Level the Playing Field: Put California's Underground Economy Out of Business

REPORT #226, MARCH 2015

LITTLE HOOVER COMMISSION

DEDICATED TO PROMOTING ECONOMY AND EFFICIENCY IN CALIFORNIA STATE GOVERNMENT

Little Hoover Commission

Pedro Nava†
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Vice Chairman

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Assemblymember

David Beier

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Senator

Jack Flanigan

Don Perata

Sebastian Ridley-Thomas
Assemblymember

Richard Roth
Senator

David A. Schwarz

Jonathan Shapiro

Sumi Sousa

**Served on subcommittee*
†Served as subcommittee chair

Former Commissioners Who Served During the Study

Anthony Rendon
Assemblymember

Commission Staff

Carole D'Elia
Executive Director

Jim Wasserman
Deputy Executive Director

Krystal Beckham
Project Manager

Sherry McAlister
Associate Governmental Program Analyst

Jasraj Singh Sangha
Intern

To Promote Economy and Efficiency

The Little Hoover Commission, formally known as the Milton Marks "Little Hoover" Commission on California State Government Organization and Economy, is an independent state oversight agency.

By statute, the Commission is a bipartisan board composed of five public members appointed by the governor, four public members appointed by the Legislature, two senators and two assemblymembers.

In creating the Commission in 1962, the Legislature declared its purpose:

...to secure assistance for the Governor and itself in promoting economy, efficiency and improved services in the transaction of the public business in the various departments, agencies and instrumentalities of the executive branch of the state government, and in making the operation of all state departments, agencies and instrumentalities, and all expenditures of public funds, more directly responsive to the wishes of the people as expressed by their elected representatives...

The Commission fulfills this charge by listening to the public, consulting with the experts and conferring with the wise. In the course of its investigations, the Commission typically empanels advisory committees, conducts public hearings and visits government operations in action.

Its conclusions are submitted to the Governor and the Legislature for their consideration. Recommendations often take the form of legislation, which the Commission supports through the legislative process.

Contacting the Commission

All correspondence should be addressed to the Commission Office:

Little Hoover Commission
925 L Street, Suite 805,
Sacramento, CA 95814
(916) 445-2125
littlehoover@lhc.ca.gov

This report is available from the Commission's website at www.lhc.ca.gov.

State of California

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Carole D'Elia
Executive Director

March 9, 2015

The Honorable Edmund G. Brown Jr.
Governor of California

The Honorable Kevin de León
President pro Tempore of the Senate
and members of the Senate

The Honorable Bob Huff
Senate Minority Leader

The Honorable Toni G. Atkins
Speaker of the Assembly
and members of the Assembly

The Honorable Kristin Olsen
Assembly Minority Leader

Dear Governor and Members of the Legislature:

During the past year, the Commission heard from more than 150 concerned Californians about the challenges of the insidious multi-billion dollar underground economy. Long-time business owners told us how hard it is to stay afloat as competitors undercut bids to gain an unfair advantage by ignoring laws and licensing rules. California workers told stories of being harassed and demoted for filing unfair wage claims against unscrupulous bosses. These lawbreakers misclassify, shortchange and do not adequately insure their employees and pocket payroll and sales taxes that should be paid to the state.

Non-compliance by some California businesses hurts everyone as the impacts ripple outward: honest business owners, employees, the neighborhood, the state. State estimates suggest losses of $8.5 billion or more annually in uncollected tax revenue.

Putting an end to cheating is one of those issues where business and labor agree and can rally together to bring about solutions. In this study, the Little Hoover Commission provides 15 recommendations to help level the playing field for California businesses and protect workers by reducing the scale of the underground economy. The recommendations fall into three broad categories: 1) enforcement, 2) accountability and 3) education.

Enforcement. The Commission found the underground economy is growing and thriving in part because of insufficient resources for enforcement. The Commission learned that many cheaters break the rules because getting caught is unlikely. If they are caught, few are charged in court. When found guilty, the profits from cheating often outweigh the fines and penalties. More, there is an abysmal record of collecting restitution, as the cheaters hide assets to avoid paying anything at all and quickly set up shop again under new ownership. Unfortunately, for some, cheating is business as usual.

The Commission found laws can be so confusing and inconsistent that even business owners who try to comply sometimes later learn they have broken rules. Recommended improvements include defining independent contractor in statute, bolstering asset seizure laws, and generally refining laws to improve clarity and to ensure rewards don't outweigh risks. The Commission also recommends replicating the current workers' compensation fraud grant funding model to other high-fraud areas, enabling local district attorneys to increase their role in tackling the underground economy.

Milton Marks Commission on California State Government Organization and Economy ◆ http://www.lhc.ca.gov/
925 L Street, Suite 805 ◆ Sacramento, CA 95814 ◆ 916-445-2125 ◆ *fax* 916-322-7709 ◆ *e-mail* littlehoover@lhc.ca.gov

The state should make it easier for agencies to do their jobs by expanding and improving information sharing – while ensuring privacy is adequately protected. And it recommends the state evaluate its investigator and audit and compliance civil service classifications for consistency.

Accountability. The Commission found that although numerous government organizations focus on tackling the underground economy, no one is directly in charge. Hardworking government employees do their best to combat the problem, but often without adequate resources or the data or equipment to effectively do their jobs.

There are four major state task forces focused on the underground economy, but it is not clear, overall, what the outcomes have been. The Commission recommends the Governor appoint a temporary independent leader, in consultation with state leaders who have jurisdiction over the underground economy, with clear authority to untangle any overlaps in responsibilities, bridge silos and move efficiently toward results. This leader should report back in six months on administrative or legislative changes needed to overcome the obstacles.

Government also must lead by example. The Commission recommends that government entities award contracts to the lowest "responsible" bidder to avoid hiring businesses that may be breaking laws to provide the lowest bid.

Education. Education, outreach and simply making it easier to comply should be the first priority of government. The Commission calls for a three-pronged statewide educational strategy that teaches consumers, public employees and businesses and workers about the harmful effects of the underground economy and how to avoid participating in it. To make it easier for businesses to comply, the Commission recommends a one-stop information shop on how to legally own and operate a business and a master business application that would allow business owners to interact with various state government entities through one portal. Finally, it recommends expanding opportunities for voluntary audit programs and working with industry associations to create self-certification programs.

Taking more aggressive action against the underground economy is essentially about fairness. Business owners should know the state stands with them against cheating competitors. Workers should know they stand a chance against employers who misclassify them or short their checks. Taxpayers should expect they will not pay more because some businesses don't pay at all.

The Commission maintains that an economy based on fairness will go far in assuring California's continued success. It respectfully submits these findings and stands ready to help you take on this challenge.

Sincerely,

Pedro Nava
Chairman

LEVEL THE PLAYING FIELD: PUT CALIFORNIA'S UNDERGROUND ECONOMY OUT OF BUSINESS

Table of Contents

Executive Summary i

The Underground Economy in California 1

Leadership Void Creates Incentive to Cheat 17

Improving Tools for Enforcement 37

Preventing the Underground Economy 51

Conclusion 73

The Commission's Study Process 77

Appendices & Notes 81

- *Appendix A: Public Hearing Witnesses* 83
- *Appendix B: Advisory Committee Meeting Participants* 85
- *Appendix C: The Commission's 1985 Recommendations* 89
- *Appendix D: Case Study: Heating, Ventilation and Air Conditioning Unit Replacements* 91
- *Appendix E: Employment Development Department Data Submitted to Commission* 93
- *Appendix F: Board of Equalization Data Submitted to Commission* 103
- *Appendix G: Franchise Tax Board Data Submitted to Commission* 105
- *Appendix H: Department of Industrial Relations Data Submitted to Commission* 107
- *Notes* 109

Table of Sidebars & Charts

Agency Staffing Against the Underground Economy iv

One Worker's Experience in Encountering and Reporting Underground Economy Violations 6

Common Cheating Methods 7

Other Important State Actors Combating the Underground Economy 10

Underground Economy Task Force Composition 12

No Center of Accountability for the Underground Economy 18

Revenue Recovery and Collaborative Enforcement Team 21

BOE Chairman on Performance Evaluation 23

EDD Investigative Division Staffing Levels, FYs 1990-91 to 2014-15..... 25
Employers in California, FYs 1990-91 to 2014-15..... 25
Number of Businesses in California, 1997 to 2011..... 26
Agency Staffing Against the Underground Economy..... 26
What does Protecting Privacy Mean?..... 44
Workers' Compensation Grant Funding Process..... 45
How to Start a Business in California..... 56-57
Survey: Would Your Competitor Get Caught?..... 62
Survey: What Would Be the Consequences of Getting Caught?..... 62

Executive Summary

California's well-being depends on the success of its businesses. To succeed, businesses need to compete on a level playing field. California has many rules and regulations by which its businesses must abide, and when some entrepreneurs do not play by those rules, it creates an unfair advantage.

When business owners cheat by illegally underpaying employees, for example, or not paying taxes – allowing them to undercut prices of law-abiding businesses – it hurts compliant businesses and California workers alike. They make employees work an hour or two without pay. They don't get the required licenses for their occupations or provide workers' compensation coverage. This business model, when allowed to prevail, nourishes a powerful downward economic spiral. It is a bane to the above-board businesses, particularly the small businesses that are the backbone of the California economy.

"Successfully combating the underground economy is bigger than protecting employees and businesses and returning revenue to the state. It is a matter of preventing the erosion of confidence in the institutions that protect the public." – Jennifer Lentz Snyder, Head Deputy District Attorney, Healthcare Fraud, Los Angeles District Attorney's Office

Employees working within this illegal business model, particularly those in labor intensive industries – people who clean buildings, wash cars, wait on customers, pack and ship goods in warehouses, harvest the food Californians eat – often suffer the greatest harm. Employers may short their paychecks. Or they may intentionally misclassify them as independent contractors, making them pay the employer's share of payroll taxes. Often, these are workers in or near poverty, and they endure such conditions because any job is better than no job.

And at the same time, public health and safety is at risk – from biohazards transported by untrained couriers, misclassified truck drivers passing the limits of drive time, counterfeit prescription drugs and contact lenses on the shelves or shoddy construction being performed by unlicensed contractors.

Entrepreneurs who cut corners by not paying taxes, not providing adequate insurance and skimming off their employees' paychecks are considered to be part of the underground economy. But the term underground economy means different things to different people. Broadly defined, it includes any activities that individuals and businesses try to hide from government licensing, regulatory, tax and law enforcement agencies. Some of these activities, such as drug dealing or human trafficking, are illegal transactions that should be shut down.

Other activities are conducted by individuals or businesses who otherwise would be legal operators but who are breaking the law to gain a leg up on their competition.

The underground economy typically includes everyone from the low-income worker trying to make a "few extra bucks" on the side by doing home improvement projects, landscaping or housekeeping for cash to the street gangs and terrorists who have penetrated the highly lucrative counterfeit goods market and the many, many layers in between. It can be easy to ask, particularly at the lower end of the spectrum, why should I care?

When consumers don't care, it feeds the demand that allows the underground economy to grow and thrive. When government doesn't care, as evidenced by a lack of enforcement or a lower priority in the criminal justice system, it erodes trust in government and signals to law-abiders that crime in California actually does pay.

In this review, the Commission found that the tentacles of the underground economy reach deep in California and that it plagues both businesses and workers. The underground economy also robs the state of an estimated $8.5 billion to $10 billion in uncollected tax revenue, money that could fund education, law enforcement or long-overdue infrastructure investments or reduce taxes for the majority of Californians who play by the rules.

Because of the breadth of this topic, the Commission limited its focus in this review to those activities that are legal when all laws and regulations are followed – and illegal when not. One exception to the narrow focus of this review is counterfeiting, in part due to the authority of state taxing agencies in shutting down counterfeiting operations, the damaging effect that counterfeit goods sellers have on legitimate businesses and the significant public health and safety risks posed by the very broad array and availability of modern counterfeit products.

The Commission's year-long study process included two public hearings, three public advisory committee meetings and as well as staff research including interviews with more than 150 experts and stakeholders. The Commission heard from dozens of employers, workers and the associations that represent them. It heard from federal, state and local officials, including organizational leaders as well as the investigators, auditors, attorneys and law enforcement officials battling the underground economy on the front lines, often without adequate resources or in some cases, the tools and technology to be most effective.

This reports includes 15 major recommendations on ways California can level the playing field for compliant businesses and protect workers from

unscrupulous employers. First and foremost, it must educate – consumers, employers, workers, and public officials – both on the public safety as well as the economic perils of letting the underground economy go unchecked. The Commission applauds the many outreach efforts of various state organizations that help businesses and workers who simply don't know or understand the rules to become compliant. But for those who knowingly and willfully break the law to gain an upper hand or fatten their wallets by forgoing taxes and licensing fees, underpaying workers or taking shortcuts with insurance, the state must take bold and immediate moves to show it is serious about tackling this problem.

Thirty years ago, the Little Hoover Commission reviewed the underground economy and concluded "the state can and must do more to deter the growth of the underground economy and eliminate its activity in many areas." Sadly, not enough has changed in this arena since its 1985 report. As the number of employers has doubled in the state in the past 30 years, and as rules and regulations have grown increasingly complex, the state has done a woeful job responding, both in terms of providing easy access to information to help businesses comply and in terms of growing its enforcement resources to tackle those businesses that knowingly cheat.

This report is organized into four chapters, a background chapter that describes the negative effects the underground economy has on the California business climate, on workers and on health and safety. It also includes a description of the state government entities primarily responsible for curbing the underground economy and the various task forces that have been formed to better leverage limited investigation and auditing resources. The background chapter is followed by three chapters that provide findings and recommendations on leadership challenges, opportunities to improve tools for enforcement and proactive options to stop the underground economy before it starts.

Leadership Void

California's long campaign against the underground economy suffers from a lack of leadership. As it found in 1985, the Commission in this review again found that there is no single executive accountable for leading the charge against the underground economy. There are many champions and leaders within the organizations that have jurisdiction over the underground economy. Today, there is not just one statewide task force, as recommended by the Commission in 1985, but four major task forces as well as numerous other statewide collaborative efforts, plus the many state-local partnerships fighting these crimes on the streets in California's communities. At the state level, however, the alphabet soup of task forces at times seems more of a cacophony than a concerted effort.

To level the playing field for California businesses, the state must make reining in the underground economy a priority, as important as achieving the many other policy goals that have benefitted from the concentrated effort of a dedicated leader. In 2012, when the Commission reviewed energy governance, specifically whether the state had the structure in place to achieve the renewable energy goals enacted in 2011, it found that significant progress was taking place because a senior advisor was given the authority to get all the necessary players together in the same room, develop a plan, set milestones and then hold everyone accountable. The model was simple – get everyone together, cut through the red tape, get it done. Following this model, the Governor should appoint a short-term independent policy advisor with clear authority to untangle the current overlap of responsibilities, bridge silos and move efficiently toward results. This leader must be able to work with and garner cooperation from the various elected officials who lead the organizations that have jurisdiction over the underground economy outside of the Governor's purview, including the Board of Equalization members, the Attorney General and the State Controller.

Lack of Enforcement Resources

During the past three decades since the Commission's last review of this topic, California's economy has grown and changed significantly. The number of employers in California has more than doubled to 1.3 million in 2014 from 621,000 in 1985.[1] Policymakers enact well-intentioned laws to regulate businesses but then do not allocate robust funding to enforce the rules. Funding enforcement comes down to fairness and transparency. Honest businesspeople pay a high price to comply with the state's laws and regulations. When legislators enact laws but don't allocate the funding necessary to enforce them, they are failing law-abiding constituents by giving an unfair advantage to those who cheat. The graph below shows the enforcement personnel devoted to curbing the underground economy over the years.

Agency Staffing Against the Underground Economy*

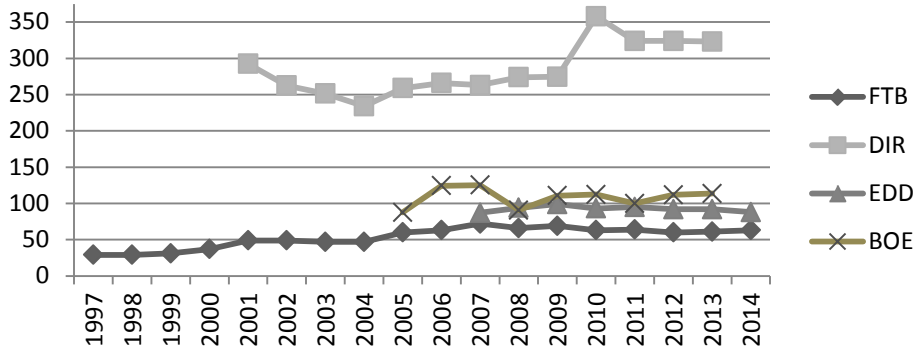


*Chart updated with EDD staffing information specific to the underground economy. See page 101 of Appendix E.

Not only has enforcement funding not kept pace with population and business growth, in some cases, the funding for enforcement comes from siloed special funds with strict rules on how the money can be spent. The Department of Industrial Relations, responsible for Californians' safety and protecting California's most vulnerable workers, relies entirely on money received through special funds. Each of these special funds has rules determining how the money can be used. Further, several of these funds funnel revenue into reserves for times of economic uncertainty. The Commission found one of these funds, the Car Wash Worker Fund, has a reserve that is 19 times the annual operating budget of the enforcement program it is supposed to fund. The Commission recommends that policymakers establish a prudent reserve level for the special funds – money paid by business through fees and surcharges – and use the rest of the revenue accrued through these funds for enforcement efforts, as originally intended.

Laws Unclear, Penalties Too Lax

In this review, the Commission also found laws and rules that can be so confusing and inconsistent that even those business owners who try to be compliant sometimes find they are not, while providing cover for those who intentionally cheat. The lack of clarity in the definition of independent contractor, for example, is one way that participants in the underground economy shroud themselves in legitimacy. Long-time California janitorial firms told the Commission they are going out of business because they cannot compete with companies that classify their workers as independent contractors to avoid paying payroll taxes and carrying workers' compensation insurance. The employees work set hours at set locations, but it is difficult to prosecute these businesses because there is no clear definition of independent contractor. The Commission recommends enacting a law that defines independent contractor and once defined, requires all state departments to abide by the same definition.

Beyond the lack of clarity, the Commission also found that the state lacks a coherent strategy for its sentencing laws related to white collar crime. The Commission, in decades of work focused on the state's criminal justice system, has called for an examination of California sentencing laws to reduce disparities and increase fairness. In this review, the Commission makes the call once again, recommending the state assess existing penalties for white collar crimes and, where appropriate, make adjustments to ensure that rewards of breaking the law do not outweigh the risk or the penalties imposed if caught breaking the law.

Participants in the Commission's advisory committee process pointed out various laws and inconsistencies that contribute to lax penalties for underground economy-related violations. The Commission recommends that the state identify and refine laws that are unclear or inconsistent. Until rules and definitions are clear, businesses should be provided a safe harbor when following advice from administrative agencies.

When violators are caught and fined, the state and local prosecutors often have great difficulty collecting restitution. Assets are hidden, have been spent by the cheaters or are transferred beyond the state's reach. The Commission recommends that the state refine and expand its asset seizure laws.

Improving Enforcement Tools

A common thread emerged over the course of the Commission's underground economy study process: The state needs not only to enhance but also to improve enforcement efforts. This recommendation came from a broad spectrum of Californians who are often at odds on many issues but spoke in unison on the state's need for better tools to police the underground economy. This included business owners, labor groups, state and local officials, workers, taxpayers. Participants on the various state and local task forces and partnerships agree the single most important improvement needed is access to better information. Better information could help the state focus the limited resources for enforcement on the most egregious offenders. In this review, however, the Commission found both policy and technological impediments to information sharing. The Commission recommends that policymakers enable state agencies to expand information sharing, including allowing some non-taxing agencies to obtain information currently only available to taxing agencies. The Commission also recommends that the Governor designate an advocate to negotiate with federal agencies for expanded access to data.

At the same time, the Commission urges caution to ensure that departments that collect and share data to combat the underground economy follow best practices and do not violate Californians' state constitutional right to privacy. The Commission recommends a review process to determine whether information and data sharing actions are conducted according to established terms of use and whether they are making departments and agencies more efficient.

Funding for Local Enforcement

The state has a valuable asset in local law enforcement that can be leveraged by expanding or replicating existing state-local funding models. The Commission heard repeatedly that the workers' compensation grant model, financed by premiums paid by California employers for fraud investigations and prosecutions, is an effective funding model. This program was endorsed by employers who pay into the grant fund, by local prosecutors and two members of the commission overseeing the program who spoke with Commission staff. Counties that receive this grant money have dedicated prosecutors and staff who investigate and develop expertise in workers' compensation fraud. These prosecutors often uncover violations beyond workers compensation fraud, including unlicensed contracting, cash-pay transactions and tax evasion. Advisory committee members recommended, and the Commission agrees, that the workers' compensation grant model should be replicated and expanded and should include dedicated funding for complex multi-year investigations that currently are difficult to conduct within the existing grant formula.

Equity for Enforcement Personnel

Successful enforcement against the underground economy ultimately depends on the people doing the audits and investigations. At the state level, the Commission found inequity and discrepancy in the compensation and protective resources for employees holding similar positions. Specifically, the Commission found that some investigators are not paid commensurately with colleagues in similar positions at other levels of government. Additionally, the state requires criminal investigators to complete Peace Officer Standards and Training and perform the duties of sworn peace officers, but not all of these investigators are armed, even though they often are in dangerous situations. The Commission was told that issuing search warrants and making arrests can sometimes be delayed until contracted partners who are armed become available. The Commission recommends that the state evaluate civil service classifications for consistency for the same level of work in the investigation, tax audit and compliance and management series.

Making it Easier to Comply

Education, outreach and simply making it easier for businesses to comply should be the top priority of state government. In its 1985 report and again in this review, the Commission calls for a one-stop shop to provide business owners all the information they need to comply with

state rules and regulations in one location. The Governor's Office of Business and Economic Development (GO-Biz), an organization created in response to a Little Hoover Commission recommendation in 2010, has made considerable progress in reviving a defunct permit assistance unit in a website called CalGOLD, www.calgold.ca.gov. Currently a user can go to the website, select the type and location of the planned business and view a list with links and contact information for all the paperwork required to open the business. GO-Biz is continuing to enhance this website and later in 2015 expects to add a wizard-type application in which the user is asked a series of questions and receives specific information in response. The Commission commends this effort and recommends the state continue to build the "one-stop" center with a technology solution that automatically is updated by state and local authorities as requirements are added or revised.

The Commission also recommends going a significant step further by creating a master business application that lets business owners interact with all government agencies through a single portal. For businesses that want to comply with all the rules, the portal would provide all the information needed. The goal of the master business application should be to reduce and streamline paperwork for businesses and provide a common identifier that the business owner could use to enter and update information. A common identifier also would benefit underground economy enforcement efforts as there would be a common number that could be used across departments and agencies.

Incentives, Education and Outreach

Every state entity involved with tackling the underground economy has outreach efforts, yet the Commission found more can be done to educate businesses, workers, consumers and even public officials. Although much of this report focuses on the supply side of the equation, consumer demand for low prices feeds the underground economy. Consumers could have a tremendous impact on the underground economy if they had the tools and information to recognize and then choose not to patronize cheating businesses.

The Commission found the state also could adjust incentives to change results. One example highlighted during the Commission's public hearing process was the rebates rewarded to homeowners who replace old heating, ventilation and air conditioning (HVAC) units with energy efficient units. To qualify for the rebate, the homeowner must pay for a permit and have air ducts inspected and sealed if leaks are detected. In 2010, approximately $11 million in taxpayer-funded rebates were awarded, yet some 90 percent of HVAC replacement units installed statewide are not properly permitted and do not meet quality verification

requirements.[2] Throughout most of the state, the homeowner is not required to submit proof of meeting permitting requirements before receiving the rebate. The Commission recommends that administrators of taxpayer-funded rebates should require proof that legal obligations to receive the rebates were met.

The Commission also found that more could be done to ensure that government contracts are not awarded to businesses that do not comply with state laws. There is a lot of pressure for government officials to take the lowest bid. Parameters have been put in place to ensure that public works projects are awarded to compliant businesses. Similar steps should be taken to ensure that all public contracts are awarded not just to the lowest bid, but to the lowest responsible bid. Tools that might help achieve that goal include a prequalification database, mechanics liens and stop notices and stricter requirements for recordkeeping with correspondingly sharper penalties.

Every state department that provided input to the Commission during this project indicated a high priority on education and outreach. The Commission applauds these efforts and encourages the state to continue to educate through traditional and social media and by working with community-based organizations that can provide outreach to businesses and workers that may not trust government. Finally, the Commission recommends that the state develop incentive-based opportunities for businesses to become compliant and work with industry associations to develop self-certifications and fiscal incentives for businesses to self-certify.

The state cannot successfully battle the underground economy alone. In addition to developing better cooperation between state agencies, the state must work with local and federal partners, community-based organizations, law-abiding businesses, consumers and workers. The state must take the lead, however, in transforming a culture of indifference into a level playing field for Californians.

Recommendations

Recommendation 1: The Governor, in consultation with state leaders who have jurisdiction over the underground economy, should designate an independent chief policy advisor for the underground economy and give that leader the authority to take action to eliminate the barriers that have prevented the state from successfully fighting the underground economy. This independent policy advisor should:

- ❑ Monitor the state's task forces and interagency partnerships to ensure they are organized efficiently, eliminate or restructure task forces that are ineffective, ensure they have sufficient resources

and that there are no gaps or overlaps in enforcement of the constantly-evolving underground economy and develop recommendations to eliminate barriers that are preventing these task forces from being fully effective.

- Lead a strategic planning process to develop performance outcomes for combating the underground economy.
- Review enforcement staffing and funding levels and work with legislative leaders to develop a plan to adequately fund enforcement.
- Report on progress and any barriers requiring administrative or legislative changes within six months. Before the advisor's work concludes, work with the administration to designate a position that will periodically review the state's efforts to combat the underground economy.

Recommendation 2: The Governor and Legislature should establish a prudent reserve for the special funds that support the Department of Industrial Relations and use the rest of the revenue accrued through the special funds to expand enforcement.

- State officials should work with stakeholders to determine enforcement needs and allocate funding authorization accordingly.
- If the state is unable to provide fee-payers the enforcement they are paying for, then the state should reduce their fees to support the level of enforcement actually provided.

Recommendation 3: With stakeholder input, the Legislature should enact a law that defines independent contractor. This definition should be standardized across state agencies.

Recommendation 4: The Legislature should assess existing penalties for white collar crimes and make adjustments to ensure rewards do not outweigh the risks of participating in the underground economy. The Legislature should identify and refine areas where legal definitions are unclear or inconsistent.

- Until inconsistencies are resolved, individuals receiving advice from administrative agencies should receive safe harbor for following the advice given to them.

Recommendation 5: The state should refine and expand its asset seizure laws to improve the collection of victim restitution.

Recommendation 6: The chief policy advisor recommended previously should have the authority to enable agencies to expand the use of information sharing, including allowing certain non-taxing agencies to obtain more information currently available only to taxing agencies. The Legislature, through the budget process, should allocate appropriate resources to cover the costs involved with data sharing. Additionally:

- ❑ The Governor should designate an advocate to negotiate with federal agencies for expanded access to its data.
- ❑ An expanded information sharing program should include the following components in which the state:
  - ✓ Determines what data it wants, where the data is and what it plans to accomplish with its data.
  - ✓ Plans its access controls, evidence-based methodology and information sharing infrastructure architecture.
  - ✓ Creates terms of use for its data in a public and transparent manner, allowing stakeholders a voice in the process. This should include development of an oversight process if third parties are granted access to the data.
  - ✓ Ensures it has the appropriate technology for investigators to accomplish their mission, users of the technology are appropriately trained and information sharing systems are compatible statewide.

Recommendation 7: The Governor and the Legislature should create a review process to determine whether information and data sharing actions are being conducted according to the pre-determined terms of use and whether they are making departments and agencies more efficient.

- ❑ Any discrepancies between agency actions and terms of use or results indicating that efficacy is not increasing should result in the cessation of that data sharing or an action plan to assist the agency or agencies in reaching the desired outcome.

Recommendation 8: The state should replicate the workers compensation grant funding programs in other high-fraud areas, and the grants should include dedicated funding for complex multi-year investigations.

Recommendation 9: The executive branch should evaluate civil service classifications for consistency for the same level of work, including the investigation, tax audit and compliance and management series.

Recommendation 10: The Governor and Legislature should create a "one-stop" center for business information including regulatory and financial information. The state should implement a technology solution so that this information center is automatically updated by state and local authorities with any revised requirements or changes in contact information.

Recommendation 11: The state should create an online statewide master business application to make it easier for businesses to comply with state requirements. The state should disseminate the information collected to appropriate departments to reduce the time a business owner spends filling out paperwork.

- The state should assign each business a common identification number to facilitate information sharing.
- State field offices and public libraries should provide Internet access to the master business application.
- The application and annual renewals should ask if the applicant plans to hire or has hired independent contractors. If the applicant responds in the affirmative, the state should ensure the applicant receives independent contracting compliance information.
- The master business application should be created in an electronic portal that would allow businesses to quickly and easily make updates. Information about their employees should include their name, identification number and workers' compensation job classification against which workers' compensation claims should be cross-referenced.
- The state should work with willing local jurisdictions to create a master state/local business license, which would not prejudice existing local fees.
- The state should include stakeholders in every stage of the application planning process, including design and user-testing, to develop a tool that meets their needs. These should include business owners, state agency representatives, labor representatives, law enforcement personnel, district attorneys and Department of Justice officials.

Recommendation 12: Administrators of taxpayer-funded rebates should require proof that legal obligations to receive the rebate were met. If administrators are unwilling or unable to collect this proof, administration of the rebate should be moved to another entity or the constituents under that administrator's jurisdiction excluded from the taxpayer-funded rebate program.

Recommendation 13: The Legislature should require all state and local contracts that meet the threshold for bidding to accept the lowest responsible bid and provide these agencies with the tools to identify and act upon the lowest responsible bid. These should include:

- A pre-qualification database that requires disclosure of previous violations and outstanding obligations to workers and the state, as well as proof that the contractor is meeting all regulatory obligations. Any subcontractors used must also be on the pre-qualification database. The funds derived from pre-qualification

registration and renewal should go toward underground economy enforcement and education.

- An adjudication authority should be able to put a stop notice or mechanics lien on a public contract when the contractor or subcontractor is shown to be in violation of the law.
- Public works recordkeeping requirements and penalties should be applicable to all public contracts.

Recommendation 14: The state should develop a three-pronged statewide educational strategy that teaches consumers, public employees and businesses and workers about the harmful effects of the underground economy and how to avoid participating in it. The intent of this educational outreach program should be statewide culture change.

- The state should evaluate where there are gaps in education and outreach and determine how those gaps should be filled, using best practices.
- The state should assess the needs of its more disenfranchised populations, including immigrant business owners and low-wage workers, and work with community-based organizations to develop strategies to bring participants in the underground economy into compliance, encourage workers to report violations and build trust in government institutions.

Recommendation 15: The Governor and Legislature should work to expand voluntary audit programs and, working with industry associations, create incentive-based education and industry certification programs.

The Underground Economy in California

The underground economy is both elusive and everywhere. Experts find it difficult to define, calculate and track, yet it permeates nearly every commercial industry in California and costs the state billions of dollars annually in uncollected taxes and other revenue.

Broadly understood, the underground economy encompasses any unlawful or "off the books" activities conducted by businesses or individuals that create an illegal and unfair business environment, put employees at a disadvantage or in harm's way or cheat government agencies out of taxes. Examples of these activities include working without required permits or licenses, not complying with regulated mandatory processes, evading taxes and operating without proper insurance. Others include underpaying employees, underreporting numbers of employees, inaccurately reporting employee hours or wages and allowing unsafe working conditions.

Underground economy operators, in short, gain a competitive advantage with a business model of cheating and cutting corners. With this advantage, they undercut prices of law-abiding business operators, gradually undermining them. Allowed to run unchecked, they feed a downward economic spiral in which licensed, legitimate businesses lose bids and customers, then downsize and lay off employees.

Eventually, this spiral reaches the taxpayer. The University of California, Los Angeles, Labor Center estimates that state government loses $8.5 billion annually in tax revenue to the underground economy.[3] The Franchise Tax Board estimates the annual revenue loss at approximately $10 billion.[4] These billions of dollars represent revenue uncollected for law enforcement, higher education, freeway maintenance or lower tax rates for people and businesses.

The Little Hoover Commission last studied this issue 30 years ago and made numerous recommendations on how the state could counteract the underground economy. (A brief outline of these recommendations can be found Appendix C.) Few of those recommendations were implemented.

However, laws have been enacted to address some issues, particularly labor violations. In 2004, the state enacted the Private Attorney General Act, which allows employees to seek civil penalties for any labor code violation. In 2014, the Legislature enacted Assembly Bill 1897 (Hernández), which makes client employers liable for workers supplied by a third party in certain situations. Still, the underground economy has continued to thrive.

In this study, the Commission specifically excluded from its review illegal activities that often are considered part of the underground economy, such as human trafficking or illegal drug sales. The Commission narrowed its focus to common businesses practices that are legal when all laws and regulations are followed – and illegal when not. The Commission focused, for example, on paying required payroll and other taxes, properly classifying employees, meeting minimum wage, insurance and workers' compensation obligations and obtaining required licenses and permits. All these are legal obligations overseen and enforced by the government tax, labor and licensing agencies.

Underground economy operators ignore these obligations to gain a financial edge over honest competitors. Some business owners are simply unaware of all the laws and requirements. For example, immigrants may not understand the many complicated requirements for operating a business in California. Helping entrepreneurs understand California rules and regulations should be the top priority in addressing the underground economy.

The Commission reviewed the range of state actions and activities that can bring businesses into compliance. Encouragingly, state officials told the Commission that many offenders will comply once contacted by government and informed of their errors. Additional resources focused on education and helping business owners become compliant could avert the need for enforcement efforts against those who are unaware of the state's rules and regulations. In its recommendations and discussion of problems, the Commission distinguishes between those who deliberately ignore tax and labor laws in their business model and those who break those laws out of ignorance.

Finally, the Commission made one exception to its narrowed focus by considering a widespread industry the state is clearly trying to shut down: counterfeiting. The Commission made this exception because of the authority of state taxing agencies over anti-counterfeiting operations and the damaging impact that counterfeit goods sellers have on public safety and the ability of legitimate businesses to compete.

Measuring the Scale of the Underground Economy

The State of California has no standard definition of the underground economy. Without a definition, the state cannot reliably measure the magnitude of the underground economy, nor the pieces that comprise it and how these have changed over time. It is inherently difficult to measure something that is hidden, and the State of California complicates matters by lacking a standard definition of the underground economy. Further, there is much academic debate about how to measure the underground economy at the national level. Many of the measurements used at the national level are difficult to apply to the state level because they include national-level indicators, such as currency circulation.

Nevertheless, several estimates of the scale of California's underground economy exist. One holds that underground economy-related transactions in California total between $60 billion and $140 billion annually. It is based on Internal Revenue Service (IRS) estimates of the underground economy at the national level from more than a dozen years ago.[5] Despite its weaknesses, this figure was recently used in legislative committee analysis, highlighting the need for investment in research to better measure the underground economy.[6]

The Board of Equalization (BOE) estimates that underground transactions annually cost the state $8.5 billion in lost personal and corporate income, sales and use tax. The BOE calculated its estimate based on refinements to a formula published by the International Monetary Fund (IMF).[7]

Using an IMF and World Bank estimate that 8.4 percent of the U.S. economy is underground, Franchise Tax Board (FTB) officials estimate that California's $2 trillion annual economy contains $170 billion of off-the-books activity. Taxes lost as a result total approximately $10 billion. An estimated 15 percent of that figure is attributed to the illegal economy – untaxed economic activities for which the state's goal is to shut down the activity instead of bring it into compliance, such as human trafficking – leaving an estimated $8.5 billion annually in lost revenue.[8]

Regardless of measurement methodology, California clearly suffers multi-billion dollar losses in tax revenue to the underground economy. Often these losses occur through hidden corner-cutting activities that are difficult to track.

Routinely losing $8.5 billion or more annually has significant state budget consequences. Overall, $8.5 billion in lost revenue represents roughly 80 percent of the state's corrections budget, or almost 60 percent of the General Fund allocations for California's 10 University of California campuses, 23 California State University campuses and 112 community college campuses.[9]

How the Underground Economy Damages the Business Climate

If the FTB's $170 billion estimate of underground economic activity is accurate, the loss to law-abiding businesses is formidable. California's 3.6 million small businesses represent 99 percent of the state's businesses.[10] Some not only compete with the pricing pressures and cost-cutting demanded by large corporations, but also must compete with unscrupulous competitors. A janitorial company owner told the Commission he lost a $1,100 weekly contract cleaning the building of a large, publicly-traded company to a competitor that bid $440 weekly – an improbable figure to be operating legally. "Some guy sits in some office and looks at the cheapest number, and doesn't care how many hours it takes or whether the company pays taxes. He just cares about reaching his number," a business owner told the Commission.[11]

Compliant business owners, in addition to losing billions of dollars to cheating competitors, carry the extra burden of undergoing repeated inspections in the name of limiting unlawful business practices. This creates a perverse effect in which it costs law-abiding businesses more money and time to prove their compliance, thereby giving a greater financial advantage to cheating businesses operating below the radar. A car wash and detailing business owner explained the difference between his compliant business and a nearby cheating competitor: He said he must annually register with the state and pay $300 per year per location, and also maintain a $150,000 surety bond. "I am inspected by the fire department, water department and storm drain people every year like clockwork. But [the cheating competitor] never gets inspected," he said. "No one is going to ask where his payroll records are, where his timecards are, how he is doing $2 million worth of business with two employees that he says are his kids."[12]

Law-abiding business owners told the Commission they can't continue to compete in a business climate when cheating occurs on a scale of tens, possibly hundreds, of billions of dollars annually. One veteran industry representative described for the Commission the corrosive effect on his colleagues' firms, saying, "These companies have been legally providing services for 40 years. In five years, they won't exist."[13]

Underground Economy Tactics Rough for Workers

There are numerous ways in which unscrupulous operators cheat to provide lower prices than law-abiding competitors. These underground economy business practices can fall hard on workers and often limit their upward mobility. The practices also increasingly occur as employment structures transition toward part-time work with fewer benefits, independent contracting and temp agency hiring. Many of these newer hiring arrangements can confuse employers who want to be compliant, while providing layers of ambiguity for noncompliant employers who don't. Two significant ways that businesses circumvent employment law rules to gain an upper hand on competitors include employee misclassification and third-party staffing.

Employee Misclassification

Employers misclassify employees for many reasons. Some are accidental. Employment structures have moved away from the traditional employer-employee paradigm that served as the foundation of employment law. Entrepreneurs work with freelancers, consultants, technical advisors, specialists, associates, coaches, analysts, suppliers and salespersons, among others. These relationships mean different things to different people and how they should relate to them in terms of tax and other employment obligations is not always intuitive.

Businesses hire independent contractors to scale their business needs for seasonal sales and production increases or to bring in specialized short-term expertise. Many workers prefer the flexibility of being an independent contractor, setting their own work hours and timeframes for project completion. Some businesses, however, intentionally misclassify employees as independent contractors to give them an unfair advantage over compliant competitors. Misclassifying employees substantially reduces costs, particularly in labor-intensive businesses such as janitorial firms, warehouses, trucking, housekeeping, agriculture, garment manufacturing and construction.

Contracting becomes a problem when employers unintentionally or deliberately misclassify people who should legally be employees as independent contractors. Whether intentional or accidental, once misclassified as an independent contractor, the employee loses many employee-specific protections. The employee also must pay the employer's share of Medicare and Social Security.[14] The savings to employers from misclassifying employees allow them to offer their products or services at a lower cost than their compliant competitors. In 2013, the IRS estimated that, on average, an employer can save

One Worker's Experience in Encountering and Reporting Underground Economy Violations

Silvia is a former Los Angeles-area car wash worker who participated in the Commission's September 2014 advisory committee meeting.

Silvia told the Commission that she worked for a car wash run by an employer who required her to work 10-hour days for $35. When she finally reported her employer's illegal actions to California's Division of Labor Standards Enforcement (DLSE), she said DLSE faxed her complaint to her employer with her name and signature on it. She had expected it would be anonymous. Her employer called her in front of the rest of the staff and screamed at her, she said: "You are a knife to me, go away! What are you doing here? The doors are open." She told the Commission that he went on to tell her that she was worthless, that she had the same value as a bottle waiting to be taken out for recycling. When he asked if anyone else had a complaint, she told the Commission that no one spoke up. Ultimately, she said the owner cut her hours and reassigned her to a harder work area.

Silvia told the Commission that she also has worked for compliant employers in the car wash industry and valued her work with them. She said the problem is not the industry, but some of the people who work in it. "They need to think that we are people, too," she said.

Despite her experience, she advised other workers to stand up for their rights. "If you file a claim, sign your name," she said. "It's the best defense we could have."

As for her employer who reportedly built a business model on wage theft and harassment? She said he's still in business.

approximately $3,710 per worker per year if the employer misclassifies an employee – and this figure does not capture any state-level savings from misclassifying, such as not carrying workers' compensation insurance for the employee.[15]

The Commission heard anecdotally that the rate of independent contracting is growing in California. Current data is lacking, however, and it is difficult to measure because there is no clear-cut definition of independent contractor. The IRS last assessed the level of employee misclassification in 1984. It found that 15 percent of employers misclassified employees as independent contractors.[16] The IRS is including studies of independent contracting and misclassification in its National Research Program, and expects to publish its results later in 2015.[17]

Studies of other states indicate that rates of misclassification are increasing. In 2000, the U.S. Department of Labor conducted a nine-state study and found misclassification rates ranging between 10 percent and 30 percent.[18] Maine auditors found in 2004 that 29 percent of employers across all industries had misclassified employees. That figure increased to 41 percent in 2007.[19]

Third-Party Staffing

Entrepreneurs also are moving away from the traditional employment structure by contracting with third-party staffing agencies that manage businesses' human resources functions. They hire workers and fulfill employers' legal obligations, including paying the employer's share of payroll taxes and covering employees on their workers' compensation insurance policies. Business owners report that they primarily use temporary workers to fill in for absent employees, provide extra support during busy seasons and staff special short-term projects.[20] Like independent contracting, there is nothing inherently wrong with the staffing agency model. Many workers rely on temporary staffing agencies

Common Cheating Methods

The ways unscrupulous individuals cheat to give themselves an advantage over compliant competitors are limited only by their imagination. Some of the more common ways include:

Counterfeit Goods. Producing or selling counterfeit goods allows an individual to cash in on a name brand while paying significantly less to buy the item than those selling the legitimate product.

Insurance and Provider Fraud. An individual making a false claim often comes to mind as typical of insurance fraud, but there are some groups that establish "paper companies" in order to make large-scale insurance claims, such as disability or insurance, for fake employees. Provider fraud happens when service providers – such as doctors and lawyers – bill insurance companies for services clients never received, and in some cases, for clients that do not exist.

Tax Evasion. The nonpayment or underpayment of taxes. This spans the spectrum of income to sales and use taxes.

Wage Theft. Wage theft occurs when employers do not pay workers the wages and benefits they are legally owed. There are several forms of wage theft. Some of the most common types of wage theft violations include:

- ***Minimum Wage Violations.*** Violations occur when a worker is not paid minimum wage. Even when a worker is paid piece rate, he or she is still legally entitled to minimum wage. The 2015 minimum wage in California is $9 per hour. On January 1, 2016, the state's minimum wage will increase to $10 per hour.
- ***Overtime Violations.*** Violations occur when a worker is not paid for overtime hours. In general, California workers must be paid 1.5 times their regular rate of pay after working eight hours in a day. The overtime rate doubles the worker's pay after 12 hours in a day or after eight hours if the employee has worked seven or more consecutive days. Exceptions are made for alternative work weeks, such as four 10-hour shifts in a week.
- ***Off-the-clock Violations.*** Violations occur when workers are required to work without pay before or after their shifts.
- ***Meal and Rest Break Violations.*** California law requires workers to receive uninterrupted 30-minute breaks when they work five or more hours. Employees also are entitled to a 10-minute rest break for every four hours on the job; violations occur when employees forfeit these breaks.
- ***Late / No Pay.*** California requires an employer to establish a regular payday and post the date, time and location of payment. Generally, employers must pay their employees at least twice per month, with some exceptions. Farm labor contractor employees must be paid at least weekly, for example, while executive, administrative and professional employees may be paid monthly.
- ***Illegal Deductions***. Employers may deduct state and federal required withholdings such as income taxes, insurance premiums if authorized in writing by the employee and deductions authorized by a collective bargaining agreement. In most cases, employers are not allowed to deduct other items from an employee's paycheck. Common illegal deductions include business and equipment expenses, damage or loss, transportation and uniforms.
- ***Tip Stealing***. Employers and managers may not appropriate any portion of employee's tips in settings where tips are customary in California.

Workers' Compensation Insurance Inadequate or Missing. California requires employers to carry workers' compensation insurance for workers who become ill or are injured from work-related causes. Workers' compensation violations occur when an employer does not carry insurance, misclassifies its employees to pay less or discourages sick or injured employees from making a claim.

to fit their part-time schedules or to build industry-specific skills. Some staffing agencies specialize in finding jobs for people who have a difficult time finding employment, such as those with criminal records.[21]

The temporary administrative assistant who once represented the face of the staffing industry, however, has been replaced by the warehouse worker, truck driver or farm laborer. Third-party staffing represents the fastest-growing segment of warehouse industry jobs in Southern California's Inland Empire. Eight of the 10 largest staffing firms in the U.S. now list industrial work as their largest staffing segment.[22]

Problems occur when neither the staffing agency nor the business accepts responsibility for the worker. Employers may purposefully use this employment structure, with its ambiguous delegations of responsibility, to keep costs low. When violations happen, workers have few protections and little recourse if they want to keep their jobs. When there is a problem with a temporary staffing employee – for example, the worker is not fully paid or is injured on the job – the layers between the worker and the client employer can prevent the worker from receiving assistance.[23]

Sometimes the worker is not aware that he or she works for a temporary staffing company until there is a problem. Workers from one hospitality company told Assembly Labor and Employment Committee staff that they wore the uniform of the company, worked the hours set by the company, were supervised by an employee of the company, but when an injury happened, found out they technically worked for a man in a pickup truck in the parking lot, who promptly disappeared.[24] Legislation enacted in 2014 created protections when responsibility for workers is shared among multiple parties, making client employers liable for workers supplied by a third party in certain situations.[25]

Effect on Californians' Health and Safety

California's underground economy and its associated labor violations also escalate the risks for consumers' health and safety. The National Employment Law Project (NELP) conducted a 2014 study on the dangers associated with labor violations in trucking at seaports including Oakland, Long Beach and Los Angeles. Port drivers – often misclassified as independent contractors – reported that even if they needed time off or had exceeded their allowable driving hours, they could not turn down loads for fear of being fired. Federal regulations limit drivers to 60 hours in a seven-day period and require 10 hours of rest after a driver has been on duty for 14 hours or driven 11 hours. A NELP survey of Southern California drivers found 10 percent report working 72 or more hours

weekly, representing a risk not only to themselves but to Californians on the roads.[26]

The president of a courier company based in Southern California described to the Commission her dismay at the labor violations generally endured industry-wide by couriers, largely as a result of misclassification. She reported that drivers often work 14-hour to 16-hour days and earn very little per delivery, from which they need to pay for vehicle fuel and maintenance. These couriers may carry bio-materials from hospitals, physicians groups and laboratories. Though state law requires specialized training for workers who handle bio-materials, the courier company president said few receive training. She noted that couriers are involved with a growing practice of preserving babies' umbilical cord blood so that stem cells can be harvested should the child develop leukemia or other illnesses. Training to transport such sensitive material takes hours, she said, adding that few companies provide the training to their couriers because it is expensive and that time cuts into profits. The result, she told the Commission, is possible compromise of umbilical cord blood and other sensitive materials transported and improperly handled by couriers.[27]

Kris Buckner, president of Investigative Consultants, a Southern California-based private investigative company that works closely with law enforcement, testified to the Commission about the health and safety risks of buying counterfeit goods. Many people think of knockoff purses or athletic shoes when they think of counterfeit products, but contact lenses, for example, are a trending counterfeit item. Mr. Buckner testified to the Commission about counterfeit cancer medicine and other pharmaceutical products being sold by medical facilities. Counterfeiters also sell vehicle brake pads, aircraft parts, bulletproof vests, cough syrup, shampoo and tobacco. People die from using counterfeit products, said Mr. Buckner, and the customer base is not limited to inexperienced or careless shoppers. He told the Commission some public agencies have unknowingly purchased counterfeit goods.[28]

The State's Response to the Underground Economy

California state government agencies have attempted for decades to limit the many dimensions of the underground economy. The state's taxing and labor agencies occupy the front lines of this fight. But a wide range of other agencies also play key or supporting roles and often work collectively within underground economy enforcement task forces. Primary state players include:

Other Important State Actors Combating the Underground Economy

Contractors State License Board (CSLB): A 15-member board appointed by the Governor and Legislature to protect consumers by regulating the construction industry. Anyone performing construction work in California worth more than $500 in materials and labor must be licensed by the CSLB and adhere to its policies. The board's Statewide Investigative Fraud Team (SWIFT) conducts weekly stings and sweeps around the state.

Department of Insurance (CDI): The CDI licenses and regulates insurance companies, agents and brokers in California. It pre-approves property and casualty insurance rates before they go into effect and, since the 1990s, has been a law enforcement agency, with some agents having peace officer status. Divisions within CDI investigate auto insurance, workers' compensation, property/casualty and healthcare/disability fraud, as well as complaints of unlawful activity against the public by those in the insurance industry.

Department of Justice (DOJ): Headed by the Attorney General, the DOJ serves as legal counsel to state officials and represents Californians in actions to protect the environment and to enforce consumer, antitrust and civil laws. The department administers a number of programs designed to protect Californians from fraudulent, unfair and illegal activities.

Sources: California Department of Insurance. "About Us: An Introduction to CDI Operations." http://www.insurance.ca.gov/0500-about-us/0100-cdi-introduction/. Accessed December 24, 2013. Also, Governor's Budget 2013-14 Proposed Detail. "0820 Department of Justice Mission Statement." http://www.ebudget.ca.gov/2013-14/StateAgencyBudgets/0010/0820/mission_statement.html. Accessed December 19, 2013

Board of Equalization (BOE). The BOE was created in 1879 through the California Constitution to regulate county assessment practices, equalize county assessment ratios and assess properties of interconnected railroads. The Legislature and voters have since assigned it additional responsibilities, most notably the authority to collect sales and use taxes. Sales tax applies to retail goods and merchandise except where exempted by law. Use tax is paid on goods purchased from retailers in transactions not subject to state sales tax. The BOE collected $56 billion in revenue in FY 2012-13.[29] Per the California Constitution, the board comprises four members elected from districts and the State Controller, also elected. The BOE is the only elected tax commission in the United States.

Department of Industrial Relations (DIR). Created by the Legislature in 1927, the DIR works to improve working conditions for California's wage earners and to advance opportunities for profitable employment in California.[30] DIR also administers California's workers' compensation program.[31] The department has four divisions and several boards and councils to govern wages, hours and breaks, overtime, retaliation, workplace safety and health, apprenticeship training programs and medical care and other benefits for injured workers. Critical to combating the underground economy is the Division of Labor Standards Enforcement (DLSE), headed by the Labor Commissioner. The division enforces labor standards by adjudicating wage claims, investigating reports of retaliation and issuing licenses for a number of industries.[32] The DIR operates within the Labor and Workforce Development Agency. The DIR director and the Labor Commissioner are appointed by the Governor.

Employment Development Department (EDD). Created by the Legislature in 1935 to provide a monetary reserve to protect the public from the social effects of unemployment, the EDD helps connect job seekers and employers and operates the state's unemployment and disability

insurance programs. It collects payroll taxes from employers and personal income tax withheld from employee paychecks. During 2012, it collected more than $54 billion in employment taxes. EDD is a department under the umbrella of the Labor and Workforce Development Agency in the executive branch. Its director is appointed by the Governor and reports to the Secretary of the Labor and Workforce Development Agency.

Franchise Tax Board (FTB). The FTB's primary purpose is to administer California's personal income and corporation tax laws.[33] It collects corporate income tax and personal income tax from individuals whose tax is not withheld from their paycheck or who owe more than was collected through payroll taxes. Additionally, it collects funds for several non-tax programs and delinquent debt collection functions.[34] The programs it administers bring in approximately $75 billion annually, although approximately 60 percent of those funds are physically collected by the Employment Development Department.[35] The Franchise Tax Board operates within the Government Operations Agency of the executive branch. Its board members, however, are the State Controller and BOE chair, both elected, and the Director of Finance, appointed by the Governor. The executive officer is appointed by the three board members.

State Task Forces Focus on the Underground Economy

While individual agencies can appropriately handle some underground economy violations, witnesses told the Commission that forming partnerships creates more substantial impacts. "Agencies working in silos 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," BOE Chairman Jerome E. Horton wrote in his testimony to the Commission. "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."[36]

Because the underground economy is multifaceted, stakeholders told the Commission, enforcement actions conducted through multi-agency partnerships are natural and effective. It is rare for a noncompliant entity to only cheat in one business area, the Commission heard.[37]

Four major state-level task forces focus on the underground economy. The Labor Enforcement Task Force and the Joint Enforcement Strike Force primarily focus on labor and payroll tax violations. Two more recently established task forces, the Revenue Recovery and Collaborative Enforcement Team and the Tax Recovery and Criminal Enforcement Task Force focus on identifying and prosecuting criminal tax evasion.

Labor Enforcement Task Force (LETF). LETF, led by DIR, was created in 2011 through the state budget process and launched in 2012, a modern iteration of an earlier task force called the Economic Enforcement and Education Coalition (EEEC). The EEEC replaced an even earlier task force called the Targeted Industries Partnership Program (TIPP). Both the EEEC and TIPP used a sweep model of enforcement that sent multi-agency teams to randomly visit businesses and concentrated on a specific region for each sweep.[38] LETF has instead developed and used empirically-based methodology to target businesses in low-wage high-hazard industries. DIR Director Christine Baker testified that this

Underground Economy Task Force Composition

	Agency / Department	JESF	LETF	RRACE	TRaCE§
State	Agricultural Labor Relations Board		✓		
	Alcoholic Beverage Control (Dept. of)	✓			✓
	Board of Equalization	✓	✓	✓	✓
	Consumer Affairs (Dept. of)	✓	✓	✓*	
	Employment Development Department	✓#	✓	✓	✓
	Franchise Tax Board	✓		✓	✓
	Justice (Dept. of)	✓	✓	✓	✓
	Health and Human Services			✓*	
	Industrial Relations (Dept. of)	✓	✓#	✓#*	
	Insurance (Dept. of)	✓	✓	✓*	
	Motor Vehicles (Dept. of)			✓*	
Federal	Federal Bureau of Investigation				✓
	Homeland Security Investigations				✓
	Internal Revenue Service	✓			
	U.S. Dept. of Labor, Wage and Hour Division	✓			

Notes:

✓: Indicates task force member.

#: Indicates task force lead.

***:** Indicates RRACE advisory tier members.

§: Includes state and federal partners as of January 31, 2015; community partners are not included. TRaCE continues to add partners. The task force chairperson is elected by the executive board; the Board of Equalization currently holds chairpersonship.

approach has been more successful than the sweep model of enforcement.[39]

Joint Enforcement Strike Force (JESF). Led by EDD, the JESF was created by executive order in 1993 in response to the Little Hoover Commission's 1985 recommendation that the state create a multi-agency task force to investigate tax and cash-pay violations, publicize enforcement efforts and administer a tip line.[40] The JESF was charged with combating the underground economy by pooling resources and sharing data among the state agencies charged with investigation and enforcing licensing, labor and payroll tax laws.[41]

JESF targets specific industries with historically high noncompliance with licensing, labor and payroll tax laws, including the construction, janitorial, public works and private security industries. EDD's Tax Branch Audit Program delivers administrative penalties for violations found while EDD's Criminal Tax Enforcement Program works with law enforcement and partner agencies to prosecute violations eligible for penalties.[42]

Revenue Recovery and Collaborative Enforcement Team (RRACE). Created by the Legislature in 2013 through AB 576 (Manuel Pérez), RRACE is a pilot program, currently scheduled to sunset in 2019, which created a core team of the state's tax agencies – BOE, EDD and FTB – and the Attorney General's office to share information and create leads for investigation. It also created an advisory team with which RRACE could collaborate and share leads as needed.

By bringing together "agencies that have expertise, data and resources to focus on criminal tax evasion and provide a venue to identify and pursue other crimes with a tax nexus," wrote BOE Chairman Jerome Horton in written testimony, the team fills an enforcement void in the state's older task forces, which did not result in significant criminal tax evasion leads.[43]

Elaborating on Chairman Horton's testimony, Randy Silva, BOE Chief of Investigations & Special Operations, told the Commission:

> *"AB 576 allows the RRACE team to share intelligence, data, documents, information complaints and lead referrals for the purpose of collaboratively investigating and prosecuting criminal tax evasion associated with the underground economy. Previously, each agency primarily investigated such illegal activities in silos rather than collectively. The lack of effective communication among agencies likely led to missed opportunities to capture state revenues that were otherwise lost. This legislation provides clear*

> *direction to the departments of the RRACE Team to share data in its efforts to investigate and prosecute criminal tax related violations without having to navigate through the multitude of Memorandums of Understanding between departments that in some cases have limits to information shared."*[44]

Tax Recovery and Criminal Enforcement Task Force (TRaCE). Established in January 2014 and fully operational in May 2014, TRaCE dovetails with the purpose of RRACE: The information sharing and leads generated by RRACE, in addition to leads generated from other sources, would be acted upon by TRaCE. Leads that would not warrant a criminal investigation by TRaCE would be directed to the appropriate agency for civil prosecution or administrative measures.[45]

A critical feature of the TRaCE partnership is a dedicated prosecutor from the Attorney General's Office with jurisdiction to prosecute crimes anywhere in California. In written testimony, Deputy Attorney General Peter Williams stated:

> *"By dedicating a prosecutor to the task force, as the Attorney General's Office has done here, it has allowed commitments from other agencies to be more forthcoming. Having a prosecutor embedded with the task force allows other agencies to feel comfortable that the time expended by their personnel will result in timely review by a prosecutor familiar with underground economy issues, and likely result in the filing of criminal cases and eventual convictions. Without a dedicated prosecutor, many agencies can be reluctant to commit personnel or resources to a new or novel effort."*

Between May 2014 and December 2014, TRaCE personnel have conducted 42 surveillance, undercover and other surreptitious operations, interviewed 41 witnesses and suspects and obtained 27 search warrants for physical sites and bank records. These actions have resulted in 11 arrests for crimes including piracy, currency and merchandising counterfeiting, sex trafficking, payroll violations, bribery and running illegal gambling rings. As of December 2014, TRaCE members were working on several large, high-dollar wide-ranging cases that include a multi-state cargo theft case, a multi-state tax fraud scheme and a statewide money-laundering scheme.[46]

Local Partnerships and Task Forces Also Fight the Underground Economy

Beyond the state-level task forces, officials at every level of government partner to combat the underground economy. In many of the most

effective efforts, local law enforcement serves as the front line of defense with partners in various state and federal departments. Coordinating these local efforts can expand the range of charges and sentencing consequences and creates a deterrent effect by increasing the risk for perpetrators far beyond a simple cost of doing business. A multi-agency investigation can present legal charges involving combined losses of $400,000 to $500,000, for example, versus a case involving $40,000 to $50,000 by a single agency.[47]

Stakeholders hailed some partnerships as particularly effective, potentially serving as models for other parts of the state. For example, the Los Angeles Police Department's intellectual property crime team, headed by Detective Supervisor Ryuichi "Rick" Ishitani, partners with the Federal Bureau of Investigation (FBI). Detective Supervisor Ishitani has five police officers, including himself, who are cross-deputized as FBI agents and work with five other FBI agents, effectively doubling their resources in California's most populous city. This partnership allows for more comprehensive policing and prosecution. As federal agents, Detective Supervisor Ishitani's FBI partners can only investigate federal crimes and they can only make an arrest with prior indictment by the Assistant U.S. Attorney General (AUSA). The police powers of Detective Supervisor Ishitani's team provide more latitude. However, when cases are best handled by the AUSA, partnering with the FBI allows them to file directly with the AUSA. Detective Supervisor Ishitani also partners with private industry, state agencies such as the Board of Equalization and federal agencies such as the Internal Revenue Service.[48]

County prosecutors frequently play a key role in creating effective partnerships. The San Bernardino District Attorney's Office teams with a variety of actors to combat fraud in the construction industry. Their investigators regularly conduct sweeps with the Contractors State License Board, Employment Development Department and code enforcement investigators. They work closely with Immigration and Customs Enforcement (ICE) to target those who base their business models on undocumented worker schemes. They also have close relationships with the California Professional Association of Specialty Contractors and other construction-related organizations.[49]

Similarly, in San Diego, Deputy District Attorney Dominic Dugo's office houses CDI's San Diego Premium Fraud Task Force. Under the leadership of District Attorney Bonnie Dumanis, he provides permanent workstations for Department of Insurance detectives and forensic auditors, dedicates three district attorney prosecutors and four investigators, as well as paralegals, to the task force, and provides resources for Employment Development Department and Franchise Tax Board investigators.[50]

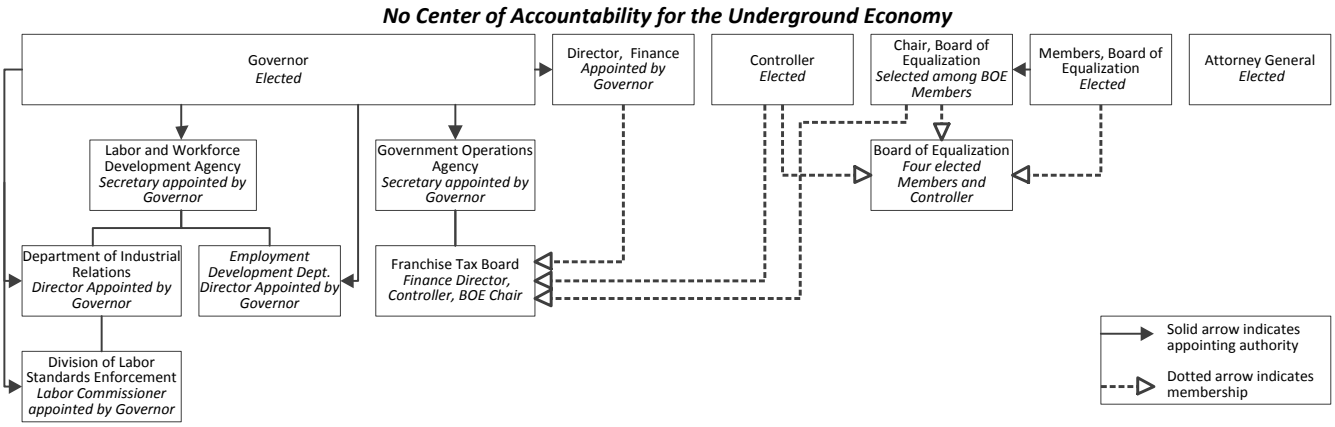
Leadership Void Creates Incentive to Cheat

California's underground economy might best be described as an innovative and constantly-evolving business sector that can handily outpace the tangle of government agencies and alphabet soup of task forces assigned to police it. Policymakers enact laws that regulate business and labor practices but do not allocate resources to enforce them. Penalties for underground economy-related violations are not sufficient to deter lawbreakers and often go uncollected. The larger problem beyond lack of enforcement resources and staffing, however, is the hodgepodge of efforts without a clear center of accountability. California has no single executive to pull together the varying efforts and coordinate a unified response to tackle the underground economy.

Multiple Agencies, No Accountability

As described in the previous chapter, California has one labor and three taxing authorities with jurisdiction over the underground economy. Two of these, the Department of Industrial Relations and the Employment Development Department, are housed within the Labor and Workforce Development Agency. The top officials in these organizations are appointed by the Governor. The Franchise Tax Board is housed within the Government Operations Agency and its board includes the director of the Department of Finance, and two elected constitutional officers. The Board of Equalization is led by five elected officials.

Several other government organizations also have important roles. The Department of Justice prosecutes lawbreakers and the Department of Insurance ensures businesses have adequate workers' compensation insurance, among other duties. Both organizations are led by elected constitutional officers. The Contractors State License Board licenses businesses in the construction industry and conducts sweeps and audits to catch lawbreakers. There are myriad other agencies, departments, divisions, bureaus, boards and commissions that have an impact on the state-level investigation and prosecution of the underground economy. The result is a chaotic jumble of government entities with widely varying missions, goals and resources.



With no one explicitly responsible for reining in the underground economy, the state has responded with various task forces to bring order to the chaos and ideally improve the coordination and effectiveness of state education and enforcement efforts. With no single entity in charge, however, there is no one to eliminate ineffective task forces or modify missions or membership of the existing task forces. And there is no one to even define and measure the problem much less assess whether the state as a whole is investing appropriate resources to combat the underground economy.

Task Forces Fall Short

To curb the underground economy, California operates four overlapping and occasionally competing task forces as described in the previous chapter: the Labor Enforcement Task Force (LETF), the Joint Enforcement Task Force (JESF), the Revenue Recovery and Collaborative Enforcement Team (RRACE) and the Tax Recovery and Criminal Enforcement Task Force (TRaCE). Yet, none of these embody the full scope of the multi-agency task force recommended by the Little Hoover Commission in 1985. At the time, the Commission called for sweeping reforms, including consolidating the state's taxing agencies into a single Department of Revenue and an underground economy task force with a wide scope, dedicated funding and direct reporting to the Governor or a Cabinet member. Having noted that the state's underground economy enforcement efforts were missing a tax focus, the Commission outlined the characteristics a multiagency task force should have to rectify the situation. It should, the Commission wrote:

- Conduct complete audits and investigations of blatant tax violations and cash-pay transactions.
- Consist of representatives from FTB, BOE, EDD, CSLB, DIR, DOJ and district attorneys with representatives from other agencies available to serve as needed.

- Ensure staffing included personnel with backgrounds in sales tax, income tax, cash-pay transactions, unemployment insurance, law enforcement and other appropriate skills.
- Include a public information officer to publicize the task force's efforts.
- Assign teams to every metropolitan area.
- Receive designated funding so that individual departments would not suffer from the loss of personnel to the task force.
- Be given very high priority by the Governor and Legislature.[51]

2002 Reorganization Promised Better Coordination

In 2002, Governor Gray Davis developed a reorganization plan to create the Labor and Workforce Development Agency. The reorganization plan moved the Employment Development Department, which then was housed in the Health and Human Services Agency, and the Department of Industrial Relations, which reported directly to the Governor, into the proposed agency. The plan, submitted to the Little Hoover Commission, identified improved coordination as a major benefit of the reorganization. Specifically, the plan stated:

> *"For workers, coordination will result in improved access to employment and training programs and additional protection of their workplaces. For employers, coordination will enhance enforcement and extend a level playing field that decreases the unfair economic advantage of employers who do not pay employment taxes, the minimum wage or fail to provide workers' compensation coverage."*[52]

In testimony to the Commission in support of the 2002 plan, the former director of the Department of Industrial Relations described how the reorganization would build on the coordinating relationship between the DIR and EDD established through the Joint Enforcement Strike Force. He wrote, "ensuring the various enforcement entities are not only coordinating, but sharing databases, staff allocations, discussing timing of enforcement actions, etc. will increase the effectiveness and consequently, the reach of each individual department and board."[53] The former director of the Employment Development Department in written testimony added, "Californians would benefit by a consolidated Labor Agency that shares data and resources to protect the rights of California workers and businesses. Although the existing statutory partnership between the DIR and EDD provides for coordination of common efforts, focused leadership decisions on resource allocation among state and

federal programs and funding would result in more efficient use of resources and effective program administration."[54]

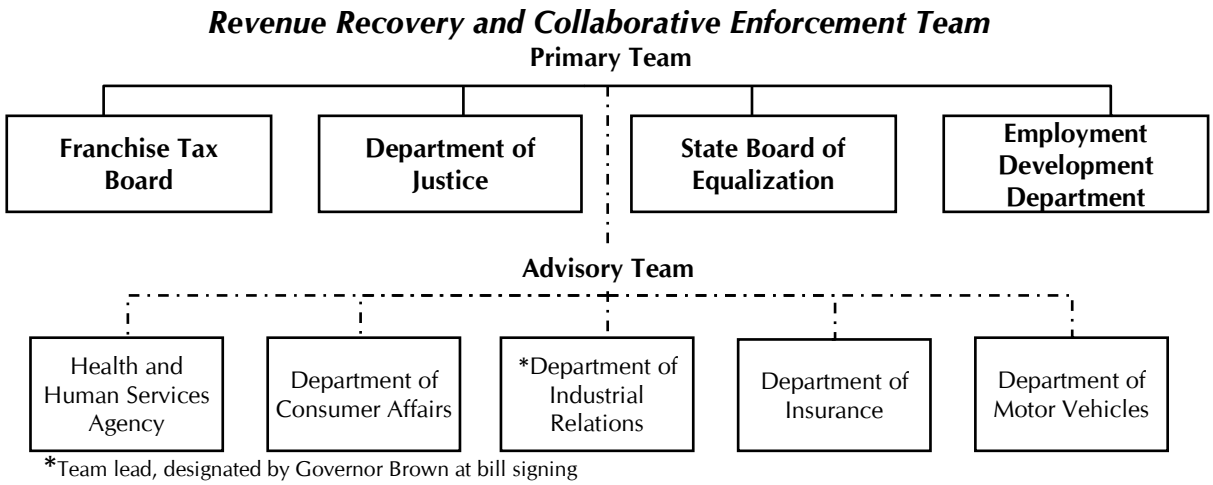
The Commission found the reorganization plan lacked details necessary to conclude with significant confidence the plan would improve service delivery. However, receiving no opposition to the plan during its review, the Commission recommended the Legislature allow the plan to go forward. Still, the Commission noted, "with no changes to actual programs or their organization, there is little evidence that enforcement activities will be more effective than they could be today."[55]

More than a decade later, efforts are being made to act on past promises to improve coordination. In late 2013, the Labor Enforcement Task Force and the Joint Enforcement Strike Force began an administrative collaboration called the LETF/JESF Collaborative Enforcement Partnership. The purpose was to improve communication and foster joint use of resources through joint strategic executive meetings and bi-weekly operational meetings. One of the outcomes of this partnership has been cross-training to leverage the resources of both programs.[56]

Additionally, random sweeps – once the hallmark of the two task forces – have been replaced by more focused and data-based investigations. During the course of this study, business owners repeatedly told the Commission that this was a welcome improvement. They said that past practices typically focused on minor infractions by otherwise compliant businesses, while organizations completely ignoring labor and employment laws often escaped state scrutiny. The Commission acknowledges and applauds the recent efforts of Labor Commissioner Julie Su and the DIR and EDD leaders in their shift toward targeted, evidence-based investigations and their efforts to coordinate and cross-train staff.

Governance Structure Challenges the New Task Force

Assembly Bill 576 (Manuel Pérez), enacted in 2013, was supposed to fill a long-recognized need for a task force to focus on criminal tax evasion. Although the focus of the task force is primarily tax evasion, Governor Brown designated the Department of Industrial Relations as the RRACE lead when he signed AB 576 into law, despite the fact that DIR is a labor-focused agency with no tax jurisdiction. Problematically, DIR does not have access to confidential tax information. Tax agencies have strict controls on how they use the sensitive information they receive from businesses and individuals, and face severe penalties for sharing it inappropriately. State tax agencies could lose their access to IRS data – key to unearthing underground economy-related financial crimes – if they share information with unauthorized parties. As a result, a



legislatively-designated advisory member without access to tax information is leading a team of tax agencies to generate leads on tax-related crimes. The task force has existed for more than a year and has not yet generated any leads for state investigators.

Meanwhile, Another Task Force Emerges

Following the establishment of RRACE, officials at the Board of Equalization and the Department of Justice moved forward to fight the underground economy by establishing the Tax Recovery and Criminal Enforcement Tax Force (TRaCE). TRaCE has partnerships with various state, local and federal organizations and investigates and prosecutes leads generated from these sources.

While individual agencies take administrative action against infractions and have investigative divisions to put together cases for criminal prosecutions for more egregious offenders, TRaCE, like RRACE provides a multi-agency financial crimes-focused task force. By necessity, TRaCE must triage the leads it receives and focus on the worst of the worst. Deputy Attorney General Peter Williams told Commission staff that the task force turns away an average of 15 cases per month because of resource constraints, not meeting dollar value or multiple agency thresholds or some combination thereof.[57] In order to transform business culture into one of voluntary compliance, the impact of TRaCE must be felt by run-of-the-mill criminals: Those who are not running elaborate multi-state operations or trafficking humans on the side. A change of culture necessitates significant outreach to educate those who are misinformed and for the truly criminal, recognizing there is a real possibility the task force could be coming for them. During its short tenure, the TRaCE team has shown promising results. In March 2015, a second TRaCE team will be launched and based in Los Angeles. But

these two multi-agency financial crimes teams with two prosecutors are not enough in a state as large as California. At a minimum, California should have a multi-agency financial crimes-focused task force based in every major metropolitan region.

In this review, the Commission learned that TRaCE established a web presence that includes one-stop reporting for all types of underground economy-related crime and also has created a repository to house all incoming complaints from the public, other law enforcement agencies and informants.[58]

The simultaneous emergence of both RRACE and TRaCE has been challenging and confusing for some of the agencies involved in both efforts. Departments are legislatively mandated to devote resources to RRACE, which already has spent one of its six allotted years of the pilot project holding committee meetings and developing an operational framework. Significant information sharing challenges remain. Instead of augmenting the state's underground economy enforcement efforts, the RRACE/TRaCE bifurcation could potentially spread limited resources even thinner.

No task force has the breadth, funding and relationship with the state's chief executive that the Commission envisioned in 1985. It took nearly 30 years to create a task force to focus on lost criminal tax revenue, yet this program has limitations: As a pilot program, it is set to expire in 2019 unless reauthorized by the legislature. Its designated lead lacks access to the information that the team is supposed to be sharing.

To overcome the jurisdictional challenges that have prevented the state from successfully fighting the underground economy, the Governor should appoint a short-term independent policy advisor with clear authority to eliminate the barriers and to develop a strategy for efficiently going forward. This advisor should monitor the task forces and interagency partnerships to ensure they are organized efficiently, eliminate or restructure task forces that are ineffective, ensure there are sufficient resources and that there are no gaps or overlaps. This leader must be able to work with and garner cooperation from the various elected officials who lead the organizations that have jurisdiction over the underground economy outside of the Governor's purview, including the Board of Equalization members, the Attorney General and the State Controller.

Performance Metrics and Outcomes

The Commission was encouraged to learn that state agencies are adjusting the metrics of their performance outcomes from numbers of citations issued or inspections conducted to outcomes with a greater impact on the underground economy. By focusing largely on the number of citations, investigators often seek quick, easy violations – such as the fire extinguisher being in the wrong place – instead of addressing the more serious problems that constitute the underground economy. Even focusing on metrics such as arrests and restitution ordered does not capture the overall outcome. Important questions remain unanswered: How much restitution was actually collected? How much deterrence was accomplished by an enforcement method? What is the effect of these actions on the underground economy? Employment Development Department officials, for example, publish JESF's performance metrics in the task force's annual report to the Legislature. One metric they track, in conjunction with the State Contractors License Board, is the amount contractors eligible for license suspension owe to EDD and how much is actually collected.[59]

BOE Chairman on Performance Evaluation

"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."
– Jerome Horton, Chairman, Board of Equalization. January 23, 2014. Written Testimony to the Commission.

According to Department of Justice deputy attorney general Peter Williams, TRaCE uses 39 performance metrics to measure progress, but focuses on two core performance outcomes. One is for tax revenue to increase without raising taxes. The other is a culture change among business people who currently evade taxes as part of doing business and view any enforcement actions as a cost of doing business. He acknowledged that these outcomes are difficult to measure. Incoming revenue is influenced by many factors and determining the cause and effect from TRaCE's efforts will not be easy. Measuring culture change and its causes will require 'soft' metrics, such as informants' reports. Mr. Williams indicated that at a minimum, he hopes to establish correlation, if not causation. "We don't want to be in existence just to exist," he said. "If we're not making an impact, or the right impact, on culture change and revenue, then we should reconsider what we're doing."[60]

Measuring deterrence and identifying the cause of increased tax revenue or culture change is difficult. Still, the state should develop a plan to

measure the underground economy and the impact of different state activities on the underground economy in order to answer a basic question: Are efforts to halt the underground economy working?

State Enforcement Resources are Insufficient

Data the Commission requested in the course of this review reveal that resources for tackling the underground economy have not kept pace with the state's business environment, which has grown in size and complexity during the past several decades.

California's population, and consequently its number of businesses and employees, has increased dramatically since the Commission last reviewed the underground economy in 1985. At the time, the U.S. Census Bureau estimated the population of California to be 26.4 million.[61] Between 1985 and 2014, California's population grew to be 38.5 million.[62] In 1992 there were 2.5 million businesses in California. That number has increased to 3.6 million.[63] Although the vast majority – some 99 percent – is small businesses, many without employees, the number of businesses with employees also has grown in California to 1.3 million employers in 2014 from 621,094 employers in 1985.[64]

1:144,000

The ratio of payroll tax investigators to employers in California

The Commission heard repeatedly that the state does not adequately provide resources for underground economy enforcement efforts. At the Commission's request, officials from the Employment Development Department, Board of Equalization, Franchise Tax Board and Department of Industrial Relations provided data on staffing and funding levels for investigation and enforcement efforts associated with the underground economy over time. Based on the data provided, the Commission found that investigative resources have remained flat and in some cases declined, and the departments that have increased enforcement resources have not grown commensurately with growth in the economy and regulations:

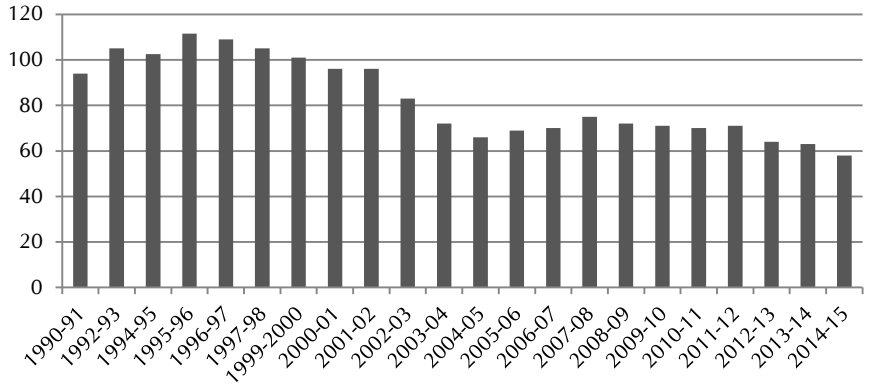
- As the number of employers expanded in the early 1990s, so did the Employment Development Department investigative division staff, peaking at 111 positions in FY 1995-96. Since then, staffing has steadily decreased while the number of employers has grown. In FY 2014-15, the investigative division has 58 staff members for California's 1.3 million employers. Just nine of

those 58 are payroll tax investigators.[65]

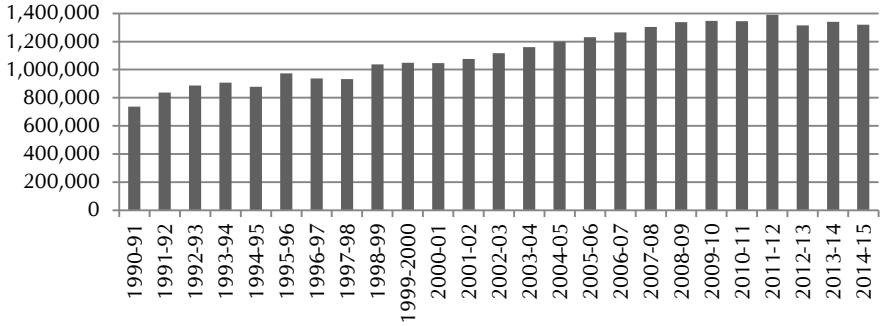
- California's other two tax agencies – the Board of Equalization and Franchise Tax Board – are under-resourced compared to the IRS. Franchise Tax Board officials told the Commission that the IRS devotes approximately 3 percent of its personnel to investigative functions.[66] BOE's investigative division represents approximately 2.3 percent of its personnel resources, while the FTB's represents roughly 1.16 percent of its personnel resources. This equals approximately one criminal investigator for every 220,500 individual and business returns received.[67]

EDD Investigative Division Staffing Levels, FYs 1990-91 to 2014-15

No Data Available for FYs 1991-92, 1993-94 and 1998-99



Employers in California, FYs 1990-91 to 2014-15



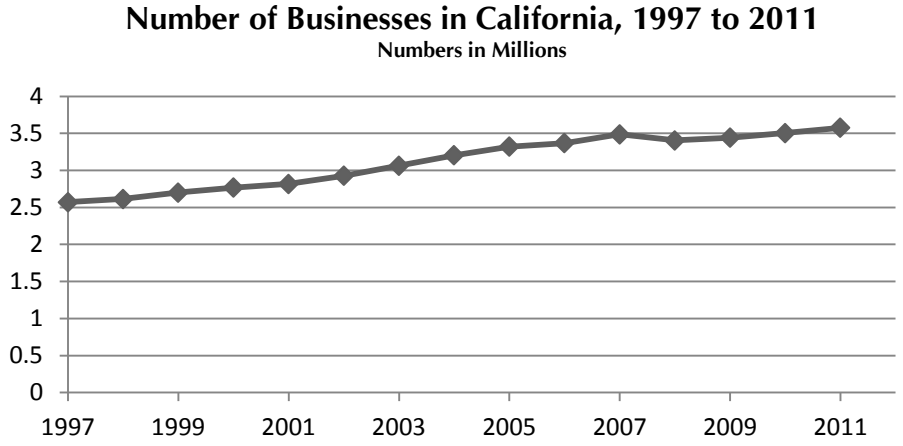
- The Department of Industrial Relations has increased its underground economy enforcement-related staffing, but not at a rate comparable to business growth in California. The number of businesses in the state grew by 29 percent between FY 2001-02 and 2013-14, while its personnel who work on activities associated with the underground economy grew by only 10 percent during that same time. The Division of Labor Standards Enforcement – charged with enforcing Labor Code

statutes designed to protect workers – in FY 2013-14 had approximately one staff member focused on activities associated with the underground economy for every 55,000 workers.[68]

1:55,000

The ratio of DLSE underground economy-focused staff members to workers in CA

The graphs below summarize the personnel data received by the Commission. The full data provided by these agencies, including funding data for underground economy-related enforcement activities, can be found in Appendices E – H.



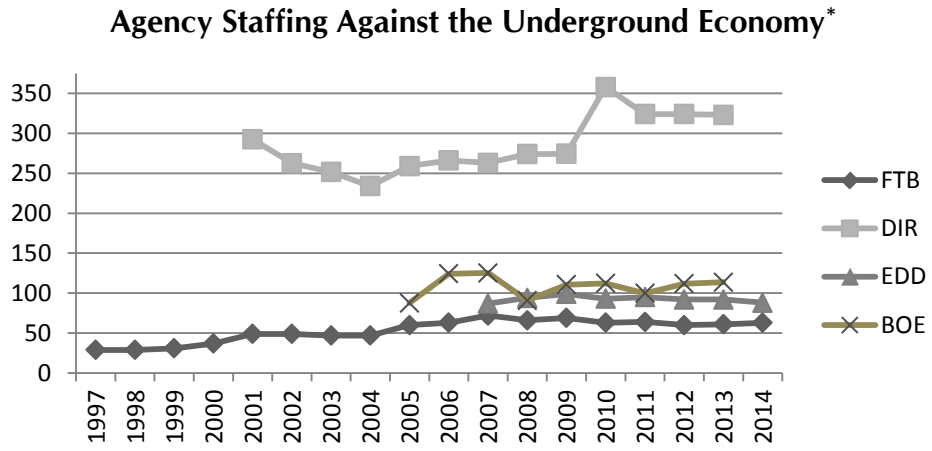


*Chart updated with EDD staffing information specific to the underground economy. See page 101 in Appendix E.

The state's unwillingness to invest in adequate resources to claim the money it is owed baffles law-abiding business owners. "If you tell this group of businessmen there is a billion dollars on the other side of that wall and we just have to go get it," said Ed Waldheim, head of a family-owned janitorial company, "we'll get the manpower to go get it. Why won't the state?"[69]

Californians pay taxes with the expectation that the government will use their tax dollars to protect law-abiding business owners from unfair competition, consumers from con artists selling unsafe products and hard-working Californians from exploitative employers. "It's the state's job to protect workers," said advisory committee meeting participant Jose Mejia. "When something in your home breaks, you have to fix it. The same goes for the state. You have to find the revenue to fund enforcement, period."[70]

1:220,500

The ratio of FTB criminal investigators to annual returns filed

More Regulation, Greater Complexity

Not only has the number of businesses increased in California over the past several decades but so has the complexity of the rules compliant businesses must follow. During its 2011 study of California's regulatory landscape, *Better Regulation: Improving California's Rulemaking Process*, the Commission heard that most regulated businesses recognize rules as the foundation of a fair, safe and stable society, but also feel burdened by them, especially when they seem inconsistent and produced through a process with little transparency or accountability. The Commission also heard repeated complaints from business owners about the overlap of state, federal and local regulations. The resulting confusion makes it hard to plan expansions and make investments, and consequently undermines their confidence in the system. The Commission found that state regulation writers must consider alternatives to lessen impacts on small businesses.

Participants in this study expressed frustration at the cost of complying with excessive regulation, particularly when operators in the underground economy gain a financial advantage from circumventing it.[71] One business owner outlined 21 to 22 – depending on the year – different local, state and federal entities with which he must interact annually through permits, fees, reporting or inspections. This number did not include interactions within each agency or department, such as

collecting sales tax for the Board of Equalization and complying with the relevant special tax and fee programs it administers.[72] Many business owners and industry representatives agreed that California's labyrinth of numerous and costly regulations could incentivize some businesses and consumers to consider unlawful behavior to reduce expenses.[73] Further, when the law is confusing or unclear, for example when defining independent contractor, some may slip into noncompliance because they are unable or unwilling to expend the effort and financial resources to make sense of it.[74]

Funding enforcement comes down to fairness and transparency. Honest businesspeople pay a high price to comply with the state's many laws and regulations. When legislators enact laws, but refuse to allocate the funding necessary to enforce them, they give cheaters an unfair advantage. If the state has no intention of enforcing a law, it should remove the law from the books. Compliant businesses should not be held to laws their competitors can break with impunity.

Excessive Reserves of Special Funds for Enforcement

Some enforcement funding comes from siloed special funds with strict rules on how the money can be spent. The Department of Industrial Relations, responsible for Californians' safety and protecting California's most vulnerable workers, received no state General Fund allocation in fiscal year 2014-15 and is not budgeted to receive any in fiscal year 2015-16. Instead it relies entirely on money received through special funds. Many of these special funds come from fees charged to employers. Each of these special funds has rules determining how the money can be used. Further, several of these funds funnel revenue away from the purpose of the fund into a reserve. Saving some money for the future, particularly for those funds that have a history of overspending, can be prudent, but some of the amounts of money that remain unspent in certain funds seem illogical given the dearth of enforcement resources.

The Car Wash Worker Fund, which funds enforcement of the car wash industry and administration of a related employee wage restitution fund, stands out when compared to all of the special funds for enforcement. The fund was created in 2003, when Governor Gray Davis signed AB 1688 (Goldberg) into law. The law requires car wash employers to register with the Labor Commissioner and pay a $300 registration fee for each car wash location: $250 is deposited into the Car Wash Worker Fund and the remaining $50 is deposited into the restitution fund.[75] Penalties collected for failing to register are divided equally between the two funds.[76]

Initially, the Division of Labor Standards Enforcement spent the revenue accrued through the Car Wash Worker Fund. In 2006-07, however, Governor Schwarzenegger diverted some of the fund's resources into a reserve for economic uncertainty.[77] The following year, using his line item veto, the Governor eliminated five DLSE positions "provided for recently enacted legislation including the registration of employers in the car washing and polishing industry."[78] In his veto message, he stated that the reduction was necessary "to further build a prudent reserve in light of the various uncertainties in revenues and spending that we face this year."[79]

Since then, each year's budget has channeled approximately half of the fund's revenue away from administration and enforcement into the reserve. In 2014-15, the fund is projected to receive $408,000 from car wash registration fees and penalties. The Legislature has appropriated $216,000 to DIR to spend for enforcement and restitution fund administration. The other 47 percent of the fund's revenues will go to the reserve for economic uncertainties. The funding is similar in FY 2015-16. By the close of the 2015-16 fiscal year, the reserve will total than $4 million and amount to more than 19 times the annual operating budget for enforcement.[80]

With limited resources for enforcement, it is indefensible that the state continues to build such a large reserve from this funding source. Law-abiding business owners are being charged a fee – that their noncompliant competitors do not pay – with the promise of enforcement against those noncompliant competitors. Instead of using the fees to fully fund enforcement, however, the state since 2006 has used approximately half of the fund's annual revenue to build up a reserve. If the state is to make progress against the underground economy, it needs the cooperation and buy-in of California's millions of honest entrepreneurs. The Car Wash Worker Fund provides a striking example of how the state erodes trust in government.

Both compliant business owners and worker advocates told the Commission about the need for better enforcement in the industry. The state should work with stakeholders to determine and then fund an adequate level of enforcement, leaving a prudent reserve for economic uncertainty. If the state is unable to provide fee payers the enforcement they are funding, the Labor Commissioner should adjust the fee. Labor Code Section 2059 gives the Labor Commissioner the authority to periodically adjust the car wash registration fee for inflation to ensure that the fee is sufficient to cover actual administration and enforcement costs. Presumably, the Labor Commissioner could lower the fee and if not, the code should be amended to provide for a fee reduction when a prudent reserve is established. Additionally, the Joint Legislative Audit

Committee could request that the California State Auditor conduct an audit of the various special funds.

Crime Actually Does Pay

People participate in the underground economy because the rewards outweigh the risk. Penalties are meaningless and unenforced, stakeholders from multiple industries and levels of government told the Commission, and people conclude they can get away with it without facing consequences. The head of one police department's anti-counterfeiting unit reported that he has five officers, including himself, to monitor a city of four million people. He asked the Commission to extrapolate what that means in terms of potential consequences for lawbreakers, who have a significant impact on law-abiding business owners in the area and the state's lost tax revenue. "Your low-level street vendor makes maybe $4,000 a month in cash," he said. "A mid-level distributor might make $1 million per year in cash. [As the intellectual property crimes team], some think that we just care about how much Louis Vuitton makes," he said. "It's more than that. These are organized crime groups, sometimes terrorists. We care about how much money these groups are making. We care about what this represents in lost taxes. How this is hurting the state."[81]

Prosecutors told the Commission that the criminal justice system lacks understanding about the significance of underground economy-related offenses. White collar crimes are treated as a nuisance, they explained, with one prosecutor describing them as the "ugly stepsister" of the legal system. They reported their cases being reduced to misdemeanors in court and encountering reluctance to impose stiff penalties on businesspeople: There is an attitude of "just let them pay it back."

San Bernardino Deputy District Attorney David Simon told the Commission that in his experience, it is possible to get resources for prosecution and appropriate adjudicative attention when cases are worth millions of dollars. The problem is with smaller cases. "Death by a thousand cuts is killing some industries," he said. "Not one of these cases hits above the $100,000 threshold, but combined, they're destroying industries in communities. There is an enforcement problem with these little cases, when there is no possibility of prison because the dollar amount is too low."[82]

Jennifer Lentz Snyder, head deputy of healthcare insurance fraud in the Los Angeles County District Attorney's Office, told the Commission that the prosecutor's responsibility is to help the bench understand the intricacies of complex white collar criminal cases that judges might not be used to trying, but it also would help if the law were clear.[83]

Legislature Should Define "Independent Contractor"

One legislative fix to clarify the law would be specifically identifying what constitutes an independent contractor. Misclassifying employees as independent contractors can result in significant cost-savings for employers, particularly in labor intensive industries, making it difficult, if not impossible, for compliant companies to compete.

In part, the reason behind misclassification is the lack of a standard definition of independent contractor. In California, the definition of an independent contractor varies among departments. The Division of Labor Standards Enforcement, within the Department of Industrial Relations, states on its website: "There is no set definition of the term 'independent contractor' and as such, one must look to the interpretations of the courts and enforcement agencies to decide if in a particular situation a worker is an employee or independent contractor."[84] Stakeholders told the Commission that properly classifying employees is often confusing and compliance would be easier if there were a consistent definition across state agencies.[85]

"Independent contractors are how underground economy participants shroud themselves in the illusion of legitimacy," Ms. Snyder said. "The 1099 sniff test is very vague. If you are up against a good defense attorney or a smart businessperson, you can't bring them down."[86] The president of a small business association echoed her call to carefully select a definition of independent contractor and apply it uniformly. "Sit everyone around a table and choose a definition of independent contractor … clarify it and be consistent. We need uniformity and consistency."[87]

The murky definition of independent contractor makes it difficult for entrepreneurs to comply with the law. The state must do a better job at helping businesses become compliant and save enforcement remedies for those who knowingly break the rules. Until rules and definitions are clear, businesses should be provided a safe harbor when following advice from administrative agencies.

White Collar Crime Penalties Too Lax?

The Little Hoover Commission for more than 20 years has called for an examination of California's sentencing laws and penalties to reduce disparities and increase fairness. In this review, the Commission again found that the state lacks a coherent strategy for its penalties for white collar crime. Stealing $10,000 from employees should not be treated more leniently than stealing $10,000 from a bank. No one has taken a

broad look at whether existing sentencing laws and penalties are effective at reducing the underground economy.

Stakeholders highlighted laws and inconsistencies that contribute to lax penalties for underground economy-related violations:

- 2,500 cartons of cigarettes make illicit tobacco sales a felony. But only 100 counterfeit DVDs bring felony charges.[88]
- The state's identity theft statute – frequently used when prosecuting workers' compensation fraud cases – has no teeth, prosecutors said.[89]
- Statutes of limitations for many white collar crimes are short, forcing prosecutors to move quickly on the information they have instead of building a case that might carry more substantial penalties because they can't wait six months before another agency's audit is concluded.[90]
- Restitution granted through asset seizure under Penal Code Section 186.11 is proscribed under narrow circumstances, prosecutors told the Commission. An offender must be charged with two felonies of more than $100,000 with the white collar enhancement activated, or a fraud and an embezzlement-related felony of more than $100,000. If the statute were expanded so that it could be triggered whenever there was a loss of $100,000 or more, the state would be able to recover greater amounts of restitution.[91]

The state should assess existing sentencing laws and penalties for white collar crimes and, where appropriate, make adjustments to ensure that rewards do not outweigh the risks for committing these types of crimes. The state also should identify and refine areas where laws are unclear or inconsistent.

Restitution to Victims is Challenging

Restitution to victims of underground economy offenses is another key challenge for the state, whether at the administrative level or through the criminal justice system. In 2012, the Division of Labor Standards Enforcement collected only 17 percent on final judgment restitution amounts (this number does not include the restitution collected before judgment, which was more than $40 million dollars in 2013).[92] To Labor Commissioner Julie Su's credit, the 17 percent collections rate on final judgments has more than doubled from rates of prior years.[93]

State and local prosecutors told the Commission that, while they can get restitution orders, collecting the restitution is another matter because

people launder assets or pass them off to others. Prosecutors said they need more robust ways to subject individuals to financial scrutiny. An Assistant U.S. Attorney told the Commission that her colleagues use debtors' exams, through which defendants answer questions under oath about their assets, and they also require defendants to disclose financial resources before sentencing.[94]

Information is only one part of the equation, however. Collecting restitution requires earlier physical control of a defendant's assets, otherwise assets are often inaccessible by the time a defendant is sentenced.

Stakeholders presented a number of ideas to the Commission for enhancing access to assets for restitution. Among them: a suggestion to restructure asset forfeiture laws to freeze assets at arrest. Law enforcement officials would have to prove to a judge that the assets were gained unlawfully. The judge would then issue a warrant and the funds would remain in escrow until the defendant is tried and either found not guilty or convicted.[95] This idea is getting traction with state legislators. In January 2015, Assemblymember Matthew Dababneh introduced AB 160, which would expand the list of offenses that could subject a person to prosecution for criminal profiteering activity to include piracy, insurance fraud and tax fraud. Under the California Control of Profits of Organized Crime Act, this would enable the prosecution, in conjunction with certain criminal charges, to file a petition for asset forfeiture in these cases.[96]

The Assistant U.S. Attorney told the Commission that her agency has a financial litigation unit to track and retrieve assets from individuals convicted of wrongdoing. County prosecutors told the Commission that while California code does allow for civil remedies for unpaid restitution orders, they often do not have the resources to pursue that option. A representative from the California Department of Justice said that his department's former staff position devoted to collecting restitution no longer exists.[97]

Summary

California's long campaign against the underground economy suffers today from a lack of leadership. The Legislature makes well-intentioned laws to help law-abiding businesses and their employees compete, but it doesn't allocate robust funding to enforce them. Penalties to deter participation in the underground economy are not sufficient. California lawmakers have not done the hard work of reviewing and revising laws so

that risks of underground economy practices might outweigh the rewards.

Meanwhile, no single authority in particular administers the laws that do exist. California needs a coordinated focus to determine a desired outcome, untangle the current overlap of responsibilities, bridge silos and move efficiently toward results. The Governor should appoint a short-term independent policy advisor to cut through the red tape, identify existing bureaucratic obstacles as well as recommendations for overcoming these obstacles. This leader must be able to work with and garner cooperation from the various elected officials who lead the organizations that have jurisdiction over the underground economy outside of the Governor's purview, including the Board of Equalization members, the State Controller, and the Attorney General.

Without a focused effort, underground economy participants can conveniently continue to believe they will not get caught. Or if they do get caught, any penalty will be minor. And if they are assessed a penalty, the government is unlikely to collect it. The state's failure of leadership has created the perfect incentive to cheat.

Recommendations

Recommendation 1: The Governor, in consultation with state leaders who have jurisdiction over the underground economy, should designate an independent chief policy advisor for the underground economy and give that leader the authority to take action to eliminate the barriers that have prevented the state from successfully fighting the underground economy. This independent policy advisor should:

- Monitor the state's task forces and interagency partnerships to ensure they are organized efficiently, eliminate or restructure task forces that are ineffective, ensure they have sufficient resources and that there are no gaps or overlaps in enforcement of the constantly-evolving underground economy and develop recommendations to eliminate barriers that are preventing these task forces from being fully effective.
- Lead a strategic planning process to develop performance outcomes for combating the underground economy. Review enforcement staffing and funding levels and work with legislative leaders to develop a plan to adequately fund enforcement.
- Report on progress and any barriers requiring administrative or legislative changes within six months. Before the advisor's work concludes, work with the administration to designate a position that will periodically review the state's efforts to combat the underground economy.

Recommendation 2: The Governor and Legislature should establish a prudent reserve for the special funds that support the Department of Industrial Relations and use the rest of the revenue accrued through the special funds to expand enforcement.

- State officials should work with stakeholders to determine enforcement needs and allocate funding authorization accordingly.
- If the state is unable to provide fee-payers the enforcement they are paying for, then the state should reduce their fees to support the level of enforcement actually provided.

Recommendation 3: With stakeholder input, the Legislature should enact a law that defines independent contractor. This definition should be standardized across state agencies.

Recommendation 4: The Legislature should assess existing penalties for white collar crimes and make adjustments to ensure rewards do not outweigh the risks of participating in the underground economy. The Legislature should identify and refine areas where legal definitions are unclear or inconsistent.

- Until inconsistencies are resolved, individuals receiving advice from administrative agencies should receive safe harbor for following the advice given to them.

Recommendation 5: The state should refine and expand its asset seizure laws to improve the collection of victim restitution.

Improving Tools for Enforcement

A common thread emerged over the course of this study process: The state needs not only to expand enforcement efforts, as described in the prior chapter, but also to improve enforcement efforts. This recommendation came from a broad spectrum of Californians who are often at odds on many issues but spoke in unison on the state's need for better tools to police the underground economy: business owners, labor groups, state and local officials, workers, taxpayers. Participants on the various state and local task forces and partnerships provided a unanimous answer when queried on the tools they need to more effectively enforce state laws: better information.

Successful Information Sharing

Information sharing lies at the heart of successful investigation and prosecution of the underground economy. On one level, this occurs by sharing leads and tips. When a Board of Equalization (BOE) auditor finds indicators of criminal tax fraud, for example, the auditor will refer the case to the Investigations Division for possible criminal investigation of tax evasion. The Investigations Division also receives leads from the public, confidential informants, industry, other government agencies, law enforcement, its own inspection program and task forces. On large-dollar tax evasion cases, BOE shares data and collaborates with the U.S. Attorney's Office, the Bureau of Alcohol, Tobacco, Firearms and Explosives (ATF) and the California Department of Justice. In 2010, they formally established a specialized tobacco task force, called Operation Big Pinch, which has since identified over $100 million in tax losses. As of December 2014, their efforts won more than $33 million ordered in restitution to the BOE and convictions of 23 defendants.[98]

Information sharing can take the form of a deep investigation into different agencies' numbers. Orange County Deputy District Attorney Debbie Jackson told Commission staff how their forensic auditor works with companies and state agencies to determine underreporting and provide the data to build a case. The forensic auditor does the difficult job of reconciling all of the numbers, which reduces everyone's workload because each agency does not have to perform its own analysis.[99]

Other types of information sharing include collaborative databases. The California Department of Insurance (CDI) has a database for suspected fraud. Investigators can locate a record and see what actions the department has taken against a suspect.[100] Not all solutions are high-tech or expensive. District attorneys have access to the Consumer Protection Index Network, a blog that allows them to learn what actions are being taken against particular entities. This is useful when a business that has an injunction against it in San Diego County, for example, attempts to re-open in Imperial County.[101]

Finally, information sharing can take the form of cross-referencing data. Riverside County Deputy District Attorney Homan Hosseinioun, for example, uses information from the Department of Motor Vehicles (DMV) and the BOE to investigate the relationship between cars sold and sales tax paid.[102] Similarly, the Division of Labor Standards Enforcement (DLSE) and EDD are strengthening their information-sharing relationship for cross-referencing data. Labor Commissioner Su said her investigators may go onto a site and find 100 employees, then see that EDD only has 50 employees listed for the employer in question. The investigators are quickly able to ascertain a problem. She described "a wealth of information" coming from this relationship.[103]

These data sharing success stories provide models for solving crimes. The Commission was told repeatedly, however, that greater data sharing would improve underground economy enforcement efforts, but there are barriers that impede better data sharing.

Policy Impediments to Information Sharing

Departments grapple with how to share sensitive federal and state tax data that could be immensely useful in identifying criminal tax evasion and labor law violations. Franchise Tax Board Executive Officer Selvi Stanislaus testified:

> *"Data collection and sharing has improved considerably since the Commission last issued its report on the underground economy, but it still presents a challenge for investigators. FTB obtains personal information from various sources including the IRS and other agencies that have rules governing the use of that information. The same is true of other state agencies that obtain personal information for their particular use.*
>
> *The rules are not arbitrary, but reflect the need of each agency to ensure that its information is not used inappropriately. As a result, agencies are often reluctant to*

> *share this information for fear of losing access to the very information that is critical to [their] business operations.*
>
> *For example, FTB databases contain federal taxpayer information. Providing unfettered access to this data by other state agencies would violate existing federal privacy agreements and put at risk its ability to secure this critical data.*
>
> *FTB investigators must navigate through these often complex provisions as they conduct their investigations. In most cases, the barriers can be overcome, but it consumes time and can prolong an investigation.*"[104]

Similarly, EDD Investigation Division Chief Lisa Schmith testified, "Federal restriction of sharing key Internal Revenue Service data is one barrier to conducting joint investigations. Enforcement agencies should work collectively to seek changes at the federal level to remove the restrictions to data sharing, thereby giving all agencies access to data that can be used to combat underground economy activities and enforce labor and tax laws."[105]

In addition to legal restrictions, cost is also a factor when developing an information sharing agreement between agencies. Information sharing is more than simply emailing a file: It requires determining what data is needed, how it will be used, developing and implementing safeguards to keep it from being used inappropriately and often, bridging multiple technology systems. These processes are time-consuming and can be expensive. When state officials negotiate how to share data, often the costs are prohibitive and much time is lost determining how the financial burden associated with information sharing will be distributed. Data sharing costs are something that could be addressed by the Legislature through the budget process. The Commission was encouraged, however, to learn that the state's three tax agencies are working on a consolidated master information sharing agreement, expected to be adopted in 2015, that would allow them to more easily share certain types of tax data. There are limitations to this agreement, and it does not expand non-taxing agencies' access to data, but it is a step toward efficient information sharing.

Not only are information sharing problems encountered across agencies and departments and at different levels of government, but data sharing across divisions within departments also can present challenges. A prosecutor told the Commission about working with state departments' criminal investigators, only to discover shortly before going to trial that the departments were pursuing administrative action against those he

was taking to trial. Collateral estoppel prevents him from prosecuting once the administrative side of an agency has taken action against a violator. Time and resources could be saved, he told the Commission, if administrative and criminal sides of a department or agency better communicated with each other.[106]

Technological Obstacles to Information Sharing

The state lacks the technological capacity or information-gathering wherewithal in many cases to share information. Labor Commissioner Su, for instance, explained that DLSE conducts a certain number of quarterly employer checks to ensure employers have workers' compensation coverage. The department cross-references EDD data against the Workers' Compensation Insurance Rating Bureau (WCIRB) database. Commissioner Su reported that the bureau is helpful and willing to share information with DLSE – as required by law. The problem, she said, is the database is unreliable. "Effective information sharing depends on effective information gathering," Commissioner Su said.[107] The right laws and the right policies do not matter if the state does not have the right information in the right format.

Others concurred. Each department has a different system. FTB recently replaced its information technology system. EDD replaced its system in 2011. The BOE is in the process of replacing its data system. As these departments replace and update their technology, some state entity – the Department of Technology, for example – should be ensuring that technology does not create an additional barrier to sharing information across departments and agencies.

Technology woes apply to internal data sharing as well. "One of the biggest barriers is a lack of an effective database in each of the separate agencies," Labor Commissioner Su told Commission staff. She is working on a project to create an integrated database. "Deputies in the field should be able to know immediately if a car wash is registered," she said. "If someone has filed a wage claim, DLSE should be able to know immediately if field deputies have an investigation open against the employer. Internal data sharing is the first step."[108]

A BOE investigator told the Commission that 30 percent of the top 500 BOE debtors are used car dealers.[109] Investigators are working with the DMV to go after unscrupulous dealers. A problem, Riverside County Deputy District Attorney Homan Hosseinioun said, is that potential checks and balances are lost when DMV field offices rely on legacy technology and paper filing. On an updated computer system, red flags could be established to detect when duplicate titles are issued in a short period of time or when bills of sale are issued with the same numerical

sequence. Additionally, Mr. Hosseinioun described how blocks of paper bills the DMV issues to car dealers end up for sale on the black market. These paper bills are not only used to defraud the state on sales tax, but also create a public safety hazard when consumers unknowingly purchase vehicles that have a fraudulent vehicle identification number and may have undetectable safety and performance issues. Switching to an electronic bill of sale could cut down on some fraud schemes, the Commission was told, or creating a computer program that would alert the state when an out of business car dealer made sales to a different out of business dealer. The DMV, understandably, has invested its resources modernizing the technology that most directly affects the public, such as systems that provide online car registration renewals. The state could make an impact on the underground economy by further updating its technology, Mr. Hosseinioun told Commission staff. "There will be more sophisticated schemes, but updated technology designed with simple checks and balances could flag the obvious fraud and make a real difference."[110]

Lack of Information Sharing Hinders Possibilities for Enforcement

State, local and federal officials are aware of what they are leaving on the table through insufficient information sharing. The Contractors State License Board (CSLB) can put holds on delinquent contractors' licenses until they settle their accounts or agree upon a payment plan with other state agencies. Stakeholders have said similar holds should be put on violators' licenses and permits when consent orders are issued in other industries. This would require sharing, however. "We need to bridge the gap in the sharing of information," U.S. Department of Labor Wage and Hour Division District Director Kimchi Bui told the Commission. Referring to the garment industry in Los Angeles, she said, "the state restricts licensing to the individual after a consent judgment, but it's a cat and mouse game. We find the same character out there, but now the ownership is under the son's name. We have to hope that we can somehow take the agency finding and use it as leverage before a new license is issued to the employer."[111]

Labor Commissioner Su told Commission staff how information sharing could make it easier to collect on a judgment order. "If law enforcement agencies had instant access to all the information the Secretary of State has," she said, "they could know immediately how to find who is on their board."[112] Instant access to information is critical; the Commission learned that many state investigators do not have electronics in the field because of a policy that prohibits employees from having a computer and a tablet or smartphone.[113] This results in severe inefficiencies for field

personnel who must return to their office to look up or input information during the course of an investigation.

Predictive and Advanced Analytics Can Leverage Limited Resources

With improved data collecting and information sharing, investigators also could use predictive modeling techniques to better target perpetrators of the underground economy and maximize limited resources. Chicago, for example, faced the problem of monitoring more than 1,500 restaurants with only 32 health inspectors. By analyzing more than a decade's worth of data, the city determined where and when health code violations were likely to happen. It found that establishments with previous health code violations were less likely to pass inspection than those without a history of health code violations. The city also learned that restaurants near construction sites were more likely to have health code violations. The single best predictor of a restaurant's not passing a health inspection, however, was weather that spoils ingredients.[114] Using that data, the city educates restaurant managers and deploys its health inspectors appropriately to address potential health problems before patrons contract food poisoning.

Predictive modeling and other advanced analytic techniques, former Washington state fraud prevention specialist Carl Hammersburg testified to the Commission, could assist the state's efforts in combating the underground economy in several ways:

- It allows the state to detect previously unknown tax and compliance evasion.
- Investigators can discover networks of interconnected violators.
- Departments can rank violators by risk, which allows them to focus limited resources on the worst violators or those with the highest return on investment.
- Advanced analytics provide detailed understanding as to why a business looks out of compliance, which allows lower level of enforcement engagements. Not everything needs a full audit or investigation, and lower level violators may be better served by receiving educational resources and monitoring rather than harsher penalties.[115]

Ideally, predictive analytics would identify where underground economy-related violations are most likely to occur before they happen, and the state would respond by offering educational resources to keep businesses in compliance. Entrepreneurs who shun attempts at assistance because they are determined to gain an advantage through illegal business

models could be apprehended early in their activities, thereby limiting damages to their workers, compliant competitors and to taxpayers' wallets.

Privacy and Information Sharing

Protecting individuals' privacy while government agencies share Californians' information is a primary concern regarding information sharing. Commission staff spoke with privacy experts at the Electronic Frontier Foundation (EFF) about how to protect privacy while sharing information. They outlined an inherent tension between government and its constituents, saying that there is a delicate balance between the goals of maximizing efficiency and protecting privacy.[116]

"People expect contradictory things from government. They expect government to be efficient, but they value the fact that the DMV doesn't know what the IRS knows about you." – Lee Tien, Senior Staff Attorney, Electronic Frontier Foundation

Information sharing is a great idea in theory, said EFF attorney Hanni Fakhoury, but there are two problems. One, data tends to be shared in ways not originally anticipated. A general principle of the American Privacy Act holds that information collected for one purpose should not be used for other purposes. Agency data creep is common, however, as officials think of new ways they can use data.[117]

The other problem is whether the collection of data leads to the intended results. In the wake of the September 11, 2001, attacks on the World Trade Center, Mr. Fakhoury told Commission staff, government leaders attempted to make fusion centers to collect data from different law enforcement sources – with lackluster results. Lee Tien, an EFF senior staff attorney, added that Americans have seen over and over how government agencies launch information-sharing programs that look good, but are not rooted in evidenced-based practices. Without transparent oversight, it is years before the public finds out that hundreds of millions of dollars were spent on these programs that accomplished little or nothing. The government must address these questions early and often, he said. When it does not, the result is a certain amount of "budget inertia" in which the vendor has a strong incentive to keep the program going and the government officials involved have a strong incentive to not admit a mistake. "It is really easy to collect lots of data," Mr. Fakhoury said, "and really hard to analyze it."[118]

The state should take steps to ensure that departments that collect and share data to combat the underground economy follow best practices to ensure Californians' state constitutional right to privacy is protected.

What Does Protecting Privacy Mean?

Lee Tien and Hanni Fakhoury, attorneys with the Electronic Frontier Foundation, outlined some minimum guidelines the state should consider when planning to share information. Before data collection begins:

- Know what specific data the state wants, where it is currently located, and what it will be used for. Mr. Fakhoury warned that the state must know what it means when it says it wants to use data to combat the underground economy. "The underground economy can be interpreted as different things," he said. "Differentiate what it is and what it is not."
- Plan infrastructure architecture. Know what software will be used, for example.
- Develop a policy of access control for data. Decide who will have access to the data, how it will be collected and stored and whether it will be deleted after a certain time.
- Clearly delineate specific terms of use for the data and adhere to those terms of use.
  - ✓ Mr. Tien warned that this entails answering difficult questions. If information is taken from someone with just cause and authorized once to be put in a database, does that mean officials are authorized to run hits against that database at any point in the future without seeking authorization? Does having proven just cause once count as proving just cause indefinitely? Data collection in the 21st century will increasingly take the form of video from cameras, be it police lapel cameras, cameras integrated into wearable technology or license plate scanners, and bio-material, such as DNA. What happens to video footage of or DNA information about an individual? Does that remain in a database indefinitely? What if the person is found not guilty? These policies should be established in advance, they should be transparent and they should be followed.
- Use evidence-based methodology to design a data collection system, and to collect and analyze data.
- If, at any point in the process, the private sector will have access to the data, account for this in access controls and terms of use, and also clearly define the relationship with the vendors involved. Develop oversight controls to make sure access to the data is not abused.
- Make sure that tools are in good condition and people know how to use them. This means, for example, that the computers are well-maintained and have adequate security programs, people are trained to use them well and that systems are compatible with each other.
- Create a review process to determine whether the data is being used the way it is supposed to be used and whether it is making the agency or agencies involved more efficient. If the answer to either of those questions is no, then the state should reassess whether it should collect that data. If it determines it does need the data, it should transparently adjust its processes using evidence-based practices to achieve the appropriate outcome.

Source: Lee Tien and Hanni Fakhoury, Senior Staff Attorneys, Electronic Frontier Foundation. June 6, 2014. Telephone conversation with Commission staff.

Funding Local Enforcement Efforts

By expanding or replicating existing state-local funding models, the state can leverage enforcement resources at the local level. Many stakeholders told the Commission that the workers' compensation grant model, financed by premiums paid by California employers for fraud investigations and prosecutions, is an effective funding model. Nearly $59 million has been allocated for the FY 2015-16 grant cycle.[119] A

worker's compensation manager of a Fortune 100 company and member of the Fraud Assessment Commission, which determines how much grant funding will be available for the program, told Commission staff that good oversight is what makes the grant process effective. "The Fraud Assessment Commission pushes and pushes and pushes for counties to do better. We constantly tell them that they have to do better to get the money. And it works," he said. "If similar programs are established, you should create a similar mechanism that requires proven performance for funding."[120]

Counties funded by the grant dedicate prosecutors to investigating workers' compensation fraud. "I have no problem finding prosecutors for workers' compensation cases, because of the grant," the EDD Chief of Investigations told the Commission.[121] Many district attorney offices have opened workers' compensation fraud sections, in part because of the grant. Representatives from the Orange County District Attorney's Office said the grant program allowed them to hire fraud specialists. "These cases can take years sometimes to get up to speed. The grant funding allows someone to build an expertise in fraud."[122]

Prosecutors investigating workers' compensation fraud cases frequently uncover additional unlawful activity. San Bernardino Deputy District Attorney David Simon told Commission staff:

> *"Workers' compensation fraud is just one spoke in a wheel of a wide variety of illegal conduct that we refer to as unfair business practices. This is what the Business and Professions Code defines as practices that unfairly advantage one business that disadvantage another business in the free market. We find that businesses without workers' compensation are often unlicensed to do contracting, engaging in cash-pay transactions and income tax evasion, not paying overtime or engaging in theft of labor. They're all related and a legitimate businessperson cannot possibly compete against the bid of these companies."* [123]

Workers' Compensation Grant Funding Process

California employers pay an assessment on their workers' compensation premium. The funds raised through this surcharge fund workers' compensation grants distributed to district attorneys' offices to investigate and prosecute workers' compensation fraud. The California Fraud Assessment Commission, consisting of seven gubernatorial appointees, determines available funding based on the revenue generated from the workers' compensation surcharge. The Insurance Commissioner then convenes a Workers' Compensation Grant Review Panel consisting of two members of the Fraud Assessment Commission, the director of the Department of Industrial Relations, an expert in consumer crimes and prosecution as designated by the Insurance Commissioner and the chief of the Department of Insurance Fraud Division. The panel reviews grant applications and makes funding recommendations. The review panel sends their recommendations to the Insurance Commissioner, who accepts or amends their recommendations. Finally, the Insurance Commissioners' recommendations are submitted to the Fraud Assessment Commission for its advice and consent.

Sources: California Department of Insurance. June 21, 2012. "Insurance Commissioner Jones Announces $32 Million in Grants to Local Law Enforcement to Fight Workers' Compensation Insurance Fraud." http://www.insurance.ca.gov/0400-news/0100-press-releases/2012/release077-12.cfm. Accessed November 5, 2014. Also, Fraud Assessment Commission. June 18, 2014. Summary Meeting Minutes. Sacramento, CA. http://www.insurance.ca.gov/0300-fraud/0100-fraud-division-overview/20-fac/upload/2014June18.pdf. Accessed November 5, 2014.

He said he understood why some counties with limited budgets focus only on the workers' compensation mandate, but said that a broad approach is needed to make a difference in the underground economy, stating, "You have to go after the whole wheel, not the just one spoke, if you want to stop it from turning."[124] Orange County Assistant District Attorney Scott Zidbeck echoed these sentiments. "If a person is committing fraud, the workers' compensation insurance policy is just a means to an end. They don't care about the type of fraud, just the money."

Because of the effectiveness of the workers' compensation grant program, stakeholders suggested that it could be expanded and replicated in other high-fraud areas, including dedicated funding for complex cases. Orange County Deputy District Attorney Debbi Jackson explained to Commission staff what a complex case entails:

> *"Sometimes we're up against people who have earned hundreds of millions of dollars from theft, and it is hard to prosecute that with just one or two deputies. A case with over a million dollars in loss will involve a very large or multiple entities. Businesses broken up into multiple entities are going to require forensic accounting. It is likely there will be multiple defendants in multiple jurisdictions, and violations are likely to include EDD payroll tax, workers' compensation, health fraud, tax fraud, among others, and these fraud schemes are likely to cross county lines. All their assets will be used against us."*[125]

The Commission recognizes that these types of cases may not easily lend themselves to annual grant funding cycles, but are among the most critical to investigate and prosecute to shut down the most egregious operators in the underground economy.

Attracting and Keeping Effective Enforcement Personnel

When asked what made his partnership with the FBI successful, Los Angeles Police Department Detective Supervisor Rick Ishitani did not reference a specific policy, MOU or technology. Instead, he praised his team members and described a culture of humility. "What makes it work is you have to be humble," he said. "The agents on the LAPD side are humble. The agents on the FBI side are humble. There isn't ego. People don't get caught up in rank structure. Everyone is willing to help, and willing to ask for help when they need it."[126] In short, Detective

Supervisor Ishitani described an exceptional organizational culture created by an effective leader.

Similarly, Labor Commissioner Su is credited by many in California's business community as being responsive to their concerns. Additionally, she simultaneously increased the number of complaints the Division of Labor Standards Enforcement accepts by 20 percent and reduced the average time to investigate a complaint by almost a quarter by reprioritizing how the division handles cases.[127] Leadership matters.

To be able to effectively and efficiently do their jobs, California's agency officials and enforcement personnel need the right laws and regulations, funding and technology. But without good personnel, the right laws and regulations, funding and technology have little value.

The Commission learned that some investigators, particularly those subject to civil service requirements, are not paid commensurately with their colleagues at other levels of government or non-civil service positions inside state government. Further, the state has stricter requirements for investigative positions than those for some similar positions at other levels of government. The state, for example, requires a college degree. The civil servant might be better educated, yet be paid much less than his or her peer at a different level of government. This results in high turnover in these positions, typically after the state has gone to considerable expense to train the individual. Moreover, it undercuts a core principle of meritocracy: that one holds a position and is compensated thusly according to one's ability. When different members of a task force are performing similar work, there should not be dramatic differences in their level of compensation.

The Commission also learned about coordination difficulties and delays in issuing search warrants and arresting individuals charged with crimes because some state-level criminal investigators, who are sworn peace officers, are not permitted to carry firearms when conducting these activities. Currently they have to contract with the California Highway Patrol or rely on other law enforcement agencies authorized to carry firearms when conducting these operations. While the topic may lend itself to jokes about arming tax collectors, the safety of California's civil servants is a serious concern. Organized crime and terrorist groups are increasingly turning to the underground economy as a relatively risk free way to earn money. These criminal investigators sometimes are placed in dangerous situations. Operations become further complicated when their partner officers are distracted by continuously monitoring the safety of the unarmed criminal investigators.

The Commission found that the state lacks equity and logic in deciding which criminal investigators should be armed. If the state requires its criminal investigators to complete Peace Officer Standards and Training and perform the duties of sworn peace officers, then they should be allowed the resources to fulfill their job responsibilities. If it does not want its criminal investigators to perform these functions, then it should not require them to become sworn peace officers nor should it require them to work unarmed in potentially dangerous situations. Additionally, the state should not have to delay the administration of justice because its investigators lack protective resources.

The Commission was impressed by the caliber of investigative, enforcement and prosecutorial personnel it heard from during this study, whom overall it found to be smart, dedicated, hard-working, resourceful and talented. These officials are charged with protecting the health and safety of Californians, ensuring law-abiding businesses can compete on a level playing field, protecting taxpayer resources and ensuring safe working conditions. Their jobs are critical to the functioning of the state, yet they often find themselves prioritized below many others, resulting in funding and resource challenges. The state has given these people a job to do – an important job to do – and it is incumbent on the state to provide them with the tools they need to succeed in their mission.

Summary

California's enforcement personnel are missing tools to aid in their efforts against the underground economy. Officials unanimously told the Commission that they need better information sharing, but there are both policy and technological impediments to information sharing. There also are data sharing costs that must be addressed. To improve enforcement efforts, the state must enable agency officials to share data when it is needed, with strict controls to protect privacy. California needs an advocate to negotiate expanded access to federal data. The state must invest in its technology so that when policies are developed to share information, its physical infrastructure is capable of doing so. If done correctly, data analytics can be used not just to retroactively find lawbreakers, but to predict where Californians might make mistakes and allow the state to allocate educational and other resources to provide assistance before someone accidentally breaks the law.

Enforcement personnel also are short of funds to perform their duties. The workers' compensation grant model has proven effective. The state should consider funding for grants to combat other high-fraud areas. There also is a need, however, for funding for complex investigations that

cannot be easily defined by a single type of grant nor be evaluated in regular grant reporting timelines.

Finally, successful enforcement against the underground economy ultimately depends on the people holding those positions. There is currently inequity and discrepancy in the compensation and security arrangements for officials holding similar positions. This counters the basic tenets of meritocracy and civil service and costs the state in turnover and training costs, as well as delays in the administration of justice.

Recommendations

Recommendation 6: The chief policy advisor recommended in the previous chapter should have the authority to enable agencies to expand the use of information sharing, including allowing certain non-taxing agencies to obtain more information currently available only to taxing agencies. The Legislature, through the budget process, should allocate appropriate resources to cover the costs involved with data sharing. Additionally:

- ❑ The Governor should designate an advocate to negotiate with federal agencies for expanded access to its data.
- ❑ An expanded information sharing program should include the following components in which the state:
  - ✓ Determines what data it wants, where the data is and what it plans to accomplish with its data.
  - ✓ Plans its access controls, evidence-based methodology and information sharing infrastructure architecture.
  - ✓ Creates terms of use for its data in a public and transparent manner, allowing stakeholders a voice in the process. This should include development of an oversight process if third parties are granted access to the data.
  - ✓ Ensures it has the appropriate technology for investigators to accomplish their mission, users of the technology are appropriately trained and information sharing systems are compatible statewide.

Recommendation 7: The Governor and the Legislature should create a review process to determine whether information and data sharing actions are being conducted according to the pre-determined terms of use and whether they are making departments and agencies more efficient.

- ❑ Any discrepancies between agency actions and terms of use or results indicating that efficacy is not increasing should result in the cessation of that data sharing or an action plan to assist the agency or agencies in reaching the desired outcome.

Recommendation 8: The state should replicate the workers compensation grant funding programs in other high-fraud areas, and the grants should include dedicated funding for complex multi-year investigations.

Recommendation 9: The executive branch should evaluate civil service classifications for consistency for the same level of work, including the investigation, tax audit and compliance and management series.

Preventing the Underground Economy

The most effective way to combat the underground economy is to prevent it before it starts. Adequate enforcement is necessary to deal with those intent on building a business model based on cheating, but education, outreach and simply making it easier for businesses to comply should be the first priority of government. "The solution is not criminal investigation – that's a small part," Selvi Stanislaus, executive officer of Franchise Tax Board told Commission staff. "You have to have systems and processes that make it easier for people to do the right thing."[128] Similarly, Randy Silva, chief of investigations and special operations for the Board of Equalization testified, "Enforcement is the last line of defense for the Board of Equalization. It does not go out there and pick on someone who does not have knowledge or intent."[129]

The ability to reach an individual immediately after a violation is critical, officials told the Commission. It allows for early intervention if a business owner is not aware of or does not understand a law. Outreach also redirects those who purposefully cheat toward a lawful path. As the Commission heard repeatedly from enforcement officials, people cheat because they can get away with it and they often start by cheating a little, then increase the scope of illegal activity after they go undetected.[130] Christine Baker, director of the Department of Industrial Relations, testified that when matching workers' compensation to payroll records, 85 percent of those found to be out of compliance will move into compliance upon receipt of a letter informing them of their error.[131] Similarly, Christine Sexton, administrator of the filing enforcement section of the Franchise Tax Board, testified that when staff contacted non-filers identified through the filing enforcement program, 50 percent of them filed the following year.[132]

Centralized Business Information

Commission staff asked business owners how they learned about the different laws and regulations that govern them. Summarizing the overall consensus, one replied, "A lot of things you don't know until you get fined."[133] The Commission has long advocated for the creation of a

comprehensive education program for businesses to prevent unintentional violations by creating a centralized source of compliance information for businesses, often called a "one-stop shop." In its 1985 report on the underground economy, the Commission criticized the state's lack of a one-stop shop, writing:

> *"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…existing state agencies could cooperate in providing information to taxpayers on all state requirements.*[134]

When Governor Gray Davis in 2002 sent the Commission the reorganization plan to create the Labor and Workforce Development Agency, one of the goals of the reorganization was to expand upon the nascent efforts to create a one-stop shop for employers. Specifically, the plan stated that its reorganization objective would build on one-stop taxpayer service centers by adding services for employers and workers.[135]

In its review of the plan, the Commission called for an action plan, detailing specific goals, how the goals would be pursued, timelines and performance measures.[136] None were supplied.

In 2010, the Commission recommended the creation of a "lean, nimble economic development unit within the Governor's Office." One of the three "essential" features of California's economic development portfolio with which it would be entrusted should be, the Commission recommended, "designating a visible, point-of-contact and liaison for information about business growth opportunities, economic development assistance, and navigating permitting issues and regulations."[137]

The state has shown progress on this front. In April 2010, Governor Schwarzenegger created through executive order the Governor's Office of Business and Economic Development that would carry out the functions the Commission recommended. In 2011, the Legislature enacted and Governor Brown signed AB 29 (Pérez), which codified the Governor's Office of Business and Economic Development (and dubbed it GO-Biz) and its role in strategic leadership of the state's economic development. In 2013, Governor Brown expanded the capacity of GO-Biz through a 2012 Governor's Reorganization Plan.

Permit Assistance

GO-Biz rekindled the Permit Assistance Unit initially created in 1977 "to assist businesses with identifying required permits, navigating the

permitting process and acting in an 'ombudsman' capacity in facilitating the resolution of conflicts between businesses and governments."[138] This unit had been dismantled when the Legislature shut down the Trade and Commerce Agency in 2003 in the face of a budget crisis and embarrassment over claims of mismanagement of the agency's overseas trade centers.

Additionally, following the passage of Assembly Bill 2012 (Pérez, 2012), GO-Biz assumed ownership over the formerly defunct California Government to Online Desktops (CalGOLD) program, which was originally created in 1998 by the California Environmental Protection Agency (CalEPA) and CalRecycle to assist individuals and businesses with the information they needed to comply with environmental and other regulatory and permitting requirements. This program also was "withdrawn" in 2003 due to the budget crisis, although CalGOLD remained on the CALEPA website with its information becoming out of date as the years passed.[139]

Revitalized by GO-Biz, today CalGOLD (www.calgold.ca.gov) allows users to view the permit requirements in the location they want to start their business. Users select the appropriate city and county, then choose from one of more than 140 business types. The application then displays the relevant permit requirements for more than 270 permit types from every California city and county, 60 regional entities, 28 state departments and 14 federal agencies. The user then can follow the links provided to access the permit information. It also directs users to more than 20 business assistance programs.[140]

In 2013, CalGOLD received more than 202,000 visits from 90,000 unique visitors. 83 percent of visitors were from California, while the other 17 percent came from other states and 143 countries. More than 1,300 websites link to CalGOLD. The average user spends more than three minutes on the website, indicating user engagement.[141] GO-Biz officials told Commission staff that they plan to transform the current format of CalGOLD into a wizard-type application, in which the user is asked a series of questions and receives specific information in response. The improved CalGOLD will address many of the frequently-asked questions GO-Biz receives, and is expected to be finished in 2015.[142]

California Fed-State Partnership

The California Fed-State Partnership is a cooperative effort between the Franchise Tax Board (FTB), Employment Development Department (EDD), Board of Equalization (BOE) and Internal Revenue Service (IRS) to increase tax compliance. Michele Ostby, former chief of the EDD field audit and compliance division testified that its goals include:

- Enhancing taxpayer access to information and services.
- Reducing taxpayers' burden.
- Increasing voluntary compliance.
- Increasing the sharing of taxpayer data among partner agencies to enhance compliance activities.
- Enhancing communication among the tax partner agencies regarding current and long-range agency specific projects.
- Identifying opportunities to leverage resources among partner agencies.[143]

The Fed-State Partnership sponsors the California Tax Service Center (www.taxes.ca.gov), which aims to provide one-stop tax help.[144] "The website is not an integrated portal," cautioned Selvi Stanislaus, executive officer of the Franchise Tax Board, "but a conglomeration of all the participating agencies' websites."[145] On this website, users can select information about income, payroll, sales and use and special taxes. The website provides answers to frequently-asked questions and highlights important dates. For more information and links to online processes, the website directs users to the appropriate tax agency's website. It also provides detailed contact information for each agency, advises users about a joint agency physical location where taxpayers may walk-in and access help from all three state tax agencies and links to business assistance organizations.

A One-Stop Shop Should Be One Stop

The Commission commends GO-Biz and the Fed-State Partnership on their work to create online information centers. Technology projects are difficult to implement within one government agency, let alone one that encompasses many departments and different levels of government. Yet, entrepreneurs should be able to access all the information they need on how to start and run their business in California from a single source. The Commission recognized this need in 1985. The state can and must do more to help business owners and managers follow the maze of rules and regulations to prevent them from unknowingly breaking state laws.

Master Business Application

When the Little Hoover Commission recommended creating a one-stop shop for business information in 1985, it envisioned the one-stop shop as part of a reorganized government with consolidated revenue responsibilities. It also discussed the need for centralized business information within the context of different agencies providing a single path to compliance with multiple business registration requirements.

The Commission recommended a reorganization and consolidation of revenue responsibilities, which would create a number of efficiencies and accomplish a number of goals. Among these: Greater non-enforcement methods of increasing voluntary compliance, one-time registration and the ability for taxpayers to obtain information and advice at one time in one place.[146]

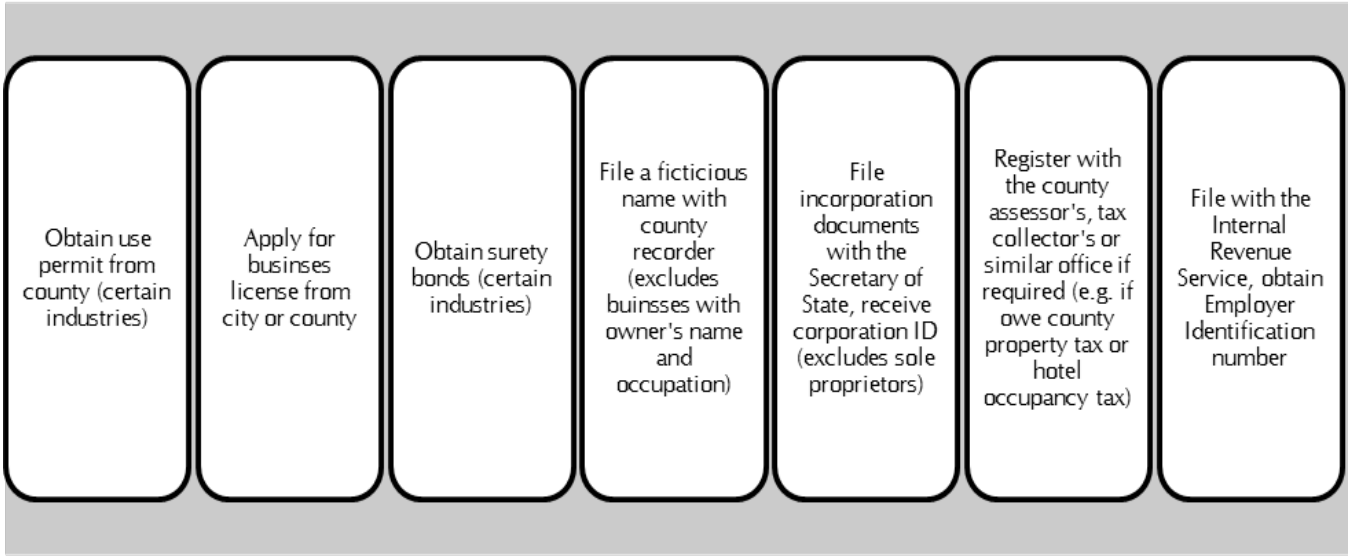
Reorganizing the state's revenue functions goes beyond the scope of this study, but implementing the 21st century equivalent to a one-time registration – a master business application – could make it seem like the state streamlined its revenue organizations to the businesses that now have to deal with numerous agencies. Some stakeholders have asked for it. "Whatever we do, we can't have more paperwork," president of the California Small Business Association Betti Jo Toccoli told the Commission. "We have got to have less paperwork, paperwork that removes duplication and makes it easier to meet the requirements."[147]

A master business application, if implemented properly, would consolidate the different licensing, registration and other related interactions with government that entrepreneurs experience when starting and running a business. This would not add another layer of interaction, but would streamline existing requirements. There would be two critical results from implementing a master business application. It would simplify and centralize the processes to start a business in California, potentially making it easier to comply with the state's rules and regulations. It also would create a common business identifier that could improve efficiency for businesses and the state entities with which they interact.

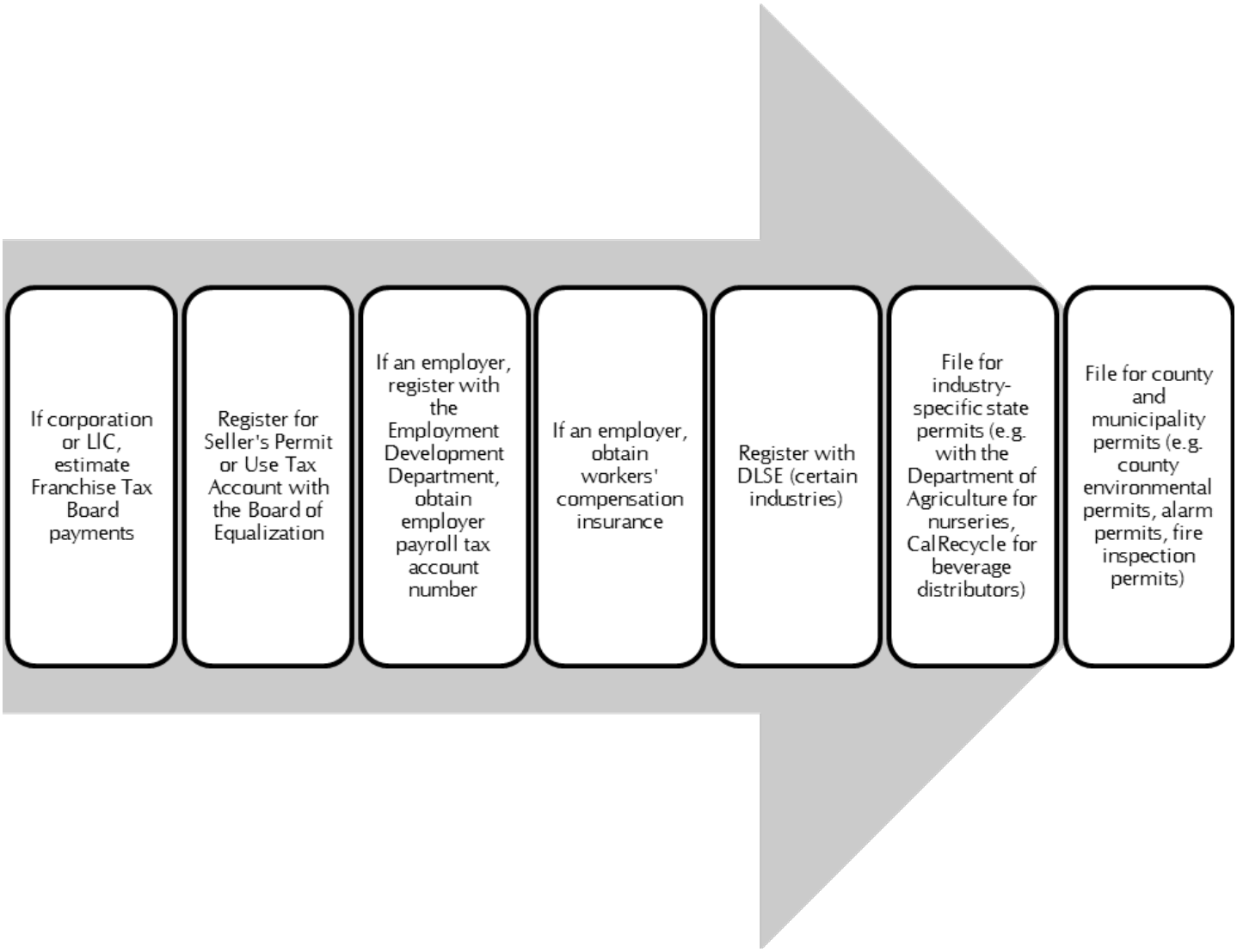
Aspiring business owners have a multitude of responsibilities to government, as outlined in the chart on the following pages. With so many different requirements, stakeholders have told the Commission, even a business owner who fully intends to be compliant can make a mistake.

A master business application also would enable the state to utilize a common business identifier – a number assigned to a business that could be used for all interactions with state government. From an efficiency standpoint, business owners would only have to keep track of one number that could be used for all state interactions. Additionally, sole proprietors could interact with the state using their common business identifier instead of their social security number, which would add a measure of protection against a growing threat of identity theft.[148]

Starting a Business in California Can Be Complex and Confusing



Thirty years ago, the Commission warned that the lack of a common identifier would limit state agencies from using high-tech means for comparing information.[149] The warning rings just as true today. Further, if the state continues to move toward more robust data sharing, a common identifier could cut down on duplicative data gathering, making the state more efficient.[150] Finally, a master business application with a common identifier could serve as a statewide business license, and a statewide business license could be revoked. Affecting someone's ability to conduct business constitutes a real penalty with respect to the underground economy.



What Would a Master Business Application Look Like?

Ideally, the master business application would be an online application in which the user is asked a series of questions to determine the type and location of the new business. Users without an Internet connection should be able to access the online business application at state offices or public libraries. The application would request the relevant information from the individual, based on responses to the questions. The program would assign a common business identifier and disseminate the appropriate information provided by the individual to the relevant agencies. For maximum ease of use, the portal should link all of the businesses owned by an individual, by social security number or tax identification number. This would also have a secondary effect of

allowing individuals to discover if someone has opened up a business under their identity. Investigators told the Commission that this is not uncommon when an offender is trying to hide assets or conduct business after being ordered to stop.[151] Some documents require physical signatures and some licenses require proof of meeting specific requirements, such as obtaining a surety bond. The user should be able to print, sign, scan and upload these documents into the application package.

At a future juncture, the state could consider a master business application that would encompass both state and local requirements, allowing local entities to opt into the state system. This model is used in Washington State. Cities and counties can opt in to the state business license process with the following division of duties and revenue: the state issues the initial business license through its master business application, assigning a universal business identifier. The state keeps the initial license fee. Local jurisdictions – cities and counties – process license renewals, which are simple unless information changes. They keep the renewal fees. As a result, the work and revenue are split, with the state handling the burden of establishing the business and the local entity managing renewals.[152]

There is significant educational potential in a master business application. In Washington State, for example, business owners are asked if they plan to hire employees or independent contractors. If they plan to hire either, they are directed to pertinent information. Former Washington State fraud and compliance specialist Carl Hammersburg testified, "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 workers' 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."[153]

Concerns Raised by Stakeholders

Business owners generally liked the idea of a master business application, but expressed concerns about the state's capacity to create an efficient and seamless portal. GO-Biz officials confirmed that technology in state government is currently on many different platforms developed at different times, and it would be difficult to meet the

requirements of a master business application. Even if agencies had the technological capacity, the stringent information-sharing requirements agencies adhere to could prevent the information on a master business application from being shared efficiently.[154]

Business owners at one Commission meeting questioned whether the state had the capacity to do anything with a common business identifier, or if it would simply become another unused tool in the toolbox. "Conceptually, I like the idea," said a business owner, "but it seems like it could get complicated really quickly. The state must be clear about what it hopes to accomplish, what its end goal is and what it's going to do with the information. It has to have a game plan."[155]

One official from the Attorney General's office said, "So this means that criminals will now have registered business numbers. What does it do besides tell me they have a business license?"[156] He went on to explain that what is included on the master business application and the information-sharing policies surrounding it – as they relate to enforcement – are critical to its impact on the underground economy. He suggested including a certificate stating that individuals will pay their taxes under penalty of perjury, which would give prosecutors a tool to work with to obtain a meaningful penalty if the individual does choose to participate in the underground economy.

At a minimum, a master business application could streamline the process of opening a business and provide an opportunity to educate new business owners on laws and regulations. A common business identifier also would improve efficiency and potentially improve data sharing for state enforcement efforts. The state should make the appropriate technology investments and broker the information-sharing agreements so appropriate data can be shared and move toward a master business application and common business identifier. For a master business application to be successful, the state needs to include the voices of all of the stakeholders to determine what they need out of it, what policies must be in place and how to measure the results.

Include Workers' Compensation Reporting with EDD Reporting

Workers' compensation insurance works differently than other types of insurance in that employers supply the amount of payroll they have for different job classifications: individuals are not insured. This creates an incentive for cheating employers to commit workers' compensation fraud, as it is difficult to get caught. No one is likely to know if an employer is not carrying enough workers' compensation insurance or is

misclassifying employees to save costs. There is no equivalent in the insurance industry. Life insurance policies are not sold without naming the person the policy covers. Automobile insurance is not sold without listing the vehicle the policy covers. Some suggested that insurance companies have incentives to ensure employers do not cheat because the insurance companies will lose money from fraudulent claims. In reality, if insurance companies lose money, they can raise their rates to cover their losses without expending additional costs for auditing and enforcement. A 2014 Oregon workers' compensation premium rate study showed that California employers pay the highest workers' compensation rates in the nation. California employers pay, on average, $3.48 per $100 of payroll. The national median is $1.85 per $100 of payroll.[157] Law-abiding employers lose twice in this scenario. They are competing against businesses that are able to offer lower costs because they are not paying their legally required workers' compensation insurance, and they potentially are stuck with higher workers' compensation premium rates to cover losses from these fraudulent employers.

Some employers, particularly in larger businesses with high turnover, expressed concerns about the additional costs of listing the names, identification number and job classification of employees. If included as part of a master business application that allows employers to make updates through an electronic portal, the process could be streamlined. Employers already share employee names and identification numbers with EDD. Adding the employee's classification would be an additional step, yet one that would help level the playing field for compliant employers. Employers still could misclassify employees or not carry sufficient coverage. But if there were swift and certain consequences when an uninsured or misclassified worker was hurt on the job, the incentive to cheat might diminish.

Finally, policymakers also should consider why it is a felony to misclassify employees or not carry sufficient workers' compensation coverage, but only a misdemeanor to not carry workers' compensation insurance at all. Legislation to correct this disparity has been attempted on several occasions, but stalled due to the state's prison overcrowding crisis. The state should consider rectifying this sentencing disparity as part of a thorough review of state sentencing laws.

Create the Right Incentives for Consumers

Much of the Commission's review focused on the supplier side of the underground economy. But the Commission also asked stakeholders about how to address consumer demand for low-cost goods and services. Most indicated the need for more consumer education. The impact

consumers could have on California's underground economy would be significant if they collectively decided that they would not patronize cheating businesses. The state could do more to build greater awareness of the tools available to consumers. When hiring a contractor for home repairs, consumers can visit the Contractors State License Board website to check to see if the contractor being hired has a current license. The Department of Industrial Relations maintains databases of registered farm labor contractors, garment manufacturers, car washes and talent agencies. Policymakers enacted laws requiring these registries. But they are of little value if no one knows they exist or understands the harm caused when patronizing noncompliant businesses not listed in the state databases.

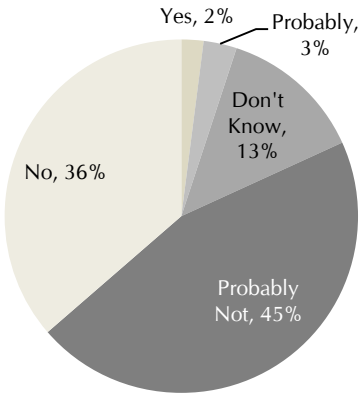
Public agencies always should use compliant businesses, but the private sector should be educated and encouraged to do so as well. "One of the biggest changes to combat the underground economy would be for those who take bids to award the work to legitimate contractors in the first place," said California Professional Association of Specialty Contractors Risk Management Director Bruce Wick.[158]

Sometimes consumer education will not be enough to change behavior. In these cases, the state should consider how to adjust incentives to change results. One example highlighted in the Commission's public hearing process involves compliance with California Energy Commission regulations for installing residential heating, ventilation and air conditioning (HVAC) replacement units. Only 10 percent of HVAC replacement units installed statewide are properly permitted and meet quality verification requirements.[159] The California Energy Commission (CEC), the Contractors State License Board and utility companies have educational campaigns for consumers about the importance of proper HVAC installation to the environment, California's energy grid and consumer health. In 2009, the CEC implemented a federally-funded rebate program for consumers installing high efficiency appliances, including HVAC units. In 2010, approximately $11 million in rebates were awarded to consumers for HVAC unit replacements. Some utility companies, however, awarded the rebates to customers without requiring proof that the proper permits had been obtained. After protest from the state, some utilities added a box to the rebate form for consumers to indicate that they had complied with all requirements.[160] A case study of this issue is included in Appendix D.

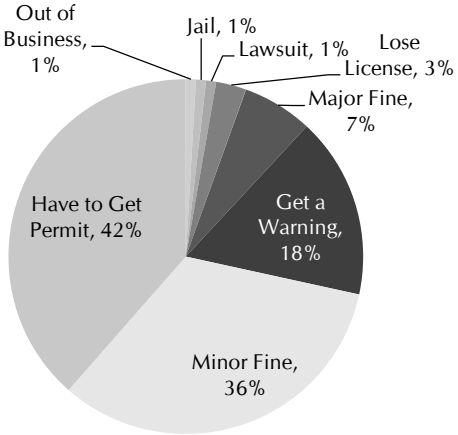
Western HVAC Performance Alliance in 2010 surveyed contractors to better understand why they did not comply. They purposefully worded the questions to ask about competitors to elicit a more forthright response than asking about the contractors themselves. The survey revealed that there is a very low expectation that any wrongdoing will be

detected for contractors who don't obtain a permit. In the unlikely event they are caught there is an equally low expectation that there would be any significant consequence.[161]

Would Your Competitor Get Caught?



What Would Be the Consequences of Getting Caught?



Source: Kristin Heinemeier, University of California, Davis. August 2012. "Contractors Walk on the Wild Side... Why?" http://wcec.ucdavis.edu/wp-content/uploads/2013/07/Kristin-Heinemeier-ACEEE-2012.pdf. Accessed March 27, 2014. Also, Bill Pennington, Senior Technical and Program Advisor, California Energy Commission Energy Efficiency Division. March 27, 2014. Written testimony to the Commission.

The financial motivation to cheat is obvious. A homeowner faced with deciding to hire a compliant contractor who will get the permit, perform the duct work and refrigerant inspection could face thousands of dollars of unexpected repairs. By hiring a noncompliant contractor who does not get the permit and does not conduct the required inspections or repairs, the homeowner will pay much less. Throughout most of the state, the homeowner is not required to submit proof of meeting permitting requirements and still receives a taxpayer-funded rebate without complying. Put simply, the fiscal incentives are misaligned.

Education and Outreach

Education is one of the most important tools the state has to limit the scale of the underground economy. To broadly generalize, there are three basic audiences on which to make an impact: consumers, public officials and businesses and workers.

Consumer Education and Public Awareness

Consumers drive the demand for the underground economy, seeking the lowest costs and greatest convenience without understanding the potentially harmful effects of their purchasing behavior on their community and state.

Some law enforcement agencies have outreach units that try to influence shopping habits. Los Angeles County Sheriff's Department Sergeant Janice Munson runs programs that reach out to college students. Los Angeles Police Department Detective Supervisor Rick Ishitani targets middle-school children. "High school is too late," he said.[162] The Board of Equalization and other agencies have worked with Crime Stoppers to create video programming to raise public awareness.

San Diego Deputy District Attorney Dominic Dugo is widely credited for running a comprehensive public awareness campaign about workers' compensation fraud by flooding the market with his department's simple message: "Don't do it. Don't tolerate it. Report it: (800) 315-7672." During the fiscal year 2013-14, his office purchased Facebook and Google ads, attracting 3.3 million and 1.1 million views respectively. The department posted trolley and bus ads to reach the 250,000 people who use public transportation in San Diego daily. It distributed bilingual anti-fraud flyers on both sides of the border to the 50 million people who annually cross San Diego's border with Mexico. The office has created bilingual public service announcements for television and radio, and participated in interviews on radio stations in both English and Spanish. District Attorney Bonnie Dumanis was interviewed on a Vietnamese television show that ran six times during a three-month period.

It is difficult to determine the precise effect this education campaign has had on workers' compensation fraud or compare it, for example, to the impacts of enforcement actions. But the combination of publicity tools has had some effect. The number of suspected fraudulent claims remained essentially unchanged from 2011 to 2013 despite population increases, while the rates of District Attorney's Office investigations, prosecutions and convictions increased 63, 67, and 57 percent respectively.[163]

The state should support successful efforts through grant funding and facilitating collaboration on best practices. It should not interfere where educational efforts are succeeding. But it should evaluate where there are gaps in education and outreach and determine how to fill those gaps.

Using the Media for Deterrence

Since the Commission's last review in 1985, the state appears to have improved deterrence by publicizing arrests and convictions. Every agency that testified before the Commission described its deterrence strategy. Stakeholders also provided suggestions for further empowering those strategies. David Kersh, executive director of the Carpenters/Contractors Cooperation Committee told the Commission that publicizing enforcement actions in small, local newspapers and

industry publications often is more effective than in larger publications because the message is more likely to reach its intended audiences.[164]

Educating Public Officials

Educating public officials about the harmful effects of the underground economy is vital to creating change. Agency leaders set the tone and priorities. One reason the San Diego District Attorney's Office succeeds in its workers' compensation fraud outreach is because of support and participation from District Attorney Bonnie Dumanis. The Board of Equalization succeeds in prioritizing the underground economy in large part due to the leadership of Chairman Jerome Horton and a supportive board. Efforts to combat the underground economy across the state need buy-in from top leadership.

Stakeholders at every level reported obstacles in the public sector thwarting their efforts to combat the underground economy. State officials told the Commission they sometimes have a hard time finding prosecutors to take their cases. Prosecutors told the Commission that sometimes their cases are held up for months when they work with state agencies. They also spoke of difficulties with bench officers who do not understand the harm caused by the underground economy. Some law enforcement officials said that they see other law enforcement officials and employees of district attorneys' offices buying underground economy products.

Cultural change must begin with California's public servants. It is happening in some places. LAPD Detective Supervisor Ishitani runs a piracy training program for district attorneys and judges. He develops specialized training for specific agencies, if requested.[165] State Department of Justice Deputy Attorney General Peter Williams spends considerable time educating public officials on the effects of the underground economy. He also emphasizes the gains to the state from investing in enforcement as he persuades various agencies to supply personnel to the Tax Recovery and Criminal Enforcement Task Force. But there is no systematic statewide attempt to educate public servants on what the underground economy is and how it hurts California.

Keeping Public Agencies Out of the Underground Economy

Government may not be able to easily identify illegal contracts in the private sector, but it should at least be able to police itself. Confidence in government is further eroded when the public learns of licensing and employment law violations in expensive public works projects. Two

different subcontractors working on the Tercero II dormitory for the University of California, Davis, for example, were ordered to pay approximately $1.5 million each in back wages and penalties by the Division of Labor Standards Enforcement in 2010. One of the subcontractors had paid its 74 employees $150,152 when they were owed $1.48 million for their work. Another subcontractor owed its 149 workers $1.2 million in wages. Local outrage erupted when the university allowed the prime contractor to bid on the Tercero III dormitory the following year, despite its history of contracting with subcontractors that owed millions to their workers.[166]

Contracting relationships between public agencies and the underground economy extend beyond public works. Public agencies contract with many different types of businesses, from printers to janitors, and are susceptible to the same pressures the private sector faces. Business groups told Commission staff about losing bids to the state to cheating competitors and prosecutors told the Commission of prosecuting the awardees of state contracts who conducted business unlawfully.[167] While public works projects are required to accept the lowest responsible bid, many public agencies that are contracting for services often simply are able to accept the lowest bid. "You should have a comma after lowest bid, to make it lowest responsible bid, to be within the parameter of the law," Lilia Garcia-Brower, executive director of Maintenance Cooperation Trust Fund told Commission staff. "The public sector is contributing to unfair competition."[168]

It is unacceptable that the underground economy operates within the purview of public agencies. It is illegal for a public agency to accept a bid so low that it requires the bidder to evade tax and labor laws. But multiple stakeholders told the Commission that many public agencies do not adequately investigate their lowest bid. Labor Commissioner Julie Su outlined some public works tools that could aid agencies when contracting services to help ensure they select a responsible contractor:

- Before bidding on a public works project, contractors must register online with the Department of Industrial Relations. The $300 fee to register and renew annually is used for enforcement through the State Public Works Enforcement Fund. Contractors must show they meet the following requirements:
    - ✓ Workers' compensation coverage for employees.
    - ✓ Applicable licenses.
    - ✓ No delinquent or unpaid wage or penalty assessments owed to any employee or enforcement agency.
    - ✓ Must not be under federal or state debarment.
    - ✓ Subcontractors used must be registered public works contractors.[169]

- Effective laws around public works are mechanics liens and stop notices: If it is possible to stop the project when violations are found, that incentivizes both the awarding agency and the contractor to behave legally.
- There are stricter requirements for public works in terms of what kinds of records must be kept and penalties for not making them available for inspection.[170]

Labor Commissioner Su also spoke to the organizational cultural issue of closely examining the lowest bid and considering the second lowest when the first seems too low. "There is a lot of pressure to take the lowest bid," she said, "and when you start layering in subcontractors, it can become difficult to evaluate how the general contractor is doing his job."[171]

Public agency leaders need to work to create a culture of responsibility so that taxpayer dollars go to law-abiding contractors and the workers who serve the public are compensated fairly. Educating the public will be a significant part of that cultural shift. While there is dire need for better due diligence, officials face immense pressure from their constituents to review contracts quickly and select the lowest bid. Leaders must cultivate an understanding on the part of their constituents that thoroughly reviewing bids and awarding a contract to a compliant company may be more time-consuming and cost more upfront than quickly selecting the lowest bidder. In the long-run, however, the community is better off when honest entrepreneurs prosper; workers are safe, properly compensated and insured; and shortcuts are not taken in the work itself.

Outreach to Businesses and Workers

Creating a one-stop business information center and integrating that information into a master business application would go a long way toward providing business owners the opportunity to better understand compliance obligations. To their credit, all state agencies with jurisdiction over the underground economy have outreach programs. The Department of Industrial Relations has outreach teams that meet with small businesses and can communicate in many languages, including Spanish, Korean and Chinese.[172] Through DLSE and in conjunction with EDD, it runs a seminar in several California cities on state labor law and payroll taxes. The EDD additionally runs 10 walk-in offices throughout California where the public can obtain information and advice.[173] The Board of Equalization has an outreach and media unit and publishes information in seven core languages.[174] In her testimony to the Commission, FTB Executive Officer Selvi Stanislaus

outlined two pages of ways the FTB reaches out to and assists its clients.[175]

Several business owners suggested requiring education for business owners. Flooring company owner Cynthia Mitchell told the Commission that to get a construction license an applicant has to prove basic business knowledge. This includes bookkeeping, payroll and insurance. She suggested it might be helpful if those who do business in other industries also had to prove basic knowledge of legal requirements before they were allowed to conduct business.[176]

Ross Hutchings, former executive director of the Western Car Wash Association, told the Commission, "The industry has a number of first generation car washes, where the owners come from a different culture where they may not trust any type of organization, let alone government. Many problems come from owners who do not understand the laws or rules, or do not want to register because they're afraid of being under government scrutiny."[177] Mandatory education could make it easier for all to compete on an equal footing.

The state should examine new opportunities for education and outreach with the California workforce. Maintenance Cooperation Trust Fund Executive Director Lilia Garcia-Brower described to Commission staff the novel way her organization reaches out to workers and investigates complaints. It has bilingual staff who are available at night. They are able to travel to workers and talk at off-site locations.[178] These methods meet the realities faced by workers, particularly low-wage workers who are extremely vulnerable to unscrupulous employers. The state should facilitate this type of outreach.

Worker advocates told the Commission about the importance of working with community organizations to educate workers and support them when they encounter their employer's violations. "What people fear is losing their job. Putting at risk their economic livelihood is basically inconceivable for low-wage workers," Shaw San Liu, lead organizer for the Tenant Worker Center of the Chinese Progressive Association, told the Commission. "That's why it takes so much work to get workers to come forward. High-level campaigns are great. But there also needs to be support for community and grassroots institutions that people know and can provide an open door to workers."[179] Workplace Justice Initiative Attorney Charlotte Noss told the Commission, "you need organizations with trust in the community to get workers to come forward. You need to have on board those organizations that can build the trust."

April Mackie, director of safety and regulatory compliance at Ramco Enterprises, suggested that compliant employers teach their employees about lawful working conditions. This idea is particularly powerful in an industry like hers, farm labor contracting, where workers are mobile and work for many different employers. "We're missing an educational opportunity to point out to the employee that we are providing you with a check stub and with workers' compensation information – this is what's *supposed* to happen. This is normal. If you work for someone else and they're not doing these things, then you're working for an employer who is working in the underground economy. We can tell them about resources to make a report if this happens. We can teach them that the longevity of their work resides on their working for a legal company."[180]

Incentive-Based Compliance

Stakeholders told the Commission that a number of businesses make good faith efforts to comply with the law, but fall short because they are confused by the tangle of laws and regulations or they receive faulty or contradictory advice from government agencies.[181] They told the Commission that self-audit programs can be valuable for business owners who want to be compliant. These are programs in which businesses audit themselves, typically under the guidance of an agency auditor, correct any problems and implement a plan to ensure future compliance. In return, they typically receive a financial reward, such as a reduced interest rate on back taxes owed that were identified in the audit or waived penalty fees. An example is the Board of Equalization's Managed Audit Program, a voluntary program through which eligible businesses can audit their sales and use tax performance. If the business owes money, the interest rate is lowered by half. The program also is intended to be an educational tool to help business owners understand their tax and record-keeping obligations and improve sales and use tax business procedures.[182]

Stakeholders suggested incentive-based education as another way the state could encourage voluntary compliance. Business owner Chris Buscaglia explained that the state could establish education requirements for different industries. When the business owner or manager completes the education requirement, the business could receive a credit against a registration fee or another cost associated with that industry, such as a surety bond.[183] These types of incentives encourage people to obtain the education needed to learn about labor, financial and industry requirements and best practices and avoid punitive approaches toward those making a good faith effort to follow the law.

Similarly, the state should work with industry associations to create industry certifications for businesses that meet criteria for best business practices. This could include meeting voluntary education requirements, self-audits and industry-specific guidelines. There should be a financial incentive to obtain these voluntary certifications.

Summary

The best way to combat the underground economy is to stop it before it starts in the first place. The state must do a better job of providing information to business owners and making it easier for them to meet their compliance obligations. It could do this by creating a one-stop shop for business information and creating a master business application that lets business owners interact with all government agencies through a single portal. A master business application also would benefit enforcement with a common number to identify a business across agencies. California also could use this portal to combine workers' compensation reporting with regular EDD reporting, which would allow workers' compensation policies to cover specific individuals without increasing the workload for businesses.

There is considerable room for improvement in educating businesses, workers, consumers and even public officials. The state should develop incentive-based opportunities for businesses to become compliant and work with industry associations to develop self-certifications and fiscal incentives for businesses to self-certify. Officials should create policy and develop tools to keep the underground economy and its practices out of state and local government operations and contracts. Tools might include a prequalification database, mechanics liens and stop notices and stricter requirements for recordkeeping with correspondingly sharper penalties. The state should work with local agencies and community-based organizations – some of which have already developed coordinated outreach and educational programs – to reach groups that might otherwise be missed, such as immigrants and low-wage workers.

Most responses to the underground economy focus on supply, but to ignore consumer demand is to ignore half of the problem. While education and positive incentives help to change consumer behavior, sometimes these may not be enough. Officials should consider innovative ways to incentivize consumers into law-abiding behavior.

Ultimately, it will take the cooperation of state officials, law enforcement, community-based organizations, law-abiding businesses, consumers and workers to combat the underground economy. The state must take the lead, however, in transforming a culture of indifference into a level playing field for Californians.

Recommendations

Recommendation 10: The Governor and Legislature should create a "one-stop" center for business information including regulatory and financial information. The state should implement a technology solution so that this information center is automatically updated by state and local authorities with any revised requirements or changes in contact information.

Recommendation 11: The state should create an online statewide master business application to make it easier for businesses to comply with state requirements. The state should disseminate the information collected to appropriate departments to reduce the time a business owner spends filling out paperwork.

- The state should assign each business a common identification number to facilitate information sharing.
- State field offices and public libraries should provide Internet access to the master business application.
- The application and annual renewals should ask if the applicant plans to hire or has hired independent contractors. If the applicant responds in the affirmative, the state should ensure the applicant receives independent contracting compliance information.
- The master business application should be created in an electronic portal that would allow businesses to quickly and easily make updates. Information about their employees should include their name, identification number and workers' compensation job classification against which workers' compensation claims should be cross-referenced.
- The state should work with willing local jurisdictions to create a master state/local business license, which would not prejudice existing local fees.
- The state should include stakeholders in every stage of the application planning process, including design and user-testing, to develop a tool that meets their needs. These should include business owners, state agency representatives, labor representatives, law enforcement personnel, district attorneys and Department of Justice officials.

Recommendation 12: Administrators of taxpayer-funded rebates should require proof that legal obligations to receive the rebate were met. If administrators are unwilling or unable to collect this proof, administration of the rebate should be moved to another entity or the constituents under that administrator's jurisdiction excluded from the taxpayer-funded rebate program.

Recommendation 13: The Legislature should require all state and local contracts that meet the threshold for bidding to accept the lowest responsible bid and provide these agencies with the tools to identify and act upon the lowest responsible bid. These should include:

- A pre-qualification database that requires disclosure of previous violations and outstanding obligations to workers and the state, as well as proof that the contractor is meeting all regulatory obligations. Any subcontractors used must also be on the pre-qualification database. The funds derived from pre-qualification registration and renewal should go toward underground economy enforcement and education.
- An adjudication authority should be able to put a stop notice or mechanics lien on a public contract when the contractor or subcontractor is shown to be in violation of the law.
- Public works recordkeeping requirements and penalties should be applicable to all public contracts.

Recommendation 14: The state should develop a three-pronged statewide educational strategy that teaches consumers, public employees and businesses and workers about the harmful effects of the underground economy and how to avoid participating in it. The intent of this educational outreach program should be statewide culture change.

- The state should evaluate where there are gaps in education and outreach and determine how those gaps should be filled, using best practices.
- The state should assess the needs of its more disenfranchised populations, including immigrant business owners and low-wage workers, and work with community-based organizations to develop strategies to bring participants in the underground economy into compliance, encourage workers to report violations and build trust in government institutions.

Recommendation 15: The Governor and Legislature should work to expand voluntary audit programs and, working with industry associations, create incentive-based education and industry certification programs.

Conclusion

No single raindrop is responsible for the flood, the saying goes. So it is for California's underground economy, grown strong and destructive from accumulations of indifferent policies and lack of action. Lawmakers enact regulations for businesses, but not sufficient funding to enforce them. On rare occasions when lawbreakers are caught, the penalties are minor – a cost of doing business – when paid at all. In the event of convictions, victims who are owed restitution seldom fully collect. And always, few legal mechanisms exist to prevent these operators from continuing to do business.

At the state level, responsibilities for the underground economy are fragmented across multiple agencies and departments. None are fully in charge and all are preoccupied with more pressing matters. The work of controlling the underground economy falls into silos across the breadth of state government, the tasks divided, uncoordinated, and incomplete.

At the local level, investigators who develop criminal wage theft cases against the most egregious violators find few district attorneys or judges who view them in the same category as stealing equivalent amounts from a bank. "Just let them pay it back," they are told in the courtroom.

These individual stories are pulled from more than a year of Commission hearings, meetings and interviews. But collectively, through their common threads of neglect, misunderstanding and shortsightedness, is the larger truth:

The state has unwittingly created an incentive to cheat.

The repercussions of this are deeper than undermining California's business climate by rewarding cheating as a business strategy and making it difficult for honest players. It has eroded the confidence of business owners and workers that the government is capable or that government stands with them. The state asks law-abiding business owners to attract customers and win bids against competitors who evade the costs of compliance. Then it asks them to shoulder higher fees and surcharges to pay for enforcement and restitution for the misdeeds of others. The state asks workers living paycheck to paycheck and victimized by a dishonest employer to wait almost a year for the 17 percent chance they will receive what they were owed last week. And

the state asks Californians to approve tax hikes, even as it fails to pursue up to $10 billion annually it is owed by those who cheat on taxes and fees as a business strategy. The social contract between the state and 38 million Californians obliges it to be a better partner.

Thirty years ago, the Little Hoover Commission issued 20 recommendations intended to guide the state in reining in the underground economy. Many of those recommendations remain valid today. The Commission reiterates its original 1985 call for a better state response. In short, California's government agencies should:

- ***Prioritize curbing the underground economy and create accountability for the effort.*** No single government entity has complete jurisdiction over the underground economy. This has long heightened challenges for agencies and their variety of task forces, preventing a unified, effective response. These challenges within government can be overcome, however. Leaders must engage by raising the profile of the fight, designating clearer lines of authority and holding players accountable for stronger results.

- ***Make it easier for businesses to comply***. California is home to Silicon Valley, a thriving technological landscape with companies devoted to organizing information. There is little reason why California's state government cannot similarly organize a single definitive portal for compliance obligations, or why entrepreneurs must navigate a tangle of bureaucracies to open a business. A new business owner and job creator should not be baffled by conflicting legal definitions within different agencies or be advised to refer to case law for guidance. Anecdotal evidence suggests that most business owners want to be compliant. California should make it easier for them.

- ***Make it more risky than rewarding to participate in the underground economy***. Lawmakers should raise the stakes for cheaters, revisiting laws and penalties and funding enforcement to make it costlier to cheat and less expensive to abide by the rules. There is little sense in having laws on the books that are unenforced and handily violated while burdening only the law-abiding.

- ***Incentivize responsible behavior***. In addition to raising the costs and risks of participating in the underground economy, state government should reward compliance with the law. The state should treat its law-abiding entrepreneurs as valued partners in its fight against the underground economy. Those who go the extra mile to meet best practices should be rewarded, for

example, with fewer inspections and reduced fees or other financial incentives. This also rewards the state by allowing it to focus its limited resources on problem violators.

- ***Educate the public sector and hold it to a high standard***. The public sector should not facilitate the underground economy. Lawmakers should require public sector agencies to accept the lowest responsible bid, not merely the lowest bid. Administrators should enforce white collar rules and regulations. Public sector officials at every level and across every branch of government must be educated about the harm caused by the underground economy; how, at a minimum, they can avoid perpetuating it; and their role in protecting the social contract between Californians and their government.

- ***Address consumer demand***. The state should develop compelling consumer education and outreach programs to reduce demand for the underground economy's many goods and services. These programs should better explain the larger cost of the cheapest price and make clear the economic impacts to legitimate neighboring businesses and the community.

Repeatedly during the course of its study, the Commission was told that implementing its recommendations will be difficult. The Commission understands the enormous technical challenges in creating a master business application or the complexities of defining who is an independent contractor. But the Commission also is encouraged by the caliber of numerous stakeholders who provided suggestions, policy ideas and stories from the front lines of business and government while participating in its year-long study.

Californians inside and outside of government are ready to push back on the underground economy if the state's leaders make it a priority and provide the necessary resources. The state's business climate will undoubtedly benefit from a level playing field for law-abiding entrepreneurs who provide fair workplaces for workers. The benefits of higher numbers of legally compliant businesses for taxpayers and state revenue, likewise, can hardly be overstated.

The great majority of Californians who engage in honest work should be advantaged by state government policies and actions. Too long they have been disadvantaged by lack of enforcement and clarity in the law. Success, and the ability to climb the economic ladder is, and always has been, key to the California dream. Ensuring a fair game as Californians compete is vital to keeping that dream alive.

The Commission's Study Process

The Little Hoover Commission last looked at California's underground economy in 1985. It did so at the request of Governor Deukmejian, who wanted to learn how California could more effectively deter the underground economy through improved detection and enforcement. The Commission found:

- There was no centralized source of information to aid business owners in meeting compliance obligations.
- State agencies encountered significant information sharing obstacles.
- Audit and investigative functions were understaffed.
- Penalties were insufficient for deterrence.
- The lack of a clear definition of independent contractor enabled fraud.
- Agency silos hindered the state's ability to fight the underground economy.

To solve some of the fragmentation, coordination and information sharing problems, the Commission recommended reorganizing the state's taxing authorities into a single Department of Revenue. It also recommended the creation of a multiagency task force, with dedicated funding, that would approach underground economy-related violations more holistically than contemporary efforts. The Commission put special emphasis on enhancing capacity to investigate criminal tax evasion and other financial violations, as it believed those represented a significant gap in the state's enforcement against the underground economy. Additionally, it recommended creating a common business identifier, increasing penalties for underground economy-related violations and reevaluating staffing levels.

The Commission decided to revisit the underground economy shortly after the Legislature enacted AB 576 (Manuel Pérez, 2013), which created the Revenue Recovery and Collaborative Enforcement pilot program. Among Commission concerns were how the new task force would relate to the state's already-existing task forces, partnerships and agency efforts to combat the underground economy. The Commission also wanted to better understand and shed light on the effect of unfair

competition created by the underground economy on California's business climate.

Immediately, the Commission was confronted with the issue of how to define the underground economy since California's leaders have not agreed upon a common definition. It decided to be consistent with its prior study and focus on violations in industries that would otherwise be legal if the operator were abiding by all the rules. Blatantly illegal activities often associated with the underground economy, such as human trafficking, consequently were excluded from the study. The Commission made an exception to its scope for counterfeit products, even though counterfeiting is an illegal industry. The Board of Equalization and several of its partners include anti-counterfeiting activities among their enforcement activities and AB 576 included counterfeit goods as part of a larger holistic strategy to combat criminal tax evasion. Additionally, counterfeit goods create unfair competition that affects California's business climate.

President Obama and Congress were discussing significant immigration reform at the federal level when the Commission began this study. Although immigration is a topic often associated with the underground economy, the Commission decided not to include immigration in this review in case the law changed mid-study.

The Commission also limited the scope of this review to operators who purposefully, or out of ignorance, build business models with underground economy practices. It recognizes the adverse impact of individuals who defraud businesses or the state through false workers' compensation or disability claims, for example, and believes many of the recommendations from this report would make inroads in combating those types of fraud. For the purpose of this study, however, the Commission limited its scope to business practices that result in unfair competition to law-abiding business owners.

Following decades of fruitless discussion about reorganizing the state's tax organizations into a single agency, the Commission did not see value in recommending it again. Instead, it recommended the Governor appoint an independent policy point person – who has the buy-in of the constitutional officers who also have jurisdiction over the underground economy – and invest this official with the authority to cut through the red tape to create the efficiencies that the Commission previously hoped to create through reorganization. It also recommended technological solutions to create the appearance of a single revenue department to the end-user. Thirty years later, the remainder of its recommendations are nearly identical to those made in 1985.

The Study Process

The study began in January 2014. The findings and recommendations presented in this report are based on oral and written testimony presented during two public hearings, a series of advisory committee meetings, extensive Commission staff research and interviews with more than 150 experts and stakeholders from the business and worker community, academia and all levels of government.

The Commission's first hearing on January 23, 2014, served as an introduction to the scope of the underground economy in California and the agencies and task forces charged with addressing labor and workforce violations and recovering lost tax revenue. The hearing also highlighted the effect of unfair competition on California's industries and the effect of the underground economy on Californians' health and safety.

A second hearing on March 27, 2014, introduced the Commission to additional efforts the state was undertaking to combat the underground economy. Officials also testified about the state's efforts to create a central hub for business information and the high rate of non-compliance with regulations for installing heating, ventilation and air conditioning systems and the implications on the state's energy goals. Finally, experts testified to the Commission about how other states were using data analytics to combat fraud. A list of all witnesses is included in Appendix A.

The Commission's study process included three advisory committee meetings to explore other policy areas with the help of stakeholders. On April 29, 2014, the Commission met in Los Angeles with officials from local, state and federal government to discuss the characteristics of successful partnerships to combat the underground economy and the perspective from those on the front lines. On July 22, 2014, and September 9, 2014, the Commission met with business representatives and worker advocates, respectively, to discuss potential policy solutions. A list of all advisory commitee participants is included in Appendix B.

Throughout this study, the Commission has benefited immensely from the expertise of entrepreneurs, workers, industry representatives, advocates, academics, investigators, auditors, prosecutors, law enforcement and officials from every level of the government. All gave generously of their time, providing great benefit to the Commission. The findings and recommendations, however, are the Commission's own.

Appendices & Notes

- ✓ ***Public Hearing Witnesses***
- ✓ ***Advisory Committee Meeting Participants***
- ✓ ***1985 Recommendations***
- ✓ ***HVAC Case Study***
- ✓ ***EDD Data Submitted to Commission***
- ✓ ***BOE Data Submitted to Commission***
- ✓ ***FTB Data Submitted to Commission***
- ✓ ***DIR Data Submitted to Commission***
- ✓ ***Notes***

Appendix A

Public Hearing Witnesses

The lists below reflect the titles and positions of witnesses at the time of the hearings in 2014.

Public Hearing on California's Underground Economy
January 23, 2014
Sacramento, California

Christine Baker, Director, Department of Industrial Relations

Kris Buckner, Chief Executive Officer, Investigative Consultants

Shellie Hughes, Chief Legal Advisor for Chairman Jerome E. Horton, Board of Equalization

Randy Silva, Chief of Investigations & Special Operations, State Board of Equalization

Bruce Wick, Risk Management Director, California Professional Association of Specialty Contractors

Peter Williams, Deputy Attorney General, Department of Justice

Public Hearing on California's Underground Economy
March 27, 2014
Sacramento, California

David Fogt, Enforcement Chief, Contractors State License Board

Carl Hammersburg, Government Fraud and Solutions Specialist, SAS Institute Inc.; former Fraud Prevention and Compliance Manager, Washington State Department of Labor & Industries

Paul Martin, Deputy Director of Permit Assistance, Governor's Office of Business and Economic Development

Michele Ostby, Chief, Field Audit and Compliance Division, Employment Development Department

Bill Pennington, Senior Technical and Program Advisor, California Energy Commission Energy Efficiency Division

Lisa Schmith, Chief, Investigation Division, Employment Development Department

Selvi Stanislaus, Executive Officer, Franchise Tax Board

Appendix B

Advisory Committee Meeting Participants

The lists below reflect the titles and positions of participants at the time of the meetings in 2014.

Advisory Committee Meeting on State, Federal, County and Municipal Partnerships and Local Efforts to Combat the Underground Economy
April 29, 2014
Los Angeles, California

Renée Bacchini, Special Assistant to the Director, Department of Industrial Relations

Kris Buckner, Chief Executive Officer, Investigative Consultants

Kimchi Bui, District Director, Los Angeles District Office, Wage and Hour Division, U.S. Department of Labor

Yvette Cordero, Captain, Department of Insurance

Colleen Courtney, Deputy City Attorney and Assistant Supervisor, Complex Litigation Division, Los Angeles City Attorney's Office

Gonzalo Hernandez, Southern Area Administrator, State Board of Equalization

Homan Hosseinioun, Deputy District Attorney, Special Prosecutions Section, Consumer Fraud Unit, Intellectual Property Rights Protection Unit, Riverside County District Attorney's Office

Rick Ishitani, Detective Supervisor, Vice Section, Detective Support and Vice Division, Los Angeles Police Department

Ranee Katzenstein, Assistant United States Attorney and Deputy Chief, Major Fraud Section, U.S. Attorney's Office

Mike Lee, Chief, Compliance Development Operations, Employment Development Department

Aston Ling, Senior Safety Engineer, Division of Occupational Safety and Health, Department of Industrial Relations

Janice Munson, Sergeant, Los Angeles Sheriff's Department

Laureen Pedroza, Bureau Chief, Department of Insurance

Lisa Schmith, Chief, Investigative Division, Employment Development Department

David Simon, Lead Deputy District Attorney, San Bernardino County District Attorney's Office

Jennifer Snyder, Head Deputy, Healthcare Insurance Fraud, Los Angeles County District Attorney's Office

Charles Spaeth, Senior Investigator, Board of Equalization

Frank Waldschmitt, Supervising Criminal Investigator, Investigation Division, Employment Development Department

W. Scott Zidbeck, Assistant District Attorney, Orange County District Attorney's Office

Advisory Committee Meeting on the Business Perspective on the Underground Economy
July 22, 2014
Sacramento, California

Jennifer Barrera, Policy Advocate, California Chamber of Commerce

Chris Buscaglia, Owner, Zoom Car Wash

Richard Cohen, Owner, Richard Cohen Landscape and Construction

Lilia Garcia-Brower, Executive Director, Maintenance Cooperation Trust Fund

Ross Hutchings, Executive Director, Western Carwash Association

David Kersh, Executive Director, Carpenters/Contractors Cooperation Committee

April Mackie, Director, Safety and Regulatory Compliance, Ramco Enterprises LP

Cynthia Mitchell, President, Citadel Tile and Flooring

Betty Jo Toccoli, President, California Small Business Association

Chris Waldheim, Chief Financial Officer, J's Maintenance

Bruce Wick, Risk Management Director, California Professional Association of Specialty Contractors

Advisory Committee Meeting on the Worker Perspective on the Underground Economy
September 9, 2014
Sacramento, California

Rene Bayardo, Government Relations Advocate, Service Employees International Union California

Cesar Diaz, Legislative and Political Director, State Building and Construction Trades Council of California, AFL-CIO

Lilia Garcia-Brower, Executive Director, Maintenance Cooperation Trust Fund

Ross Hutchings, Executive Director, Western Carwash Association

Jose Mejia, Director, California State Council of Laborers

Shaw San Liu, Lead Organizer, Tenant Worker Center, Chinese Progressive Association

Rosemarie Molina, Strategic Campaign Coordinator, CLEAN Carwash Campaign

Silvia Molina, Former Carwash Employee

Charlotte Noss, Workers' Rights Attorney, Workplace Justice Initiative

Hillary Ronen, Legislative Aide, San Francisco Supervisor David Campos

Mark Schacht, Deputy Director, California Rural Legal Assistance Foundation

Julie Su, Labor Commissioner, Division of Labor Standards Enforcement – *via telephone*

Caitlin Vega, Legislative Advocate, California Labor Federation

Appendix C

The Commission's 1985 Recommendations

In its 1985 report, *A Review of Selected Taxing and Enforcing Agencies' Programs to Control the Underground Economy,* the Commission made the following recommendations:

1. The Governor and Legislature should consider reorganizing some or all of the state's taxation responsibilities to lead to better-coordinated enforcement and data sharing, eliminating redundancies and a unified statewide tax enforcement policy and direction.
2. The Legislature and Governor should establish a multi-agency task force, with dedicated funding and teams in each metropolitan area, to complete audits and investigations of blatant tax violations and cash-pay transactions, publicize enforcement efforts and administer a tip line.
3. The Governor and Legislature should require representatives from the state's taxing, labor and employment agencies to form a standing committee to study opportunities for sharing information.
4. The Legislature and Governor should require all state agencies to use a common identification number or a system of cross-referenced numbers for all businesses.
5. The Governor and Legislature should provide ways for nontaxing agencies to obtain and use greater amounts of information currently available only to tax agencies.
6. Additional management emphasis should be placed on ensuring that leads are shared and used and that field office supervisors establish and maintain greater cooperation and coordination between offices.
7. 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 other agencies' laws. If the test is successful, this should be expanded to all auditors and investigators.
8. The Department of Industrial Relations should review the need to increase the number of audit staff employed in the Labor Standards Enforcement Division.
9. The Governor and Legislature should reevaluate the staffing levels needed by audit, investigative and enforcement units.
10. The state's taxing, labor and employment agencies should each develop a policy, associated goals and measurable objectives for improving self-assessment of increased voluntary compliance resulting from their activities. These should be based on the respective agency's responsibilities and the broader goals and objectives of its sister taxing and enforcement agencies.
11. The Legislature and Governor should reevaluate the criteria currently used to select potential violators for audit to give greater weight to increasing voluntary compliance.

12. The state's administrative agencies should increase their level of prosecutions and develop an expanded program to actively publicize cases in which violators have been successfully prosecuted. The use of media should also include an expanded public education program.
13. The Governor and 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.
14. The Governor and Legislature should authorize a "graduated" penalty system where appropriate to provide more severe penalties for repeat violators.
15. State agencies should develop a system of selective "follow up" visits to insure that previous violators are still in compliance with the law.
16. State tax and enforcement agencies should consider expanded use of automatic, computer-generated citations based upon work done by other agencies.
17. EDD, DIR and FTB should initiate a trial project to determine the loss to the state because of cash-pay employees committing unemployment or tax fraud.
18. The Legislature and Governor should increase the penalties for employers who do not carry workers' compensation insurance.
19. The state should increase the proportion of cases developed for criminal prosecution and work closely with district and city attorneys to ensure these cases are prosecuted.
20. The Legislature should amend current statutes to require that any contracts using any form of state monies be awarded based upon criteria that includes an assessment of the contractor's past compliance with tax and labor laws.

Appendix D

Case Study: Heating, Ventilating and Air Conditioning Unit Replacements

In the 1990s, the California Energy Commission (CEC) found that the average duct leakage for Heating, Ventilating and Air Conditioning (HVAC) systems was almost 30 percent. The result was increased energy use and potentially unhealthy conditions created by sucking in dust, insulation material or carbon monoxide. The CEC's research also found that air conditioning units were often poorly installed, with a corresponding reduction in efficiency of 20 to 40 percent.[184]

In 2005, requirements developed by the CEC went into effect for duct sealing and refrigerant change verification for HVAC replacement units. Research has shown that only 10 percent of HVAC residential replacement installations are properly permitted and meet quality verification requirements.[185]

In 2009, the CEC allocated grant funding to local and regional agencies to develop and implement programs to pilot whole house energy upgrades in collaboration with the California Public Utilities Commission and investor-owned utilities (IOUs). Approximately 40 percent of the more than 5,400 projects funded by the program included HVAC change-outs.

Also in 2009, the CEC received $35.2 million in grants from the U.S. Department of Energy to administer the American Recovery and Reinvestment Act State Energy Efficient Appliance Rebate Program in California, which provides rebates for consumers who install high efficiency appliances, including HVAC units. In 2010, $11 million in rebates were paid for 17,505 HVAC unit replacements. The CEC required that applications for rebates include the contractor license number, copy of executed building permit and a copy of the certificate of verification showing the duct sealing and refrigerant charge requirements were met. In 2010, the Attorney General's office investigated complaints that investor-owned utilities were awarding rebates for installation of HVAC units without proof that consumers met the requirements for the rebates. After much debate, the utilities in 2011 posted a customer education notice about HVAC systems on their websites and added a box on their rebate applications that consumers could mark to indicate that they used a licensed contractor, if appropriate, and followed applicable permitting requirements.[186]

Senate Bill 454 (Pavley, 2011) codified a requirement that rebates or incentives offered by utilities for energy efficiency improvements or installations should be certified by the rebate recipient that the improvement or installation met applicable permitting and contractor licensing requirements. CEC Senior Technical and Program Advisor Bill Pennington testified:

"This language essentially codifies what the IOUs agreed to do in response to the request from the Attorney General's Office. … Relying solely on a certification by the homeowner or contractor assumes that the homeowner is knowledgeable regarding whether building permits are required,

and assumes that the 'honor system' will be reliable to ensure that permits are pulled and the Standards requirements are met. That flies in the face of the reason why the Little Hoover Commission finds it necessary to hold this proceeding on the underground economy."[187]

Investor-owned utilities flatly declared that they should not be responsible for enforcement, stating, "It is not the role of IOUs to act in an enforcement capacity for other jurisdictional agencies and we are unaware of any statutory or regulatory requirements that would require us to implement an enforcement program… Collecting specific permit and license information may cause the IOUs to overreach in this respect…"[188]

Publicly-owned utilities responded a little better. Mr. Pennington testified that the Sacramento Municipal Utility District's high efficiency and heat pump rebate program historically has required documentation requiring rebate applicants to supply the license and permit number, copy of the permit and certification of verification. In his written testimony, he indicated that permits were obtained in Sacramento for approximately 20 percent of HVAC replacements, which is twice as high as the state average.[189] Although the installation of high efficiency HVAC units that qualify for the rebate program likely is a small percentage of all HVAC units installed in Sacramento, there is a perception that the Sacramento Municipal Utility District program drives the higher number of permits in Sacramento as compared to the rest of the state.

Appendix E

Employment Development Department Data Submitted to Commission

Data Submitted November 26, 2014

Please find the Employment Development Department's (EDD) response to the data request from the Little Hoover Commission (LHC) on the Underground Economy (UE). We are providing historical information on EDD's total staffing and funding levels, annual funding and staffing related to EDD's enforcement activities, and the total number of State of California employers in the same time period.

At the broadest level, the EDD offers a wide variety of services to millions of Californians under the Employment Service, Unemployment Insurance, State Disability Insurance, Workforce Investment, and Labor Market Information (LMI) programs. As one of California's largest tax collection agencies, the EDD also handles the collection, accounting, and auditing of payroll taxes and maintains employment records for nearly 17 million California workers through the Employment Tax Program. The table below identifies the annual Personnel Year (PY) and funding for EDD at the enterprise level and the PY and funding level specific to EDD's tax enforcement activities.

Employment Development Department State Fiscal Year 2007-08 through 2014-15								
State Fiscal Year	**07-08**	**08-09**	**09-10**	**10-11**	**11-12**	**12-13**	**13-14**	**14-15**
EDD*								
PY	8,962.4	9,731.2	11,192.7	11,237.1	9,386.4	8,879.1	8,877.1	8,775.1
Dollars	$447,175,689	$457,821,563	$488,505,701	$538,618,131	$512,996,442	$488,089,912	$506,848,819	$511,507,452
Tax Auditors								
PY	191.0	209.0	213.0	210.0	202.0	200.0	210.0	193.0
Dollars	$12,361,902	$13,526,898	$13,785,786	$13,591,620	$13,073,844	$12,944,400	$13,591,620	$12,741,173
Tax Collectors								
PY	196.0	193.0	192.0	194.0	189.0	202.0	184.0	168.0
Dollars	$10,257,072	$10,100,076	$10,047,744	$10,152,408	$9,890,748	$10,571,064	$9,629,088	$8,967,612
Tax Investigators								
PY	11.0	11.0	11.0	9.0	10.0	9.0	9.0	9.0
Dollars	$666,336	$666,336	$666,336	$545,184	$605,760	$545,184	$545,184	$556,088
Tax Attorneys								
PY	9.0	9.0	9.0	8.0	9.0	9.0	10.0	9.0
Dollars	$764,532	$764,532	$764,532	$679,584	$764,532	$764,532	$849,480	779,823
*Data acquired from the "Salaries and Wages" document released by the Department of Finance each year								

As a benchmark for comparison, the following table identifies the number of EDD Auditors, along with the number of Employers for the period covering 1981-1984[1]:

Fiscal Year	1981	1982	1983	1984
Audit Staff	304	258	261	248
Employers	582,000	614,000	629,000	664,000

Scope of EDD's Enforcement Activities

The EDD has enforcement activities in several program areas: the Audit and Collection Program within Tax Branch, Investigation Division and Legal Office. The information below provides a high level description of each program's enforcement activities, the historical staffing numbers, and the total number of employers for each year based on reported LMI data. Based on the historical records retained by the Department, we are able to provide complete staffing numbers for State Fiscal Year (SFY) 2007-2008[2] through the current time period.

Tax Branch

The EDD's Tax Branch mission is to work with employers to collect state employment taxes and data to support the employment security, child support, and Personal Income Tax programs. The EDD is committed to reducing unfair business competition and protecting the rights of workers by coordinating the joint enforcement of tax, labor, and licensing law, detecting and deterring employment tax violations in the UE, and educating customers to increase compliance with employment tax laws. The EDD's Audit Program issues assessments for payroll taxes due and any applicable penalties and interest to employers located in the State and to employers out of State having California workers. When appropriate, penalties for intent to evade and/or fraud may be applied to the assessment. The EDD also performs follow-up audits to confirm continued employer compliance. The EDD continually works on identifying new methods to promote and verify prospective compliance. The EDD's Collection Program operates the tax and benefit collection programs and is responsible for maximizing revenue collection of State Payroll taxes and benefit overpayments. This includes tax liabilities as a result of efforts of the audit program assessments, including UE cases. The Program maintains the integrity of the tax and benefit programs administered by EDD.

The table below displays the staffing levels for EDD's Audit and Collection Program[3] and the total number of Employers from the third quarter of each year provided by LMI.

[1] Little Hoover Commission report, issued August 1985

[2] EDD maintains records based on the State Administrative Manual's retention guidelines.

[3] Program support staff not included in the employee counts, although the work performed does support the enforcement activities.

State Fiscal Year	07-08	08-09	09-10	10-11	11-12	12-13	13-14	14-15
Field Auditors	160	175	173	173	162	162	174	158
UE Auditors	31	34	40	37	40	38	36	35
Total Enforcement Auditors*	191	209	213	210	202	200	210	193
Direct Collectors	156	149	149	151	148	161	140	128
Audit Collectors**	40	44	43	43	41	41	44	40
Total Enforcement Collectors	196	193	192	194	189	202	184	168
Employers	1,304,291	1,337,920	1,347,245	1,344,480	1,390,289	1,315,510	1,341,123	1,320,538

*Auditors dedicated to Employment tax audits (such as obstructed claims, payroll tax audits, audit review and tax hearings) and underground economy activities.

**Staff dedicated to the collection of tax liabilities as result of audits performed, including UE cases.

Investigation Division

The EDD's Investigation Division actively investigates allegations and suspected violations of the California Unemployment Insurance Code, and other laws and regulations pertaining to fraud or misconduct; and pursues criminal enforcement action against violators to protect the integrity of the EDD's programs and resources. The Investigation Division conducts criminal investigations and seeks prosecution of employers committing payroll tax fraud against the EDD. In addition, the Investigation Division identifies, investigates, and prosecutes disability and unemployment insurance benefit fraud. The EDD Investigation Division partners with other law enforcement agencies and is a member of several task forces for the purpose of sharing information on criminal activity and to conduct investigations more effectively and efficiently.
It is important to note that while EDD does not have complete staffing numbers available prior to SFY 2007-2008; Investigation Division does have reports from the late 1990s reflecting a peak staffing level of approximately 60 investigators, 18 of which were dedicated to tax fraud cases.

The table below displays the staffing levels for EDD's Investigation Division and the total number of Employers.

State Fiscal Year	07-08	08-09	09-10	10-11	11-12	12-13	13-14	14-15
Tax Investigators	11	11	11	9	10	9	9	9
Investigators for other EDD programs	27	27	27	29	28	27	26	23
Total Investigators	38	38	38	38	38	36	35	32
Employers	1,304,291	1,337,920	1,347,245	1,344,480	1,390,289	1,315,510	1,341,123	1,320,538

Legal Office

The EDD's Legal Office provides legal advice and support to the Director and Department management in connection with court cases, administrative hearings, contracts, legislation and regulation. The Legal Office also provides specialized support for underground economy cases, complex criminal investigations and prosecution efforts.

This table below displays staffing levels for EDD's Legal Office and the total number of Employers.

State Fiscal Year	07-08	08-09	09-10	10-11	11-12	12-13	13-14	14-15
Tax Attorneys	9	9	8	9	9	10	9	9
Attorneys for other EDD programs	11	12	14	13	13	11	7	7
Total Attorneys	20	21	22	22	22	21	16	16
Employers	1,304,291	1,337,920	1,347,245	1,344,480	1,390,289	1,315,510	1,341,123	1,320,538

Closing

Upon review of the data, the staffing level of tax enforcement PYs and the employer count from SFY 2007-08 thru 2014-15 has a general level of consistency. However, comparison of benchmark data from the 1985 LHC report with the most current information reflects a decline in the audit enforcement resources. Furthermore, the number of registered employers has substantially increased over the past 30 years. In fact, the number of employers has nearly doubled over this time period from 664,000 in 1984 to 1.3 million in 2014, which is a 98.5 percent increase.

The EDD is committed to reducing unfair business competition and protecting the rights of workers by coordinating the joint enforcement of tax, labor, and licensing law, detecting and deterring employment tax violations in the underground economy, and educating customers to increase compliance with tax laws. The EDD manages its resources in the best manner possible to meet the needs of the people of California.

Data submitted December 22, 2014

Number of Employers in California

State Fiscal Year	Number of Employers
85-86	621,094
86-87	635,069
87-88	711,733
88-89	785,553
89-90	762,810
90-91	735,819
91-92	837,768
92-93	888,141
93-94	908,369
94-95	877,629
95-96	974,052
96-97	937,164
97-98	931,875
98-99	1,038,376
99-00	1,049,380
00-01	1,046,790
01-02	1,075,523
02-03	1,117,316
03-04	1,160,080
04-05	1,198,147
05-06	1,231,532
06-07	1,265,268
07-08	1,304,291
08-09	1,337,920
09-10	1,347,245
10-11	1,344,480
11-12	1,390,289
12-13	1,315,510
13-14	1,341,123
14-15	1,320,538

EDD Investigation Division Position Information for the Little Hoover Commission

SFY 1990-1991	Investigators	Support	Managers	Total
Total Number of Staff	61	17	16	94
Staff Assigned to Tax Cases	Unknown			

SFY 1992-1993	Investigators	Support	Managers	Total
Total Number of Staff	67	19	19	105
Staff Assigned to Tax Cases	Unknown			

SFY 1994-1995	Investigators	Support	Managers	Total
Total Number of Staff	63	20.5	19	102.5
Staff Assigned to Tax Cases	Unknown			

SFY 1995-1996	Investigators	Support	Managers	Total
Total Number of Staff	67	23.5	21	111.5
Staff Assigned to Tax Cases	Unknown			

SFY 1996-1997	Investigators	Support	Managers	Total
Total Number of Staff	65	24	20	109
Staff Assigned to Tax Cases	Unknown			

SFY 1997-1998	Investigators	Support	Managers	Total
Total Number of Staff	61	23	21	105
Staff Assigned to Tax Cases	13			

SFY 1999-2000	Investigators	Support	Managers	Total
Total Number of Staff	60	23	18	101
Staff Assigned to Tax Cases	18			

SFY 2000-2001	Investigators	Support	Managers	Total
Total Number of Staff	54	22	20	96
Staff Assigned to Tax Cases	17			

SFY 2001-2002	Investigators	Support	Managers	Total
Total Number of Staff	55	21	20	96
Staff Assigned to Tax Cases	16			

SFY 2002-2003	Investigators	Support	Managers	Total
Total Number of Staff	43	24	16	83
Staff Assigned to Tax Cases	Unknown			

SFY 2003-2004	Investigators	Support	Managers	Total
Total Number of Staff	36	21	15	72
Staff Assigned to Tax Cases	10			

SFY 2004-2005	Investigators	Support	Managers	Total
Total Number of Staff	34	19	13	66
Staff Assigned to Tax Cases	9			

SFY 2005-2006	Investigators	Support	Managers	Total
Total Number of Staff	36	20	13	69
Staff Assigned to Tax Cases	11			

SFY 2006-2007	Investigators	Support	Managers	Total
Total Number of Staff	37	20	13	70
Staff Assigned to Tax Cases	11			

SFY 2007-2008	Investigators	Support	Managers	Total
Total Number of Staff	38	22	15	75
Staff Assigned to Tax Cases	11			

SFY 2008-2009	Investigators	Support	Managers	Total
Total Number of Staff	38	20	14	72
Staff Assigned to Tax Cases	11			

SFY 2009-2010	Investigators	Support	Managers	Total
Total Number of Staff	38	19	14	71
Staff Assigned to Tax Cases	11			

SFY 2010-2011	Investigators	Support	Managers	Total
Total Number of Staff	38	19	13	70
Staff Assigned to Tax Cases	9			

SFY 2011-2012	Investigators	Support	Managers	Total
Total Number of Staff	38	20	13	71
Staff Assigned to Tax Cases	10			

SFY 2012-2013	Investigators	Support	Managers	Total
Total Number of Staff	36	16	12	64
Staff Assigned to Tax Cases	9			

SFY 2013-2014	Investigators	Support	Managers	Total
Total Number of Staff	35	16	12	63
Staff Assigned to Tax Cases	9			

SFY 2014-2015	Investigators	Support	Managers	Total
Total Number of Staff	32	14	12	58
Staff Assigned to Tax Cases	9			

Data Submitted April 13, 2015

The total numbers provided in the chart below include tax auditors, tax collectors, criminal investigators and attorneys:

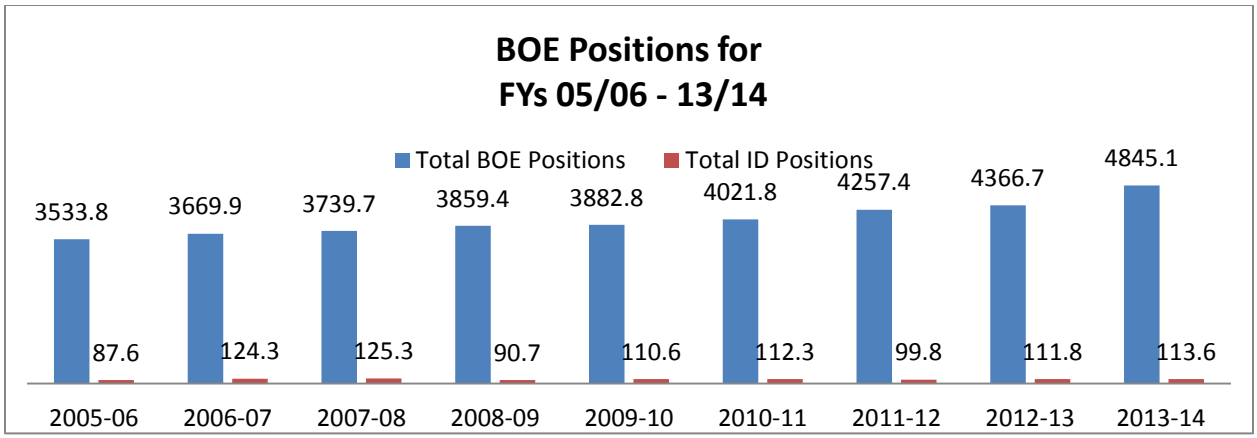
EDD Staffing Against the Underground Economy								
State Fiscal Year	2007/2008	2008/2009	2009/2010	2010/2011	2011/2012	2012/2013	2013/2014	2014/2015
Total	87	94	99	93	95	92	92	88

Appendix F

Board of Equalization Data Submitted to Commission

December 1, 2014

State Board of Equalization Funding and Positions from FY 1998-99 to FY 2013-14				Investigation Division Funding and Positions from FY 2005-06 to FY 2013-14 Unit 326, 327, 472			
Fiscal Year	Funding (in Dollars)	Posit-ions	% Year-Over Year	Funding (in Dollars)	Posit-ions	% Year-Over Year	% of ID's Positions of Total BOE Positions
1998-99	$ 286,154,000	3737.6					
1999-00	$ 289,523,000	3752.3	0.39%				
2000-01	$ 297,553,000	3777.6	0.67%				
2001-02	$ 311,974,000	3787.1	0.25%				
2002-03	$ 316,322,000	3667.8	-3.15%				
2003-04	$ 319,461,000	3516.1	-4.14%				
2004-05	$ 337,484,000	3418.9	-2.76%				
2005-06	$ 360,334,000	3533.8	3.36%	$ 7,122,345	87.6		2.48%
2006-07	$ 368,875,000	3669.9	3.85%	$ 10,728,734	124.3	41.89%	3.39%
2007-08	$ 390,412,000	3739.7	1.90%	$ 11,134,754	125.3	0.80%	3.35%
2008-09	$ 408,169,000	3859.4	3.20%	$ 8,299,272	90.7	-27.61%	2.35%
2009-10	$ 408,846,000	3882.8	0.61%	$ 9,915,734	110.6	21.94%	2.85%
2010-11	$ 425,640,000	4021.8	3.58%	$ 10,290,563	112.3	1.54%	2.79%
2011-12	$ 474,411,000	4257.4	5.86%	$ 9,116,775	99.8	-11.13%	2.34%
2012-13	$ 501,279,000	4366.7	2.57%	$ 10,161,093	111.8	12.02%	2.56%
2013-14	$ 562,538,000	4845.1	10.96 %	$ 11,106,450	113.6	1.61%	2.34%


BOE Positions for
FYs 05/06 - 13/14
Total BOE Positions
Total ID Positions
3533.8
87.6
3669.9
124.3
3739.7
125.3
3859.4
90.7
3882.8
110.6
4021.8
112.3
4257.4
99.8
4366.7
111.8
4845.1
113.6
2005-06
2006-07
2007-08
2008-09
2009-10
2010-11
2011-12
2012-13
2013-14

Appendix G

Franchise Tax Board Data Submitted to Commission

November 5, 2014

Criminal Investigations Bureau
Staffing Numbers from 1985 to Present

Year (Authorized)	Positions	Funding
1984-85	6.0	$189,169
1985-86	6.0	$206,897
1986-87	5.0	$180,600
1987-88	6.0	$232,343
1988-89	5.0	$187,828
1989-90	5.0	$199,175
1990-91	5.0	$217,034
1991-92	4.0	$175,728
1992-93	4.0	$178,486
1993-94	5.0	$217,958
1994-95	27.0	$1,474,352
1995-96	28.0	$1,599,219
1996-97	28.0	$1,602,964
1997-98	29.0	$1,658,272
1998-99	29.0	$1,654,522
1999-00	31.0	$1,904,525
2000-01	37.0	$2,320,248
2001-02	49.0	$3,134,190
2002-03	49.0	$3,375,304
2003-04	47.0	$3,181,767
2004-05	47.0	$3,433,243
2005-06	60.0	$4,006,792
2006-07	63.0	$4,486,214
2007-08	72.0	$5,384,018
2008-09	66.0	$5,537,773
2009-10	69.0	$4,793,733
2010-11	63.0	$5,371,590
2011-12	64.0	$5,345,496
2012-13	60.0	$5,377,143
2013-14	61.0	$5,399,326
2014-15	63.0	$5,693,953

Departmental Funding
From 1985 to Present

Year (Authorized)	Positions	Funding
1984-85	2543.0	$107,674,000
1985-86	2595.0	$122,775,000
1986-87	2737.5	$136,223,000
1987-88	2814.0	$148,229,000
1988-89	2966.0	$162,425,000
1989-90	3350.0	$182,036,000
1990-91	3530.0	$208,489,000
1991-92	3688.0	$212,099,000
1992-93	3920.0	$224,677,000
1993-94	4103.0	$247,397,000
1994-95	4427.0	$276,011,000
1995-96	4672.0	$313,016,000
1996-97	4675.0	$331,983,000
1997-98	4865.0	$330,662,000
1998-99	5007.0	$336,202,000
1999-00	5045.8	$335,113,000
2000-01	5233.3	$349,569,000
2001-02	5301.5	$363,780,000
2002-03	5497.5	$383,088,000
2003-04	5440.5	$380,150,000
2004-05	5072.0	$403,512,000
2005-06	5077.9	$431,057,000
2006-07	5116.0	$439,936,000
2007-08	5181.5	$471,234,000
2008-09	5392.5	$504,990,000
2009-10	5110.0	$517,921,000
2010-11	5275.5	$550,327,000
2011-12	5380.0	$571,686,000
2012-13	5183.0	$648,241,000
2013-14	5341.0	$717,470,000
2014-15	5454.0	$660,970,000

Appendix H

Department of Industrial Relations Data Submitted to Commission

December 23, 2014

Notes:

1/ DIR positions as reflected in the annual schedule 7A (Salaries and Wages Supplement) current year authorized column.

2/ DIR personnel years (authorized positions less salary savings and/or adjustments) and dollars as relected in the January 10th proposed Governor's Budget current year estimated column.

3/ DOSH's Underground Economy targeted enforcement began in FY 2005/06 with the creation of the Economic and Employment Enforcement Coalition (EEEC), now referred to as the Labor Enforcement Task Force (LETF).

4/ DOSH staffing taken from State Controller's listing of authorized positions, as EEEC/LETF staff are merged with DOSH Administration/Field Enforcement in the Schedule 7A.

5/ DOSH funding based on internal records.

6/ Additional DOSH positions and funding utilized for Underground Economy activities beyond the resources received in BCP. Positions taken from internal tracking documents. Dollars taken from expenditure reports.

7/ Fund sources based on 05/06 BCP for fiscal years 05/06-07/08; FY 08/09 BCP for 08/09 and 09/10 and FY 10/11 BCP for on-going, permanent fund allocation.

8/ DLSE staffing includes all authorized Underground Economy enforcement positions, including 10.0-12.0 dedicated annually to the LETF, in the following classifications: Deputy Labor Commissioner I & II, Investigator, Sr Special Investigator, Labor Standards Investigator, Industrial Relations Counsel I, II, III & IV, Legal Counsel, Industrial Relations Representative, and Management Services Technician (excluding MSTs in Headquarters). Staffing taken from the annual Schedule 7A, current year authorized. Managerial and clerical positions were not included.

9/ DLSE funding was calculated based on the percentage of salaries authorized for enforcement staff multipled by the division's total authority. On average, 65% of DLSE's authorized staffing is enforcement.

10/ Dollars by fund were estimated based on each fund's percentage of DLSE's total authorized dollars. The Electricial Certification Fund, Entertainment Work Permit Fund and Child Performer Services Permit Fund were excluded as they do not fund enforcement related activities.

11/ DLSE's FY 2013/14 includes 16.0 limited-term enforcement positions.

Data on reverse

Labor and Workforce Development Agency Department of Industrial Relations (DIR) Underground Economy Enforcement
Annual Staffing and Dollars (2001/02 to 2013/14)
Dollars in thousands

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
DIR													
Total													
Authorized:	2,897.5	2,707.3	2,671.3	2,708.2	2,820.0	2,849.6	2,876.2	2,819.2	2,856.8	2,945.3	2,868.3	2,706.6	2,791.6
Positions 1/	2,712.2	2,527.3	2,330.5	2,553.0	2,679.0	2,707.1	2,732.3	2,683.9	2,714.0	2,656.7	2,701.8	2,706.6	2,791.6
Personnel	$269,637	$252,676	$279,606	$319,013	$344,052	$362,731	$385,014	$393,160	$357,438	$393,185	$412,395	$412,471	$470,869
Years 2/													
Funding 2/													
Total Underground Economy													
Enforcement: Positions (DOSH +	292.5	262.5	251.5	234.0	259.0	266.0	263.0	274.0	274.5	358.0	324.0	324.0	323.0
DLSE)	10%	10%	9%	9%	9%	9%	9%	10%	10%	12%	11%	12%	12%
% of Total DIR Positions													
DIVISION OF OCCUPATIONAL SAFETY AND HEALTH (DOSH)													
Authorized:	3/	3/	3/	3/ EEEC/LETF Positions 4/									
EEEC/LETF Funding 5/	N/A	N/A	N/A	N/A	12.0	12.0	12.0	12.0	12.0	12.0	12.0	12.0	12.0
Additional Enforcement	N/A	N/A	N/A	N/A	$1,465	$1,608	$1,856	$1,823	$1,700	$1,968	$2,184	$2,136	$2,293
Positions 6/ Additional	N/A	N/A	N/A	N/A	N/A	N/A	N/A	5.0	5.0	5.0	5.0	6.0	5.0
Funding 6/	N/A	N/A	N/A	N/A	N/A	N/A	N/A	$308	$0	$468	$853	$483	$714
Fund Source: 7/													
Targeted Inspection & Consultation Fund - 0096	N/A	N/A	N/A	N/A	$700	$771	$890	-	-	-	-	-	-
Uninsured Employers Benefits Trust Fund - 0571	N/A	N/A	N/A	N/A	-	-	-	$1,823	$1,700	$1,968	$2,184	$2,136	$2,293
Unpaid Wage Fund - 0913	N/A	N/A	N/A	N/A	$765	$837	$966	-	-	-	-	-	-
DIVISION OF LABOR STANDARDS ENFORCEMENT (DLSE)													
Authorized:													11/ Enforcement
Funding 9/	292.5	262.5	251.5	234.0	247.0	254.0	251.0	257.0	257.5	341.0	307.0	306.0	306.0
	$28,310	$25,969	$26,860	$28,194	$30,022	$31,786	$31,660	$32,341	$30,241	$31,504	$38,532	$40,143	$43,913
Fund Source:													
10/ General													
Fund - 0001	$24,872	$22,564	$23,543	$24,335	$23,270	$25,993	$24,888	$25,387	$12,766	-	-	$1,313	$1,693
Construction Industry Enforcement Fund - 0216	$36	$36	$35	$36	$36	$34	$35	$39	$37	$44	$43	$41	-
Workers' Comp Admin Revolving Fund - 0223	-	-	-	-	-	-	$716	$790	$719	$773	$779	$808	$854
Uninsured Employers Benefits Trust Fund - 0571	-	-	-	-	$447	$441	$480	$621	$2,033	$2,412	$2,668	$2,672	$2,848
Federal Trust Fund - 0890	$174	$174	$182	$316	$316	$317	$317	$326	$324	$320	$337	$339	$340
Unpaid Wage Fund - 0913	$656	$651	$666	$838	$2,697	$1,577	$1,759	$2,086	$2,070	$2,134	$2,162	$2,250	$999
Reimbursements - 0995	$1,057	$1,018	$977	$980	$980	$983	$965	$979	$632	$311	$328	$329	$341
Garment Industry Regulations Fund - 3004	$1,515	$1,526	$1,457	$1,689	$2,172	$2,337	$2,380	$1,988	$1,755	$1,825	$1,892	$1,970	$2,054
Apprenticeship Training Contribution Fund - 3022	-	-	-	-	-	-	-	-	-	-	-	$438	$456
Car Wash Worker Fund - 3072	-	-	-	-	$104	$104	$120	$125	$120	$135	$138	$132	$136
Labor & Workforce Development Fund - 3078	-	-	-	-	-	-	-	-	-	-	-	$2,602	$2,152
State Public Works Enforcement Fund - 3150	-	-	-	-	-	-	-	-	$761	$42	$5,250	$1,404	$2,463
Labor Enforcement & Compliance Fund - 3152	-	-	-	-	-	-	-	-	$9,024	$23,508	$24,935	$25,845	$29,577

Notes

1. Employment Development Department. December 22, 2014. Written communication with staff. Employer statistics available in Appendix E.

2. Bill Pennington, Senior Technical and Program Advisor, California Energy Commission Energy Efficiency Division. March 27, 2014. Written Testimony to the Commission. Citing Steve Mohasci, Energy Standard Liaison for the Institute of Heating and Air Conditioning Industries, Inc. August 2006. "Enforcement of T-24 Compliance Pertaining to Residential Alterations. Also, California Energy Commission. June 2008. "Strategic Plan to Reduce the Energy Impact of Air Conditioners." http://www.energy.ca.gov/2008publications/CEC-400-2008-010/CEC-400-2008-010.PDF.

3. University of California, Los Angeles, Labor Center. April 19, 2013. "California and the Underground Economy: A Report Prepared for the Board of Equalization by the UCLA Labor Center." Page 2.

4. Allen Prohofsky, Chief Economist, California Franchise Tax Board and Scott Reid, Director, Bureau of Economic and Statistical Research, California Franchise Tax Board. January 27, 2014. Phone call with Commission staff.

5. Employment Development Department. 2000. "Underground Economy Operations." Accessed through the Internet Archive Wayback Machine for June 21, 2003 at http://web.archive.org/web/20030621165650/http://www.edd.ca.gov/taxrep/txueoind.htm. Accessed October 8, 2014.

6. Assembly Committee on Public Safety. April 9, 2013. "Bill Analysis: AB 576." http://www.leginfo.ca.gov/pub/13-14/bill/asm/ab_0551-0600/ab_576_cfa_20130408_094627_asm_comm.html. Accessed January 7, 2015.

7. California State Board of Equalization. Chairman Jerome Horton, 4th District. "The Underground Economy Initiative." http://www.boe.ca.gov/members/horton/initiatives/underground_economy.html. Accessed December 18, 2013. Currently unavailable. PDF of page can be viewed here: http://www.lhc.ca.gov/studies/226/Files/Underground%20Economy%20Initiative.pdf. Accessed January 8, 2015.

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47. Jennifer Lentz Snyder, Head Deputy, Healthcare Insurance Fraud, Los Angeles County District Attorney's Office. April 29, 2014. Los Angeles, CA. Little Hoover Commission Advisory Committee Meeting.

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49. David Simon, Lead Deputy District Attorney, San Bernardino County District Attorney's Office. March 26, 2014. Phone call with Commission staff.

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87. Scott Hauge, President, Small Business California. September 26, 2014. Phone call with Commission staff.

88. Kris Buckner, Chief Executive Officer, Investigative Consultants. April 29, 2014. Little Hoover Commission Advisory Committee Meeting.

89. Simon. See endnote 37.

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91. Homan Hosseinioun, Deputy District Attorney, Special Prosecutions Section, Consumer Fraud Unit, Intellectual Property Rights Unit, Riverside County District Attorney's Office.

92. Julie Su, Labor Commissioner, Division of Labor Standards Enforcement. June 4, 2014. Phone call with Commission staff.

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100. Laureen Pedroza, Bureau Chief, Department of Insurance. April 29, 2014. Los Angeles, CA. Little Hoover Commission Advisory Committee Meeting.

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105. Lisa Schmith, Chief, Investigation Division, Employment Development Department. March 27, 2014. Written Testimony to the Commission.

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109. Charles Spaeth, Senior Investigator, Board of Equalization. April 29, 2014. Little Hoover Commission Advisory Committee Meeting.

110. Homan Hosseinioun, Deputy District Attorney, Riverside County. February 3, 2015. Phone call with Commission staff.

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116. Lee Tien and Hanni Fakhoury, Senior Staff Attorneys, Electronic Frontier Foundation. June 6, 2014. Phone call with Commission staff.

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121. Lisa Schmith, Chief, Investigations, Employment Development Department. March 26, 2014. Sacramento, CA. Meeting with Commissioner Nava and Commission Staff.

122. Scott Zidbeck, Deputy District Attorney, Orange County District Attorney's Office. April 16, 2014. Phone call with Commission staff.

123. David Simon, Deputy District Attorney, San Bernardino District Attorney's Office. March 26, 2014. Phone call with Commission staff.

124. Simon. See endnote 123.

125. Debbie Jackson, Deputy District Attorney, Orange County District Attorney's Office. April 16, 2014. Phone call with Commission staff.

126. Ishitani. See endnote 48.

127. Julie Su, Labor Commissioner, Division of Labor Standards Enforcement. September 9, 2014. Little Hoover Commission Advisory Committee Meeting. Participation via telephone.

128. Selvi Stanislaus, Executive Officer, Franchise Tax Board. January 27, 2014. Sacramento, CA. Meeting with Commission staff.

129. Randy Silva, Chief of Investigations and Special Operations, Board of Equalization. January 23, 2014. Sacramento, CA. Testimony to the Commission.

130. Snyder. See endnote 47.

131. Baker. See endnote 38.

132. Christine Sexton, Administrator, Franchise Tax Board. March 27, 2014. Sacramento, CA. Testimony to the Commission.

133. Buscaglia. See endnote 72.

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142. Andrew Sturmfels, Deputy Director, Legislative and Intergovernmental Affairs, Governor's Office of Business and Economic Development and Panorea Avdis, Chief Deputy Director, Governor's Office of Business and Economic Development. October 30, 2014. Sacramento, CA. Meeting with Commission staff.

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148. Carl Hammersburg, Government Fraud Solutions Specialist, SAS Institute, Inc. and former Fraud Prevention and ComplianceManager, Washington State Department of Labor and Industries. October 3, 2014. Phone call with Commission staff.

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154. Andrew Sturmfels, Deputy Director, Legislative and Intergovernmental Affairs, Governor's Office of Business and Economic Development and Panorea Avdis, Chief Deputy Director, Governor's Office of Business and Economic Development. October 30, 2014. Sacramento, CA. Meeting with Commission staff.

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165. Ishitani. See endnote 48.

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167. Lilia Garcia-Brower, Executive Director, Maintenance Cooperation Trust Fund. May 20, 2014. Sacramento, CA. Meeting with Commission Staff. Also, Snyder. See endnote 47.

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172. Baker. See endnote 38.

173. Ostby. See endnote 41.

174. Silva. See endnote 129.

175. Stanislaus. See endnote 105.

176. Cynthia Mitchell, President, Citadel Tile and Flooring. July 22, 2014. Sacramento, CA. Little Hoover Commission Advisory Committee Meeting.

177. Ross Hutchings, Executive Director, Western Car Wash Association. September 9, 2014. Sacramento, CA. Little Hoover Commission Advisory Committee Meeting.

178. Garcia-Brower. See endnote 167.

179. Shaw San Liu, Lead Organizer, Tenant Worker Center, Chinese Progressive Association. September 9, 2014. Sacramento, CA. Little Hoover Commission Advisory Committee Meeting.

180. April Mackie, Director, Safety and Regulatory Compliance, Ramco Enterprises LP. July 22, 2014. Sacramento, CA. Little Hoover Commission Advisory Committee Meeting.

181. Barrera. See endnote 87.

182. Board of Equalization. October 2013. "Publication 53: Managed Audit Program." http://www.boe.ca.gov/pdf/pub53.pdf. Accessed December 31, 2014.

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187. Pennington. See endnote 2.

188. Quoted in Pennington. See endnote 2.

189. Pennington. See endnote 2.

Little Hoover Commission Members

Chairman Pedro Nava *(D-Santa Barbara)* Appointed to the Commission by Speaker of the Assembly John Pérez in April 2013. Advisor to telecommunications industry on environmental and regulatory issues and to nonprofit organizations. Former state Assemblymember. Former civil litigator, deputy district attorney and member of the state Coastal Commission. Elected chair of the Commission in March 2014.

Vice Chairman Loren Kaye *(R-Sacramento)* Appointed to the Commission in March 2006 and reappointed in December 2010 by Governor Arnold Schwarzenegger. President of the California Foundation for Commerce and Education. Former partner at KP Public Affairs. Served in senior policy positions for Governors Pete Wilson and George Deukmejian, including cabinet secretary to the Governor and undersecretary for the California Trade and Commerce Agency.

Assemblymember Katcho Achadjian *(R-San Luis Obispo)* Appointed to the Commission by Speaker of the Assembly John Pérez in July 2011. Elected in November 2010 to the 33rd Assembly District and re-elected to the 35th District in November 2012 and 2014. Represents Arroyo Grande, Atascadero, Grover Beach, Guadalupe, Lompoc, Morro Bay, Paso Robles, Pismo Beach, San Luis Obispo, Santa Maria and surrounding areas.

David Beier *(D-San Francisco)* Appointed to the Commission by Governor Edmund G. Brown Jr. in June 2014. Managing director of Bay City Capital. Former senior officer of Genetech and Amgen. Former counsel to the U.S. House of Representatives Committee on the Judiciary. Serves on the board of directors for the Constitution Project.

Senator Anthony Cannella *(R-Ceres)* Appointed to the Commission by the Senate Rules Committee in January 2014. Elected in November 2010 an re-elected in 2014 to the 12th Senate District. Represents Merced and San Benito counties and a portion of Fresno, Madera, Monterey and Stanislaus counties.

Jack Flanigan *(R-Granite Bay)* Appointed to the Commission by Governor Edmund G. Brown Jr. in April 2012. A member of the Flanigan Law Firm. Co-founded California Strategies, a public affairs consulting firm, in 1997.

Don Perata *(D-Orinda)* Appointed to the Commission in February 2014 and reappointed in January 2015 by the Senate Rules Committee. Political consultant. Former president pro tempore of the state Senate, from 2004 to 2008. Former Assemblymember, Alameda County supervisor and high school teacher.

Assemblymember Sebastian Ridley-Thomas *(D-Los Angeles)* Appointed to the Commission by Speaker of the Assembly Toni Atkins in January 2015. Elected in December 2013 to represent the 54th Assembly District. Represents Century City, Culver City, Westwood, Mar Vista, Palms, Baldwin Hills, Windsor Hills, Ladera Heights, View Park, Crenshaw, Leimert Park, Mid City, and West Los Angeles.

Senator Richard Roth *(D-Riverside)* Appointed to the Commission by the Senate Rules Committee in February 2013. Elected in November 2012 to the 31st Senate District. Represents Corona, Coronita, Eastvale, El Cerrito, Highgrove, Home Gardens, Jurupa Valley, March Air Reserve Base, Mead Valley, Moreno Valley, Norco, Perris and Riverside.

David A. Schwarz *(R-Beverly Hills)* Appointed to the Commission in October 2007 and reappointed in December 2010 by Governor Arnold Schwarzenegger. Partner in the Los Angeles office of Irell & Manella LLP and a member of the firm's litigation workgroup. Former U.S. delegate to the United Nations Human Rights Commission.

Jonathan Shapiro *(D-Beverly Hills)* Appointed to the Commission in April 2010 and reappointed in January 2014 by the Senate Rules Committee. Writer and producer for FX, HBO and Warner Brothers. Of counsel to Kirkland & Ellis. Former chief of staff to Lt. Governor Cruz Bustamante, counsel for the law firm of O'Melveny & Myers, federal prosecutor for the U.S. Department of Justice Criminal Division in Washington, D.C., and the Central District of California.

Sumi Sousa *(D-San Francisco)* Appointed to the Commission by Speaker of the Assembly John Pérez in April 2013. Officer of policy development for San Francisco Health Plan. Former advisor to Speaker Pérez. Former executive director of the California Health Facilities Financing Authority.

Full biographies available on the Commission's website at www.lhc.ca.gov.

"Democracy itself is a process of change, and satisfaction and complacency are enemies of good government."

Governor Edmund G. "Pat" Brown,
addressing the inaugural meeting of the Little Hoover Commission,
April 24, 1962, Sacramento, California