

## 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.

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.

***“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

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***

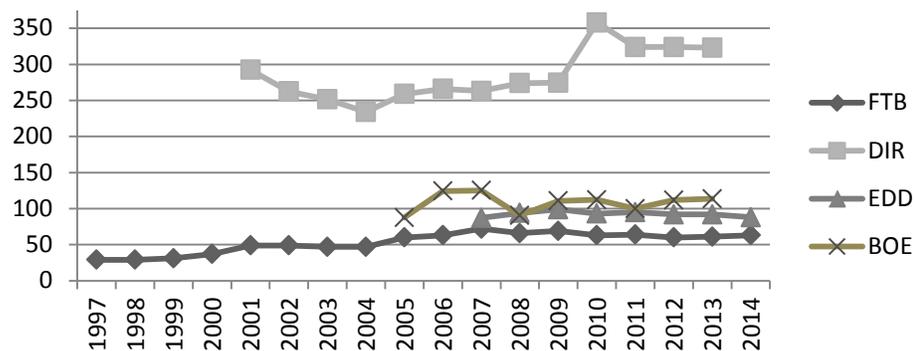
California's long campaign against the underground economy suffers from a lack of leadership. As it found in 1985, the Commission in this review again found that there is no single executive accountable for leading the charge against the underground economy. There are many champions and leaders within 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.<sup>1</sup> 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](http://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.<sup>2</sup> 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.***

