

Dear Chair Shapiro and Members of the Commission:

Thank you for the opportunity to provide testimony to the Little Hoover Commission in its work to understand and bring recommendations to fight the underground economy in California. I've spent decades dealing with this issue from a variety of perspectives, dating to my time with Department of Labor and Industries in Washington State, and now in my role with SAS.

Gaining perspective and providing the best recommendations will require analysis from a number of perspectives, including:

- Determining the size and scope of the underground economy
- Defining the portion of underground economy activity that is a key focus
- Identifying potential areas for action

My intent with testimony and attachments provided is to address each of these three key areas based on a combination of my personal experience and actions, studies and task force reports from various states.

Size and Scope of the Underground Economy

Studies are limited, but growing that look at the underground economy from various perspectives. At the highest level, economists Edward Feige and Richard Cebula from the University of Wisconsin estimated that \$2 Trillion in economic activity is unreported to the IRS annually.

(See http://www.newyorker.com/talk/financial/2013/04/29/130429ta_talk_surowiecki and Attachment A)

The internal estimates from the IRS may be lower, and somewhat outdated, as their tax gap estimates are performed every 5 years, and look backward at a filing season from 5 years prior to allow for the majority of audit and collection actions to be completed. The last IRS Tax Gap study on the 2006 Tax Year calculated a gross tax gap of \$450 Billion, with an 83.1% compliance rate – meaning nearly 17% of all taxes owed were either unreported or unpaid. Of the difference, the vast majority is underreported and non-reported income/earnings – representing \$399 Billion, or nearly 90%. (See Attachment B)

At the state level, a number of different studies have been performed, some from agency perspectives, others by universities. In 2007, the three primary Washington State taxing agencies, Department of Revenue (Sales, Corporate, Specialized), Employment Security Department (Unemployment), and Department of Labor and Industries (Workers' Compensation, which is a tax in Washington) conducted the Unregistered Business Study. The study broke down the tax compliance gap between firms that were missing completely from the rolls of one or more taxing agencies, and those that were under-reporting. This study found a gap of \$708 million in taxes annually within Washington State, and represents a conservative estimate by any measure. Please note that Washington has no income tax, which skews these numbers down significantly. (See Attachment C)

A study focused on the construction industry in Texas found 40% of workers misclassified as independent contractors or working under the table for cash. Impacts were rampant, ranging from an estimated \$54.5 million in missing unemployment tax in just that industry, along with wage theft resulting in \$117.7 million in lost wages and \$8.8

million in lost sales tax revenue. Construction worker injuries also represented 20% of unpaid workplace related injuries in Texas hospital emergency rooms, costs borne by all other taxpayers. (See <http://www.mysanantonio.com/business/article/Study-Misclassifying-workers-costly-4243546.php> and Attachment D)

A study from Cornell University utilized data from audits in New York’s unemployment insurance program to extrapolate broader estimates of worker misclassification. Utilizing four years of data, the study estimated that 39,587 firms out of 400,732 (9.9%) in selected industries misclassified workers. They also found that 10.3% of all private sector workers are misclassified, and 14.8% in construction. This represents almost \$4.3 billion in unreported wages annually, and underreporting for unemployment alone at more than \$175 million. (See Attachment E)

While these studies represent a range of calculations with respect to the size and scope of the problem, they all point to an issue that is above \$10 Billion to an economy the size of California when viewed across income, sales and unemployment taxes alone. Add in non-compliance with workers’ compensation, licensing/registration and specialized taxes (alcohol, tobacco), and the problem grows larger. Cascading effects like poor workplace safety and additional costs that are shifted to public institutions and taxpayers, as well as undercutting legitimate businesses magnify the total negative effect.

The Board of Equalization provided estimates that appear in the text of AB576, estimating gaps of \$9 Billion in individual and corporate income, sales and use taxes on an annual basis. That estimate is a good starting point. Looking at a broad selection of taxes affected by the underground economy, and applying two rates – a 10% rate that is considered a conservative estimate by experts, and the 16.9% rate from the IRS gives the potential gap amounts below:

California – Potential Tax Gaps

Agency/Program	Period	Tax Base	Gap at 10%	Gap at 16.9%
EDD – Unemployment	4 Qtrs ending 9/30/13	\$6,729,503,000 ¹	\$672,950,300	\$1,137,286,007
BOE – Sales and Use	FY12-13	\$44,679,961,000 ²	\$4,467,996,100	\$7,550,913,409
BOE – Fuel	FY 12-13	\$5,536,122,000 ³	\$553,612,200	\$935,604,618
BOE – Cigarette/Tobacco	FY 12-13	\$871,533,000 ⁴	\$87,153,300	\$147,289,077
BOE – Alcoholic Beverage	FY 12-13	\$356,551,000 ⁵	\$35,655,100	\$60,257,119
FTB – Corporate Tax	2011	\$7,807,574,000 ⁶	\$780,757,400	\$1,319,480,006
FTB – Individual Income Tax	2011	\$43,921,360,051 ⁷	\$4,392,136,005	\$7,422,709,849
Total		\$109,902,604,051	\$10,990,260,405	\$18,573,540,085

¹ USDOL Unemployment Insurance Summary Data by Quarter, Q3 2013

https://workforcesecurity.doleta.gov/unemploy/content/data_stats/datasum13/DataSum_2013_3.pdf

²⁻⁵ California Board of Equalization Annual Report FY 2012-13

<http://www.boe.ca.gov/pdf/pub306.pdf>

⁶ California Franchise Tax Board Table C-1 Corporation Tax Comparison by Taxable Years 1950 – 2011

https://www.ftb.ca.gov/aboutFTB/Tax_Statistics/Reports/2012/2012_C-1.pdf

⁷ California Franchise Tax Board Table B-1 Personal Income Tax for Resident Tax Returns, Comparison by Tax Years 1947-2011

https://www.ftb.ca.gov/aboutFTB/Tax_Statistics/Reports/2012/2012_B-1.pdf

Focus of Underground Economy Efforts

The broad umbrella of the underground economy represents a spectrum of activity ranging from errors due to lack of education, or lack of research by new business owners through knowing behavior and ultimately black market activities. This range is represented by the following figure:



While black market activities are a serious issue within the economy, they represent activities that are illegal on the surface. The high presence of both the software and entertainment industries in California's economy make them a subject that deserves attention and a set of solutions. Washington too is a state with high exposure. Microsoft products have been subject to a higher dollar level of counterfeiting and piracy than any others in the world throughout most of the last decade. However, when we conducted a study on unregistered businesses and under-reporting, we categorically excluded illegal activities, including prostitution, drug sales, counterfeiting and piracy. Nearly all state and federal studies have done the same.

A focus on the grey market – otherwise legal activities that are breaking laws regarding business regulation/licensing, taxes and regulations for purposes of the current work on the underground economy is recommended, as solutions are more focused. Specific approaches to address the spectrum of grey market issues fall into different categories and are addressed further below.

Potential Recommendations

EDUCATION AND TRANSPARENCY

Provide educational guides to assist businesses

An example is the Guide to Hiring an Independent Contractor developed by Washington's Department of Labor and Industries (See Attachment F). Some states are experimenting with a series of online questions that guide the next step based on previous answers.

Utilize one-stop approach to registering businesses, and ask the right questions

Either provide a single entry point for businesses that will ensure they are registered for all appropriate business licenses and taxes, or if multiple entry points are allowed, make sure that processes behind the scenes connect them

all. Utilizing a common business identifier also makes coordination between agencies and future data sharing easier, even if it is in addition to single-agency identifiers.

When Washington State modified their Master Business Application to ask new firms not only if they would hire employees but as a separate question if they would use independent contractors, more than 15,000 a year started checking the independent contractor box. They were directed to links to the laws, independent contractor guide, and additional information was provided in letters and phone calls. Previously, these businesses had no contact and no account with unemployment or worker's compensation. The result was millions in additional taxes paid with very low level intervention, and a record of contact if they were later found to be purposely misclassifying after education.

Conform legal definitions

In many states, the definition of who is a covered worker for unemployment, wage and hour provisions, prevailing wage projects, unemployment and safety provisions are inconsistent. Some rely on IRS rules, lacking a definition in state law. Bringing more of these into conformity allows businesses to look to fewer guidelines, or potentially a single test. It also allows for an enforcement decision based on that test in one agency to be easily utilized by another to speed up their own enforcement audit/action.

Make data publicly available

Providing data on completed enforcement actions, past violators and a track record for businesses in compliance helps fight the underground economy. It allows customers and other businesses to determine who they should be doing business with, and can bring in additional public tips. Further allowing the ability to track a business and find if they fall out of compliance through failure to pay taxes or a final audit or enforcement finding takes this approach to the next level.

A thorough review of confidentiality statutes should be conducted. Data initially believed to be unavailable is at times later determined to be able to be presented – either representing agency determinations, as opposed to underlying tax data (e.g. type of business, ratings/classifications) or presented at grouped levels. Examples of the latter is noting that a business is showing 1-5 employees, 6-10, etc. or business activity at various dollar thresholds. That approach doesn't reveal any specifics from tax reporting, but still gives a sense of size and scope that can be critical tools in helping others to help agency enforcement efforts or protect themselves.

PENALTIES

Make a thorough review of key enforcement agencies and programs and their range of penalties for standard and more egregious or repeat violations of laws. Multiple agencies and states utilize a range of penalties that might top out at 20-50% of the underlying tax that is under-reported or paid, yet provide separate schedules for certain violations.

Within Washington State, top penalties were up to 2x underlying tax for businesses that were completely unregistered, and up to 10x the underlying tax for businesses that engaged in willful/known tax evasion. Rarely would top-level penalties be applied, but these schedules allowed for the ability to ensure that the price of being caught would exceed the underlying economic gain.

In some programs, criminal provisions may be missing, or ill-defined. Codifying those in statute is important, but should be seen as the last option – for the most egregious violations and repeated violators for whom all civil provisions will not prevent continued participation in the underground economy.

ENFORCEMENT PROVISIONS

A variety of enforcement provisions exist, varying by state, and typically with a large variance between agencies within a state. Assessing what is and isn't available within California, and targeting some focused opportunities for improvement is recommended.

Useful provisions from other states include:

Stop work orders

Most common within the construction industry, and sometimes limited to just a single jobsite, or single employer at a single jobsite. Widely utilized in Florida for workers' compensation provisions, and an enforcement tool in New York, New Jersey, Washington and other states. Provides civil/criminal penalties for continuing work either at the jobsite in total, or for a specific business.

(See example at <http://www.flsenate.gov/Laws/Statutes/2011/440.107>)

Seizure provisions

Ability to seize and sell assets to resolve debts. Typically available within income/sales tax programs, but less so to resolve other liabilities and penalties. Can be an expensive operation that should be utilized with businesses that tend to be levy and garnish-proof from other methods. Variations include the till tap, which is a seizure of cash. Much less costly, and works in cash-heavy businesses.

Business revocation

Normally used as a final option. Makes it illegal to either employ (revocation for unemployment/workers' comp) or to operate in business at all. Typically goes with public posting of notice of revocation at the location and/or elsewhere/online.

(See example at <http://apps.leg.wa.gov/RCW/default.aspx?cite=82.32.215>)

Prime contractor liability

In situations with multiple tiers of business-to-business activity or contracting relationships, sets forth provisions that allow taxes and violations to be driven up the tier to the next business or to a prime contractor.

(See example at <http://apps.leg.wa.gov/rcw/default.aspx?cite=51.12.070>)

Tie in program violations and collections

Particularly in situations where firms are providing services to government, a higher bar should be set for businesses. Tying together violations from other tax and enforcement programs to "strikes" that can bar a business from engaging in work for the state and/or local agencies either temporarily or permanently is highly recommended. Similarly,

connecting release of projects and payments to ensuring that there aren't outstanding debts, or offsetting those debts, is simply good business practice.

Personal liability for corporate officers

While this more commonly exists for diversion of sales taxes collected from consumers, it should be considered for all situations involving egregious and willful or repeated violations of provisions. This may range from keeping a separate set of books and records to using "zappers" to eliminate record of transactions or withholding taxes from employees and failing to pay them to appropriate authorities.

ANALYTICS AND DATA SHARING FOR DETECTION

With the exception of extreme staffing issues and ones almost completely lacking in penalties or enforcement provisions, this is the single most opportune area for improvement on the underground economy. It also represents the single opportunity for improving across the entire spectrum of underground economy issues from errors through off the books activity, as opposed to education and transparency that hit the low-to-middle, and enforcement/penalty provisions that hit the middle-to-upper end.

Utilizing predictive modeling, outlier analysis, and other advanced analytic techniques including link analysis help programs to improve in multiple ways:

- Detect previously unknown tax and compliance evasion
- Discover networks of interconnected violators – enabling resources to focus as a single network
- Risk rank violators – ensuring that limited resources are utilized on the cases with the worst offenses and/or highest return on investment
- Detailed understanding and ability to explain reasons why a business looks out of compliance allows lower level enforcement engagements – don't treat everything as needing a full audit or investigation

It also provides for compliance programs that are very easy to defend in terms of their focus efforts and businesses chosen. If data from multiple programs is layered on, then detection algorithms improve as multiple views of the same business are seen through the same lens, identifying inconsistent information. This approach also allows for better coordination of enforcement efforts, and the potential for knowledge up-front of cross-program violators.

A white paper view of this approach from the employee misclassification standpoint is Attachment G.

Ensuring that agencies are truly coordinating data sets and moving towards a better enterprise view can come prior to or after engaging advanced analytics. Different states have fallen in different places along that timeline. If good data sharing exists up front, as it did in Washington State, then building systems off of that works well. However, experience from other states shows that if those provisions aren't in place, the barriers in place can be significant, and building analytical detection and scoring systems with more limited data sets can be faster and more efficient. That approach allows gains in the near-term, while setting up a framework for enhanced data sharing and additional modeling as more data sets become available.

Existing efforts like the Joint Enforcement Strike Force and the Labor Employment Task Force represent efforts to share data, leads, and engage in joint enforcement efforts. California Assembly Bill 576 (AB 576), passed in 2013, leverages and extends those efforts. These efforts can run in parallel with development of analytics aimed at critical

programs, and tied together as additional data-sharing provisions envisioned by the bill fall into place over the next couple of years.

Conclusion

By focusing on the grey market economy, and adopting a multi-pronged set of recommendations that address key gaps, the Little Hoover Commission can put forward a reasonable approach that:

- Addresses the entire spectrum of grey market underground economy – from errors to extra sets of books
- Ensures civil penalties are sufficient to provide deterrent
- Adopts key enforcement provisions to deal with egregious/repeat violators
- Dramatically improves the ability for agencies to detect violators, address them based on risk and gain efficiencies in how they are addressed

Testimony provided by:

Carl Hammersburg
Senior Solutions Architect
Security Intelligence Practice
SAS Institute