

A REVIEW OF SELECTED TAXING AND
ENFORCING AGENCIES' PROGRAMS
TO CONTROL THE UNDERGROUND ECONOMY

EXECUTIVE SUMMARY

In response to a request by Governor George Deukmejian, the Commission on California State Government Organization and Economy, also known as the Little Hoover Commission, initiated a comprehensive study of the underground economy with emphasis on cash-pay transactions. Because of the widespread impact of the underground economy on State operations, the Commission expanded the scope of this study to include other enforcement problems created by the underground economy.

The underground economy consists of all illegal and many legal transactions which have not been adequately reported. Estimates of the underground economy nationwide range from \$300 to \$600 billion each year, with approximately two-thirds of this consisting of legal transactions. In California, experts estimate that the underground economy exceeds \$30 billion annually, accounting for almost \$2 billion in unpaid income tax alone.

"Cash-pay," as used in this report, is the practice of paying in cash, check, barter or other means without adequately recording and reporting that payment to the appropriate taxing authorities. A comprehensive example of this type of activity is a construction contractor who receives cash from an individual for certain repairs to the individual's house. The contractor then pays his or her employees in cash without withholding taxes, or pays cash "under the table" for materials without paying sales tax on them. Because no income records exist, neither the contractor nor the employees pay income tax on their earnings. The contractor also fails to provide worker's compensation insurance for his or her employees. Finally, the contractor who violates all of these tax and labor laws may also be operating without a license issued by the Contractor's State License Board.

During this study, we reviewed the activities of five State agencies: (1) The Department of Industrial Relations, which is responsible for protecting the workforce; (2) the Employment Development Department, which has various responsibilities for employee planning, placement and training, as well as for collecting employment and withheld State income taxes and paying unemployment insurance benefits; (3) the Franchise Tax Board, which administers the personal income tax and the bank and corporation tax laws; (4) the Board of Equalization, which administers a number of programs including the sales and use tax; and (5) the Contractors' State License Board, which tests, licenses and regulates contractors.

Chapter I and Appendix A of this report provide a detailed discussion of the underground economy and a discussion of the responsibilities each of the above State agencies has in relationship to it. Chapters II through VI present the Commission's findings regarding the State's efforts to control the underground economy, and Chapter VII presents the Commission's recommendations for more effectively dealing with this problem.

SUMMARY BY CHAPTER OF FINDINGS AND RECOMMENDATIONS

CHAPTER II: STATE AGENCIES ARE NOT ADEQUATELY ENCOURAGING VOLUNTARY COMPLIANCE WITH THE STATE'S TAX SYSTEM

America's system of taxation is based on voluntary compliance and self-assessment. This means that people are expected to accurately calculate and pay their own taxes. While most individuals do just that, there is need for enforcement activities to catch and correct those who either innocently erred or intentionally misstated their tax liability.

Finding #1. The level of voluntary compliance in paying State taxes appears to be declining. Although it is difficult to measure voluntary compliance, it is generally acknowledged that the level of voluntary compliance is going down. While the State has not conducted any comprehensive study to measure voluntary compliance, the Internal Revenue Service has conducted various studies which indicate that the level of voluntary compliance with federal income tax laws is declining. In addition, tax audits are becoming more productive, which may indicate a reduction in correct self-assessment.

Finding #2. There are no centralized sources of information to aid businesses who desire to voluntarily comply. To register with all applicable State agencies and obtain all information needed to comply with State laws, a taxpayer may have to go to several locations. The Department of Commerce is establishing a small number of Small Business Development Centers which will provide referrals to other State agencies. However, instead of establishing numerous new centers, existing State agencies could cooperate in providing information to taxpayers on all State requirements.

Finding #3. The value of enforcement in encouraging voluntary compliance has not been adequately recognized. The enforcement staff of most of the agencies we studied are normally evaluated based on the number of cases completed and the amount of funds they recover. They do not normally consider the effect of their actions on voluntary compliance because these benefits are difficult to measure. However, in the long run, these effects may be the most important.

Finding #4. Taxing and enforcement agencies have not taken full advantage of the value of publicity in obtaining additional voluntary compliance. Although publicity on enforcement activities will likely result in additional voluntary compliance, most of the agencies we studied have been quite limited in their use of publicity. Although agencies appropriately give high priority to closing cases and recovering funds, equal priority must be given to increasing public awareness of taxpayer responsibilities and the severe consequences of not complying with the law.

CHAPTER III: INFORMATION SHARING SHOULD BE EXPANDED AND IMPROVED

Many State agencies have information on businesses, much of which can be shared among agencies where such agreements exist. When an agency cites a business for violation of a State law or regulation, other agencies may be able to identify other violations and issue additional citations when and if they find out about the initial violation. This sharing of information and the subsequent enforcement of additional laws would improve the State's overall effectiveness in identifying and eliminating participants in the underground economy as well as increasing overall voluntary compliance.

Finding #1. Currently available State information is not adequately shared between agencies. Because of access problems, internal agency concerns, and staffing problems, information is not shared between agencies as often as it could be. Enormous amounts of information is shared on a routine basis, but information on enforcement activities has not been shared as well as possible. Reasons for not sharing this information include privacy concerns, an agency's desire to protect its own cases, and confusion about sharing data. Because this information is not shared, the State loses revenue and additional opportunities to combat the underground economy.

Finding #2. Information which is shared with other agencies is not always used by the receiving agency. This information is not being used because of the timing of enforcement actions and due to staffing constraints. In not using this information, the State agencies are not maximizing revenue or the opportunity to influence taxpayer compliance.

Finding #3. The quality and format of shared data significantly limits its use. Some leads are not used because of the quality or the format of the data. Quality problems come about because the agency generating the lead may not be fully aware of the needs of the other agency. Therefore the lead may contain too little information for the receiving agency to properly evaluate it. Format problems also are often due to the lack of a common identifier number for State use.

Finding #4. State agencies are not actively identifying and using new sources of information. State agencies have agreements to share information and in fact are sharing enormous amounts of data. However, we found that State agencies could devote more resources to obtaining and using new information for combatting the underground economy. Other State agencies and particularly local government have data which could effectively identify potential violators.

CHAPTER IV: LIMITED AUDIT STAFF
REDUCE POTENTIAL RECOVERIES AND
OVERALL TAX COMPLIANCE

All audit and investigative agencies cite high-tech information sharing as the wave of the future. While we agree that much more can and should be done in this area, staffing shortages should not be tolerated until high-tech methods are established. While we do not believe that additional staff will solve every problem, we do feel that adequate staffing is one aspect of a balanced program of enforcement, particularly since auditors generate revenues far in excess of their cost.

Finding #1. Although audits are cost effective, auditor staffing in some agencies has decreased. While the underground economy is increasing, the number of auditors and enforcement staff has remained relatively level or actually decreased in some agencies. Although the basis of taxation is self-assessment and voluntary compliance, this concept must be reinforced with an effective enforcement program to dissuade potential tax evaders.

During the four years from 1980 to 1984, the audit staff at the EDD was reduced by 18 percent while the number of registered employers increased by 14 percent. The B of E audit staff was reduced by one percent during that same period while the number of resale licenses in force increased by 12 percent.

There is a need for a certain amount of field personnel to conduct a certain number of audits, provide "field presence," and follow-up on leads provided by other agencies through tips, other external sources, and high-tech data matches.

Finding #2. Collections backlogs have more than doubled in four years. The collective outstanding receivables balance for the B of E, the EDD, and the FTB in 1980 was \$492 million. In 1984 the balance exceeded \$1 billion. Once again, a small investment in resources will result in significant returns for the State.

CHAPTER V: ENFORCEMENT MECHANISMS
AND STATUTES NEED REFORM

Audit selection criteria, audit methods, enforcement and penalties used by the State agencies do not adequately address

the problem of the underground economy. While the impact of these activities on the underground economy is difficult to measure, it must be considered.

Finding #1. Agencies' audit selection criteria do not adequately consider the underground economy or the value of increasing voluntary compliance. The B of E and the FTB have been mandated by the Legislature to maximize revenues while the CSLB has been directed to mediate consumer and industry complaints and investigate a three percent sample of new applicants. Similarly, the EDD tax branch must give priority to obstructed claims for unemployment insurance benefits. As a consequence of these mandates, none of these entities is able to direct a significant amount of resources towards combatting the underground economy.

Finding #2. DIR deputies have not been adequately trained in methods to quantify the extent of underground economy activity. Although there are accepted techniques available to reconstruct how extensive certain past cash-pay violations were, DIR deputies tend to cite violators only for the current period or for those periods for which an employee or a past employee is willing to testify about. This occurs primarily because DIR's Labor Standards and Enforcement Division employs very few auditors, and staff in general are not trained in audit reconstruction methods.

Finding #3. State agencies are not sufficiently pursuing criminal penalties which would increase deterrence. There are various penalties available to use against tax evaders ranging from small penalties to loss of professional licenses and resale permits to incarceration. We found that agencies normally settle for minor penalties, even on blatant cases, rather than taking the time and effort to pursue criminal sanctions. Without taking a case to court, the information is normally confidential and therefore cannot be used for publicity. The general unwillingness to pursue criminal sanctions is due to the need for greater management direction and priority, and due to district attorneys' unwillingness to prosecute such cases.

Finding #4. State agencies are not using cross-agency penalties which would provide maximum deterrence and recoveries. Cross-agency penalties are available in many cases where a taxpayer violated a tax or employment law. For example, a taxpayer violating cash-pay laws may be cited or penalized by the EDD, the DIR, the FTB and the CSLB. However, because citation information is not always shared or because other cross-agency provisions are not being fully used, the State is not maximizing its enforcement tools, deterrence, and recoveries.

Finding #5. There are few penalties for repeat offenders and the need for appropriate follow-up audits of violators. Blatant or repeat offenders should be penalized at a higher

level than taxpayers making an "honest mistake." However, current regulations seldom allow significantly higher penalties for repeat offenders. Further, there are few provisions for follow-up inspections. Therefore, a taxpayer can continuously gamble on not getting caught, or, if caught, on paying a relatively minor penalty.

Finding #6. Enforcement against employees involved in cash-pay is inadequate. Cash-pay violations often are the result of collusion between the employer and employee. However, after the violation has been discovered, follow-up action is inadequate to ensure that the employee has reported the income on his or her income tax return and that he or she has not been inappropriately receiving unemployment or other benefits.

Finding #7. Penalties for not carrying worker's compensation insurance are inadequate. Unemployment Insurance and Worker's Compensation Insurance are two separate programs designed to protect employees. While failure to provide Worker's Compensation Insurance is normally considered a much more serious problem than failing to provide Unemployment Insurance, the penalty is significantly less.

Finding #8. There is continuing controversy over the definition of an independent contractor verses an employee. In many cash-pay instances there are difficulties in determining whether there is an employer/employee relationship or an independent contractor relationship. Different states have different criteria and the federal congress has been attempting to solve this problem. Until either the State or Federal government provides greater direction, many individuals will be able to continue abusing the tax system.

CHAPTER VI: REORGANIZATION COULD INCREASE EFFICIENCY AND LEAD TO GREATER RECOVERIES AND DETERRENCE

The State's major taxes are administered by three agencies, the B of E, the EDD, and the FTB. This fragmented organization causes coordination problems and certain levels of duplication. While this type of separation of responsibilities may be the most appropriate organization for this State, several past studies have recommended restructuring or consolidating these activities. Although we did not conduct a detailed analysis of the advantages and disadvantages of reorganization, this study has pointed out a number of problems created in part by the separation of these activities.

Finding #1. Lack of a single revenue agency results in duplication. Each taxing agency, including the EDD's Tax Branch, has evolved based on its individual needs. Thus the existing monitoring and management information systems appear quite different. However, there are many systems and activities which are duplicative including billing delinquent taxpayers,

issuing warrants and letters, and finally attaching wages or placing liens on property. Similarly, each agency maintains its own computerized data base files which contain certain duplicative data.

Finding #2. Because the State's revenue and enforcement agencies are separate, they have not worked together on task forces to combine efforts on blatant cheaters. If one agency catches a tax evader, it may not be able to fully punish that taxpayer due to lack of information, insufficient sanctions, or staffing constraints. Other State agencies may be able to contribute to the enforcement of these cases, but the agencies have not combined efforts to form task forces. Such an approach would, through the combined expertise of the participants, result in the levying of maximum penalties and offer the opportunity for heightened publicity, thereby generating increased deterrence.

Finding #3. Separate audit staffs preclude use of the "single audit" concept which may result in misdirected audit work. Because each agency's audit staff is concerned only with one type of tax, there is duplication in auditing. Further, taxpayers are audited for one tax, but the auditor does not address other State taxes. This is the opposite of the "single audit" concept used by private industry and the federal government. Under this concept, one auditor or team of auditors conducts a review of the auditee's compliance with all applicable laws and/or other criteria.

Finding #4. Conflicting or dissimilar objectives limit the overall effectiveness of State enforcement activities. Since each agency is most concerned with its own objectives and collecting its own revenue, the overall benefit to the State is often overlooked. Because of this, the State's overall effectiveness in combatting the underground economy may be limited. Specifically, information may not be shared, audits are not coordinated between agencies, task forces are not used, and overall fines and sanctions are not maximized.

CHAPTER VII: RECOMMENDATIONS

The underground economy costs the State of California billions of dollars each year. Although it can probably never be eliminated, a small percentage of reduction can mean hundreds of millions of dollars in increased revenues for additional State services or to reduce the liability of the honest taxpayer. These revenues will be realized both directly through additional taxes, penalties and interest, and indirectly through increased voluntary compliance.

Following is a summary of our major recommendations (we encourage the reader to review Chapter VII in detail for a complete listing and understanding of the recommendations).

1. The Governor and Legislature should consider reorganizing some or all State taxation responsibilities. The final determination on whether or not to reorganize, and if so, the level of reorganization necessary should be based upon the results of an in-depth study of all responsibilities of existing State tax agencies conducted by a team of specialists with expertise in taxation, banking, management, computer systems, and other appropriate disciplines.

2. The Legislature and Governor should, through statute or executive order, establish a Multi-Agency Task Force to conduct complete audits and investigations of blatant tax violations and cash-pay transactions. This task force should consist of representatives from the FTB, the B of E, the EDD, the CSLB, the DIR, the Attorney General's Office, and district attorneys.

3. The Governor and the Legislature should require representatives from the EDD, the FTB, the B of E, the DIR, the CSLB, and other appropriate State agencies to form a standing committee to continuously study opportunities for sharing information, improving formats for the information, and eliminating access obstacles. This committee should also include representatives from the federal government, local governments, other states and nongovernmental entities, as appropriate.

4. The Legislature and the Governor should require all State agencies to use a common identification number or a system of cross-reference numbers for all businesses.

5. The Governor and the Legislature should provide ways for nontaxing agencies to obtain and use greater amounts of information currently available only to tax agencies.

6. On a test basis, auditors and investigators from the State's taxing and enforcement agencies should be trained on the basic requirements of other agencies and, where appropriate, be given authority to enforce the other agencies' laws. When conducting an audit, they should conduct minimum tests of compliance with other agencies' requirements. If the test is successful, this should be expanded to all auditors and investigators.

7. The Department of Industrial Relations should review the need to increase the number of audit staff employed in the Labor Standards Enforcement Division to enable it to conduct more thorough audits of cash-pay violations. Additionally, division staff should receive training in "reconstruction" methods of auditing.

8. The Governor and Legislature should reevaluate the staffing levels needed by audit, investigative, and enforcement units.

9. The Board of Equalization, Department of Industrial Relations, Employment Development Department, and Contractors' State Licensing Board should increase their level of prosecutions and each should develop an expanded program to actively publicize cases in which violators have been successfully prosecuted. The use of the media should also include an expanded public education program.

10. The Governor and the Legislature should encourage the U.S. Congress to create guidelines for determining whether an individual is acting as an employee or as an independent contractor.

11. The Governor and the Legislature should authorize a "graduated" penalty system where appropriate to provide more severe penalties for repeat violators.

12. State agencies should develop a system of selective "follow-up" visits to insure that previous violators are still in compliance with the law.

13. State tax and enforcement agencies should consider expanded use of automatic computer-generated citations based upon work done by other agencies.

14. The EDD, the DIR, and the FTB should initiate a trial project to determine the extent of loss to the State because of employees receiving cash-pay who are also receiving unemployment insurance and/or are not paying income tax on their cash-pay income. Based on the results of this trial project, the three agencies should consider additional enforcement in this area.

15. The Legislature and Governor should increase the penalties for employers who do not carry workers' compensation insurance.

16. The State should increase the proportion of cases developed for criminal prosecution and work closely with district and city attorneys to ensure that these cases are prosecuted.