

**Little Hoover Commission – Underground Economy
Responses From Board of Equalization Chairman Jerome E. Horton
January 6, 2014**

1. *What is the scope of the underground economy in California and its impact on the state?*

Identifying the extent of the underground activity is difficult due to its widespread reach and to significant measures taken by operators to avoid detection. Although difficult to fully quantify, it is clear that the effects of funds generated from the underground economy are significant on other criminal activities such as terrorism, gun smuggling, prostitution, and human trafficking. The complexity of the underground economy is as diverse as California's own economy, encompassing the ever-growing manufacturing, distributing, and retailing of products, services, and technology. However, it is increasingly apparent that tax evasion is the economic engine that drives the underground economy.

California is home to many key industries such as film, music, software, garment, among others, which are prime targets for organized counterfeiting and piracy. For example, the film and television industry, which provides over 190,000 direct jobs and \$17 billionⁱ in California wages, loses an estimated \$3.27 billion a year as a result of piracy in California.

California's vast geographical borders also make it vulnerable to importation of counterfeit products. Home to two of the busiest ports in the United States, 13.4 millionⁱⁱ inbound and outbound containers moved through these ports in 2012. In addition, over 1.1 million loaded truck containers enter California's border from Mexico each year, as well as over 20 million passenger vehicles, making it more difficult to detect illicit products coming into the state.

Based on a recent study by the UCLA Labor Center, *California and the Underground Economy*, April 2013, California is losing upwards of \$8.5 billion in corporate, personal income and sales and use tax revenue due to unreported and underreported economic activity. One of the greatest challenges we face with the underground economy is educating the public and the decision-makers about the severity and significance of the problem, as well as the deleterious effect it has on California's economy.

Like most "white collar" crimes, the crimes committed in the underground economy generally go unnoticed by average citizens until they manifest themselves within their personal space. The impact of the underground economy is often far reaching—not only are legitimate California businesses confronted with unfair competition, but revenues lost to the underground economy affect its citizens through the:

- Loss of essential services—schools, hospitals, roads, police, etc.,
- Loss of job opportunities, layoffs, and basic employment protections, and
- Unsafe, inferior and tainted products in the marketplace.

Without the tax revenues legally payable to the state, local and state government agencies are required to continue providing services with limited resources. And with continued population growth in California, the loss of revenues to the underground economy results in either slower, fewer, or elimination of services available to its citizenship. As an example, California recently closed a number of its state parks due to lack of funds needed to continue their operation.

2. What is the spectrum of efforts the state employs across agencies and task forces to combat the problems? In a briefing on the Board of Equalization's website titled "The Underground Economy Initiative," you mentioned that investigators admit their efforts only succeed in addressing "the tip of the iceberg." What additional reforms may help facilitate these efforts effectively?

The sheer growth and diversification of the underground economy and the fact that criminals operating in the underground economy continue to thrive at our expense constitute telling evidence that California's current effort to arrest the underground economy is not working and has some serious impediments. To date, California's response to this problem has been limited in scope and enforcement, focusing primarily on civil remedies, with nominal planned collaboration on criminal tax evasion. In fact, it could be said that current underground task forces have not focused on criminal business, corporate, or income tax evasion. Today's criminal efforts lack sufficient personnel, enforcement synergy, strategic usage of limited resources, and collaboration between various enforcement entities to arrest organized criminal enterprises.

Joint agency enforcement programs established by law to combat the underground economy include the Joint Enforcement Strike Force (JESF) and the Labor Enforcement Task Force (LETF), and now the Revenue Recovery and Collaborative Enforcement (RRACE) task force pilot program. Additional agency efforts include such programs as the BOE's Statewide Compliance and Outreach Program and the Contractor State License Board's Statewide Investigative Fraud Team. In contrast to these joint agency efforts, individual agency enforcement programs are typically not coordinated – instead they operate within the silo of their agency.

JESF and LETF have historically focused primarily on labor issues. The BOE is an active member of both partnerships. However, due to the need to primarily pursue underground labor issues, JESF and LETF investigations have not resulted in significant criminal tax evasion leads. However, the RRACE Team brings together those specific agencies that have the expertise, data and resources to focus on criminal tax evasion, while providing a venue to identify and pursue other crimes with a tax nexus. Moreover, the Team's collaborative tax enforcement efforts intend not only to shut down the underground operators, but rather prosecute the "leaders" of such criminal activities in an effort to eliminate the resumption of those operations. These efforts, which could link to national or potentially international operations, would have an even more significant impact overall in curbing illicit underground activities.

Currently, investigators believe that they are only able to address the "tip of the iceberg" because of the limited resources available for criminal investigative activities. Appropriately, a significant portion of a tax agency's resources are directed to civil audit or compliance functions which do, in fact, effectively handle the unintentional or noncriminal instances of nonpayment of taxes. These functions are more easily measured than those of criminal investigations. Furthermore, while criminal enforcement and public education regarding these efforts are invaluable to encouraging voluntary compliance, they have not been fully leveraged.

Due to the limited resources and the tendency to sometimes focus on the same type of performance metrics as that of other administrative program elements, the criminal investigative wing of an agency often finds itself seeking the "low hanging fruit" that can more quickly bring revenue "in the door," resulting in less attention being placed on more complex cases of evasion. These more complex cases can be considered the "base of the iceberg"—cases that would have a significant impact on the underground economy.

Therefore, care should be taken to not just consider revenue when evaluating performance of enforcement efforts. The “return on investigation” should not focus solely on revenue but improved compliance. The RRACE pilot program is a great opportunity to define and establish the right balance between the value of revenue and convictions. With the proper metrics and productive results of such a program, the value of enforcement resources for tax agencies could be established.

With respect to the question of reforms, changes to some of the existing tax laws could provide tax agencies further enforcement authority for their programs. Case in point, the sales of counterfeit tangible personal property by manufacturers and distributors are subject to income tax but exempt from sales tax under current law. This is an example where a change in the law could empower the BOE to pursue manufacturers and distributors of illegal products for sales tax liability. This one reform could serve as a greater deterrence to the manufacture and distribution of illegal products.

3. *How do bureaucratic silos among state agencies and local offices affect organizations’ ability to combat the underground economy? Is the state generally gaining ground? What actions are agency and departmental leaders taking to increase collaboration and information-sharing?*

Agencies working in silos, regardless of whether they are at the state or local level, often do not capture the full extent of violations resulting from illicit activities of the underground economy and do not impose penalties sufficient to deter this type of activity. Either the agencies do not have sufficient data to disclose all criminal activities being conducted or they do not have the resources or statutory authority to conduct a full investigation into all violations. Instead the agencies often simply cite a violation and impose a fine rather than fully develop a felony case for prosecution, court-ordered restitution, and/or jail time. However, imposing tougher criminal penalties will help the state deter violators from committing similar crimes in the future. Without full criminal prosecution and significant penalties, the message is sent to perpetrators that they can “build an empire” and, when they get caught, they simply pay a fine and continue conducting their illicit activities under other identities.

Although the state has in place a number of task forces designed to combat the underground economy, their areas of focus have been limited in some cases (JESF and LETF focus primarily on labor issues); meetings held by some of the task forces occur only once or twice a year, which, while beneficial, are not sufficient to address this problem; and the Memorandums of Understanding that have been developed for sharing information between agencies are often restrictive.

The recent creation by the Legislature of the RRACE is a clear indicator of the state’s intent to more aggressively and cohesively combat the underground economy. RRACE provides the statutory authority for sharing information among the participating agencies of the RRACE Team and collaborative efforts focused on the prosecution of the most egregious cases of tax and related labor violations. This collaborative, strategic, targeted and focused effort to combat the underground economy should create a synergy among the enforcement agencies, including those serving in an advisory capacity to the Team, and significantly increase the State’s efficiency and effectiveness in recapturing revenue lost to business and organizations operating illegally in California. Of significance is the opportunity to have the Team work together daily in its review of data, leads, and other information for the sole purpose of investigating organized criminal entities and/or serial offenders for violation of tax and labor laws, while still providing for the referral of leads of lesser violations to respective agencies for administrative action.

4. ***Also in the online briefing, you wrote that there was no statutory requirement for state organizations to prioritize efforts to collect taxes and wages, despite a state history of creating task forces aimed at that result. Please discuss this further, including the reason that no requirement exists. Do the most recent actions by the Governor and Legislature represent a more effective approach to this problem?***

When noting the lack of a statutory requirement for the prioritization of obtaining lost tax revenue, my intention was to address the fact that each agency retains autonomy and that the resources allocated are distributed to their internal programs without statutory guidance regarding synergistic collaboration to collectively investigate and prosecute criminal tax fraud. As mentioned above in question number two, resources are primarily allocated to an agency's administrative compliance goals and objectives. This often leaves the criminal investigative function with less than optimal resources for effectively combating egregious, complex schemes that violate tax and labor laws.

Perpetrators range from sophisticated criminal organizations, with a global network, to the common thief reselling stolen property. In the aggregate, they violate multiple California laws thus requiring a broad base coalition of law enforcement entities to effectively arrest the problem and capture lost tax revenue. The recent passage of AB 576 by the Governor and Legislature establishing the RRACE pilot program is certainly a step in the right direction in that it creates a strong centralized enforcement program. By pooling personnel and data, RRACE can prioritize and select the cases with greatest potential for impact to the state. In contrast, other current "coordinated efforts" tend to put the investigator in a position where their focus is still on the objectives of their own agency's program. A cooperative multi-agency task force, such as RRACE, takes the agency silo burden off the investigators and allows them to collaborate in the identification of underground economy related violations, trends, joint investigations and coordinated multi-agency prosecution cases.

ⁱ Motion Picture Association of America, State-by-State Film & Television Economic Contribution (www.mpa.org).

ⁱⁱ TEU Statistics for the Ports of Los Angeles and Long Beach, 2012.