive employer fraud/abuse detection system.

The Department of Labor and Industries will also continue negotiating with the IRS for a joint data-sharing agreement for the Employment Security Department, Department of Revenue, and the Department of Labor and Industries to allow sharing of IRS data between the agencies when appropriate.

## **Other Action**

In light of the recent flooding in Southwest Washington, concerns were raised by Task Force members about the potential for abuse by the underground economy in construction activities. The Task Force recommended that a letter be written to the Governor expressing concern over potential abuse related to disaster relief and requesting that contractor registration laws be strictly enforced and unregistered contractor activities be investigated.

### Task Force Extension

The Task Force recommends that the legislation authorizing the Task Force be amended to extend the term of the Task Force through December 31, 2008. The Task Force also recommends that the contract with the Washington State Institute for Public Policy be extended to December 31, 2008.

## **Potential Issues for 2009**

During its discussion of items that could be addressed in 2008, the Task Force tabled several legislative items for further discussion in 2008 and possible action in 2009. These items address the issues of enforcement and penalties.

### Enforcement

- Whether local governments should be required to verify compliance with registration and other requirements before issuing a business license.
- Whether a process should be developed for employers to report new hires to the Department of Labor and Industries.

### Penalties and Requirements

- Whether additional penalties with respect to the underground economy should be considered.

### Independent Contractor Definition

- The Task Force recommended that determining a cohesive definition of independent contractor be accomplished in two steps. The first step involves blending the current definitions and is discussed above under Legislative Action. The second step involves defining the term “independent contractor” itself. The Task Force recommends studying this step in 2008 for possible action in 2009.

## APPENDIX

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### SENATE BILL 5926

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#### AS AMENDED BY THE HOUSE

Passed Legislature - 2007 Regular Session

**State of Washington**

**60th Legislature**

**2007 Regular Session**

**By** Senators Kohl-Welles, Clements, Kastama, Weinstein, Fairley, Keiser, Marr, Tom, Murray, Oemig, Sheldon and Kline

Read first time 02/07/2007. Referred to Committee on Labor, Commerce, Research & Development.

AN ACT Relating to creating a joint legislative task force to review the underground economy in the construction industry; creating new sections; providing an expiration date; and declaring an emergency.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF WASHINGTON:

**NEW SECTION. Sec. 1** The legislature finds that some current estimates place the percentage of unreported employment in Washington state's construction industry at between twenty percent and fifty percent, although solid data on this phenomenon is not readily available in Washington. The legislature also finds that unreported construction employment may result in the loss of a worker's employment rights and protections, including workers' compensation and unemployment insurance compensation. The legislature further finds that unreported construction employment also could deny the state the revenues it is due, including sales taxes, business and occupation taxes, and other business fees paid to the state. The legislature declares that the underground economy in this state may permit unfair conditions to exist against persons working in the construction industry who do follow the employment laws and appropriately pay taxes. It is the legislature's intent to determine the extent and potential costs to the state of the underground economy in the construction industry.

**NEW SECTION. Sec. 2** (1) The joint legislative task force on the underground economy in the Washington state construction industry is established. For purposes of this section, "underground economy" means contracting and construction activities in which payroll is unreported or underreported with consequent nonpayment of payroll taxes to federal and state agencies including nonpayment of workers' compensation and unemployment compensation taxes.

(2) The purpose of the task force is to formulate a state policy to establish cohesion and transparency between state agencies so as to increase the oversight and regulation of the underground economy practices in the construction industry in this state. To assist the task force in achieving this goal and to determine the extent of and projected costs to the state and workers of the underground economy in the construction industry, the task force shall contract with the institute for public policy, or, if the institute is unavailable, another entity with expertise capable of providing such assistance.

(3)(a) The task force shall consist of the following members:

(i) The chair and ranking minority member of the senate labor, commerce, research and development committee;

(ii) The chair and ranking minority member of the house of representatives commerce and labor committee;

(iii) Four members representing the construction business, selected from nominations submitted by statewide construction business organizations and appointed jointly by the president of the senate and the speaker of the house of representatives;

(iv) Four members representing construction laborers, selected from nominations submitted by statewide labor organizations and appointed jointly by the president of the senate and the speaker of the house of representatives.

(b) In addition, the employment security department, the department of labor and industries, and the department of revenue shall cooperate with the task force and shall each maintain a liaison representative, who is a nonvoting member of the task force. The departments shall cooperate with the task force and the institute for public policy, or other entity as appropriate, and shall provide information and data as the task force or the institute, or other entity as appropriate, may reasonably request.

(c) The task force shall choose its chair or co chairs from among its legislative membership. The chairs of the senate labor, commerce, research and development committee and the house of representatives commerce and labor committee shall convene the initial meeting of the task force.

(4)(a) The task force shall use legislative facilities and staff support shall be provided by senate committee services and the house of representatives office of program research. Within available funding, the task force may hire additional staff with specific technical expertise if such expertise is necessary to carry out the mandates of this study.

(b) Legislative members of the task force shall be reimbursed for travel expenses in accordance with RCW 44.04.120. Nonlegislative members, except those representing an employer or organization, are entitled to be reimbursed for travel expenses in accordance with RCW 43.03.050 and 43.03.060.

(c) The expenses of the task force will be paid jointly by the senate and house of representatives. Task force expenditures are subject to approval by the senate facilities and operations committee and the house of representatives executive rules committee, or their successor committees.

(5) The task force shall report its findings and recommendations to the legislature by January 1, 2008.

(6) This section expires July 1, 2008.

**NEW SECTION. Sec. 3** This act is necessary for the immediate preservation of the public peace, health, or safety, or support of the state government and its existing public institutions, and takes effect immediately.



Passed by the Senate April 16, 2007.  
Passed by the House April 9, 2007.  
Approved by the Governor May 2, 2007.  
Filed in Office of Secretary of State May 3, 2007.

# FINAL BILL REPORT

## SB 5926

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Synopsis as Enacted

**Brief Description:** Creating a joint legislative task force to review the underground economy in the construction industry.

**Sponsors:** Senators Kohl-Welles, Clements, Kastama, Weinstein, Fairley, Keiser, Marr, Tom, Murray, Oemig, Sheldon and Kline.

**Senate Committee on Labor, Commerce, Research & Development**

**Senate Committee on Ways & Means**

**House Committee on Commerce & Labor**

**House Committee on Appropriations**

**Background:** Some estimates place the percentage of unreported employment in Washington's construction industry at between 20 and 50 percent, although solid data on this phenomena is not readily available.

**Summary:** The joint legislative task force on the underground economy in the state's construction industry is created. The task force is to formulate a state policy to establish cohesion and transparency between state agencies so as to increase the oversight and regulation of the underground economy practices in the state.

The task force consists of the chairs and ranking minority members of the Senate Labor, Commerce, Research & Development and the House Commerce and Labor Committees; four members representing the construction business chosen from nominations submitted by statewide business construction organizations; and four members representing construction laborers chosen from nominations submitted by statewide labor organizations.

The Departments of Employment Security, Labor & Industries, and Revenue are to cooperate with the task force and will each maintain a nonvoting liaison representative to the task force.

The task force is to choose its chair or co-chairs from among its legislative members and the chairs of the two standing committees will convene the first meeting.

The task force is to contract with the Institute for Public Policy, or another entity if the Institute is unavailable, to assist it in determining the extent of and projected costs to the state and workers of the underground economy in the construction industry. Within available funding, the task force can hire additional staff with specific technical expertise if such expertise is needed to carry out the mandates of the study.

The expenses of the task force will be paid jointly by the Senate and House of Representatives.

The task force is to report its findings and recommendations to the Legislature by January 1, 2008.

**Votes on Final Passage:**

Senate	45	0	
House	98	0	(House amended)
Senate	49	0	(Senate concurred)

**Effective:** May 2, 2007

## Reports Submitted to the Task Force

The following agency and Washington State Institute for Public Policy reports were submitted to the Task Force during its 2007 meetings. Full text of the reports listed below is available on – line at <http://www.leg.wa.gov/Joint/Committees/UECI/>. In addition, the following reports are attached:

- August 1 – Joint Agency presentation on barriers and impediments.
- September 26 – Washington State Institute for Public Policy “The Underground Economy in Washington State” presentation.
- November 19 – Washington State Institute for Public Policy “Taxes Owed by the Underground Construction Industry” presentation

### July 10

- Department of Labor & Industries Fraud Prevention and Compliance presentation
- Employment Security Underground Economy Unit handout
- Department of Revenue unregistered business presentation

### August 1

- Joint agency presentation on barriers and impediments
- Joint agency definition sampling handout

### September 26

- Washington State Institute for Public Policy "The Underground Economy in Washington State" presentation

### October 31

- Employment Security Department handouts on enforcement and penalty issues:
  - Summary
  - District Tax Offices
  - Penalty and interest charges on employer accounts
- Department of Revenue handouts on enforcement and penalty issues:
  - FTEs by region, Audit Division
  - FTEs by region, Compliance Division
- Department of Labor & Industries handouts on contractor registration
  - Recent changes to the contractor registration law and FAQs
  - Application
  - Contractor Training Days
  - Home Shows 2007
  - Contractor registration example of training

### November 19

- Washington State Institute for Public Policy "Taxes Owed by the Underground Construction Industry" presentation
- Department of Labor & Industries handout on penalties assessed by auditors
- Employment Security Department questions and answers on penalty and related issues

- Department of Revenue handout on penalty structure
- Governor's GMAP - Economic Vitality Accountability Forum Auditor Recruitment and Retention Assignment handout
- Department of Labor & Industries "Response to Proposals - a Potential Model for 09-11 and 11-13 Biennia" presentation
- Employment Security Department data sharing handout

#### December 13

- Employment Security Department definitions changes discussion draft Title 50 handout
- Department of Labor & Industries definitions changes discussion draft Title 51 handout



**Joint L&I, ESD, and DOR Presentation  
to the  
Legislative Taskforce on the Underground Economy  
August 1, 2007**

Agency representatives will provide an overview of the barriers and impediments to monitoring the underground economy and collecting taxes in the construction industry. The overview will be followed by presentations from auditors working in the field.

**Presenters:**

**Department of Labor and Industries**

Carl Hammersburg, Fraud Prevention and Compliance Manager

Scott Nielsen, Construction Compliance Inspector

Theresa Bunten, L&I Auditor 3

**Employment Security Department**

Lisa Marsh, Director, Unemployment Insurance Tax Branch, Employment Security

Diana Johnson, Certified Management Accountant, Auditor 4

**Department of Revenue**

Drew Shirk, Legislative Policy Coordinator

Donald Gutmann, Revenue Analysis Manager, Revenue

Kevin Dickson, Revenue Auditor 3

**Major Barriers:**

- 1. Lack of clear, consistent, cross-agency definitions of “worker,” “employee,” and “independent contractor” and court decisions which have resulted in differing treatment among agencies. (See detail in “definitions” handout.)**
  
- 2. The definition of “registered contractor” and the requirements to become a contractor.**
  - A. Limited requirements for becoming a registered contractor
    - Lack of distinction between general vs. specialty contractors in practice (Many people get both designations)
    - No testing or certification process
  
  - B. SHB 1843 made some changes in 2007 including:
    - Working while unregistered now a gross misdemeanor
    - Subcontracting to an unregistered contractor now a violation

- Allows suspension of an active registration if an owner, principal, partner or officer has a prior unsatisfied final judgment from a prior entity

3. **The complexity of legally sharing data among agencies under state and federal privacy requirements.**
  - A. Complexity of confidentiality laws, both federal and state
    - Unable to share or discuss data with other agencies when it is received from IRS
    - Unable to re-disclose information once it is received from other state agencies
  - B. Issues surrounding data sharing agreements
    - Frequency of expiration of data sharing agreements
    - Data sharing agreements may be too limited in scope
    - Data sharing agreements must be amended each time additional information is identified as required
  - C. More effective method to utilize technology to identify inconsistencies in businesses' reporting to agencies
4. **Recruitment and retention of investigators and auditors and limited resources to hire staff.**
  - A. Difficult to recruit and retain people with the skills needed to generate leads, investigate leads, and conduct complex audits in the industry
    - Problem for all three agencies
  - B. Sarbanes Oxley Act placed high demand for auditors in private sector
  - C. L&I has a limited number of staff with specialized construction knowledge dedicated specifically to combat the underground economy in the industry
    - Work nights and weekends
    - Typical auditors lack construction estimation skills
    - Do not have staff to check every job site
  - D. Governor has asked agencies to work on issue
5. **The nature of the construction industry – the “layering” of subcontractors which makes identification and enforcement difficult.**
  - A. General contractors and higher tier subs typically do not report the subcontractors working on their jobsites
    - Drywall reporting of subcontractors at L&I increases compliance
    - Prevailing wage looking at requirements for reporting subcontractors
  - B. Treating workers as independent contractors to avoid tax liabilities
    - Obtaining a contractor registration does not make someone “independent”
  - C. Often a general contractor or high level subcontractor does not know which lower level subcontractors are on their jobsites



## **6. Getting access to important financial records.**

- A. Each agency has different legal authority regarding access to business and personal information.
  - Corporate vs. individual records and filings complicates our ability to identify proper reporting
- B. Record retention by contractor and subs may be limited
  - Contracts, payments, hours and bank records critical
- C. Difficult to enforce summons and subpoena authority
  - Identification of records or possessor of information inconsistent or nonexistent
  - Identification of information is labor intensive and time consuming.
  - Limited consequences for non cooperation
- D. Third party notification requirements before using information - *State v. Miles*, Washington Supreme Court No. 78656-9 (filed April 26, 2007) (court currently considering motion for reconsideration)
  - Held that state agencies cannot issue subpoena to third party without prior judicial review where the subpoena seeks information considered a “private affair” under the state constitution, even if the agency has statutory authority to do so
  - Most agencies do not currently have authority to seek prior judicial review of subpoenas
  - Examples of third-party sources are banks, building supply stores, in-state representatives of out-of-state businesses, customers, utility companies and other sources of information that can disclose whether a person is conducting business without registering or paying taxes
  - Unclear whether notice to person about whom information is sought is sufficient without judicial review

## **7. The nature of the unregistered businesses and the cash economy.**

- A. People who participate in the underground economy intentionally hide their activities and don't want to get caught
  - Business activities run through personal as well as business accounts
  - Individuals may try to shield themselves from personal liability by using an LLC or corporate structure
  - Need to structure an incentive and penalty system for enforcement that leads to greater compliance and encourages all levels of the contracting system to conduct due diligence with their subcontractors
  - Need to find ways to encourage legitimate contractors and the public to report on underground firms

- DOR, L&I and ESD maintain phone and web based reporting systems
- L&I maintains public websites that identify registered contractors and that allow tracking of subcontractors to identify when they fall out of compliance with either contractor registration or workers' compensation reporting

B. Registered with the IRS but not DOR

- In 2004 there was an estimated \$225 million in Washington state excise taxes owed by businesses registered with the IRS but not registered with DOR
- This represents 99,000 unregistered accounts and 3 percent of taxes collected from registered businesses
- Out-of-state businesses accounted for \$155 million of the total \$225 million with sole-proprietors accounting for an additional \$36 million
- Sole proprietors accounted for 45,000 of the total 99,000 with out of state businesses accounting for an additional 25,000
- Of the Washington based businesses service firms represent most of the taxable activity
- This study does not include losses for unemployment or workers' compensation insurance

C. Registered with neither the IRS or DOR

- Preliminary estimates show an additional \$150 million owed by businesses that did not file with either the IRS or DOR
- This represents the tax due from 65,000 businesses and represents 2 percent of the tax collected from registered businesses
- These estimates do not include losses for unemployment or workers' compensation insurance

# The Underground Construction Economy in Washington State: A Review of the Literature and Preliminary Findings

Presented to the Joint Task Force on the Underground Construction Economy

September 26, 2007

Jim Mayfield

Washington State Institute for Public Policy

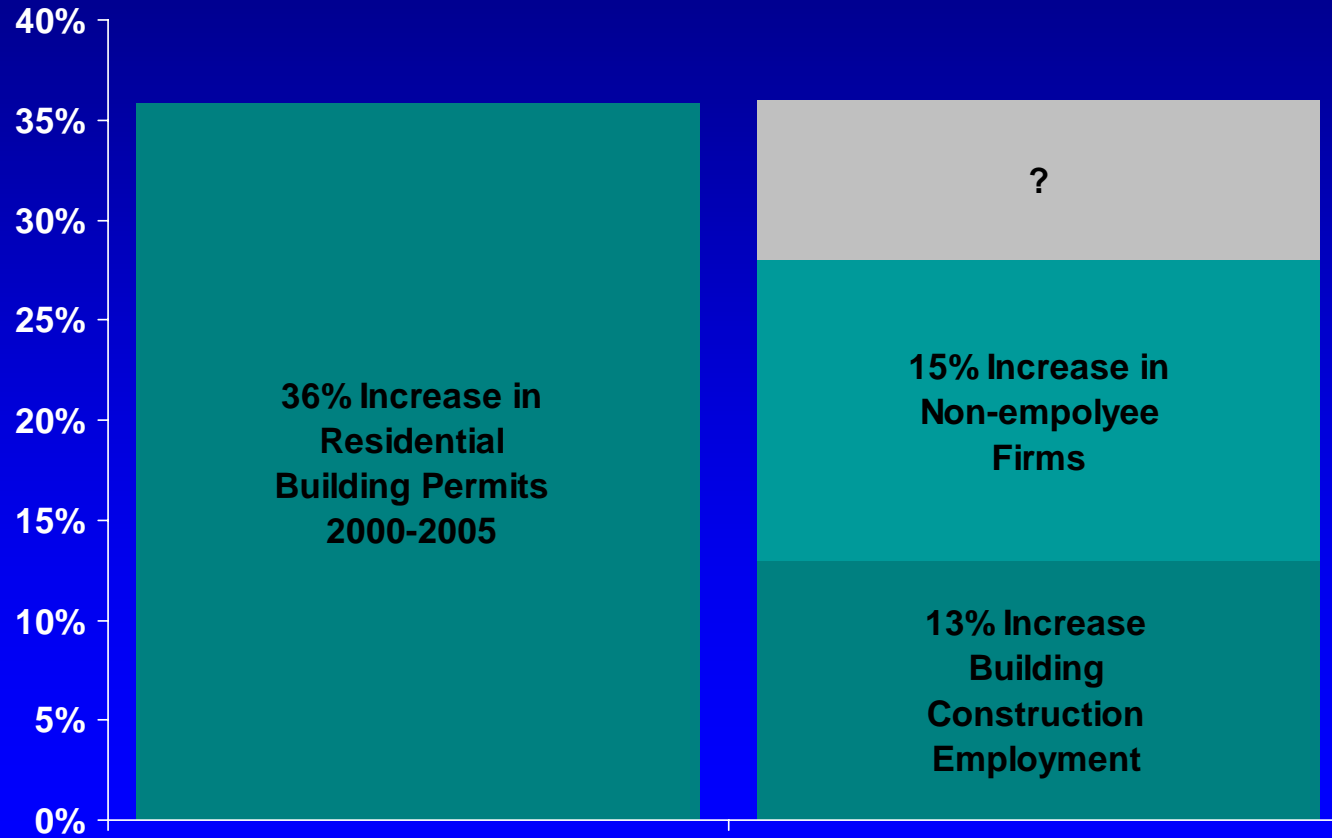
[mayfield@wsipp.wa.gov](mailto:mayfield@wsipp.wa.gov)

360-586-2783

## Topics

- Review of the Underground Economy Literature
- Update to the Washington State Unregistered Business Study
- Worker Misclassification

# Washington State Construction Activity and Employment: Keeping Pace?



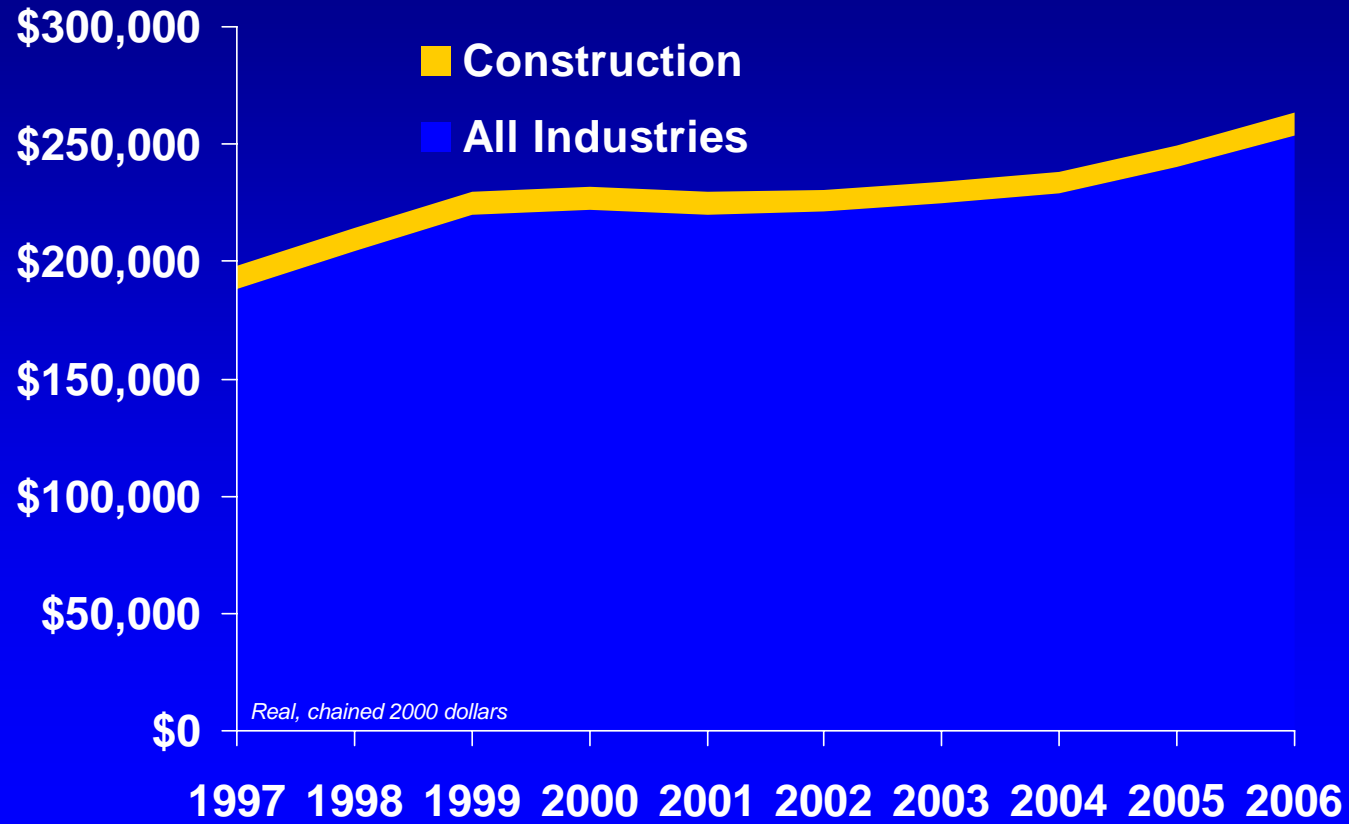
Source: Bureau of Labor Statistics and U.S. Census

# A Taxonomy of Economic Activities



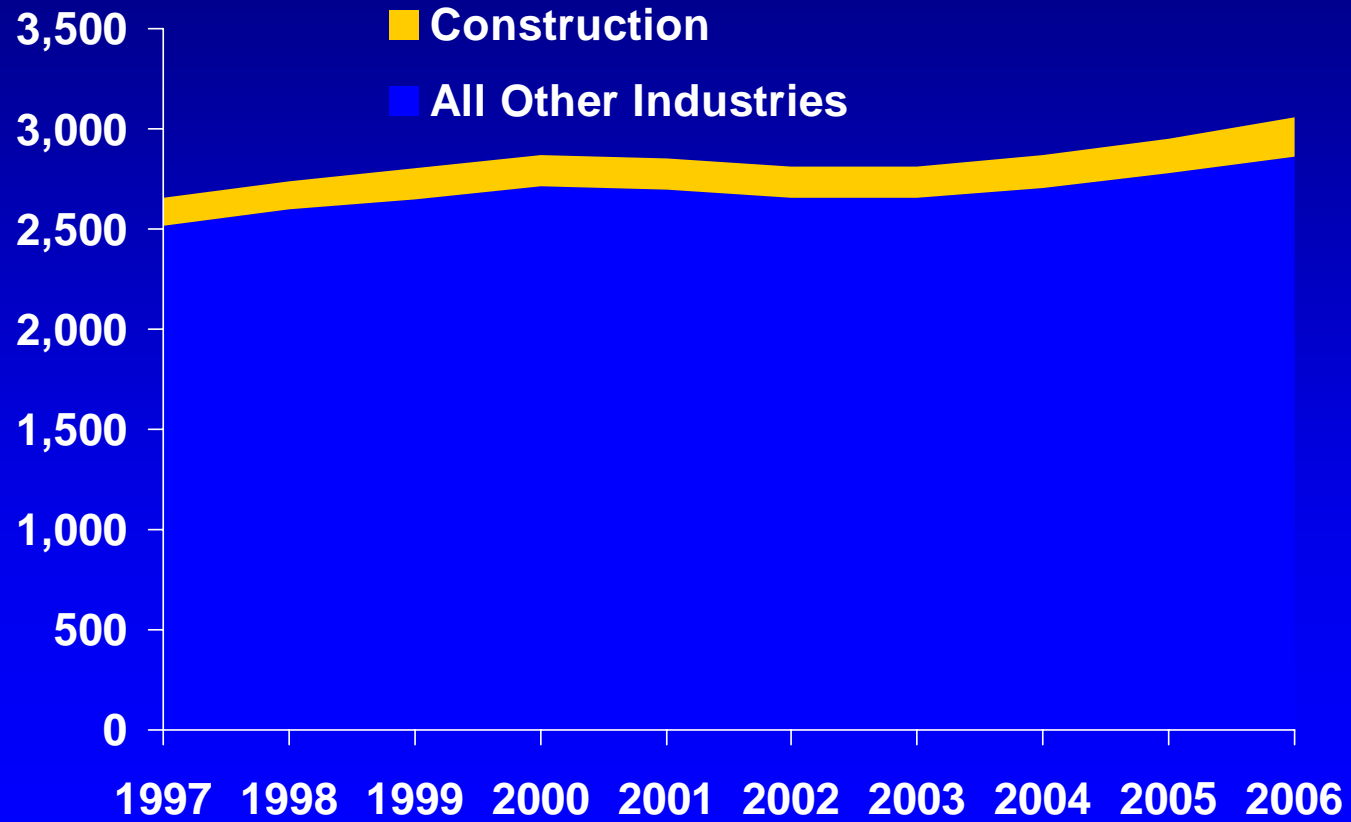
Adapted from Bajada, 2002

# Washington State's Construction Economy and the Gross State Product (Millions of Dollars)



Source: Bureau of Economic Analysis

# Washington State's Construction Economy and Statewide Employment (Thousands)

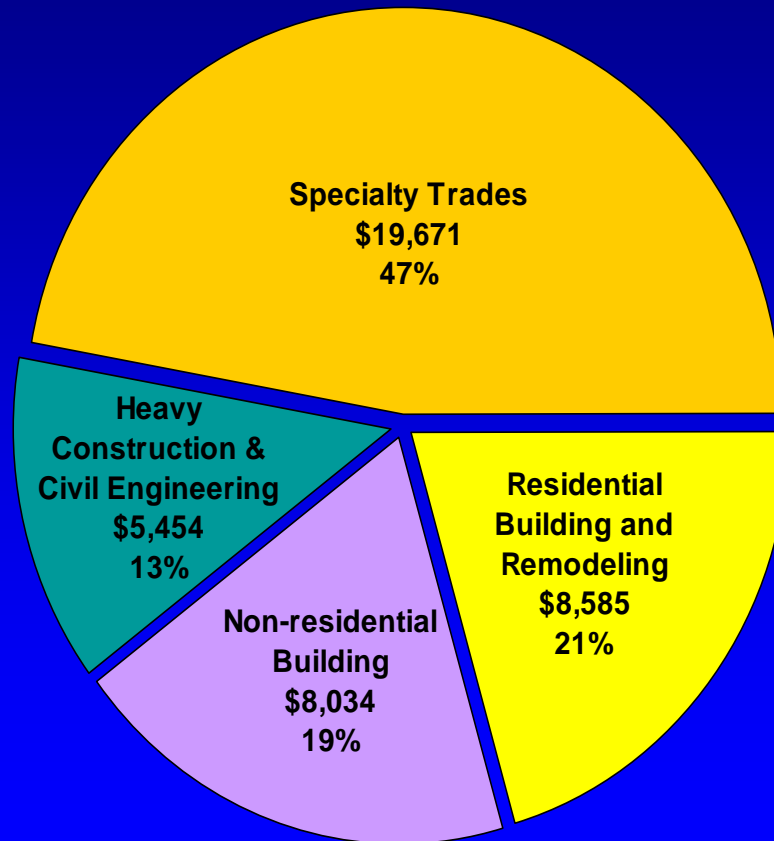


Source: Bureau of Labor Statistics



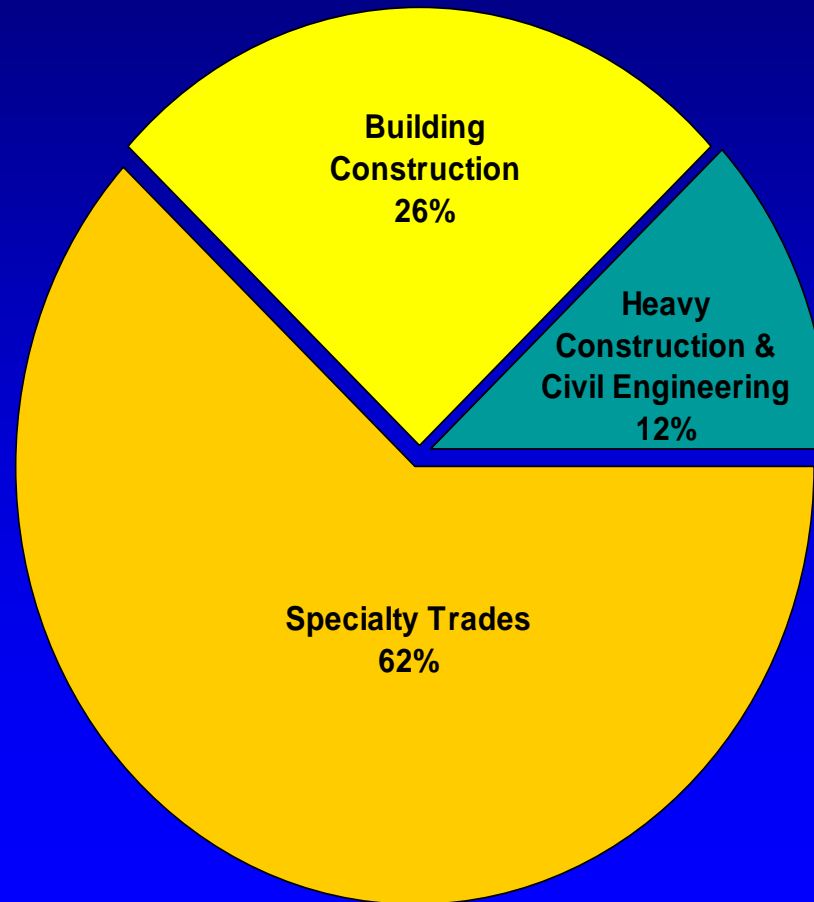
# Employer Gross Income: Washington State Construction by Sub-sector

(Millions of Dollars in 2006)



Source: Washington State Department of Revenue (2006)

# Employees: Washington State Construction by Sub-sector



Source: Washington State Employment Security Department

N = 195,000

## **Underground Economy: Literature Review**

- **Searched library data bases, the Internet, reviews, and other sources for published reports describing the underground economy and employee misclassification.**
- **Collected 106 reports, journal articles, book chapters, government studies, research reports, and other information published since 1980.**
- **Reviewed the reports and recorded results of those that attempted to measure the underground economy using generally recognized approaches.**

A listing of the reports reviewed for this study is available at [www.wsipp.wa.gov](http://www.wsipp.wa.gov).

# The Underground Economy: Pros and Cons

## Pros

- Adaptive and competitive
- A route to the formal labor market
- A “trial run” for startup firms
- Alternative to criminal activity
- Develops and sustains social networks
- Provides lower-priced goods and services

## Cons

- Reduces tax revenue
- Reduces wages
- Distorts economic data
- Increases volatility
- Creates an unfair playing field
- Reduces tax equity
- Promotes unregulated activities
- Erodes health and safety standards
- Contagious

Sources: Bajada, 2002; Schneider and Enste, 2002; and Williams, 2004

# Measuring the Underground Economy

## Direct Methods:

Based on surveys or audits.

## Indirect Methods:

**National Accounting Approach.** Based on discrepancies between national accounting of income and expenditures.

**Monetary Approach.** Based on the volume of monetary transactions in the overall economy or the demand for cash.

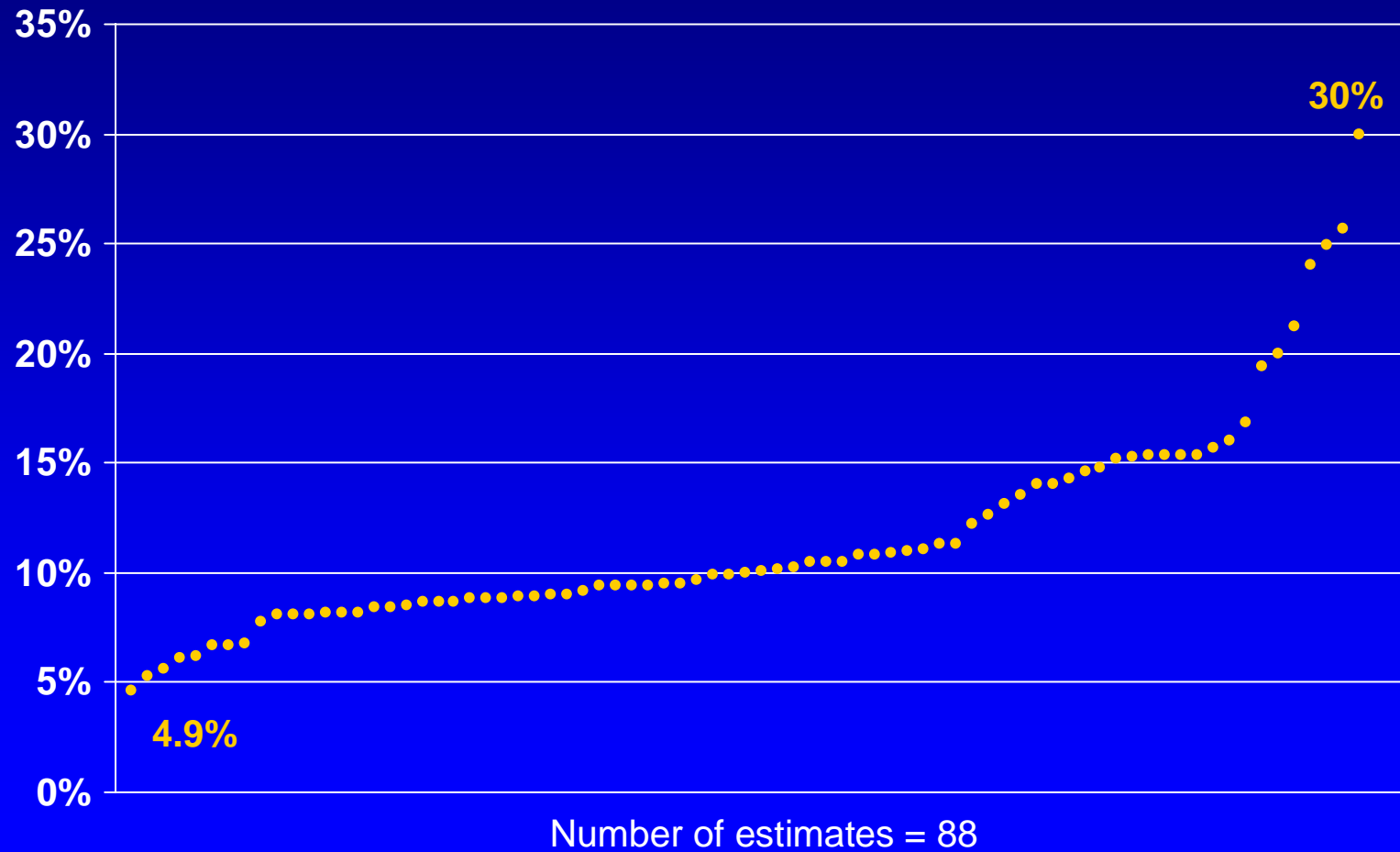
**Labor Force Statistics Approach.** Based on discrepancies between labor market and production trends.

**Physical Input Approach.** Based on the consumption of energy or other inputs to production.

**Behavioral Approach.** Statistical models based on variables assumed to influence or reflect the underground economy (tax burden, regulation, etc.)

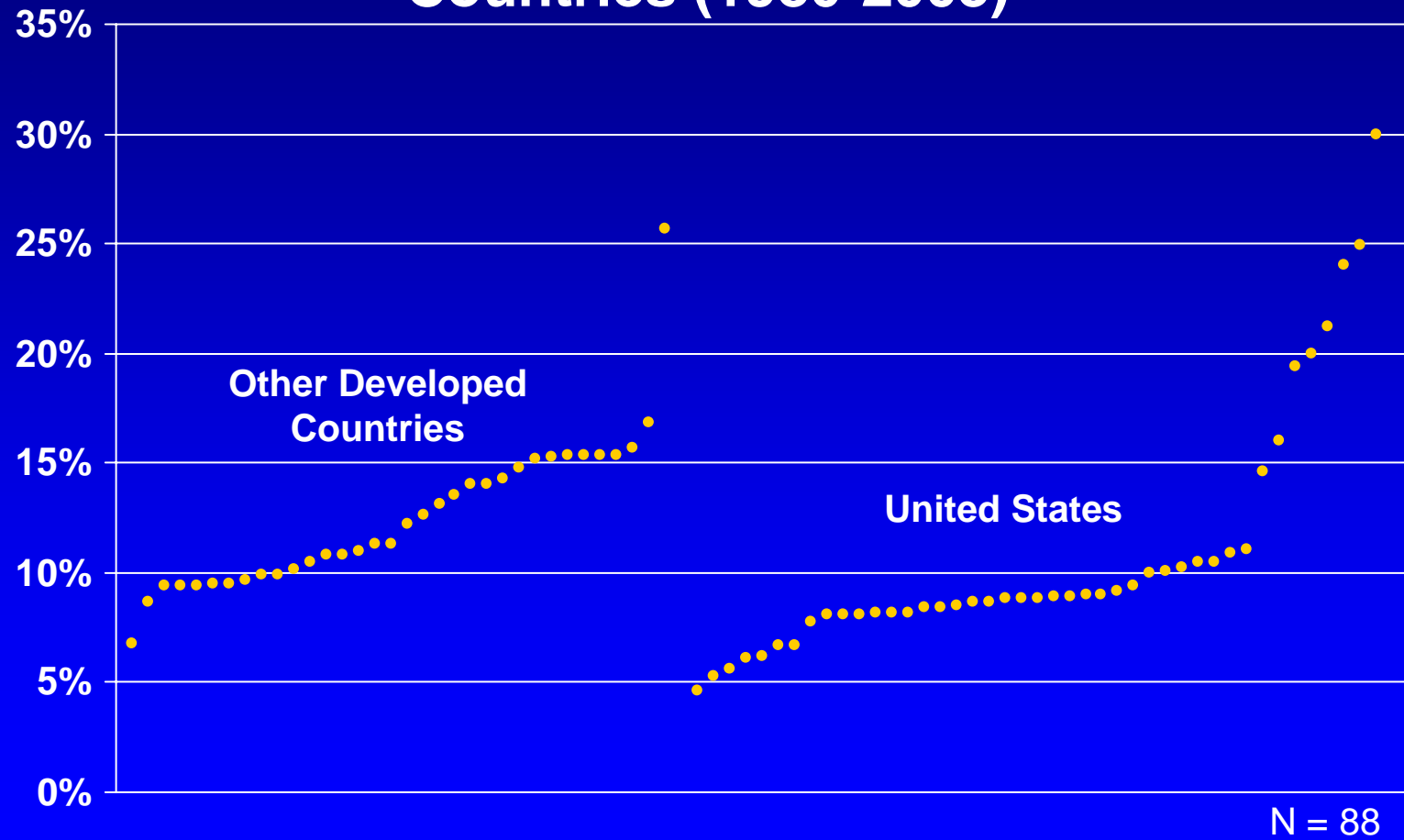
Adapted from Schneider and Enste, 2002a and 2002b

# Measurements of the Underground Economy as a Percentage of Gross Domestic Product (GDP): Estimates for Developed Countries (1980-2003)



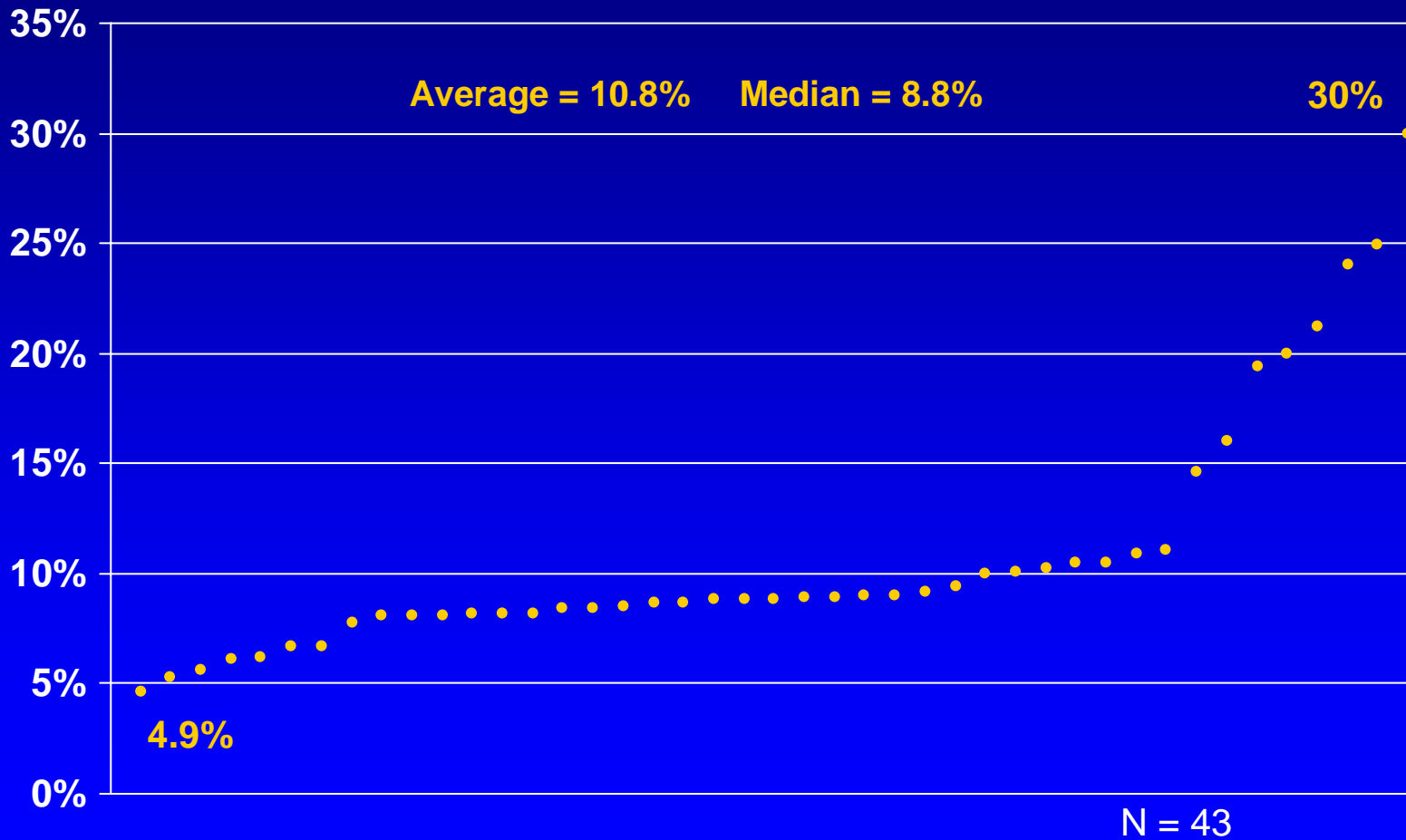
Source: WSIPP review.

# Measurements of the Underground Economy as a Percentage of GDP: Estimates for Developed Countries (1980-2003)



Source: WSIPP review.

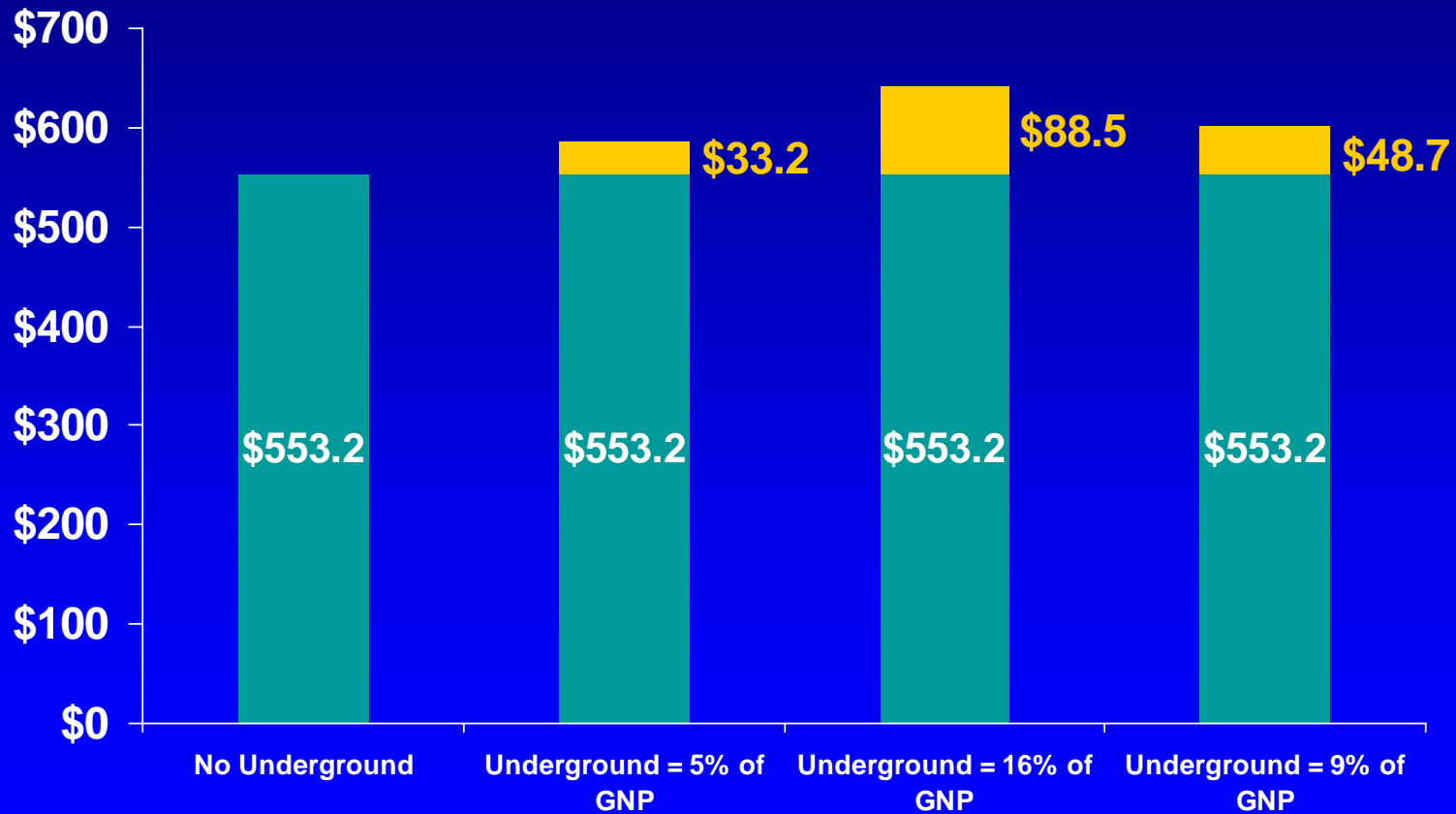
# Measurements of the Underground Economy in the United States as a percent GDP (1980-2003)



Source: WSIPP review.

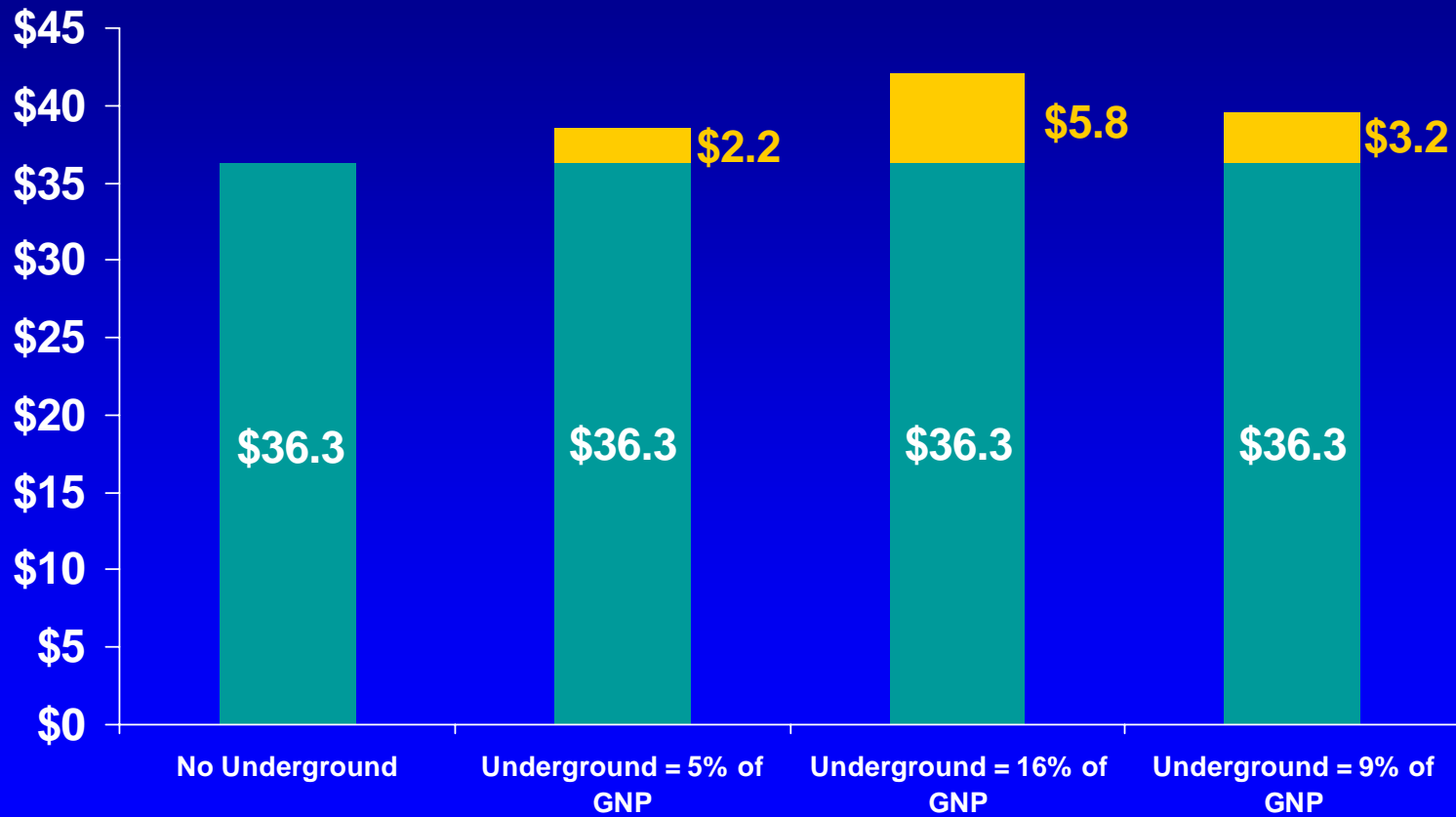


# Washington State's Underground Economy Based on Estimates of the US Underground Economy: 2006 Gross Business Income (A Preliminary Estimate in Billions of Dollars)



Source: WSIPP

# Washington State's Underground Construction Economy Based on Estimates of the US Underground: 2006 Gross Business Income (A Preliminary Estimate in Billions of Dollars)



Source: WSIPP

# Washington State Unregistered Business Study\*

Estimated taxes owed by firms conducting business but not registered in Washington State. The study examines taxes owed to three state agencies:

- Department of Revenue (sales and business and occupation taxes)
- Department of Labor and Industries (worker compensation tax)
- Employment Security Department (unemployment insurance tax)

*\*Brown, Harris, Callen, and Byington, forthcoming.*

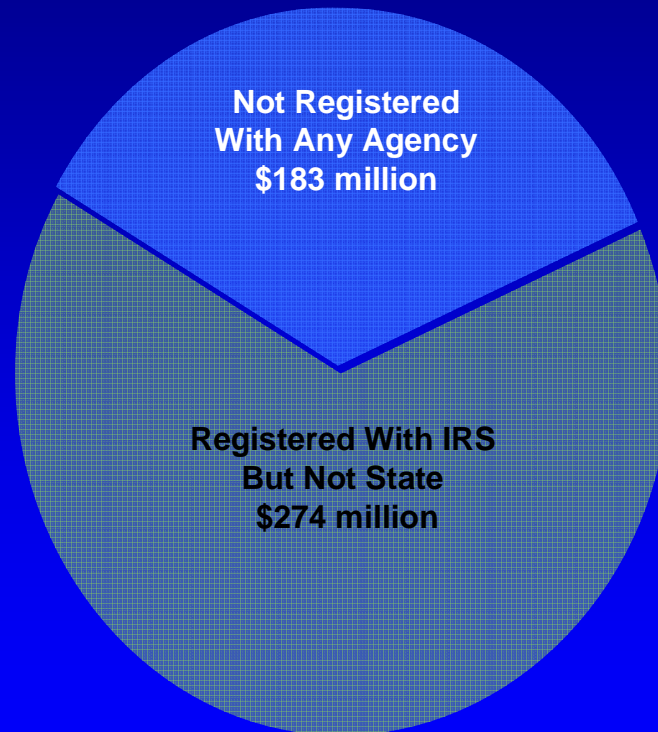
# Washington State Unregistered Business Study

Estimated taxes owed by 99,000 firms that file with the IRS but are not registered in Washington State and taxes owed by the 65,000 firms not registered with any agency.

- Cross-matches with IRS and state agency data identified businesses filing with the IRS but not with Washington State.
- National estimates from the IRS Tax Gap Study were used to approximate the taxes owed by firms not registered with any agency.
- The study does not fully capture taxes owed due to underreporting the cash-in-hand economy.

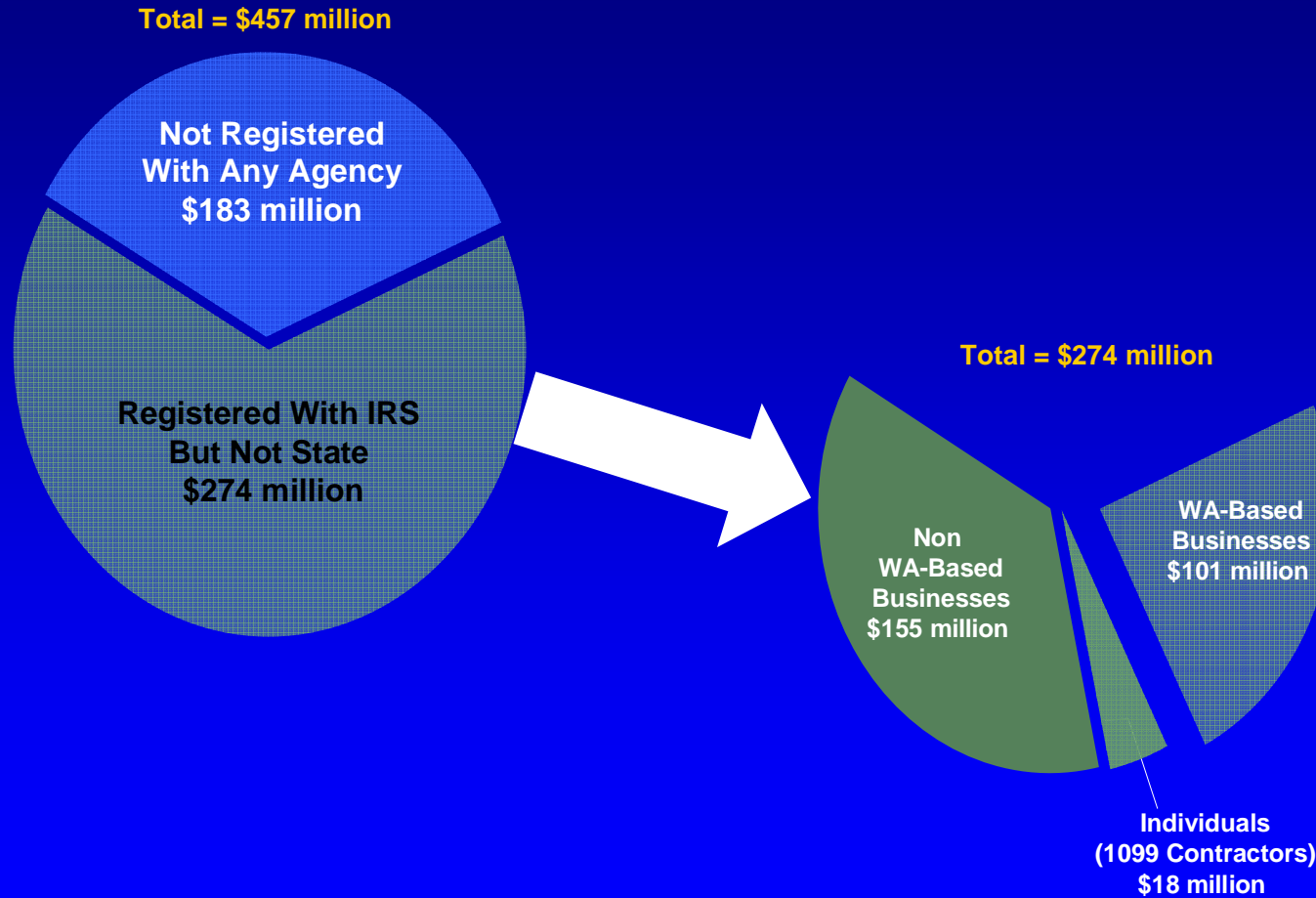
# Washington State Unregistered Business Study: Total Taxes Owed for the Study Year

**Total = \$457 million**



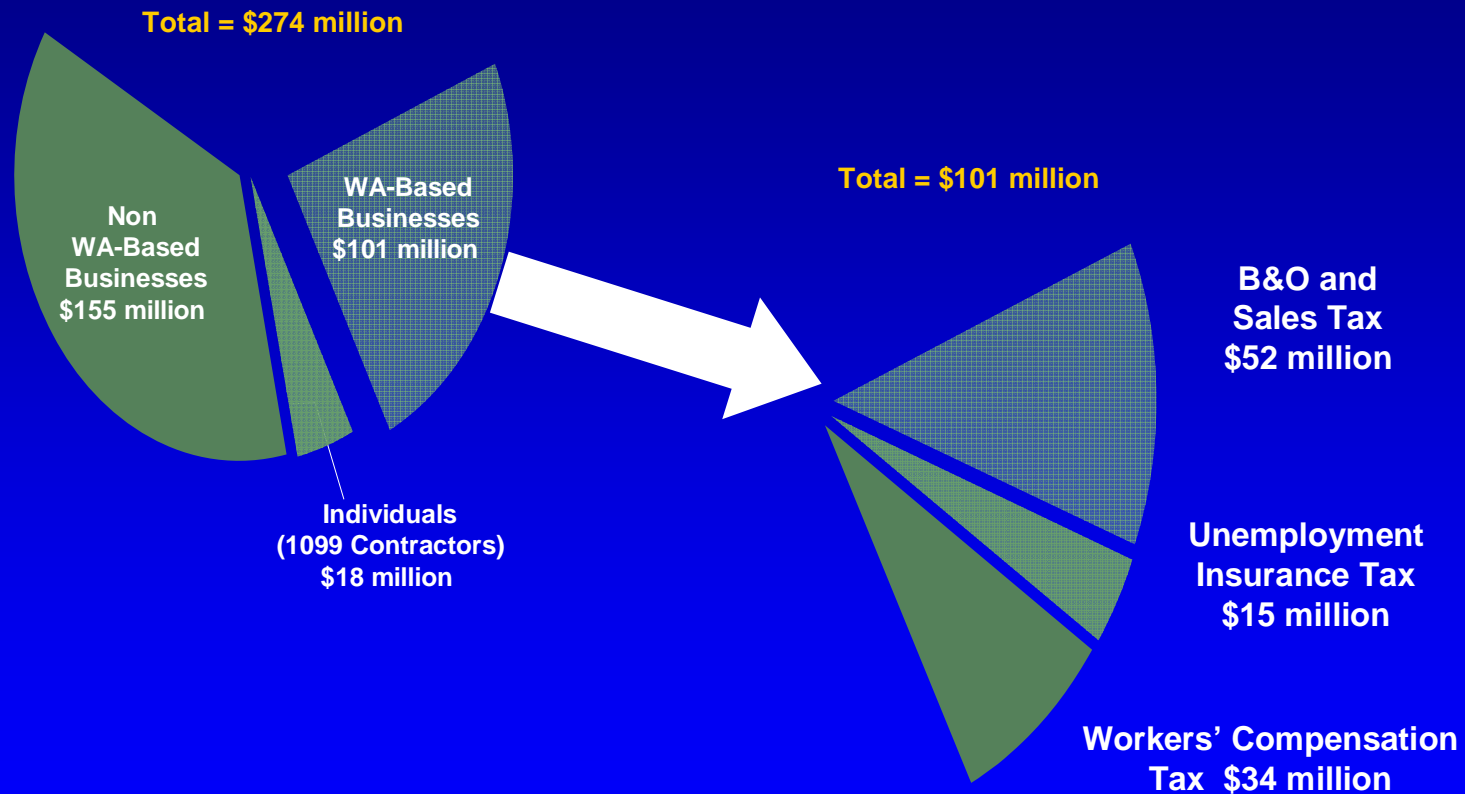
*Source: State of Washington GMAP Presentation, September 12, 2007 (Department of Revenue, Employment Security Department, and the Department of Labor and Industries)*

# Washington State Unregistered Business Study: Taxes Owed by Businesses Filing With IRS



Source: State of Washington GMAP Presentation, September 12, 2007 (Department of Revenue, Employment Security Department, and the Department of Labor and Industries)

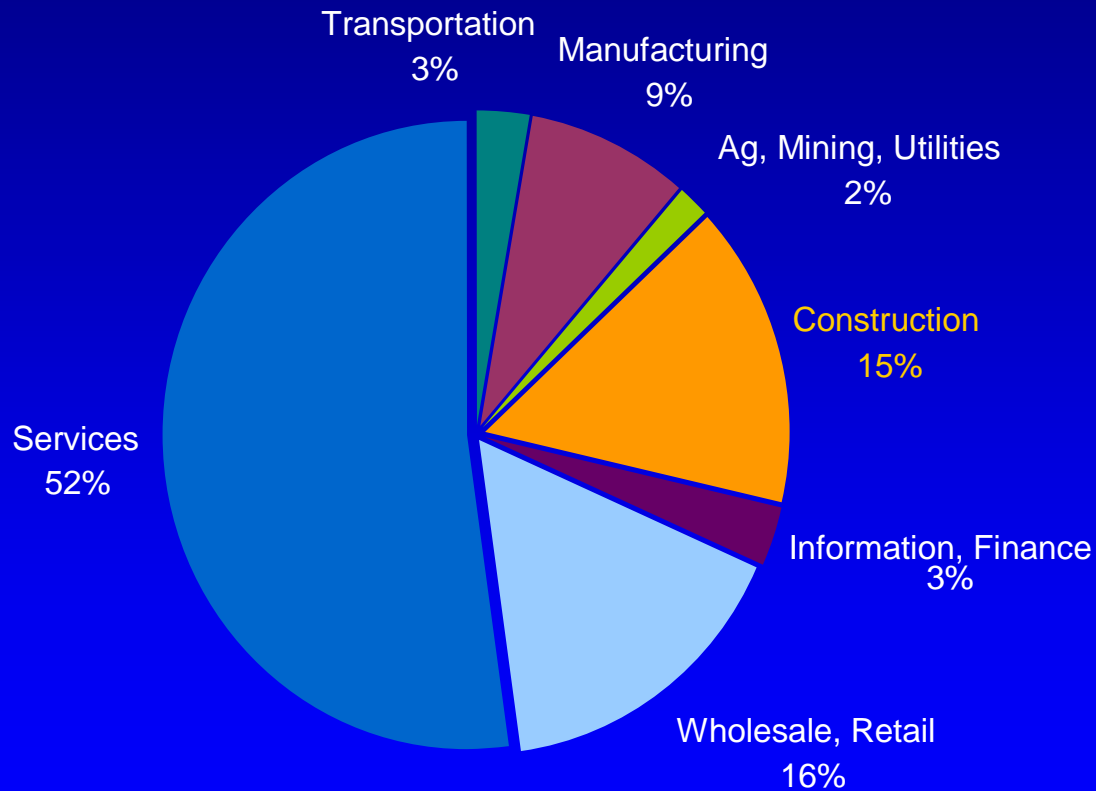
# Unregistered Business Study: Taxes Owed by Washington-based Businesses Filing With IRS



Source: State of Washington GMAP Presentation, September 12, 2007 (Department of Revenue, Employment Security Department, and the Department of Labor and Industries)

# Unregistered Business Study: Taxes Owed by Washington-based Businesses Filing With IRS by Sector

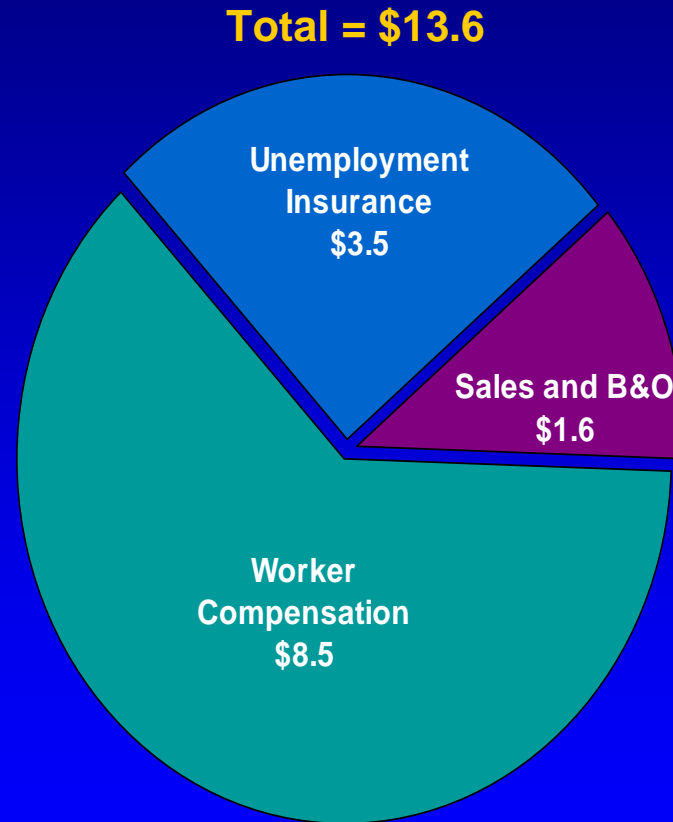
Total = \$101 million



Source: State of Washington GMAP Presentation, September 12, 2007 (Department of Revenue, Employment Security Department, and the Department of Labor and Industries)



# Unregistered Business Study: Taxes Owed by IRS-Filing Construction Firms Operating But Not Registered in Washington State (Millions of Dollars)



**Does not include taxes owed by 1099s or out-of-state firms with Washington nexus that did not register with any state agency.**

*Source: State of Washington GMAP Presentation, September 12, 2007 (Department of Revenue, Employment Security Department, and the Department of Labor and Industries)*

## Classification of Independent Contractors

- **Legitimate:** Independent contractors according to state legislation receiving IRS form 1099-Misc for receipt of *non-employee* compensation.
- **Misclassified:** Employees, according to state definitions, who should receive IRS form W-2 for *employee compensation* but receive a 1099-Misc instead.
- **Underground:** Employees and independent contractors who do not receive either a 1099-Misc for non-employee compensation or a W-2 from their employer.

## Some Reasons to Hire Independent Contractors and/or Misclassify Employees

- Greater flexibility in hiring and firing
- Avoid worker compensation premiums and other taxes
- Test out new potential employees
- Avoid regulations based on firm size
- Avoid costs associated with labor laws and worker protection.

*Source: Planmatics, 2000; and Carre, 2004 and 2005.*

# Worker Misclassification in Washington State

## The 2000 Planmatics Study:

- Percentage of employers with misclassified workers 10.3%
- Percentage of workers misclassified 3.2%

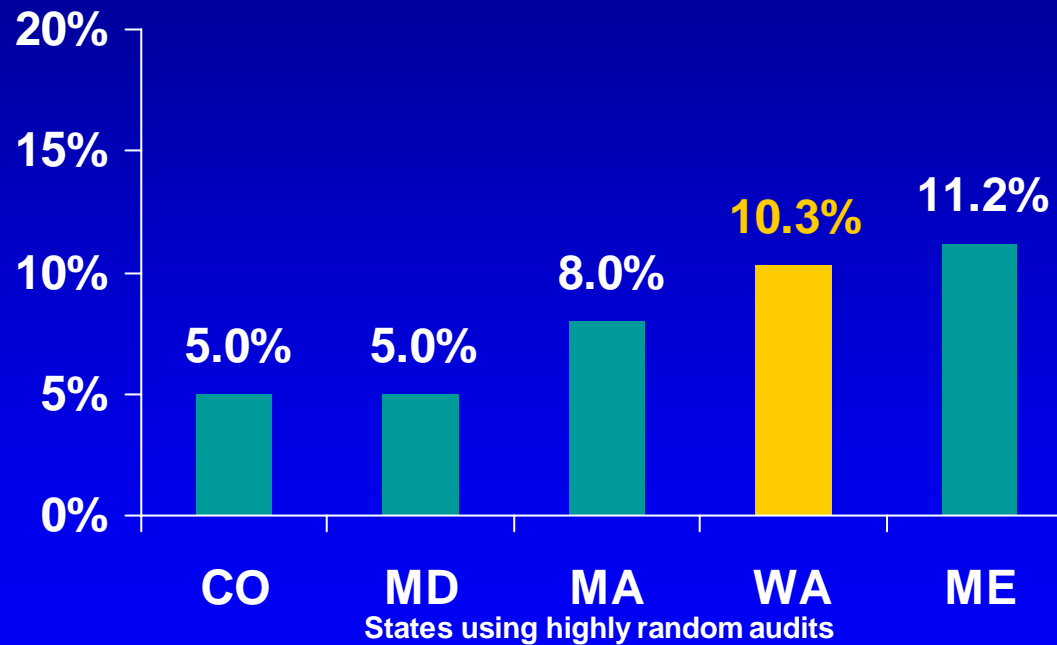
## Estimates Based on Employment Security Department Audits 2002-2005:

- Number of employees misclassified 118,000/year
- Gross wages underreported \$723.5 mil/year
- Unemployment Insurance tax owed \$12.3 mil/year

Source: Planmatics, 2000 and WSIPP analysis of Employment Security Department audits.

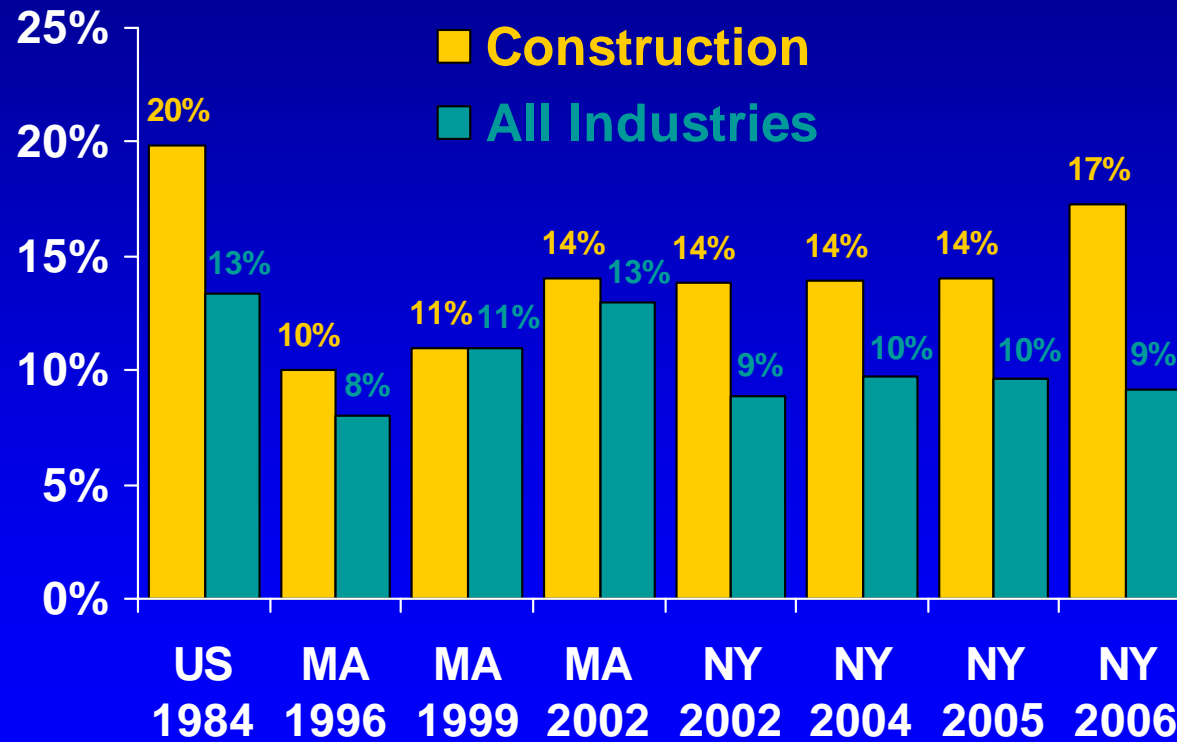
# Percentage of Employers Misclassifying Employees: Selected States

(based on audits observations from 1998 to 2001)



Source: Carre, 2005

# Misclassification is More Common in the Construction Industry: Percentage of Employers With Misclassified Workers



Employers in the construction industry are 1.4 times more likely to misclassify workers.

Source: Carre, 2004 and 2005; Coopers and Lybrand, 1994; Donahoe, 2006.

## Sources Cited

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End of Presentation

# The Underground Construction Economy in Washington State: A Review of the Literature and Preliminary Findings

Presented to the Joint Task Force on the Underground Construction Economy

September 26, 2007

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November 2007

## TAXES OWED BY THE UNDERGROUND CONSTRUCTION INDUSTRY: UPDATE TO THE JOINT TASK FORCE ON THE UNDERGROUND ECONOMY IN THE CONSTRUCTION INDUSTRY

The Washington State Institute for Public Policy (Institute) was asked to estimate the total taxes (Business and Occupation, Unemployment Insurance, and Workers Compensation) owed to Washington State by participants in the underground construction industry.<sup>1</sup> The following provides an estimate of the taxes owed in 2006 and describes differences in the estimation approaches used by Washington State and other national studies.

### Washington State Taxes and Premiums Owed by Participants in the Underground Construction Industry

Based on a review of national estimates of the underground economy and a recent multi-agency study<sup>2</sup> of unregistered businesses in Washington State, a conservative estimate of the total taxes owed by participants in the underground construction<sup>3</sup> economy is \$109 million dollars in 2006.<sup>4</sup>

This estimate is considered conservative for two reasons:

- 1) It is based on the proportion of underground activity in the overall economy, not just construction. Anecdotally, underground activity is more prevalent in the construction trades than average; and
- 2) It is also based on the lower end of a range of national estimates found in the research literature.<sup>5</sup> If the estimate were based on the median rate reported nationally, the total tax shortfall due to underground construction activity would be approximately \$156 million in 2006.

<sup>1</sup> SB 5926, Sec. 2 (2), Chapter 288, Laws of 2007.

<sup>2</sup> *Underground Economy, Governor's GMAP*, Washington State Department of Revenue, Employment Security, Department of Labor and Industries, September 23, 2007, <<http://www.accountability.wa.gov/reports/economy/20070912/Tab3UnderEcon.pdf>>.

<sup>3</sup> This estimate does not include heavy construction and engineering where underground economic activity is relatively rare.

<sup>4</sup> To arrive at this estimate, the cumulative tax rate of the Department of Revenue, Employment Security, and Department of Labor and Industries (4.86 percent) was multiplied by the \$2.2 billion lower-bound estimate of the underground construction economy.

<sup>5</sup> Jim Mayfield (2007). *The Underground Construction Economy in Washington State: A Review of the Literature and Preliminary Findings*. Olympia: Washington State Institute for Public Policy, Document No. 07-09-4101, <<http://www.wsipp.wa.gov/pub.asp?docid=07-09-4101>>.

## **Size of the Total Underground Economy: Differences in Washington State and National Estimates**

Previously, the Institute reported a range of national estimates of the total underground economy based on the research literature.<sup>6</sup> Using these estimates, we concluded that the size of Washington State's overall underground economy ranged from a low of \$33.2 billion to a high of \$88.5 billion. Based on results from the study of unregistered businesses in Washington State and additional data provided by the agencies that conducted the study, the overall underground economy was approximately \$23.2 billion in 2006.<sup>7</sup>

Why are these estimates different?

- The agency estimate may tend to underestimate elements of the cash-only economy;
- The Institute estimate uses some measures that may include elements of the "illegal" and barter economies; and
- The construction industry may be underreported in the agency estimate of unregistered businesses.

An advantage of the agency analysis is that it is state-specific and relies on actual data of companies earning income in Washington State. Because of the differences above, the agency estimate of \$23.2 billion probably suggests a somewhat conservative estimate of taxes owed, but it also suggests that using the higher range of national estimates of the underground economy may overstate the size of Washington's underground economy.

*For further information, please contact Jim Mayfield, (360) 586-2783 or [mayfield@wsipp.wa.gov](mailto:mayfield@wsipp.wa.gov).*

Document No. 07-11-4101

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<sup>6</sup> *Ibid.*

<sup>7</sup> Due to data limitations, the agencies did not provide an estimate of the total underground construction economy in Washington State.