

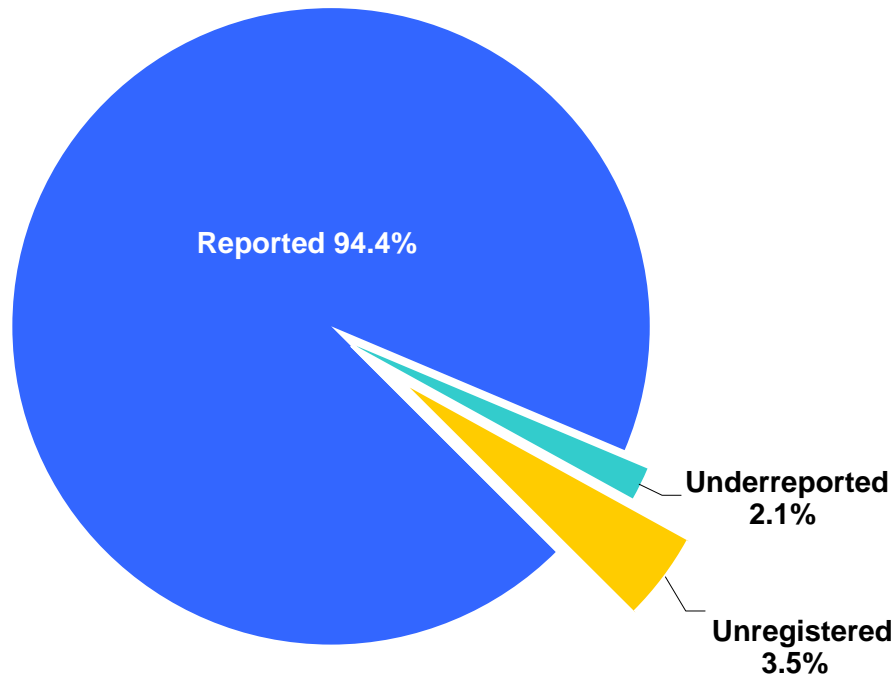
# Underground Economy

Governor's GMAP September 12, 2007



# What is the “Underground Economy” and how big is it?

## Percentages of Total Tax Owed by Businesses



Data Notes: DOR Compliance Study 2006; DOR Unregistered Business Study 2007; Joint DOR, ESD and LNI Study due Fall 2007

## Definition:

- **Underground Economy** – Businesses that gain a competitive advantage by not reporting correctly, or at all, to one or more federal or state taxing agencies.
- This report does not include barter or illegal activities.

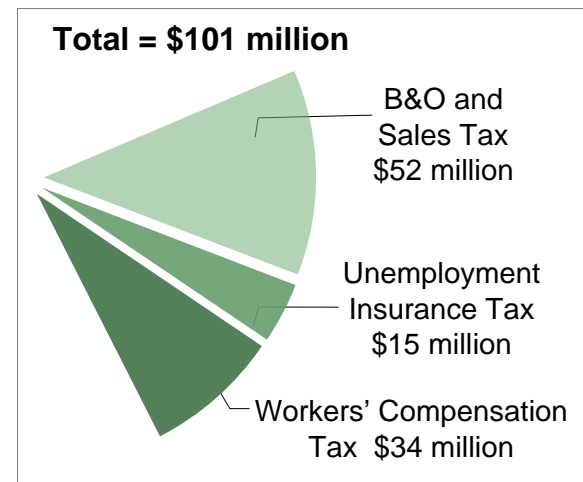
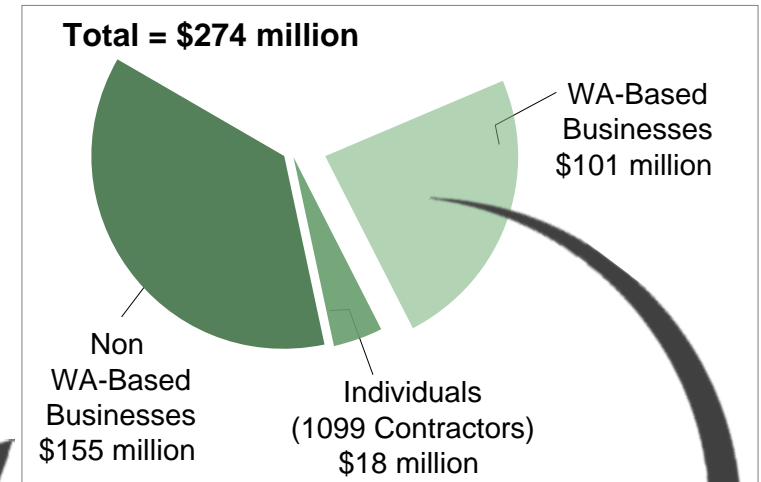
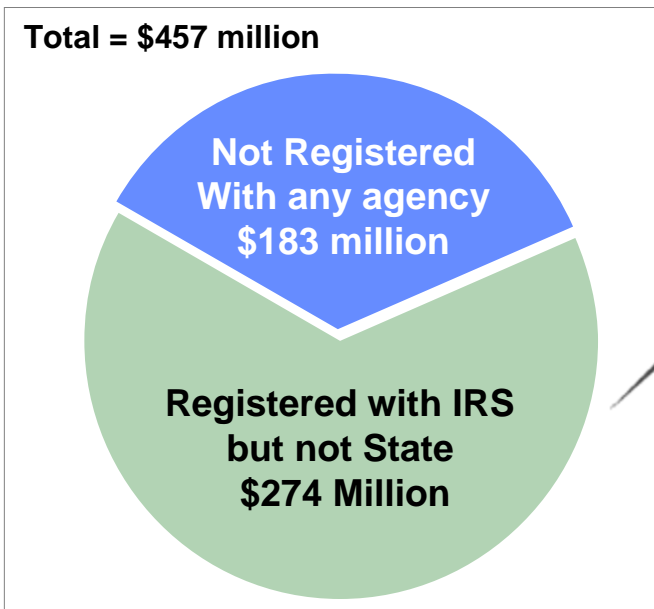
## Analysis:

- 5.6 percent of businesses either under-report or are unregistered and do not report.
  - Underreported – 2.1 percent of tax owed
  - Unregistered – 3.5 percent of tax owed
- Failure by some to pay what they owe means that others bear an additional burden (workers' compensation and unemployment insurance rates are driven up by too few businesses paying into the system; lost tax revenues affect essential government services).
- This report addresses the unreported tax by unregistered businesses.

# What do we know about unregistered businesses?

## Analysis:

- An estimated \$183 million is lost to Washington annually by businesses not registered with any state or federal agency (based on the IRS Tax Gap Study, 2002). Therefore, there is very little known about this group.
- An estimated \$274 million is lost to businesses registered with IRS but not with DOR, L&I, and ESD.
- Of the \$274 million, an estimated \$155 million is due from businesses based out-of-state but with taxable presence in Washington. An estimated \$101 million is due from Washington-based businesses.
- Of the \$101 million, an estimated \$52 million is due from B&O, sales, and other excise taxes; \$34 million from workers' compensation taxes; and \$15 million from unemployment taxes.

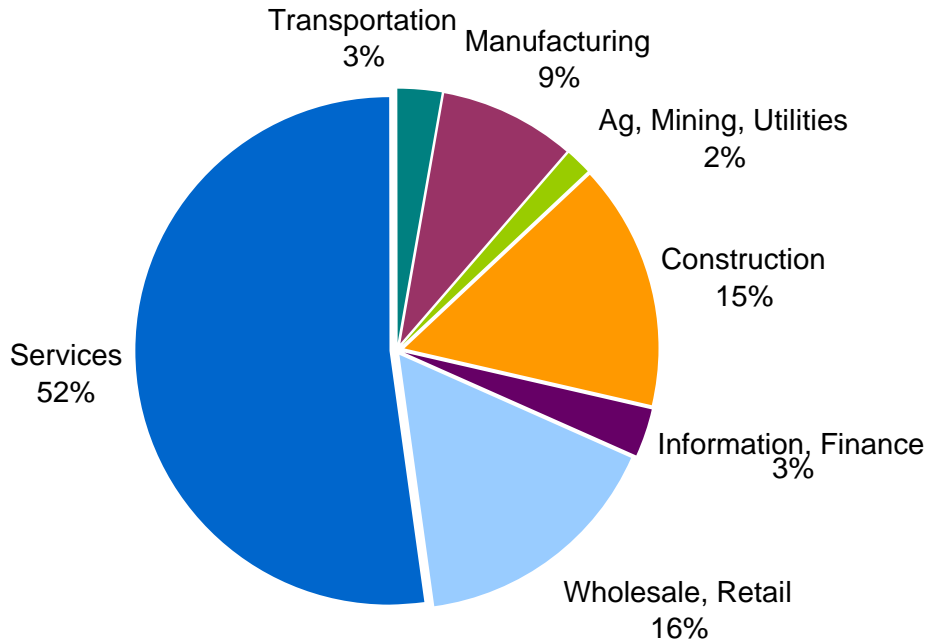


# Taxes owed by businesses that don't play by the rules.

## Washington-Based Businesses

Percentage of Taxes Owed by Industry

Total = \$101 million



Data Notes: DOR, L&I and ESD taxes combined.

## Analysis:

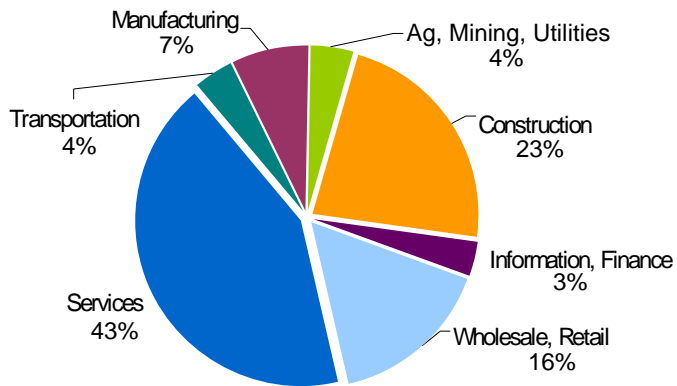
- Service firms represent one third of all unregistered firms; they owe 52 percent of unreported taxes.
- Most unregistered service firms are very small, earning less than \$100,000 annually in gross income.
- Small service firms tend to work in isolation doing work for households instead of other businesses. They may be unaware of their obligation to register.

## Implications for agency:

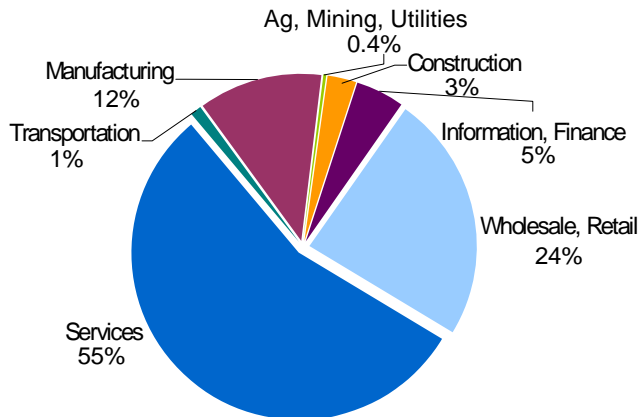
- Because unregistered service businesses are so small and numerous, education targeted at these firms, and their consumers and employees may be more cost effective than enforcement efforts.

# Taxes owed by businesses that don't play by the rules (continued).

## Unemployment Insurance Taxes – \$15 million



## B&O and Sales Taxes – \$52 million



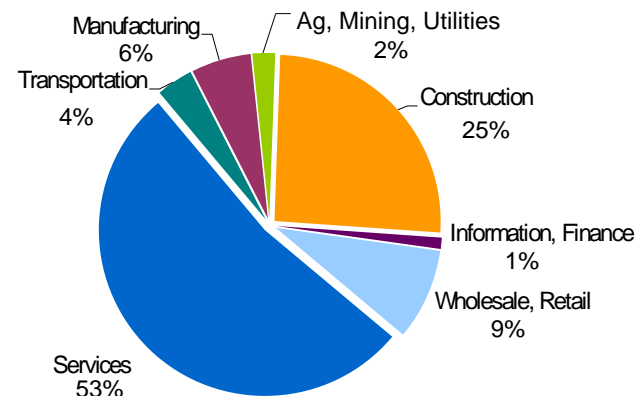
## Analysis:

- Unregistered construction businesses appear to be more of a problem for ESD and L&I than for DOR.
- ESD and L&I construction rates are high due to high injuries and the seasonality of employment. DOR tax rates are lower for construction because sales taxes, for the most part, are borne by the final consumer.
- The unregistered construction firm owes an average of \$6,000 in taxes – twice as high as the average for other businesses. High taxes can lead to evasion and give the competitive edge to the unregistered firm.

## Implications for agencies:

- Evasion in an industry calls for joint agency investigation such as data sharing and data matching. Fraud detection and anti-fraud campaigns can be appropriate.
- Registering firms that can be identified deters those businesses that can't be identified. By examining records of unregistered businesses, agencies can identify their unregistered suppliers and purchasers.

## Workers' Compensation Taxes – \$34 million



Note: Includes only Washington-based businesses with industry code on IRS return.

# Action plan to address major barriers in identifying unregistered businesses.

Barriers	Actions	Who	When
<b>1. Many citizens are unaware of the consequences of the problem and reluctant to report unregistered and underground businesses.</b>	• 1-800 report fraud lines	L&I, ESD, DOR	Done
	• Report fraud online forms	L&I, ESD, DOR	Done
	• Education for consumers, employees, and businesses on unregistered businesses and how to report	L&I, ESD, DOR	Ongoing Long Term Effort
	• Public relations campaign to “make fraud wrong again”	L&I, ESD, DOR	Ongoing
<b>2. Much of the underground economy is hidden from the view of state tax and regulatory agencies.</b>	• Underground Economy Business Study	L&I, ESD, DOR	Fall 2007
	• Work cooperatively with the Legislative Committee on the Underground Economy in construction	L&I, ESD, DOR	Report due January 2008
	• Use systematic approach to investigating underground economy via the data warehouse	DOR	Ongoing
	• Develop new detection systems to identify noncompliant businesses	L&I	2009-2011 Budget Package
<b>3. State agencies are having difficulty recruiting and retaining auditors and other staff whose expertise is needed to investigate the underground economy.</b>	• GMAP joint agency task force on recruitment and retention	L&I, ESD, DOR, DOP	Report submitted to DOP Director
	• Individual agency budget packages and/or class proposals	L&I, ESD, DOR	Next round of contract negotiations

# Action plan to address major barriers in identifying unregistered businesses (continued).

Barriers	Actions	Who	When
<b>4. The lack of clear, consistent statutory definitions of such terms as “worker”, “employer”, and “independent contractor”, and inconsistent court decisions have resulted in differing treatment of taxpayers by state agencies.</b>	<ul style="list-style-type: none"> <li>• Cross-train staff from ESD, L&amp;I, DOR</li> </ul>	L&I, ESD, DOR	Done
	<ul style="list-style-type: none"> <li>• Training classes for the public</li> </ul>	L&I, ESD	Ongoing
	<ul style="list-style-type: none"> <li>• Plain language brochure on “employer” vs. “independent contractor”</li> </ul>	L&I, ESD	Done (Now in 3rd printing)
	<ul style="list-style-type: none"> <li>• Consider request legislation (Part of L&amp;I strategic plan)</li> </ul>	L&I	By 2011 legislative session
<b>5. State and federal privacy requirements have added to the complexity of sharing data among agencies.</b>	<ul style="list-style-type: none"> <li>• GMAP data sharing task force</li> </ul>	L&I, ESD, DOR	Report due December 2007
	<ul style="list-style-type: none"> <li>• Consider joint agency data sharing agreement with the IRS</li> </ul>	L&I, ESD, DOR	Ongoing Long Term Effort (Conversations already begun with IRS)