



Underground Economy Benchmark Report (RCW 18.27.800)

2015 Annual Report to the Legislature

December 2015

Acknowledgements

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Table of Contents

Executive Summary	1
Introduction	4
Progress and Achievements in 2015	5
Department of Labor & Industries Highlights.....	5
Department of Revenue Highlights.....	9
Employment Security Department Highlights	16
Conclusion	20
Figures	
Figure 1: Intra-agency referrals and data transfers	2
Figure 2: Active contractor registrations as of June 30, 2015	6
Figure 3: Prevailing Wage strikes and debarments.....	8
Figure 4: Contractor Compliance program results.....	9
Figure 5: Number of businesses registered through tax discovery	10
Figure 6: Fraud referral total dollars collected.....	11
Figure 7: Fraud referral sources, FY 2015.....	12
Figure 8: Number of fraud hotline referrals, by month.....	13
Figure 9: Tax discovery case type	14
Figure 10: Tax discovery Washington State Patrol case project vehicle fraud referrals	15
Figure 11: Underground economy audits.....	16
Figure 12: All other audits.....	16
Figure 13: Audit leads from DOR and L&I.....	17
Figure 14: L&I FY 2015 audit assessments on unregistered or previously registered accounts .	18
Figure 15: DOR FY 2015 audit assessments on unregistered accounts	18
Figure 16: ESD FY 2015 audit assessments on unregistered accounts.....	19

Executive Summary

Introduction

The Department of Labor & Industries, Department of Revenue and Employment Security Department are pleased to provide this report on underground economy benchmarks, as required by Substitute House Bill (SHB) 1555. This bill was adopted in 2009 by the Washington State Legislature based on the recommendations of the Joint Legislative Task Force on the Underground Economy. It requires, in part, that the departments of Labor & Industries, Revenue and Employment Security coordinate and report to the Legislature by December 1 of each year on the effectiveness of their efforts to address the underground economy.

The underground economy is the loose network of businesses and individuals that do not register or do not report a significant part of their business activities with authorities as required by law. As a result, they not only fail to pay their fair share of taxes and workers' compensation premiums, but they gain an unfair advantage over competitors and may leave workers without protection in the event of injury or illness. Consumers are also put at risk because there is no bond or insurance to protect them.

The three agencies providing this report are sharing data and collaborating in other areas to uncover and take action on tax misreporting and other forms of fraud. Even though the joint task force ended in 2009, the agencies remain committed to working together and sharing information to prevent fraud and reduce the effects of the underground economy.

Progress and achievements in Fiscal Year (FY) 2015

Again in 2015, the departments of Labor & Industries (L&I), Revenue (DOR) and Employment Security (ESD) shared their information on contractor registration, taxes and other electronic data to discover and hold accountable hundreds of players in the underground economy.

At the same time, the agencies assisted construction contractors and other business owners in meeting state requirements.

July 2014-June 2015 (FY 2015) activities

- Together, L&I, DOR and ESD:
 - Uncovered a combined total of approximately 1,400 unregistered businesses that were assessed \$95.8 million in unpaid taxes, premiums, penalties and interest.
 - Exchanged almost 96,000 tips and leads through electronic data transfers.
 - Provided options for making late payments and information on the availability of interest and penalty waivers.
- ESD:
 - Found more than 6,000 unreported or misclassified workers through audits.
 - Assessed a total of more than \$531,000 on unregistered accounts.
- L&I:
 - Issued more than 1,200 infractions to unregistered contractors.

- Collected \$164.9 million from delinquent employer premiums (while most of this amount was from standard collection activities and not the underground economy, this money helps keep rates low by ensuring all employers pay their fair share).
 - Performed more than 860 audits on unregistered accounts for over \$8.2 million assessed.
 - Educated and trained more than 1,200 construction contractors through eight outreach events statewide.
 - Educated more than 39,000 consumers about their rights and how to hire legitimate contractors.
- **DOR:**
 - Collected more than \$35 million through its Tax Discovery Program.
 - Registered more than 700 non-compliant businesses.
 - Assessed taxes totaling over \$87 million from more than 740 businesses.
 - Recovered over \$578,000 in fraud related dollars.
 - Provided online outreach and assistance to consumers through SuspectFraud.com, and led discussions with stakeholders on new and relevant ways to find leads in the underground economy.

When DOR, ESD and L&I find businesses or individuals that may need to be investigated, they notify the appropriate agency by sending referrals or sharing and cross-checking data. Figure 1 shows the number of referrals and data transfers from one agency to another made by inspectors.

Figure 1: Intra-agency referrals and data transfers

Referral from....to	FY 2013		FY 2014		FY 2015	
	Interagency referral form	Electronic data file transfers	Interagency referral form	Electronic data file transfers	Interagency referral form	Electronic data file transfers
DOR to L&I	30	20,174	0	20,024	7	20,815
DOR to ESD	16	20,174	57	20,024	18	18,822
L&I to DOR	16	10,895	135	10,930	53	10,331
L&I to ESD	22	13,730	95	14,672	76	14,608
ESD to L&I	0	13,388	0	13,286	2	15,689
ESD to DOR	2	13,839	0	13,286	3	15,689
Other: L&I to L&I	N/A	N/A	N/A	N/A	16	N/A
Total	86	91,750	287	92,222	175	95,954

Source: Labor and Industries

Conclusion

The multi-agency effort to dismantle the underground economy will continue to be a critical mission for DOR, L&I and ESD. The agencies are strengthening their partnership by sharing information and meeting on a regular basis. They engage with stakeholders to identify problems and create new tools for achieving compliance. Enforcing Washington's laws and providing education and assistance will help level the playing field for employers and workers who already do their best to follow the rules.

Introduction

The underground economy is the loose network of businesses and individuals that fail to register or to report a significant part of their business activities with authorities. The result is that they not only neglect to pay their fair share of taxes and workers' compensation premiums, but they gain an unfair advantage over competitors and may leave workers without protection in the event of injury or illness. Consumers are also put at risk because there is no bond or insurance to protect them.

The departments of Labor & Industries (L&I), Revenue (DOR) and Employment Security (ESD) share data and collaborate in other areas to uncover and take action on tax misreporting and other forms of fraud. Even though a joint task force formed by the three agencies ended in 2009, the agencies remain committed to working together and sharing information to prevent fraud and reduce the effects of the underground economy.

This report provides updated information about how L&I, DOR and ESD shared information on contractor registration, taxes and other electronic data to discover and hold accountable hundreds of players in the underground economy during Fiscal Year (FY) 2015.

Progress and Achievements in FY 2015

This section describes progress and achievements of each of the three partner agencies (L&I, DOR and ESD) in working together to prevent fraud and reduce effects of the underground economy in Washington.

L&I HIGHLIGHTS

L&I protects the safety, health and security of Washington's workers and citizens. As part of this responsibility, the department is committed to helping honest workers, providers and businesses by cracking down on dishonest ones. FY 2015 highlights include:

- **Contractor compliance** – Compliance inspectors issued more than 1,200 infractions to unregistered contractors and provided training to approximately 1,700 contractors and employers
- **Collections** – L&I collected almost \$165 million in delinquent employer premiums for workers' compensation insurance.
- **Audit selection** – 81 percent of employers referred for audits were found to owe premiums. In contrast, 50 percent of employers referred for audit owed premiums in FY 2004. This increase is due to improved targeting. Prior to 2004, the department's data targeting was relatively new. Screening and refining referrals has improved, which focuses resources on those most likely to be found out of compliance in an audit.
- **Prosecution** – L&I investigated and referred one employer case to the Attorney General's Office for possible criminal prosecution. The Attorney General's Office returned the referral to the department for further investigation. The two cases below were referred in FY 2014 and charged in FY 2015. They are of interest due to their impact on several of L&I's programs.
 - A Clark County employer operated a paving company and conducted business without being registered as a contractor, without having a certificate of coverage for workers and without reporting his employees to L&I. The employer pled guilty to three counts of "operating as an unregistered contractor" and one count of "engaging in business without certificate of coverage." The paving contractor was sentenced to 30 days of work release and ordered to pay more than \$72,000 in restitution.
 - A Mason County roofing company was charged with engaging in business with a revoked certificate of coverage, hiring employees that were not reported to L&I and operating with a suspended contractor's license. The employer pled guilty to unregistered contracting and a felony count of doing business after his workers' compensation coverage was revoked. He was sentenced to 10 days in jail for both charges and must pay \$4,500 in restitution.
- **Employer fraud and misreporting** – Misrepresentation penalties occur when employers misclassify or underreport employees for workers' compensation insurance. In FY 2015, L&I pursued 26 misrepresentation penalties, for a total of almost \$351,000.
- **Prevailing Wage** – If an employer does not pay a fine or receives a repeat notice of violation of contractor registration, workers' compensation or prevailing wage requirements, the employer may be "debarred." When contractors are debarred, they are not permitted to bid on public works

projects for one to two years or until fines are paid. During FY 2015, L&I recorded 967 strikes and debarred 147 companies from bidding on public works contracts.

Contractor compliance

L&I protects consumers by registering construction contractors. To register, contractors must have a minimum level of bonding and insurance coverage. This allows some financial recourse for homeowners and suppliers who encounter problems with fraudulent or incompetent contractors. In addition, all contractors must have a valid Unified Business Identifier (UBI) number to register.

Figure 2 shows the number of contractor registrations from 2009-2015. The change in active contractor registrations varies with a fluctuating economy.

Figure 2: Active contractor registrations as of June 30, 2015

Fiscal year	With UBI
2009	56,685
2010	53,993
2011	52,645
2012	51,492
2013	52,250
2014	52,755
2015	54,529

Source: Department of Labor & Industries

L&I denies or suspends registration of contractors who do not comply with contractor registration laws and rules. During FY 2015, L&I suspended more than 21,000 contractors for the following reasons:

- Cancelled insurance: 14,570
- Cancelled bond: 6,270
- Unsatisfied judgments: 330
- Impaired bond: 30
- Outstanding contractor registration infractions: 25

Contractor penalties

L&I is committed to improving consumer protection and leveling the playing field for legitimate contractors. To do this, the department:

- Informs and educates consumers.
- Provides timely and customer-focused services, such as online renewals and insurance entry for agents.
- Actively enforces the law.

L&I tracks companies that violate registration laws, misrepresent payroll or employee hours or conduct business without an L&I certificate of coverage for workers' compensation insurance. In 2015, L&I's Construction Compliance Program issued more than 1,200 infractions to unregistered contractors. This program also can penalize individuals up to \$10,000 for submitting false information in an application to become a registered contractor. The program issued five of these penalties to contractors in 2015.

Contractors cited for failing to register can receive a reduced penalty¹ if they voluntarily register and get a bond and insurance within 10 days after the citation. In FY 2015, more than 300 unregistered contractors took advantage of that option.

Prevailing Wage program

Prevailing wage sets a minimum hourly rate of wages, benefits and overtime that contractors must pay workers on public projects. This ensures workers receive a standard rate of wages and benefits established for the same work in their locality. It also ensures all contractors competing for public works projects pay their workers the same wage rate.

L&I's Prevailing Wage program is an important part of the department's efforts to ensure fairness for legitimate contractors and employees. It ensures workers on public works projects receive the prevailing wage for their trade or occupation in their county.

Violations, strikes and debarments

When contractors commit certain violations, the Prevailing Wage Program can issue fines and "strikes." A strike is a notice of a violation of contractor registration, workers' compensation or prevailing wage requirements. If a fine is not paid, or additional strikes are received, the company faces a penalty called "debarment." When contractors are debarred, they are not permitted to bid on public works projects for one to two years, or until fines are paid.

Under RCW 39.12.055 (prohibitions on bidding on future contracts), a contractor can be debarred from bidding on public works projects for violating one or any combination of the following:

- Contractor registration law.
- Industrial insurance law for misrepresenting hours/premiums or failing to obtain a certificate of coverage.
- Apprenticeship law.

Strikes are reported under the law where the violation occurred, not in a combination category. For contractor registration and workers' compensation insurance, strikes are cumulative. For prevailing wage law, only violations of the same type count toward debarment.

During FY 2015, the program recorded 967 strikes and debarred 147 companies from bidding on public works contracts.

¹ RCW 18.27.340

Figure 3 shows the numbers of strikes and debarments issued in FY 2014 and FY 2015. Differences in the numbers for different years reflect natural variations.

Figure 3: Prevailing wage strikes and debarments

Reason	FY 2014		FY 2015	
	Number of strikes	Number of debarments	Number of strikes	Number of debarments
Contractor registration violation	567	26	486	34
Industrial insurance violation	582	24	460	9
Contractor registration and industrial insurance violation	N/A*	84	N/A*	90
Prevailing wage violation: failing to file wage report/false filing	87	62	20	14
Prevailing wage violation: failing to pay prevailing wage	1	0	1	0
Total	1,237	196	967	147

*Strikes are not reported in combined categories. Refer to above explanation of RCW 39.12.055.

Source: Department of Labor & Industries

Contractor field enforcement

In 2011, L&I and business and labor representatives discussed ways to improve compliance with state laws. Due to stakeholder concerns that inspectors still lacked a presence in the field, L&I reorganized its construction inspectors in 2012 to be more effective in the field statewide. The department assigned 23 inspectors and three supervisors to three regional compliance teams. In 2013, L&I continued to build on this emphasis, developing new tactics and tools to get inspectors to the right place at the right time.

Today, compliance inspectors are L&I's eyes and ears in the field for all types of violations. They enforce plumbing and electrical laws, check contractor registrations and identify employers owing significant debt to L&I. They confirm worker counts, compare them with reported numbers and refer cases to auditors. They refer potential violations of workers' compensation, prevailing wage and DOR rules and laws to the appropriate staff or agencies.

The underground economy does not operate on a 9-to-5, Monday through Friday schedule. Therefore, inspectors perform surprise compliance sweeps, visiting multiple jobsites over the course of a weekend. They conducted 12 such sweeps in FY 2015.

Figure 4 shows the number of violations issued, contractors referred to collections and contractors referred for auditing from FY 2011 to FY 2015. These numbers have increased significantly since FY 2011 due to increased emphasis on compliance, and appear to be fairly stable at this point.

Figure 4: Contractor Compliance program results

Compliance action	FY2011	FY2012	FY 2013	FY 2014	FY 2015
Underground economy violations issued	241	1,646	1743	1,846	1,812
Contractors referred to collections program	310	Unavailable	Unavailable	1,670	1,707
Contractors referred to audit program	546	1,303	1,401	1,488	1,477

Source: Department of Labor and Industries

Note: Results shown are for the entire Contractor Compliance Program, including the Detection and Tracking Unit (DTU) and field inspectors. In FY 2015, there were 21 field inspectors, 3 Contractor Compliance inspectors in the field, two DTU inspectors and one Construction Compliance supervisor in DTU, for a total of 27 FTEs.

Construction contractor education and outreach

The most recognizable activity in the underground economy happens in the construction industry. Construction contractors in the underground economy are typically either unregistered or underreport their workers' compensation responsibilities. This allows them to avoid paying their fair share of taxes and premiums. Unregistered contractors present a risk to consumers and gain an unfair advantage over competing businesses that play by the rules.

L&I is committed to making it easy to do business with the department. This includes making contractor registration easy. L&I provides step-by-step instructions and explanations of laws and rules online. The department also partners with the building industry to offer training events such as "Employer's Introduction to L&I" workshops, Contractor Training Days and specialized training events. In 2015, more than 500 employers attended the "Employer's Introduction to L&I" workshops. Additionally, L&I provided eight contractor training days to more than 1,200 contractors statewide.

DOR HIGHLIGHTS

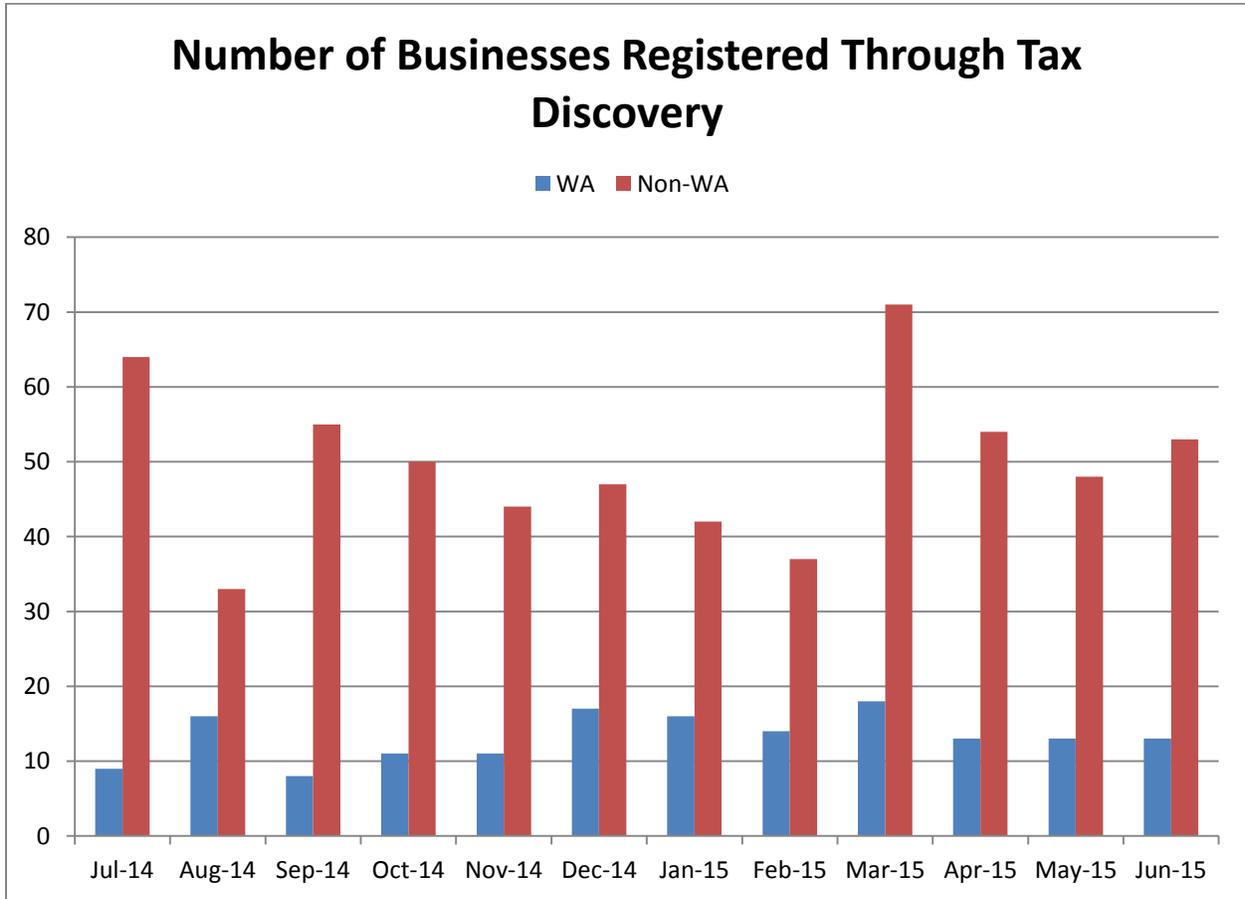
DOR's Compliance and Audit divisions continued to focus on both in-state and out-of-state unregistered businesses in an effort to address the underground economy. Both divisions investigate, assess and register noncompliant businesses.

In FY 2015, DOR registered 779 noncompliant businesses. Of those, 741 were found to owe taxes, and a total of \$87 million was assessed against them. This included:

- 155 in-state businesses assessed close to \$1.7 million.
- 586 out-of-state businesses assessed more than \$85.5 million.

Figure 5 shows the in-state and out-of-state businesses found to be unregistered and subsequently registered in FY 2015.

Figure 5: Number of businesses registered through tax discovery

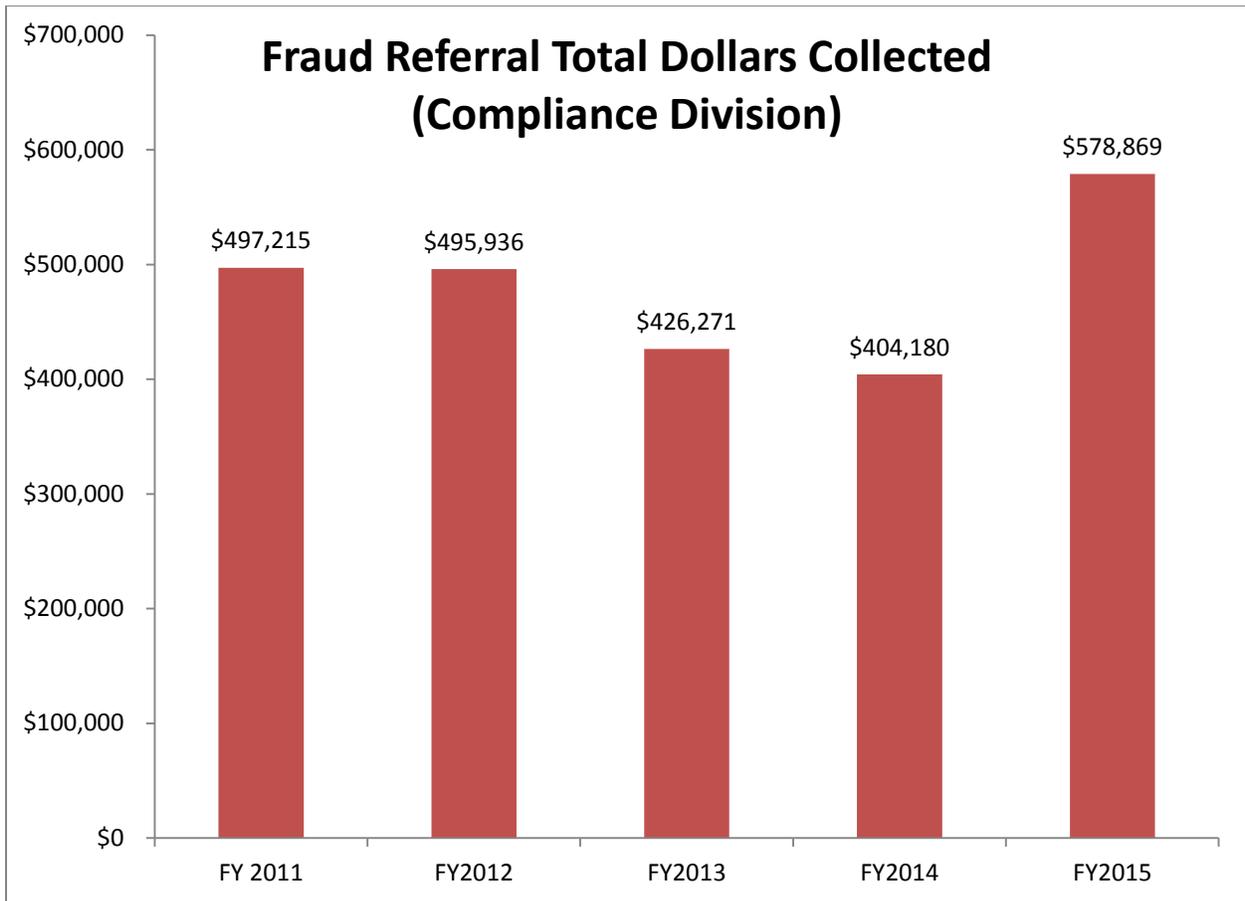


Source: Department of Revenue

In addition to unregistered businesses, DOR’s Compliance and Audit divisions refer and investigate fraud cases. The Compliance Division investigates unlicensed vehicles, vessels and airplanes. DOR continues to focus on education and enforcement to reduce non-compliance and ensure a local presence is maintained.

DOR has provided a variety of methods for making fraud referrals. This allows private citizens and other agencies to report cases where they believe fraud is being committed. Figure 6 shows the total dollars collected through fraud referrals from FY 2011-15. After a slight decrease in FY 2013-14 dollars, the amount collected increased significantly in FY 2015.

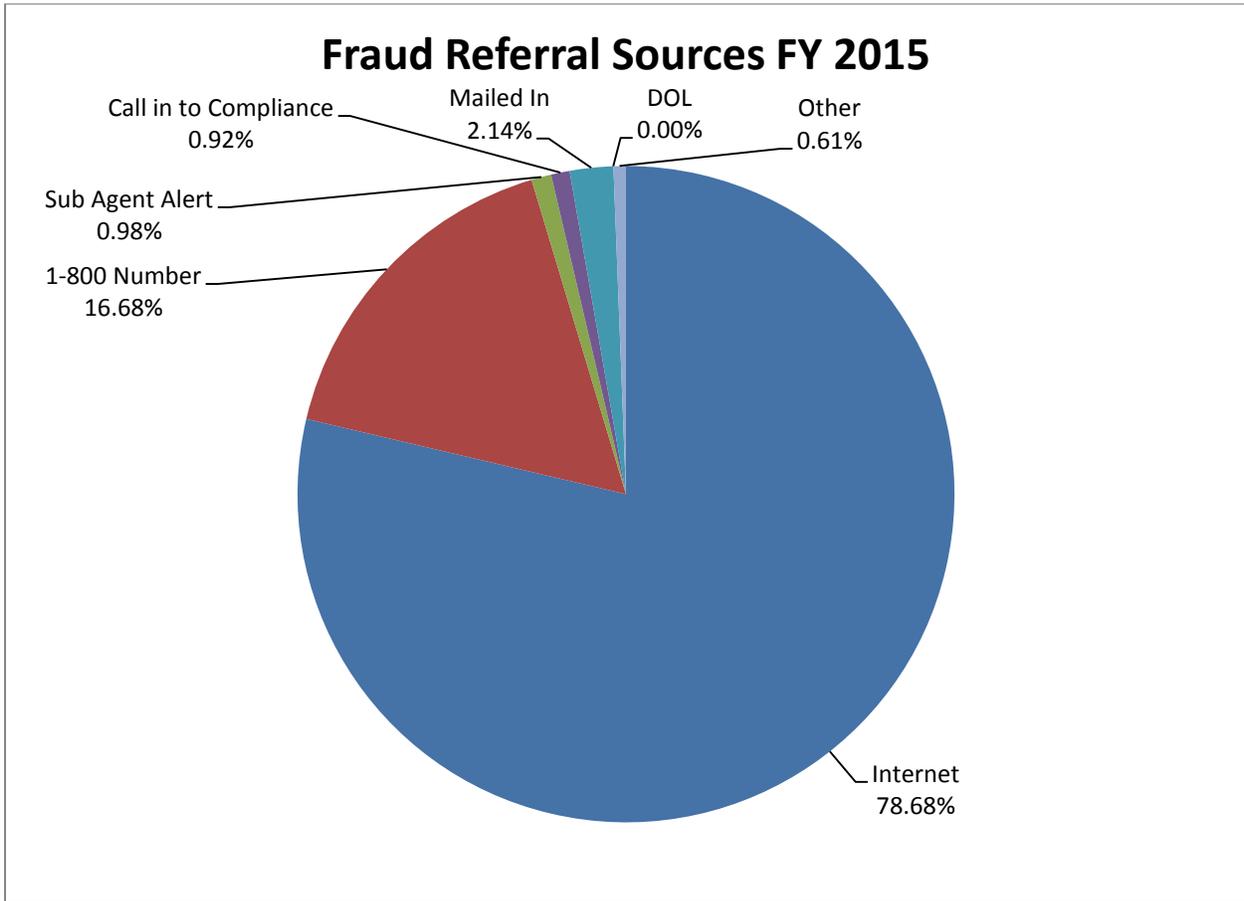
Figure 6: Fraud referral total dollars collected



Source: Department of Revenue

Figure 7 shows the sources of fraud referrals in FY 2015. As you can see, the bulk of referrals come in via the internet and the 1-800 line. In FY 2015, the department saw a five percent increase in the use of the internet as a resource to report fraud. Continued promotion of the SuspectFraud.com website has successfully directed the public to the website. In FY 2012, internet referrals made up 65 percent of the fraud referrals received, and this increased to 81 percent in FY 2013. After dropping to 74 percent in FY 2014, fraud referrals through the website are back up at 79 percent of the total referrals made. SuspectFraud.com remains a key method for the public to report fraud.

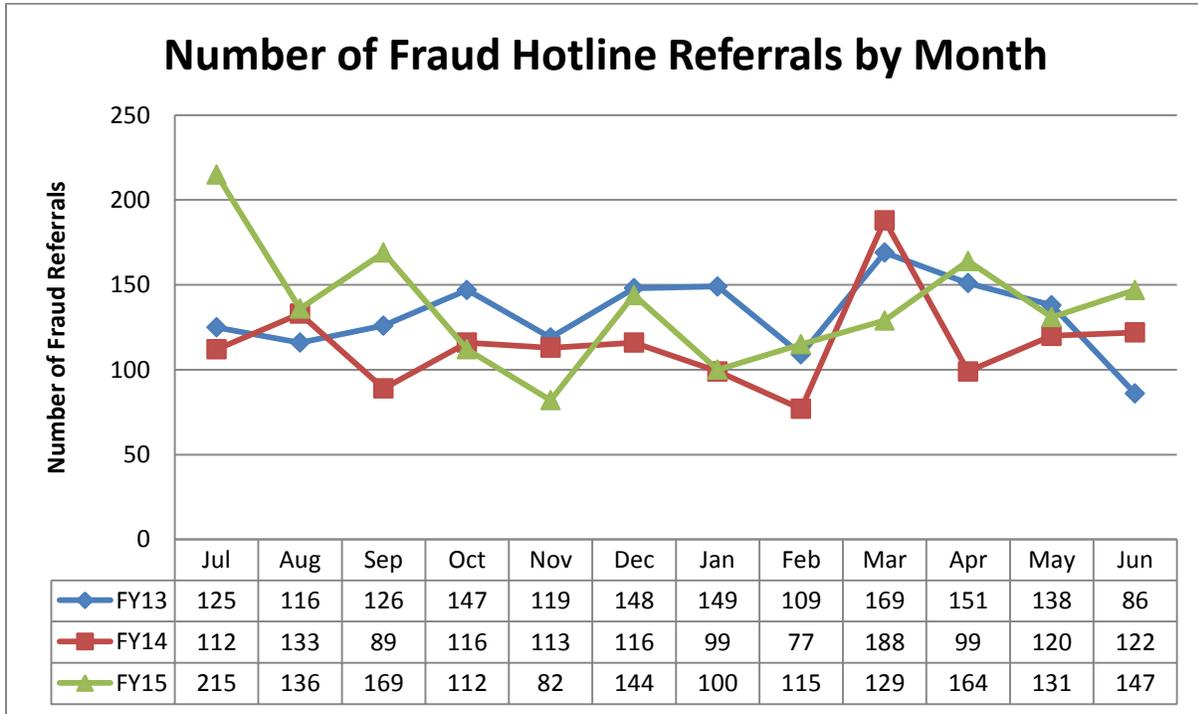
Figure 7: Fraud referral sources, FY 2015



Source: Department of Revenue

Figure 8 shows the number of referrals received through the hotline (1-800 line) each month from FY 2013-15. There does not appear to be a consistent pattern for these referrals.

Figure 8: Number of fraud hotline referrals, by month, FY 2015

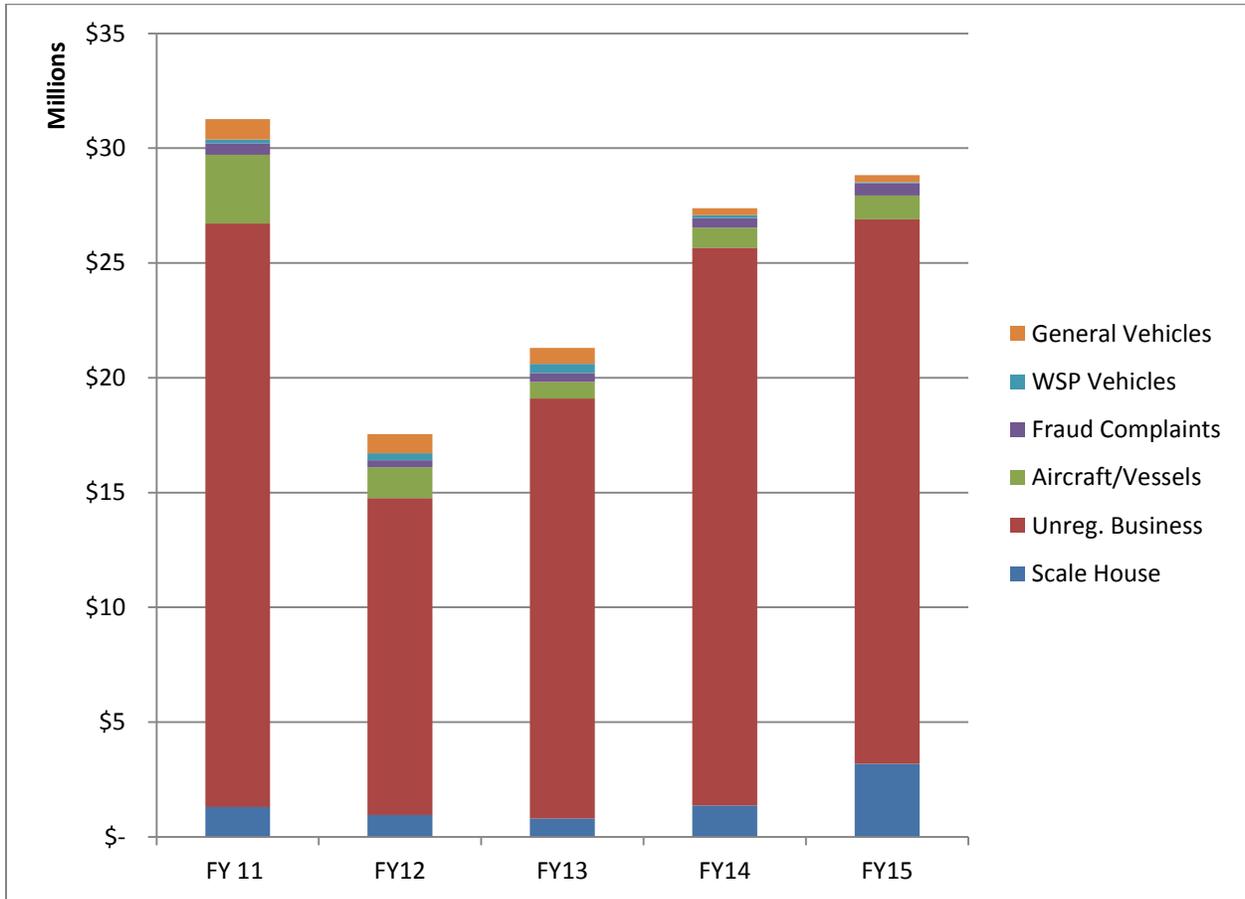


Source: Department of Revenue

If a DOR taxpayer investigation determines there is strong evidence the taxpayer is breaking reporting and/or tax laws, DOR may refer the account to its Criminal Litigation Unit (CLU). The CLU works with the Attorney General’s Office to prosecute a limited number of cases, which may include fraud, evasion or other illegal activity.

Figure 9 shows the types and frequency of tax discovery cases. Referrals for cases from the underground economy come from investigations, shared information with other agencies and fraud complaints. Unregistered businesses continue to be the largest portion of the tax discovery cases.

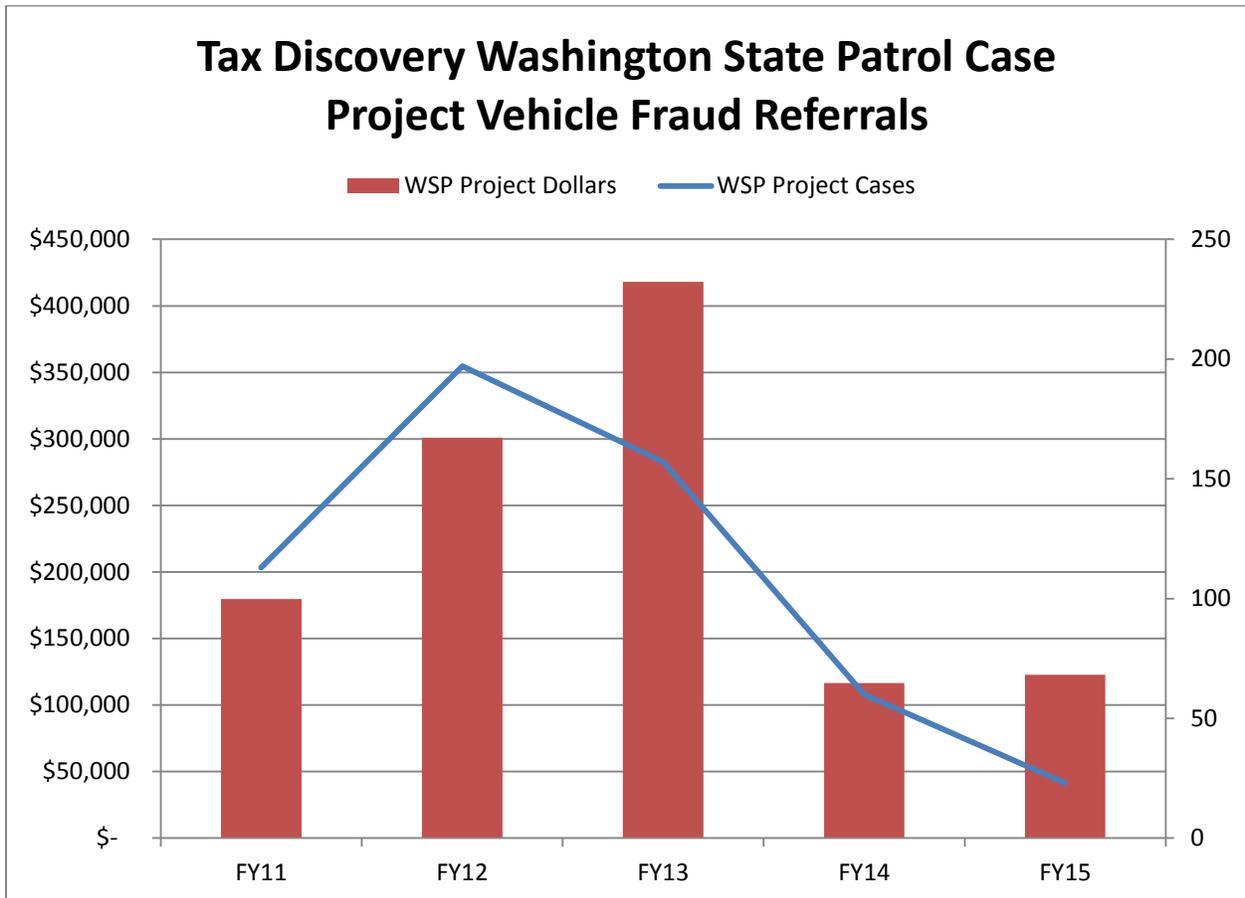
Figure 9: Tax discovery case type



Source: Department of Revenue

As resources are dedicated to projects, the projects get more referrals and collect more dollars. In FY 2013, DOR dedicated an agent to working on referrals from the Washington State Patrol. This resulted in an increase in the cases and dollars collected by the project. In FY 2014, this position experienced frequent turnover, resulting in a drop in the dollars collected, as new agents had to be trained. Figure 10 shows the cases investigated and dollars recovered for the time period from FY 2011-15. While the number of cases dropped in FY 2015, the dollars recovered increased over FY 2014.

Figure 10: Tax discovery Washington State Patrol case project vehicle fraud referrals



Source: Department of Revenue

ESD HIGHLIGHTS

During the past year, ESD continued to identify employers who failed to report or underreported employees for unemployment insurance. In FY 2015, the department dedicated six full-time employees in six audit regions for this purpose.

Underground economy compared to other audits with misclassified employees

From July 1, 2014 through June 30, 2015, underground economy audits were consistently more productive than all other ESD audits in locating misclassified employees. As shown in Figures 11 and 12, in FY 2015, an underground economy audit uncovered an average of 12.3 employees per audit compared to three employees per all other audits where previously unreported employees were found.

Figure 11: Underground economy audits

Quarter	Number of audits with employees found	Number of misclassified employees	Employees per audit
3/14	41	734	17.9
4/14	24	161	6.7
1/15	44	549	12.5
2/15	30	261	8.7
Total	139	1705	12.3

Source: Employment Security Department

Figure 12: All other audits

Quarter	Number of audits with employees found	Number of misclassified employees	Employees per audit
3/14	289	1,166	4.0
4/14	327	870	2.7
1/15	429	1,239	2.5
2/15	406	1,030	2.5
Total	1,451	4,305	3.0

Source: Employment Security Department

Electronic reporting

ESD encourages employers to file their quarterly unemployment tax reports electronically. There are currently two options for employers to file quarterly reports electronically, with each option tailored to specific business needs. In FY 2015, 98.5 percent of employers filed their tax reports electronically.

Identifying unregistered employers

ESD's underground economy auditors identified more than 130 unregistered employers during FY 2015. In addition to receiving tips from other state agencies outlined in Figure 13 which helped identify unregistered employers, the auditors use a variety of tools, including:

- A toll-free fraud hotline.
- An online fraud reporting tool.
- In-house Special Investigations.
- Blocked Benefit Claims units.

Auditors also conduct employer street-walk licensing verification checks in high traffic metropolitan areas.

Employer education

ESD is always looking for opportunities to educate employers on tax liability issues and tax reporting requirements. One of the educational tools the agency uses is the ESD voluntary audit program. This program allows employers to request an audit from ESD in order to educate them on correct tax reporting procedures. If the audit results in any findings, ESD will waive any penalties associated with the audit.

Improved audit selection

ESD continued to review historical audit data to identify industries of interest. Continuing to share audit information with DOR and L&I has also led to productive audits.

Figure 13 shows referrals between agencies made by auditors.

Figure 13: Audit leads from DOR and L&I

Department	Audit leads from auditors	Audit leads from file transfers
Labor & Industries	76	4,610
Department of Revenue	18	8,279

Source: Employment Security Department

Unemployment tax dollars assessed due to DOR and L&I leads in FY 2015 totaled \$308,424. Unemployment tax dollars collected due to DOR and L&I leads in FY 2015 totaled \$148,152.

Note: The dollar amounts showing in this section are from audits other than underground economy that ESD considers L&I or DOR referral audits. The dollar amounts from ESD's underground economy audits are contained in Figure 16 on page 20.

Agency results from auditing unregistered businesses

In FY 2015, DOR, ESD and L&I found and audited nearly 1,400 unregistered or previously registered² businesses. In these cases, the agencies “involuntarily register” the businesses as part of the auditing process. The three agencies assessed over \$95.8 million in taxes, penalties and interest on the previously unregistered firms. Due to differences in the regulatory authority of the three agencies, they each tend to audit different types of businesses:

- DOR audits all businesses in the state, regardless of whether they have workers. DOR also has a much stronger role in auditing out-of-state businesses that do business in Washington.

² Even if a business were previously registered under a different name, unless it is currently registered with up-to-date information, it is considered unregistered.

- Both L&I and ESD audit only employers with workers covered by workers' compensation and unemployment insurance. L&I tends to focus on industries with a high injury rate and has specific additional regulatory authority over the construction industry. ESD tends to focus on industries with higher unemployment rates.

Figures 14, 15 and 16 show audit assessment results for all three agencies on unregistered businesses, and for L&I on previously registered businesses.

Figure 14: Department of Labor & Industries
FY 2015 audit assessments on unregistered or previously registered accounts

Industry sector description	Accounts assessed	Dollars assessed
Construction	549	\$5,484,181
Manufacturing	12	\$66,702
Other	41	\$301,034
Retail	16	\$73,686
Service	244	\$2,288,915
Wholesale trade	3	\$20,711
Total	865	\$8,235,229

Source: Department of Labor & Industries

Figure 15: Department of Revenue
FY 2015 assessments on unregistered accounts

Industry sector description	Accounts assessed	Dollars assessed
Construction	18	\$1,168,126
Manufacturing	34	\$916,531
Other	50	\$1,749,204
Retail	76	\$62,361,984
Service	104	\$16,504,665
Wholesale	114	\$4,421,045
Total	396	\$87,121,555

*Assessments include tax, penalties and interest.

Source: Department of Revenue

**Figure 16: Employment Security Department
FY 2015 assessments on unregistered accounts**

Industry sector description	Accounts assessed	Dollars assessed
Construction	34	\$198,772
Manufacturing	1	\$2,833
Other	28	\$108,679
Retail	7	\$32,830
Service	65	\$165,419
Wholesale	4	\$22,537
Total	139	\$531,070

Source: Employment Security Department

Overall, the most productive audits during FY 2015 were for “construction” industries. They averaged more than \$5,800 in dollars assessed per audit, an increase for that industry sector over FY 2014. In FY 2014, 15 fewer audits were completed, averaging slightly more than \$3,600 in dollars assessed per audit.

Conclusion

CONTINUING THE PARTNERSHIP

The multi-agency effort to dismantle the underground economy will continue to be a critical mission for DOR, L&I and ESD. The agencies shared their information on contractor registration, taxes and other electronic data to discover and hold accountable hundreds of players in the underground economy. At the same time, the agencies assisted construction contractors and other business owners in meeting state requirements.

The agencies are strengthening their partnership by sharing information and meeting on a regular basis. They engage with stakeholders to identify problems and create new tools for achieving compliance. Enforcing state laws and providing education and assistance will help level the playing field for employers and workers who already do their best to follow the rules.