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## 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.

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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.