



Underground Economy Benchmark Report (RCW 18.27.800)

2019 Annual Report to the Legislature

December 2019

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Executive Summary

Introduction

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 unemployment insurance contributions, taxes and workers' compensation premiums, but they gain an unfair advantage over competitors. Consumers are put at risk because there is no bond or insurance to protect them.

The Department of Labor & Industries, Department of Revenue and Employment Security Department are pleased to provide this FY 2019 report on underground economy benchmarks, as required by Chapter 18.27.800 RCW. The three agencies share data and collaborate in other areas to uncover and take action against tax misreporting and other forms of fraud in order to protect consumers, workers, and employers who obey the law.

Progress and achievements in Fiscal Year 2019

In Fiscal Year (FY) 2019, the departments of Labor & Industries (L&I), Revenue (DOR) and Employment Security (ESD) continued to share information on contractor registration, taxes, and other electronic data to discover and hold accountable hundreds of players in the underground economy. Efforts focused in general on education, detection, targeted audit selection, prosecution, and debt collection, as well as prevailing wage requirements and activities. Many of these activities increased in FY 2019 compared with FY 2018 due to an increase in construction activity.

July 2018-June 2019 (FY 2019) activities

Together, L&I, DOR and ESD:

- Uncovered a combined total of over 2,500 unregistered businesses that were assessed nearly \$57.4 million in unpaid taxes, premiums, penalties and interest.
- Provided options for making late payments and information on the availability of interest and penalty waivers.

L&I:

- Educated and trained more than 1,300 construction contractors through eight outreach events statewide.
- Educated nearly 22,000 consumers about their rights and how to hire legitimate contractors.
- Educated nearly 600 businesses on the Paid Sick Leave requirements to ensure employees are able to use their benefits as required by law.
- Issued over 1,400 infractions to unregistered contractors.

- Performed over 1,000 audits on unregistered accounts for almost \$10 million in assessed premiums, penalties and interest.
- Collected \$188.4 million in delinquent employer premiums. (While most of this was from standard collection activities and not the underground economy, this money helps keep rates low by ensuring all employers pay their fair share.)

DOR:

- 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.
- Registered over 860 non-compliant businesses.
- Assessed taxes totaling over \$41 million from over 550 businesses.
- Collected more than \$113 million through its Tax Discovery Program. (This includes *collection* dollars that were *assessed* in prior fiscal years.)
- Recovered over \$472,000 in fraud-related dollars.

ESD:

- Found nearly 11,800 unreported or misclassified workers through audits.
- Assessed a total of more than \$411,500 on unregistered accounts.

Introduction

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 that contribute to the underground economy. 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, illness or lost wages. Consumers are put at risk because there is no bond or insurance to protect them.

This report provides updated information about how L&I, DOR and ESD discovered and held accountable hundreds of players in the underground economy during Fiscal Year (FY) 2019 through shared information on contractor registration, taxes and other electronic data. The agencies remain committed to working together and sharing information to prevent fraud and reduce the effects of the underground economy. In previous years, this report showed data shared by DOR, ESD and L&I to aid in investigating violators. This data is not included in the FY 2019 report due to changes in data tracking at ESD and DOR.

The three agencies, along with external stakeholders, are represented on a Construction Underground Economy Advisory Committee to fight the underground economy in the construction industry. The committee's balance between business, labor, government and consumer interests makes it possible to share information, leads to new ideas and shared perspectives, and improves collaboration and strengthens key connections.

Progress and Achievements in FY 2019

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

DEPARTMENT OF LABOR & INDUSTRIES HIGHLIGHTS

L&I protects the safety, health and financial security of Washington’s workers and citizens. As part of this responsibility, the department is committed to helping honest workers, providers and businesses through education and outreach, and by cracking down on dishonest ones. Additional details follow.

FY 2019 highlights include:

- **Education** – For first-time or lower-level violators, the focus is on education and help with voluntary compliance. Over the past year, L&I continued working across numerous program areas to analyze and refine compliance efforts to increase focus on improving compliance through education. Compliance inspectors provided training to approximately 1,300 contractors and employers during FY 2019.
- **Detection** – While education is the first step in increasing compliance, repeat violators and egregious “bad actors” get a more comprehensive and sustained focus aimed at stopping the violations. In the area of employer fraud and misreporting, L&I investigators pursued 13 misrepresentation penalties, totaling nearly \$250,000, for misclassifying or underreporting employees for workers’ compensation insurance. Contractor compliance inspectors issued 1,417 infractions to unregistered contractors. In previous years, this report showed data shared by DOR, ESD and L&I to aid in investigating violators. This data is not included in the FY 2019 report due to changes in data tracking at ESD and DOR.
- **Audit selection** – The number of employers referred for audits and found to owe premiums remains steady at about 71 percent. L&I keeps this percentage consistently high by screening and refining referrals and focusing resources on those businesses most likely to be found out of compliance in an audit, while limiting the number of audits of businesses in compliance.
- **Prosecutions** – Staff investigated and referred seven employer cases to the Attorney General’s Office for possible criminal prosecution. The Attorney General’s Office did not file criminal charges for any of these case types in FY 2019.
- **Collections** – Collections staff collected \$188.4 million in delinquent employer premiums for workers’ compensation insurance.

- **Prevailing wage program** – Education about prevailing wage requirements continued to be a focus, as L&I conducted 30 workshops for more than 1,140 participants around the state. In enforcing prevailing wage requirements, L&I recorded 926 “strikes¹” and debarred 77 companies from bidding on public works contracts. 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.

Educating employers and consumers

L&I continues its commitment to making it easy to do business with the department, with a major focus on making contractor registration easy. L&I partners with the building industry to offer training events such as “Employer’s Introduction to L&I” workshops, Contractor Training Days and other specialized training events. The department also provides step-by-step instructions and explanations of laws and rules online. In FY 2019, 579 employers attended the “Employer’s Introduction to L&I” workshops, and L&I provided eight contractor training days to more than 1,200 contractors statewide.

In addition, L&I educated nearly 22,000 consumers about their rights in dealing with contractors and how to hire legitimate contractors.

Detecting dishonest activity

The most recognizable dishonest activity happens in the construction industry, though it also occurs in other industries.

Contractor registration

Construction contractors in the underground economy are typically either unregistered, or underreport 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 protects consumers by registering construction contractors.

Figure 1 shows the number of contractor registrations from 2009-2019. In FY 2019, the number of registrations reached an all-time high of over 64,800.

¹ A strike is a notice of a violation of contractor registration, workers’ compensation or prevailing wage requirements

Figure 1: Active contractor registrations as of June 30, 2019

Fiscal Year	Contractors with UBI
2009	56,685
2010	53,993
2011	52,645
2012	51,492
2013	52,250
2014	52,755
2015	54,529
2016	56,652
2017	58,553
2018	63,300
2019	64,808

Source: Department of Labor & Industries

Contractor penalties

To register, contractors must meet the required level of bonding and insurance coverage. This allows some financial recourse for homeowners and suppliers who encounter problems with fraudulent or incompetent contractors. All contractors must have a valid Unified Business Identifier (UBI) number before applying to L&I and paying a registration fee.

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 FY 2019, L&I's Construction Compliance Program issued 1,417 infractions to unregistered contractors. This program can also penalize individuals up to \$10,000 for submitting false information in an application to become a registered contractor. The program issued three of these penalties to contractors in FY 2019.

L&I denies or suspends registration of contractors who do not comply with contractor registration laws and rules. A contractor may have their registration suspended for a period of days or weeks multiple times per year. During FY 2019, L&I suspended nearly 30,000 registrations for the following reasons:

- Cancelled insurance: more than 20,000
- Cancelled bond: more than 8,700

- Unsatisfied judgments: 950
- Impaired bond: nearly 70
- Outstanding contractor registration infractions: 200

Contractors cited for failing to register can receive a reduced penalty² if they voluntarily register and get a bond and insurance within 10 days after the citation. In FY 2019, nearly 300 unregistered contractors took advantage of that option.

Auditing businesses

L&I audits employers with workers covered by workers’ compensation, focusing on industries with a high injury rate. During FY 2019, L&I performed over 1,000 audits on unregistered accounts for almost \$10 million in assessed premiums, penalties and interest.

Figure 2 shows L&I’s audit assessment results for previously registered businesses.

**Figure 2: Department of Labor & Industries
FY 2019 audit assessments on unregistered or previously registered accounts**

Industry Sector Description	Accounts Assessed	Dollars Assessed
Construction	739	\$7,561,664
Service	204	\$1,972,895
Other*	26	\$197,604
Retail	17	\$50,104
Wholesale trade	12	\$17,291
Manufacturing	5	\$0
Total	1003	\$9,799,558

*"Other" category includes sectors such as agriculture and forest products.

Source: Department of Labor & Industries

Prosecuting illegal activity

Investigations staff investigated and referred seven employer cases to the Attorney General’s Office for possible criminal prosecution. There were no criminal filings of these case types in FY 2019.

Collecting debt resulting from violations

Inspectors in the Contractor Compliance program are L&I’s eyes and ears in the field for all types of violations. They confirm worker counts, compare them with reported numbers and refer

² RCW 18.27.340

cases to auditors. They refer potential violations of workers' compensation, prevailing wage and DOR rules and laws to the appropriate staff or agencies. In FY 2019, inspectors performed 12 surprise compliance sweeps at multiple jobsites to enforce plumbing and electrical laws, check contractor registrations, and identify employers owing significant debt to L&I.

Figure 3 shows the number of violations issued, contractors referred to collections, and contractors referred for auditing from FY 2014 to FY 2019. These numbers have remained relatively stable, even with increased construction activity, which may indicate a cap on workload capacity with current resources and processes.

Figure 3: Contractor Compliance Program results

Compliance Action	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018	FY2019
Underground Economy Violations Issued	1,846	1,812	2,030	2,103	2,108	2,420
Contractors Referred to Collections Program	1,670	1,707	1,749	1,710	1,763	1,919
Contractors Referred to Audit Program	1,488	1,477	1,508	1,494	1,710	1,775

Source: L&I Contractor Registration Program

Prevailing Wage Program

L&I's Prevailing Wage Program is an important part of the department's efforts to ensure fairness for legitimate contractors and employees. Prevailing wage sets a minimum hourly rate of wages, benefits and overtime that contractors must pay workers on public projects. It ensures workers on public works projects receive a standard rate of wages and benefits for their trade or occupation in their county, and that all contractors competing for public works projects pay their workers at least the minimum established wage rate.

Education and outreach

L&I continues to focus on improving compliance with prevailing wage requirements by educating employers and workers. In FY 2019, the Prevailing Wage program conducted 30 workshops on prevailing wage requirements around the state, reaching more than 1,140 contractors, businesses, and workers.

Violations, strikes and debarments

When contractors commit certain violations, the Prevailing Wage program can issue fines and strikes. If a fine is not paid, or additional strikes are received, the company may be debarred. A contractor can be debarred or prohibited 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 in which the violation occurred, not in a combination category. For contractor registration and workers' compensation insurance, strikes are cumulative. For example, contractors may receive strikes under the prevailing wage law for violations of contractor registration law (Chapter 18.27 RCW); industrial insurance law (RCW 51.48.020(1) or RCW 51.48.103); or apprenticeship law (Chapter 49.04 RCW). Any combination of two strikes under these laws results in a one-year debarment.

For prevailing wage law, only violations of the same type count toward debarment. Violations of public contracts laws³ stand alone and do not need to be in combination with another violation. Two strikes under RCW 39.12.050 result in a one-year debarment, and two strikes under RCW 39.12.065 result in a two-year debarment.

Figure 4 shows the numbers of strikes and debarments issued in FY 2017, FY 2018 and FY 2019. During FY 2019, the Prevailing Wage program recorded over 900 strikes and debarred 77 companies from bidding on public works contracts. The lower number of debarments issued in FY 2019 compared to FY 2018 is due to variations in the kinds of strikes reported each year.

³ RCW 39.12.050, which refers to false filings or failure to file forms such as intents, affidavits, or certified payroll reports; and RCW 39.12.065, which refers to failure to pay prevailing wages.

Figure 4: Prevailing wage strikes and debarments

Reason	FY 2017		FY 2018		FY 2019	
	Number of Strikes	Number of Debarments	Number of Strikes	Number of Debarments	Number of Strikes	Number of Debarments
Contractor Registration Violation	563	38	561	25	860	47
Industrial Insurance Violation	572	12	472	5	78	3
Contractor Registration and Industrial Insurance Violation	N/A*	76	N/A*	22	N/A*	22
Prevailing Wage Violation: Failing to File Wage Report/False Filing	14	9	22	16	7	5
Prevailing Wage Violation: Failing to Pay Prevailing Wage	5	1	12	5	3	0
Total	1,154	136	1,067	73	926	77

*Strikes are not reported in combined categories. Instead, they appear in each – or only one – category, depending on the law violated, but they may result in debarment.

Source: Prevailing Wage Program

Note: In previous years, this report included a table showing data transfers between DOR, ESD and L&I. This data is not included in the FY 2019 report due to changes in data tracking at ESD and DOR.

DEPARTMENT OF REVENUE HIGHLIGHTS

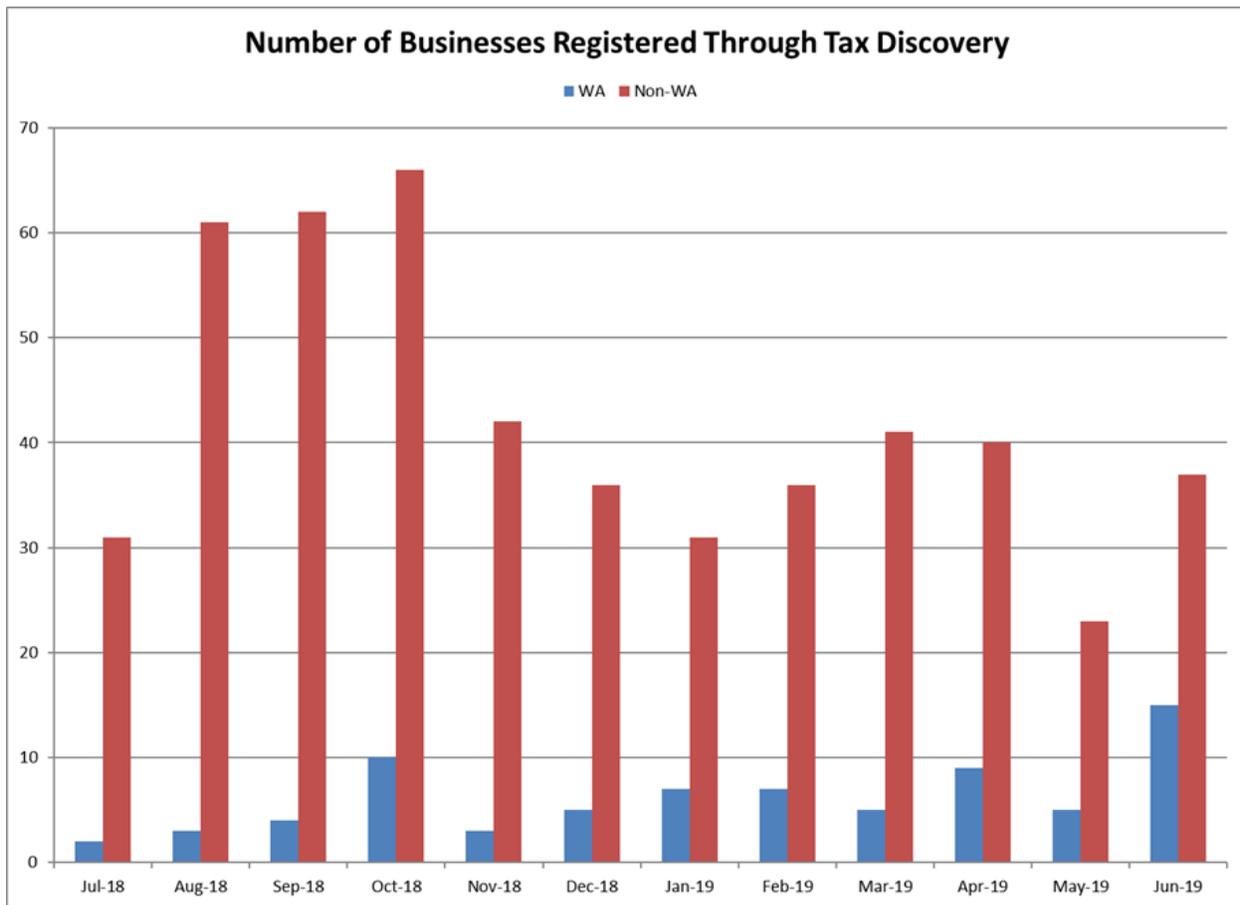
In FY 2019, the Department of Revenue's (DOR) Compliance and Audit divisions continued to focus on both in-state and out-of-state unregistered businesses in an effort to address the underground economy. Both divisions investigate, assess and register noncompliant businesses.

DOR investigated 602 noncompliant businesses in FY 2019, 581 of which were registered through Tax Discovery. Of those, 163 were found to owe taxes, and over \$46.9 million was assessed against them. This included:

- 25 in-state businesses assessed over \$5.1 million.
- 138 out-of-state businesses assessed more than \$41.8 million.

Figure 5 shows the in-state and out-of-state businesses found to be unregistered and subsequently registered in FY 2019.

Figure 5: Number of businesses registered through tax discovery



NOTE: In March of FY 2018, the Department of Revenue replaced its aging tax and licensing systems with a new, integrated system. The transition to this system affected the agency's work and reporting, and some variances have occurred since its implementation.

Source: Department of Revenue

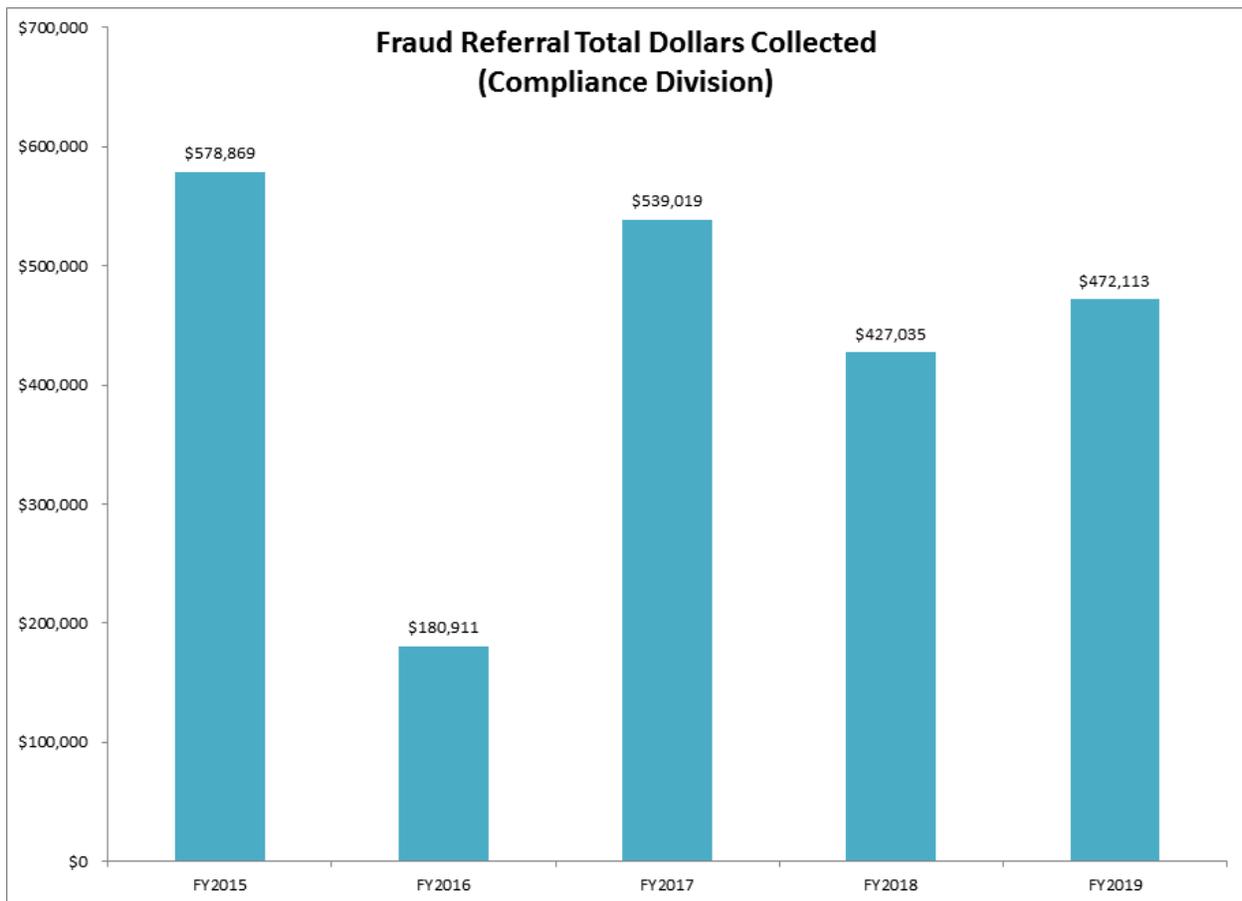
In addition to finding and addressing unregistered businesses, DOR's Compliance and Audit divisions refer and investigate fraud cases. The Compliance Division investigates unlicensed vehicles, vessels, and airplanes. DOR continues to focus on education and enforcement to reduce non-compliance and ensure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

DOR has provided a variety of methods for making fraud referrals, which allow 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 2014 to FY 2019. After a significant increase in FY 2015, the dollars collected dropped off in FY 2016. This coincides with the

decision not to run the Suspect Fraud campaign⁴ in FY 2016. Since then, in a coordinated effort between the agencies, efforts are focused toward more targeted marketing to a narrower audience, which includes a survey directed toward the business community through a marketing firm on behalf of the three agencies. This reflects a shift in marketing emphasis from consumers toward the business community.

In FY 2017, the fraud dollars collected increased, with some larger assessments resulting from referrals. In FY 2018, DOR configured and implemented a new system, which resulted in a drop in collections as employees learned the new system.

Figure 6: Fraud referral total dollars collected

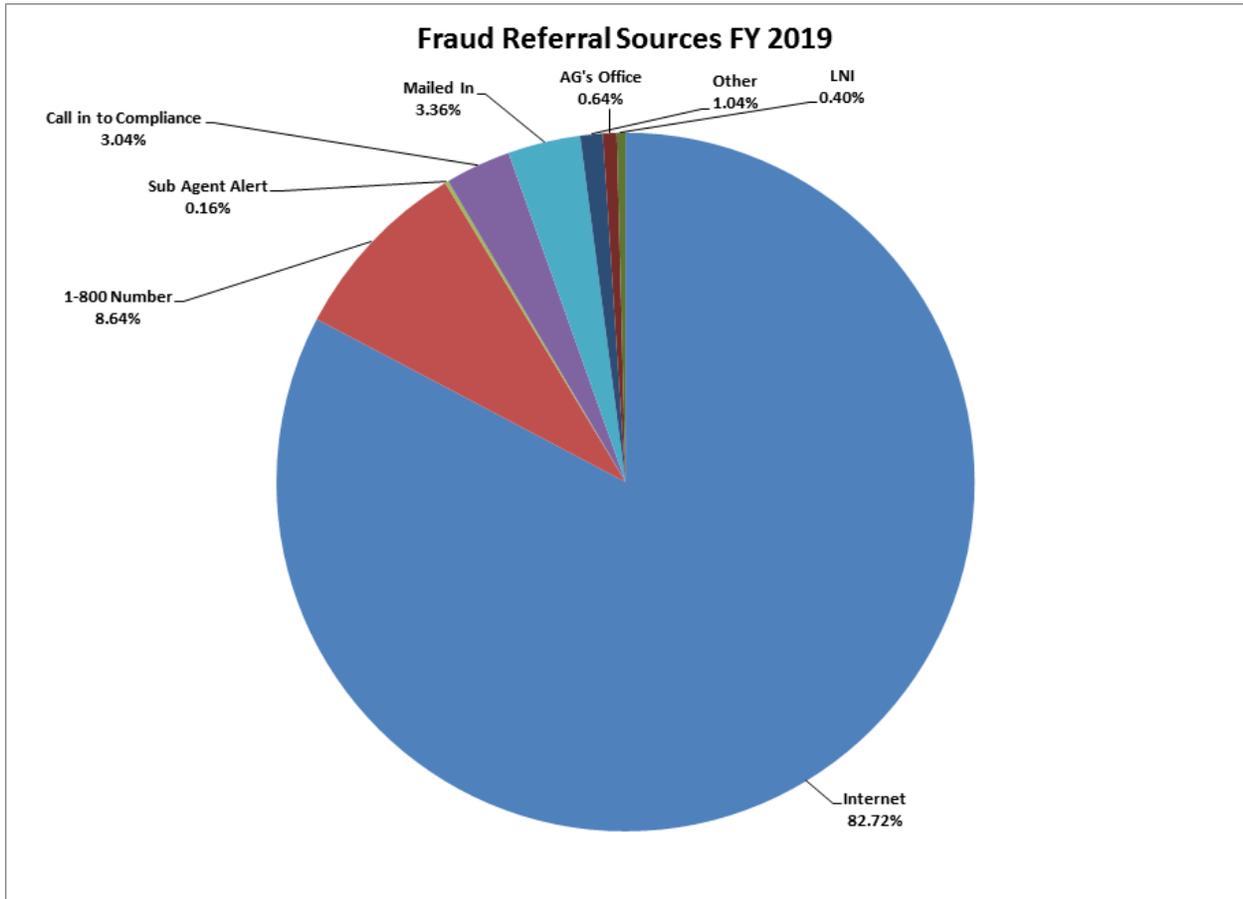


Source: Department of Revenue

⁴ L&I, DOR, and ESD sponsored the statewide Suspect Fraud campaign to encourage the public to report fraud.

Figure 7 shows the sources of fraud referrals in FY 2019. As shown, the bulk of referrals are received via the internet and the toll-free hotline. In FY 2019, almost 83 percent of fraud referrals were made via the website, which remains consistent with recent years compared to a low of 65 percent in FY 2012.

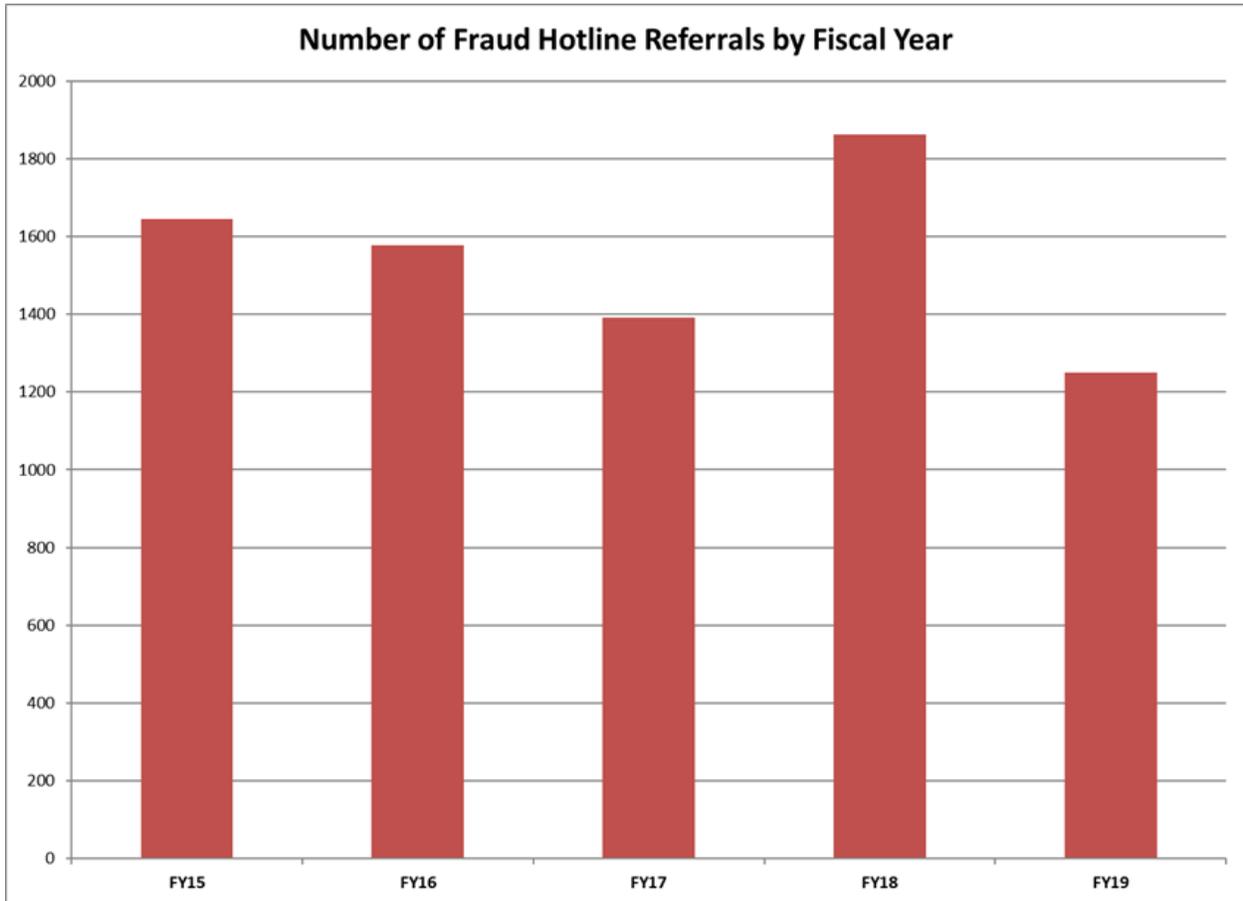
Figure 7: Fraud referral sources, FY 2019



Source: Department of Revenue

Figure 8 shows the number of referrals received through the hotline each fiscal year from FY 2015 to FY 2019. DOR investigates each referral, but it may be found that a business is already registered and reporting, or does not owe taxes.

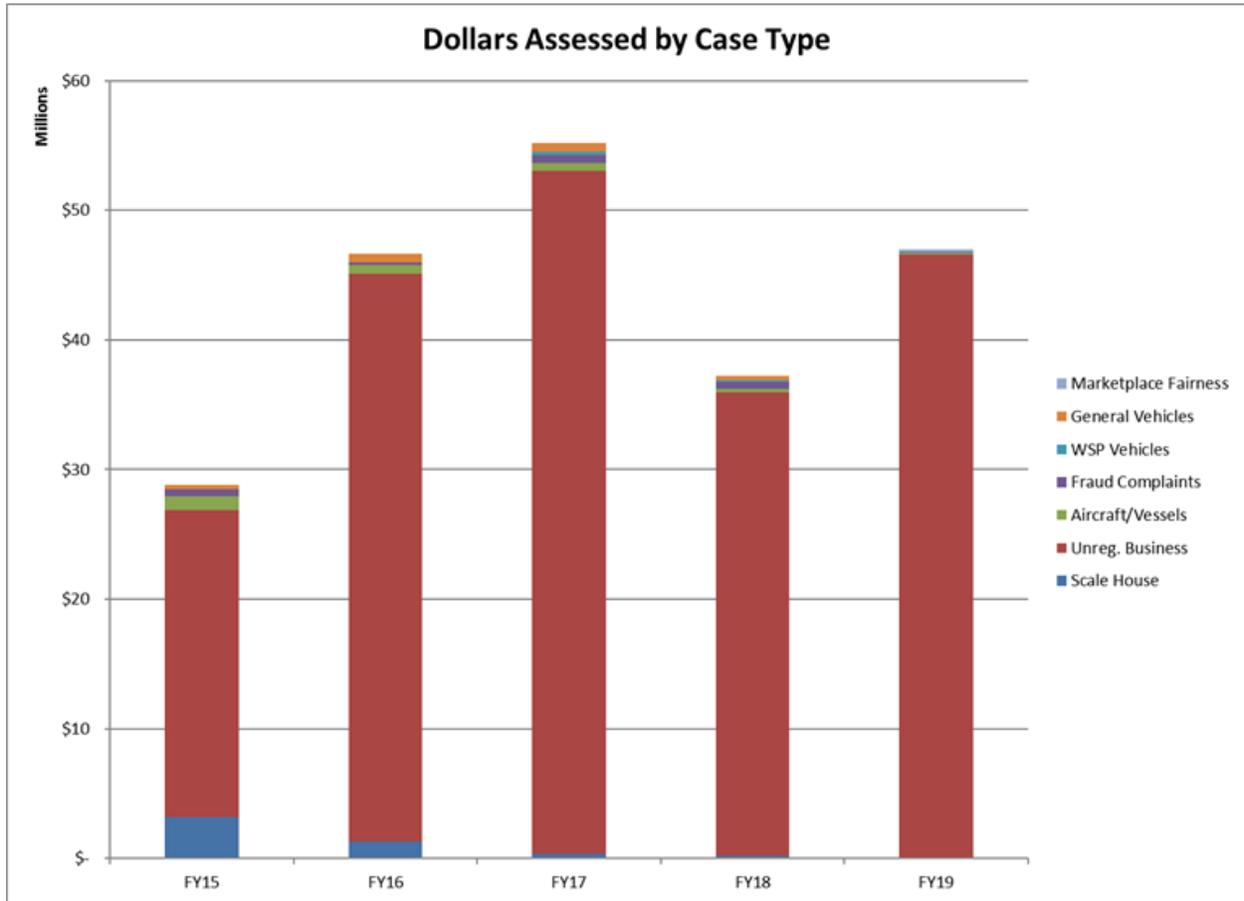
Figure 8: Number of fraud hotline referrals by fiscal year, FY 2019



Source: Department of Revenue

Figure 9 shows the types and dollars assessed in 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

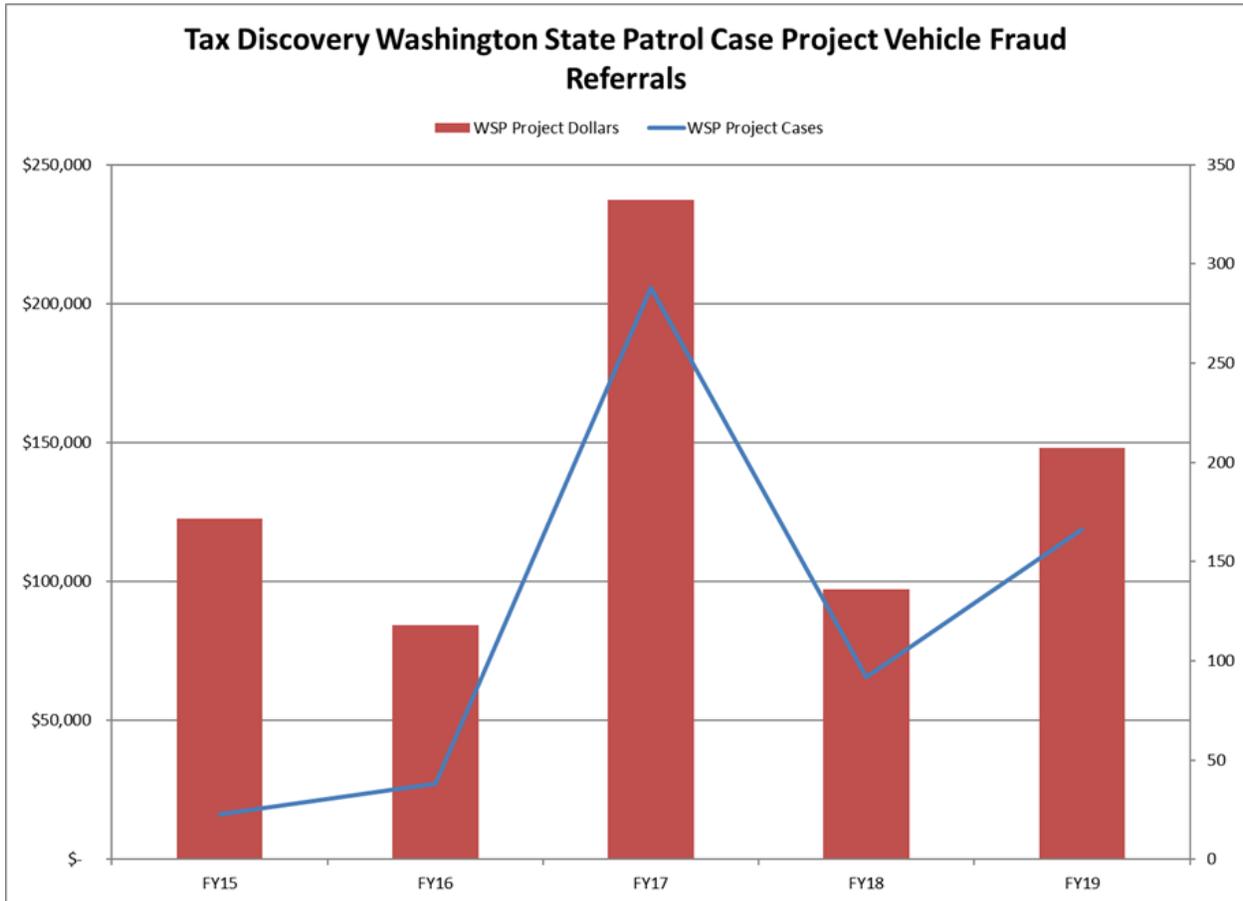


Source: Department of Revenue

As resources are dedicated to projects, the projects get more referrals and collect more dollars.

The Washington State Patrol (WSP) refers cases for investigation related to vehicle fraud, such as registering a vehicle out of state to avoid paying sales or use tax. Figure 10 shows the cases investigated and dollars recovered for the time period from FY 2015 to FY 2019.

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



Source: Department of Revenue

EMPLOYMENT SECURITY DEPARTMENT HIGHLIGHTS

During the past year, the Employment Security Department (ESD) continued to identify employers who failed to report or underreported employees for unemployment insurance. In FY 2019, the department continued to dedicate six full-time employees in six audit regions for this purpose.

Underground economy compared to other audits with misclassified employees

From July 1, 2018 through June 30, 2019, 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 2019, an underground economy audit uncovered an average of 16.4 employees per audit, compared to 5.9 employees per all other audits where previously misclassified employees were found.

Figure 11: Underground economy audits

Quarter	Number of Audits with Misclassified Employees Found**	Number of Misclassified Employees	Employees Per Audit
3/18	96	1,294	13.5
4/18	109	1,310	12.0
1/19	114	1,329	11.7
2/19	113	3,154	27.9
Total	432	7,087	**16.4

*The number of employees per audit equals the number of misclassified employees divided by the number of audits with misclassified employees found.

**Number of audits may vary depending on ESD staffing levels at any given time.

Source: Employment Security Department

Figure 12: All other audits

Quarter	Number of Audits with Employees Found	Number of Misclassified Employees	Employees Per Audit
3/18	233	1,194	5.1
4/18	130	780	6.0
1/19	237	1,533	6.5
2/19	197	1,200	6.1
Total	797	4,707	*5.9

*The number of employees per audit equals the number of misclassified employees divided by the number of audits with misclassified employees found.

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 reports electronically, with each option tailored to specific business needs. In FY 2019, 97.9 percent of employers filed their tax reports electronically.

Identifying unregistered employers

ESD's underground economy auditors identified 234 unregistered employers during FY 2019. In addition to receiving tips about unregistered employers from other state agencies as shown in Figure 13, the auditors use a variety of tools, including:

- A toll-free fraud hotline.
- An online fraud reporting tool.
- In-house special investigations.
- Benefit redetermination units that investigate and resolve issues about benefit claims.

Employer education

As in previous years, ESD continues to look 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, which allows employers to request an audit from ESD to be educated on correct tax reporting procedures. If the audit results in any findings, ESD will waive any penalties associated with the audit.

Improved audit selection

In FY 2019, ESD continued to review historical audit data to identify industries of interest for audits. Continuing to share audit information with DOR and L&I has also led to productive audits. Figure 13 shows referrals auditors made between agencies.

Figure 13: Audit leads from DOR and L&I

Department	Audit Leads from Auditors	Audit Leads from File Transfers
Labor & Industries	9	0
Department of Revenue	1	126

Source: Employment Security Department

Unemployment tax dollars assessed due to DOR and L&I leads in FY 2019 totaled over \$48,200. Unemployment tax dollars collected due to DOR and L&I leads in FY 2019 totaled over \$18,800.

COMBINED AGENCY HIGHLIGHTS

Representatives of L&I, DOR, and ESD, along with business, labor, government, and consumer representatives, make up the Construction Underground Economy Advisory Committee. This committee provides an efficient way to share information, leads to new ideas and shared perspectives, and improve collaboration between all parties.

The committee met twice in 2019, in March and October, to coordinate efforts and share information.

Results from auditing unregistered businesses

In FY 2019, DOR, ESD and L&I found and audited over 2,500 unregistered or previously registered⁵ businesses. In these cases, the agencies “involuntarily register” the businesses as part of the auditing process. The three agencies assessed over \$57.4 million in taxes, penalties and

⁵ 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.

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 may audit 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.
- 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.

Figure 14 shows ESD's audit assessment results on unregistered businesses. Dollar amounts shown are from audits other than underground economy that were referred from L&I or DOR. L&I's audit results for previously registered businesses are shown in Figure 2 on page 7. DOR has transitioned to a new auditing system and is no longer able to report assessments on previously unregistered firms.

Overall, the audits that assessed the most total dollars in FY 2019 were for the "service" industry, which is also the industry with the most dollars assessed per audit, at close to \$2,200.

**Figure 14: Employment Security Department
FY 2019 Assessments on unregistered accounts**

Industry Sector Description	Accounts Assessed	Dollars Assessed
Construction	88	\$156,443.62
Manufacturing	9	\$16,889.71
Other	18	\$24,975.56
Retail	10	\$8,504.36
Service	105	\$230,564.39
Wholesale	4	\$4,190.90
Total	234	\$441,568.54

Source: Employment Security Department

In previous years, this report included a table showing data transfers between DOR, ESD and L&I. This data is not included in the FY 2019 report due to changes in data tracking at ESD and DOR.

Conclusion

CONTINUING THE PARTNERSHIP

During FY 2019, L&I, DOR, and ESD continued to share information on contractor registration, taxes, and other electronic data to discover and hold accountable hundreds of businesses and individuals not complying with the law. In addition to protecting consumers, workers, and employers through this activity, the agencies continued to assist construction contractors and other business owners in meeting state requirements.

In addition to improving compliance, enforcing state laws, and providing education and assistance, the three agencies will continue to work together and with their stakeholders to provide meaningful information and data, identify problems, and focus future efforts.