

December 2008

## MONITORING REGULATION AND ENFORCEMENT ACTIVITIES ASSOCIATED WITH THE UNDERGROUND CONSTRUCTION ECONOMY: PRELIMINARY REPORT

### Introduction

In 2007, the Washington State Legislature enacted Senate Bill 5926 relating to the underground economy in the construction industry. The legislation created a joint legislative task force 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.”<sup>1</sup>

In addition, the Joint Task Force on the Underground Economy in the Construction Industry (Task Force) was directed to contract with the Washington State Institute for Public Policy (Institute) to assist in determining the extent of and costs associated with the underground construction economy. Subsequent legislation in 2008 instructed the Institute to organize a committee to identify benchmarks to measure the effect of Task Force recommendations and to provide a preliminary report by December 31, 2008.<sup>2</sup>

The Benchmark Advisory Committee, comprising members of the Task Force and representatives of the Department of Revenue (DOR), Employment Security Department (ESD), and Department of Labor and Industries (L&I), met three times during calendar year 2008. The Committee reviewed enacted legislation that was recommended by the Task Force (2SSB 6732 and ESHB 3122<sup>3</sup>) and identified new activities and initiatives for which data could be collected to monitor progress and results.

This report describes data (currently available or soon to be collected) that can be used to monitor the implementation of legislatively enacted policies associated with the Task Force’s recommendations. Because many of the activities enacted during the 2008 legislative session were not implemented until late summer or fall of 2008, the data presented here only represent a baseline against which to

measure future outcomes. Data reflecting the first fiscal year of implementation will be available prior to the 2010 legislative session.

### Background

**State Revenue Losses Associated With Underground Construction Activity.** The Task Force was directed to contract with the Institute to provide assistance in estimating the size of and costs associated with the underground construction economy.<sup>4</sup> The primary focus was to estimate the total state revenue (sales and business and occupation [B&O] taxes and unemployment insurance and workers’ compensation premiums) owed to Washington State by participants in the underground construction industry.<sup>5</sup>

Due to the hidden nature of the underground economy, there is little detailed data available at the state or even the national level. However, based on an extensive review of the research literature and in consultation with staff at DOR, ESD, and L&I, the Institute developed a rough estimate of the size of the underground construction industry.<sup>6</sup>

Based on the estimated size of the underground construction economy and a cumulative tax rate provided by the three revenue-collecting agencies, in fiscal year 2006, the unpaid sales and B&O taxes and premiums associated with underground construction activity were valued at roughly \$109

<sup>1</sup> Chapter 288, Laws of 2007

<sup>2</sup> 2SSB 6732, Chapter 120, Laws of 2008

<sup>3</sup> This legislation consolidated, aligned, and clarified exception tests for determination of independent contractor status under unemployment compensation and workers’ compensation laws.

<sup>4</sup> Underground construction activity includes any work in the building construction trades that is not reported (yet is required to be reported) to government agencies charged with taxing or regulating the activity.

<sup>5</sup> SB 5926, Sec. 2(2), Chapter 288, Laws of 2007.

<sup>6</sup> J. Mayfield. (2007, September). *The underground construction economy in Washington state: A review of the literature and preliminary findings*. PowerPoint presentation to the Joint Task Force on the Underground Construction Economy.

million.<sup>7</sup> This estimate includes only the sales and B&O taxes that could have been collected by DOR and the premiums collected by ESD and L&I. This estimate does not include the revenue losses experienced by city and county governments.<sup>8</sup>

Underground construction activity also influences workers' wages, worker safety, healthcare costs associated with uninsured workers, and other regulatory activities. These economic and social costs were not evaluated for this study.

### **Task Force Recommendations and Legislation.**

During the 2008 session, the Task Force submitted a report to the Legislature recommending a number of legislative, agency, and budget actions intended to improve regulation and oversight in the construction industry with respect to underground activity.<sup>9</sup>

The Task Force recommended new registration requirements and penalties, increased enforcement activities, increased education and outreach, and continuation of data sharing and detection capabilities. They also recommended consolidating, aligning, and clarifying tests for determination of independent contractor status under unemployment compensation and workers' compensation laws.

Enacted legislation resulting from these recommendations is embodied in two bills: 2SSB 6732 and ESHB 3122. The former addressed penalties, registration, enforcement, and education, the latter the definition of covered employment.<sup>10</sup>

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<sup>7</sup> Due to the high premiums paid for workers' compensation and unemployment insurance in the construction industry, the great majority of lost revenue (88 percent) is estimated to be in unpaid premiums to ESD and L&I.

<sup>8</sup> Local governments lose revenue from a variety of sources, including local sales and B&O taxes, building permit and licensing fees, and property taxes. Data to estimate the size of those revenue losses, however, are not available. And the considerable uncertainty around the statewide estimate is greatly compounded when attempting to estimate revenue losses at the local level.

<sup>9</sup> [http://www.leg.wa.gov/documents/joint/UECI/UE\\_FINAL\\_FINDINGS\\_RECOMMENDATIONS\\_021508.pdf](http://www.leg.wa.gov/documents/joint/UECI/UE_FINAL_FINDINGS_RECOMMENDATIONS_021508.pdf).

<sup>10</sup> The work of the Task Force was continued to another year and recommendations for the 2009 legislative session were being finalized at the time of this report.

### **Monitoring the Activities Recommended by the Task Force**

The Benchmark Advisory Committee reviewed relevant legislation and identified policy areas where data are or may eventually be available to monitor activities recommended by the Task Force. Data are or will be available in the future to monitor activities associated with the following policy areas:

- Contractor registration and records
- Penalties
- Enforcement
- Education and outreach
- Data sharing and detection

The 2007 recommendations of the Task Force have been implemented. This report describes the activities to be monitored, the data used to monitor those activities, the agency compiling the data, and when those data may be available.<sup>11</sup> Where baseline data are available, they are presented in this report.<sup>12</sup>

### **Contractor Registration and Records.**

Contractors must register with the Department of Labor and Industries. The revised statute requires that the registration application include a Department of Revenue Universal Business Identifier (UBI).<sup>13</sup> The statute also allows for denials and suspensions of applications of contractors who do not have a UBI, are not registered, or submit false information on their registration application.<sup>14</sup> Additionally, employers are now required to keep a record of compensation paid to contractors performing work.<sup>15</sup>

- **Contractor registration UBI requirement.** While a requirement for a UBI was not previously in statute, it effectively is a requirement because a UBI is necessary for entry into L&I's Contractor Registration Information System (CRIS). As a result, since third quarter 2004, there are no

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<sup>11</sup> The "activities to be monitored" are the activities and policies enacted for which agencies can or will be able to provide data for ongoing monitoring. They were identified in consultation with the Benchmark Advisory Committee.

<sup>12</sup> Only 2SSB 6732 included statutory changes for which ongoing data monitoring is applicable. ESHB 3122 simplified the test to determine independent contractor status.

<sup>13</sup> 2SSB 6732 Sec. 1(1)(b)

<sup>14</sup> 2SSB 6732 Sec. 1(3)(a)(iv-v), 1(3)(b)(iv-v), and 2(7)(c)

<sup>15</sup> 2SSB 6732 Sec. 5(1)(b)

registered contractors without UBI numbers (Exhibit 1).

**Exhibit 1**  
**Year-end Contractor Registrations**  
**With and Without UBIs**

Fiscal Year <sup>16</sup>	With UBI	Without UBI
2004	65,701	285
2005	67,731	0
2006	70,370	0
2007	74,601	0
2008*	75,210	0

\*Second quarter  
Source: L&I

- **Application denials and suspensions.** If applications or denials occur, L&I will be able to report the number of application denials and registration suspensions in a given year. As of December 15, 2008, however, there have been none. DOR is also able to report tax recoveries associated with any denials and suspensions reported to them by L&I.

**Penalties.** Several new penalties targeting contractors in violation of rules were enacted in the 2008 legislation. Contractors are now subject to a fine of up to \$10,000 for falsifying information on an application for registration.<sup>17</sup> Also, contractors who misrepresent payroll or employee hours, operate without a certificate of L&I coverage, or have multiple contractor registration violations may be prohibited from bidding on public works contracts for one year.<sup>18</sup>

- **Up to \$10,000 fine.** There are no baseline data regarding this new penalty and no cases have been initiated or resolved as of December 15, 2008. In the future, L&I will be able to provide the number of fines assessed, collection amounts, and accompanying narratives associated with any violations resulting in this penalty.

- **Public works contract prohibition.** There are no baseline data available regarding this new sanction and no cases have been initiated or resolved as of December 15, 2008. In the future, L&I will be able to provide the number of these sanctions resulting from construction audits and provide narrative accounts associated with violations resulting in a sanction.

ESD will also be able to provide the number of referrals (following appeal) to L&I for firms that misrepresent payroll or employee hours.

**Enforcement.** The Task Force sought to increase resources allocated to enforcement by adding more L&I investigative and auditing staff and dedicating funds for prosecution of compliance cases. The specific details of these recommendations adopted in legislation were vetoed by the Governor;<sup>19</sup> however, funds provided in the 2008 supplemental budget were used by L&I to implement increased enforcement activities. As a result, L&I increased its auditing and investigative staff.

In addition to increased investigative and auditing staff, the Legislature directed L&I to dedicate funds (if available in the 2008 supplemental budget) to the attorney general's office to be used in the enforcement of contractor compliance cases.<sup>20</sup> A prosecutor was appointed in the fall of 2008.

- **Additional investigative and auditing staff.** L&I is able to report the number of audits filed and total dollars assessed for all industries and construction. Baseline data for all industry and construction audits are provided in Exhibits 2 through 5. It is important to note, however, that the four additional auditors described above are not dedicated to only auditing the construction industry.

In fiscal year 2008, L&I's auditing staff consisted of 67 FTEs at a total cost of \$4,566,295. L&I currently fields 71 FTE auditors at \$4,926,951 for fiscal year 2009.

<sup>16</sup> The state fiscal year runs from July through June (e.g., FY04 lasts from July 2003 through June 2004).

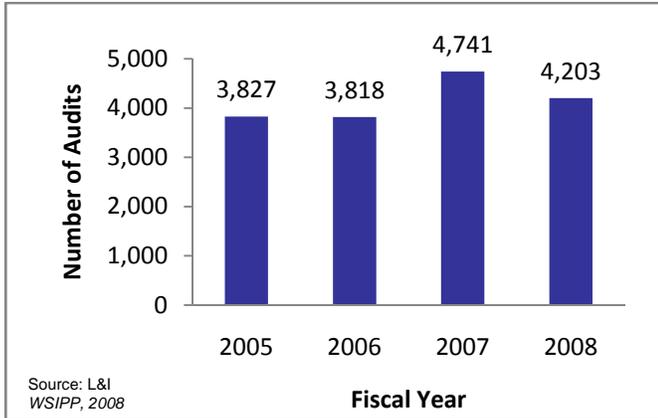
<sup>17</sup> 2SSB 6732 Sec. 2(8)(a)

<sup>18</sup> 2SSB 6732 Sec. 3

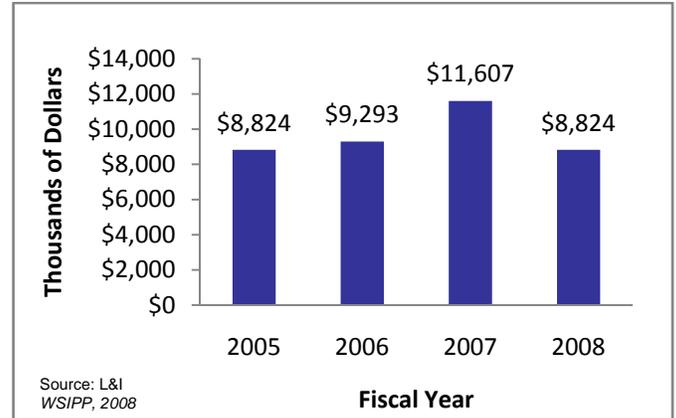
<sup>19</sup> 2SSB 6732 Sec. 11(1)(a) and 11(2), were vetoed.

<sup>20</sup> This section was also vetoed, but L&I funded this effort using available resources.

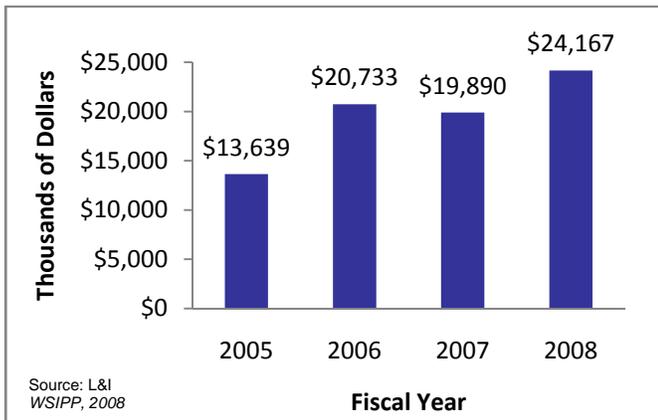
**Exhibit 2**  
**Number of Labor and Industries Audits:**  
**All Industries**



**Exhibit 5**  
**Labor and Industries Audits: Construction Only**  
**Total Dollars Assessed (in Thousands)**



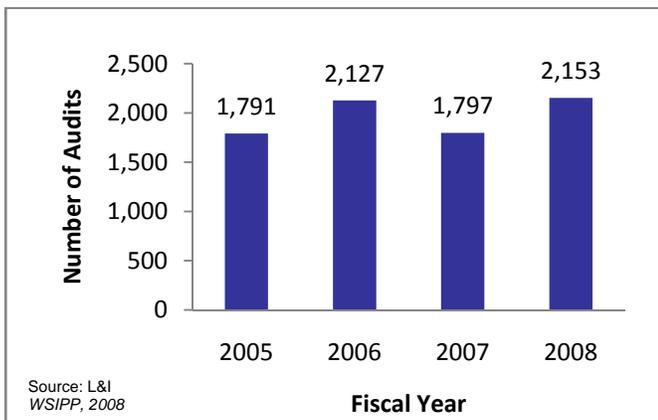
**Exhibit 3**  
**Labor and Industries Audits: All Industries**  
**Total Dollars Assessed (in Thousands)**



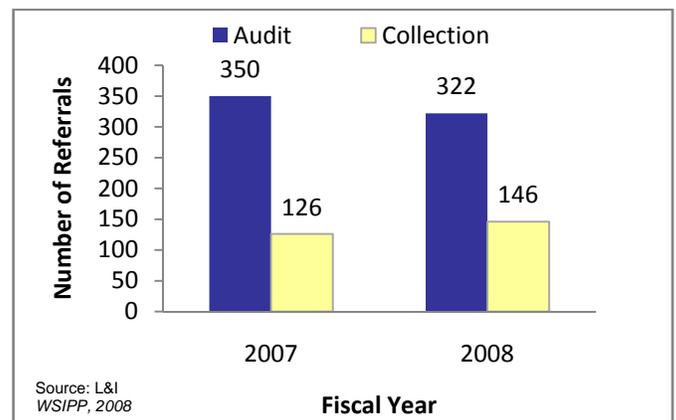
L&I is also able to report on the activities of the FAIR Team.<sup>21</sup> The FAIR Team began operations in 2006 and focus on unlicensed construction contractors and firms not paying workers' compensation. Baseline audit and collection referrals and the total dollars assessed and collected are provided in Exhibits 6 and 7, respectively.

In fiscal year 2008, the FAIR Team consisted of 3 FTEs at a cost of \$277,404 per year. There are currently six FAIR Team staff at a cost of \$636,829 for fiscal 2009.<sup>22</sup>

**Exhibit 4**  
**Number of Labor and Industries Audits:**  
**Construction Only**



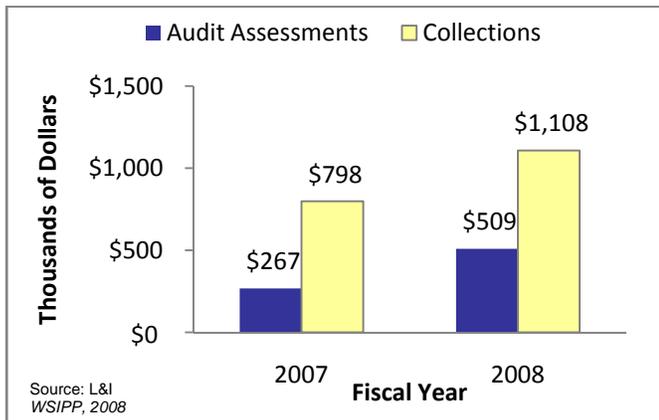
**Exhibit 6**  
**Number of Labor and Industries FAIR Team**  
**Audit and Collection Referrals**



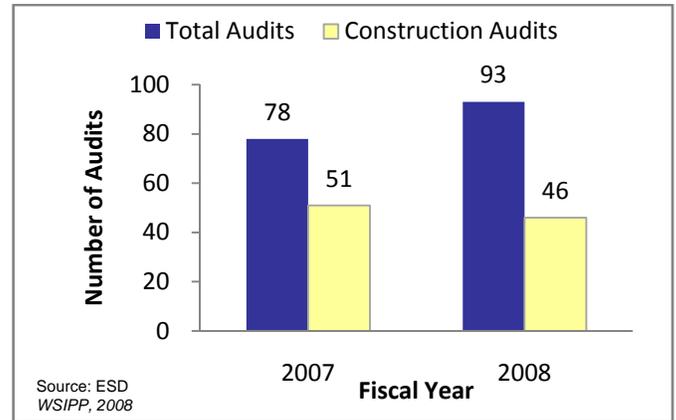
<sup>21</sup> Fraud, Audit, Infraction, and Revenue.

<sup>22</sup> FY10 funding will be \$595,535, lower than FY09 due to one-time costs associated with new FTEs in FY09.

**Exhibit 7**  
**Labor and Industries FAIR Team**  
**Audit Assessments and Collections**  
**(in Thousands)**



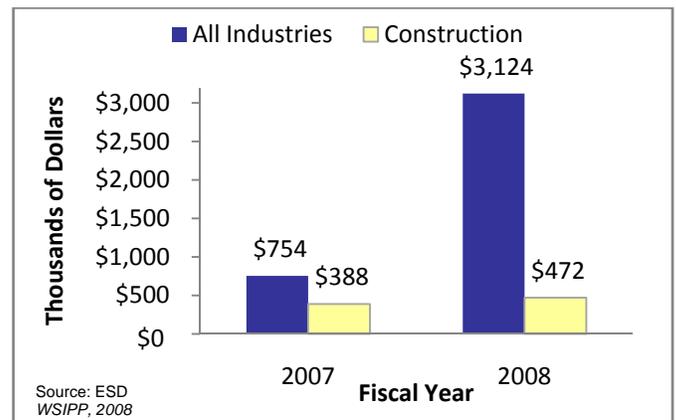
**Exhibit 8**  
**Number of Employment Security Department**  
**Underground Economy Unit Audits**



- Attorney general enforcement of contractor compliance cases.** A prosecutor was assigned in the fall of 2008. By December 15, 2008, however, no cases had been initiated. In the future, L&I will be able to report the number of cases initiated for prosecution and prosecution outcomes, and provide narrative accounts of cases brought to prosecution.
- Employment Security Department Underground Economy Unit.** The ESD's Underground Economy Unit focuses on locating businesses (not just construction) that are not registered with the Department. While the Task Force recommended no additional auditors for ESD, this activity merits inclusion as a possible benchmark for future monitoring. ESD is able to report tax discoveries, penalties, and interest owed for all industries and construction. The Underground Economy unit began operation in FY07. Baseline data for their first two years of operation are provided in Exhibits 8 and 9.

In fiscal year 2008, the ESD Underground Economy unit was staffed with 4 FTEs at a cost of \$361,384. Their efforts generated \$8.64 in tax discovery, penalties, and interest for every dollar spent that year.

**Exhibit 9**  
**Employment Security Department Underground**  
**Economy Unit: Tax Discoveries Plus Penalties and**  
**Interest (in Thousands)**



**Education and Outreach.** 2008 legislation directed L&I to “create 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 may include: providing public service announcements and other similar materials, made available in English as well as other languages, to the media and to community groups; providing information on violations and penalties; and encouraging legitimate contractors and the public to report fraud.”<sup>23</sup>

<sup>23</sup> 2SSB 6732 Sec. 12

A comprehensive strategy targeting contractors and consumers is in development; in addition, L&I's media campaign is scheduled to begin in early 2009. The Department has updated educational materials<sup>24</sup> and continues to stage contractor classes and other events such as home shows across the state.<sup>25</sup> L&I is able to describe the number of classes and events and the total attendance and contacts made at each event. Baseline data are provided in Exhibit 10.

**Exhibit 10**  
**Labor and Industries Contractor Classes and Home Shows: Events, Attendance, and Contacts Made**

Calendar Year	Classes	Class Attendance	Home Shows	Event Contacts
2005	9	988	46*	18,273
2006	7	1,036	37	18,557
2007	8	1,103	35	20,746
2008**	6	989	30	21,731

\*This figure includes special series of fraud events.

\*\*Partial year data.

Source: L&I

**Data Sharing and Detection.** The task force recommended legislation to ensure that agencies continue to share data for the purpose of investigating unregistered businesses and other compliance issues. The legislation passed ensures that records or information obtained can be used for purposes "(a) directly connected to the official purpose for which the records or information were obtained or (b) to another governmental agency which would be permitted to obtain the records or information under subsection[s]...of this section."<sup>26</sup>

Agencies continue to routinely share information and data. Related to these efforts, the Department of Revenue tracks the number of referrals across agencies and dollars assessed and collected from those referrals. During fiscal year 2008 (the first full year these data were

<sup>24</sup> Dept. of Labor and Industries. (2008, March). *Recent changes to the Contractor Registration Law*, Olympia: L&I, see: <<http://www.lni.wa.gov/TradesLicensing/Contractors/files/3-27-2008factsheet.pdf>>; and Dept. of Labor and Industries. (2007, May). *A guide to hiring independent contractors in Washington state*, Olympia: L&I see:

<<http://www.lni.wa.gov/IPUB/101-063-000.pdf>>.

<sup>25</sup> In 2008, home shows were held in Everett, Skagit County, Lynden, Bellevue, Wenatchee, Spokane, Tri-Cities, Walla Walla, Yakima, Vancouver, Olympia, Tacoma, and Seattle.

<sup>26</sup> 2SSB 6732 Sec. 6(9)

compiled), there were 8,805 referrals among DOR, ESD, and L&I (Exhibit 11), \$658,056 assessed, of which \$601,905 had been collected by the end of the fiscal year. DOR continues to compile these data on a quarterly basis.

**Exhibit 11**  
**Cross-agency Referrals During Fiscal Year 2008**

Referral From...To	Number of Referrals
DOR to L&I	508
DOR to ESD	1,069
L&I to DOR	5,320
L&I to ESD	2,009
ESD to L&I*	49
ESD to DOR*	85
Total	9,040

\*These data queries were under development during fiscal year 2008.

Source: DOR

**Other Available Monitoring Data.** Data described thus far are specific to initiatives recommended by the Task Force. The primary goal of these initiatives is to reduce the amount of underground construction activity. An obvious benchmark to monitor the overall effectiveness of these efforts would be some measure of the amount of underground activity over time.

Unfortunately, because underground activity is hidden, there are no conveniently available means of measurement. All three agencies, however, compile data that may be useful for future monitoring efforts.

- **Bi-annual non-compliance study.** DOR publishes a study every other year in which they describe revenue losses due to non-compliance. While the report does not focus on the construction industry, it provides an on-going record of DOR revenue losses attributable to non-compliance in general. The 2010 report will include data from audits conducted in 2008 and earlier years.

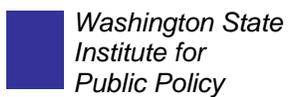
- **Employee misclassification.** One issue related to underground construction activity is the misclassification of employees as independent contractors. Based on targeted and other audits, the ESD is able to report the percentage of audited construction firms misclassifying workers and the number of workers misclassified by these audited firms. Historical data are available, and data reflecting audits conducted in calendar year 2009 could be available in January 2010.
- **Unregistered contractors.** L&I currently compiles data on construction audits, identifying the number of uncovered workers and hours worked, and dollars assessed. They also have the capacity to report the total number of unregistered contractors identified by investigative and audit staff. Data on unregistered contractors were not available for this report, but will be in the future.

## **Future Updates**

The data elements described above are or will be available on a regular basis to monitor activity associated with recommendations of the Task Force and related 2008 legislation. Data reflecting the first fiscal year of implementation will be available for a December 2009 update report and can be used to establish benchmarks for continued monitoring of the impacts of regulatory changes and enforcement activities.

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

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