

## The underground economy overshadows the official economy

Looking into the underground economy is like trying to harness a moving target. And yet this phenomenon—and its impact on the official economy—is very real. Despite the fact that Quebecers want every citizen to contribute their fair share to the state's coffers, they still toy with the underground economy. While efforts are made to recover unreported amounts, what percentage of estimated tax losses can we really recover? Can the new technologies, with all their transaction-tracking capabilities, help rein in the underground economy? This remains to be seen, but there is one certainty: the work is complex and states around the world are not giving up. In the meantime, as far as economists are concerned, much needs to be done to accurately estimate the extent of this phenomenon and its manifestations.

### SOME FACTS AND FIGURES

There are as many definitions of the underground economy as there are people or organizations trying to tackle the issue. The underground economy generally includes the black market (unreported work), tax evasion, illegal and criminal activities (drug trafficking, possession of stolen goods, etc.). These activities share a common characteristic: they circumvent shared economic and social rules and undermine the state by skirting the taxes these activities should generate.

Estimating the value of the underground economy is a challenge to anyone who ventures down this dark path. Even if we cannot pinpoint the exact value, we know that its impact on the official economy is very real. Underground activities deprive governments of income that cannot be redistributed. Taxpaying citizens have to make up the difference the tax dodgers create and such practices leave many companies vulnerable to unfair competition.

There are many reasons why the underground economy exists. Some people simply want to avoid paying taxes while others omit to make their social contributions (e.g. government pension plans, employment insurance). Some give themselves a pass from abiding by labour market standards such as the minimum wage, maximum hours of work or even health and safety requirements. Others want to bypass the administrative hassles of filling out forms,

documents, etc., and proving their accountability to the state. Those who take part in the underground economy calculate—either consciously or not—the cost between getting caught and the probability of getting caught by authorities.

### FROM THE TAXPAYER'S PERSPECTIVE

Paying our share of taxes (through income taxes or other contributions) is not something taxpayers get overly excited about, yet many Quebecers do so faithfully. The data for Quebec shown here provide a snapshot of the taxes collected in Quebec. Table 1 shows that 6.4 million taxpayers filed a tax return with Revenu Québec<sup>1</sup> in 2012, with Quebecers paying an average income tax of \$3,780. The data also

**Table 1 – Personal income tax:  
Quebec 2011 and 2012**

	2011	2012	Change from 2011 to 2012 (in %)
Number of taxpayers (in thousands)	6,372	6,414	0.7
Total income (in \$M)	248,621	259,203	4.3
Tax payable (in \$M)	23,352	24,245	3.8
Tax payable per taxpayer (in \$)	3,665	3,780	3.1
Refundable tax credits (in \$M)	3,953	5,006	26.7
Tax payable minus refundable credits (in \$M)	19,399	19,238	-0.8

Source: Statistiques fiscales des particuliers, 2012 taxation year, May 2015

<sup>1</sup> Revenu Québec, *Statistiques fiscales des particuliers, 2012 taxation year, May 2015.*

[http://www.finances.gouv.qc.ca/documents/Statistiques/fr/STAFR\\_sfp\\_2012.pdf](http://www.finances.gouv.qc.ca/documents/Statistiques/fr/STAFR_sfp_2012.pdf)

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NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

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**Table 2 – Number of Quebec taxpayers (2012)**

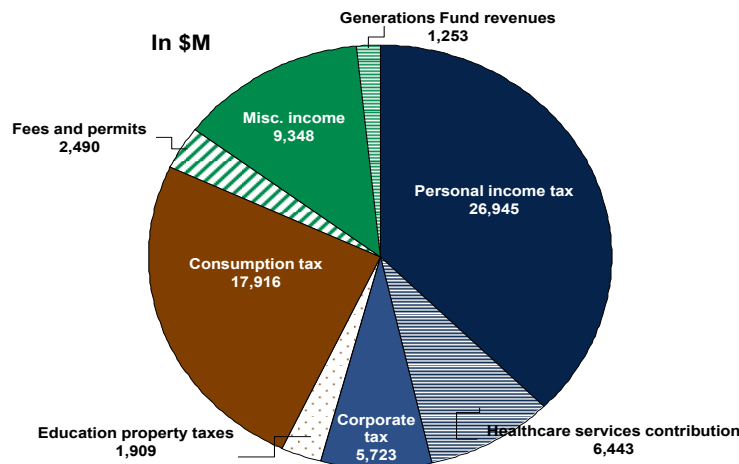
	Number (in thousands)	Proportion 2012	Change between 2011 to 2012 (in %)
Taxable Quebecers	4,042	63.0	0.1
Non-taxable Quebecers	2,372	37.0	1.7
<b>Total</b>	<b>6,414</b>	<b>100.0</b>	<b>0.7</b>

Source: Statistiques fiscales des particuliers, 2012 taxation year, May 2015

show that 63% of taxpayers—slightly more than 4 million Quebecers—were taxable (table 2).

Does this mean that these 4 million people are shouldering Quebec’s total tax burden? No, businesses and other Quebecers, to different extents, also generate own-source revenues for the state through consumption taxes, healthcare contributions, fees and permits (graph 1). In fact, 85% of Quebecers make social contributions. This overview is not comprehensive and does not include other income sources such as equalization and other source payments. But it does illustrate the multifaceted nature of tax measures—and the many ways one can avoid them.

**Graph 1 – Changes in consolidated own-source revenues, excluding government businesses**



Sources: Quebec government, 2015-2016 Budget, Economic Plan and Desjardins, Economic studies

Since paying taxes and taking money from taxpayers and consumers’ wallets is hugely unpopular, hearing them groan when the Fraser Institute publishes its Tax Freedom Day index is no surprise. This index is not widely heralded as it considers payments to the Régie des rentes du Québec as a tax, while others see it as way to force people to save for a future income or even as part of a broader measure to reduce the state’s presence. It is still a worthwhile exercise as it pinpoints the date when families in all Canadian provinces finish making their contributions to the state and can spend their earnings as they see fit. This date in 2014 for Quebec taxpayers was June 14, just ahead of Newfoundland, which came in last (June 22).

Despite the fact that Quebecers want everyone to pay their fair share, they still flirt with the underground economy, as the figures show a little further. An H&R Block survey of Canadians conducted in July and August in 2011 An H&R Block survey of Canadians conducted in 2014 showed that 53% of those surveyed said they would opt for an under-the-table transaction if it spared them the GST. This same survey reported that 58% considered that paying cash to avoid sales tax is wrong. Taxpayers seem to want their cake, and eat it too.<sup>2</sup> Taxpayers seem to want their cake, and eat it too.

**AN ASYMMETRICAL MEASURE**

Estimating the scope of the underground economy is like measuring an activity that, by its very nature, is hidden—there are almost as many methods to do so as there are researchers trying to tackle the issue. Some researchers have access to official tax data and they try to compare the figures for supply and demand to study both sides of the issue. Construction offers a prime example: the time and money spent on home improvements reported in household tax returns is compared with construction workers’ returns. The difference between the two offers a glimpse of the revenue that falls outside the official economy. Some look at data on the demand for cash while others look at under-reporting of income, especially among the self-employed.

<sup>2</sup> Hansen, Darah, Yahoo finance, Majority of Canadians would pay under the table to avoid tax: survey, July 23, 2014. <https://ca.finance.yahoo.com/blogs/insight/majority-canadians-pay-under-table-avoid-tax-survey-200029202.html>

**Table 3**  
**Size of Canada's underground economy, based on different sources**

Sources	In % of GDP	Other numbers	Comments
Statistics Canada	2.3% (in 2012) = \$42.4B	Was 2.7% in 1994	Excluding activities related to drugs and prostitution
Friedrich Schneider Johannes Kepler University of Linz	Between 10 and 20% (in 2010)		
Bank of Canada study Geoffrey R. Dunbar, Chuling Fu.	14 to 19% of GDP (between 1998 and 2004)		

Sources: Statistics Canada, Schneider, Buehn and Montenegro (2010) and Dunbar, Geoffrey and Fu, Chuling

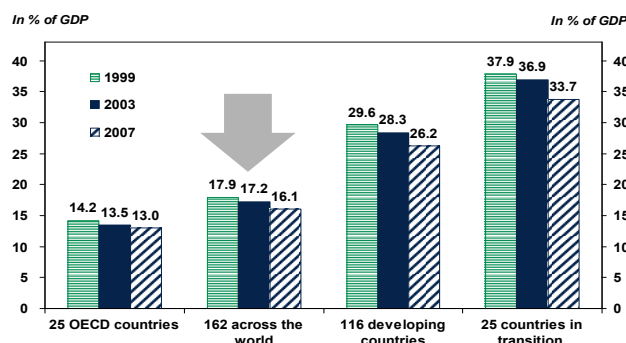
Different researchers may adopt different approaches, which can also vary by country. Access to data is not standardized and not all sectors are subject to the same scrutiny. And since labour legislation and rules around the world are also inconsistent, tax avoidance and moonlighting may or may not be a factor in a given activity depending on the region or country considered.

Table 3 provides an overview of the different measures in Canada's underground economy, estimated by Statistics Canada at \$42.4B in 2012, or 2.3% of Canada's GDP. For the researchers at this government agency, this represents a decline from the 2.7% recorded in 1994. This measure does not include activities tied to drugs and prostitution. A few priority areas of activity were targeted, i.e. construction, finance, insurance, real estate services, rental and leasing services and holding companies. Retail services, accommodations and food services were also targeted.

A recent study released by the Bank of Canada estimated that between 1998 and 2004, under-reporting of income represented 14% to 19% of Canada's GDP. This measure reflects the findings of Professor Friedrich Schneider of Johannes Kepler University in Linz, Austria, who has studied the underground economy for years. In work papers released in 2010, the share of Canada's underground economy was estimated at between 10% and 20%. Bear in mind that this measure takes different parameters into account and comparisons are inevitably imperfect.

Graph 2 allows for comparisons between Professor Schneider's estimates for the same year for different countries. From this viewpoint, Canada falls within the average according to the estimates reached by Professor Schneider and his team for 162 countries around the world.

**Graph 2 – Weight and growth of the underground economy in GDP for different groups of countries**



Source: Schneider, Buehn and Montenegro (2010)

Statistics Canada estimated that the underground economy in Quebec reached \$10.4B in 2012, or 2.9% of GDP (table 4 on page 4). Bernard Fortin, professor and researcher at Université Laval, studied the issue and reached different conclusions. Studies completed in 1996 assessed the underground economy at less than 3% of GDP in 1993. However, a new study in 2009 estimated this proportion at 4.6% in 1997 and at 5.7% in 2002. Of note, the underground

<sup>3</sup> Geoffrey R. Dunbar, Chunling Fu, *Sheltered Income: Estimating Income Under-Reporting in Canada, 1998 and 2004*, work document 2015-22, June 2015. <http://www.banqueducanada.ca/2015/06/document-travail-2015-22/>

**Table 4**  
**Size of Quebec's underground economy, based on different sources**

Sources	In % of GDP	Other numbers	Comments
Statistics Canada (2012)	2.9% (2012): \$10.4B		Excluding activities related to drugs and prostitution
B. Fortin et al (1996) including C. Montmarquette	Less than 3% of GDP in 1993	About \$2,000/household	
B. Fortin et al (2009)	4.6% in 1997 5.7% in 2002	±\$4,300/Quebec household	Excluding criminal activity

Sources: Statistics Canada, B. Fortin et al (1996), B. Fortin et al (2009)

economy was estimated at around \$4,300 per Quebec household in 2002. These measures do not include criminal activity. That different work methods were used should also be noted. Professor Fortin identified a number of relevant studies conducted by many researchers. This overview assesses the diversity of the approaches used, estimating that the scope of Quebec's underground economy in the 1980s, 1990s and 2000s fell somewhere between 3% and 27% depending on the method used. Who knows, really? Even at 3%—at a time of rising demand for public goods and services, and with government spending being increasingly scrutinized—can states and citizens afford such a loss?

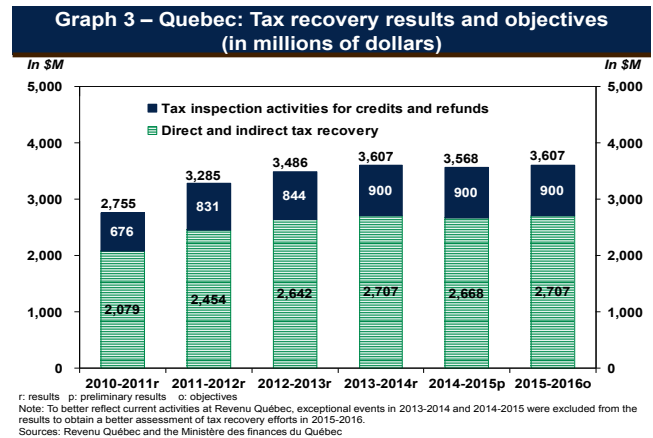
**STEMMING THE LEAKS**

What efforts should be made to recover the amounts that escape tax authorities? Like the taxpayers who try to assess if taking part in the underground economy is worthwhile, governments have to make sure that recovering any amounts owed is worth the time and money to do so. The first step involves auditing individual and business tax returns. Second, governments have developed a growing number of tools that target different areas of activity often linked to tax evasion, such as construction and food services among others.

For example, sales recording modules (SRMs), which track the transactions recorded and facilitate fraud detection, were installed in Quebec's restaurants in 2010 and 2011. The installation of these devices has been required in bars since February 2016. In the construction sector, large project audits are part of the tools the state has adopted to limit the spread of moonlighting. Revenu Québec has pegged tax evasion in the food services sector at \$415M annually. In the construction sector, the estimate is \$1.5B.

New initiatives were announced in the provincial budget tabled in March 2015 to counter the underground economy's growth. To illustrate, additional actions were introduced in the construction field, mainly regarding the "verification of requirements for holding a contractor's licence." Teams representing different government departments and organizations were assembled to closely track the construction and home renovation sectors, the illicit trade of tobacco and alcohol, and economic and financial crimes, to name just a few.

In 2013–2014, \$431.3M was recovered from the targeted sectors (construction, illicit trade of tobacco and alcohol, economic and financial crimes), with an additional \$48.7M in fines. For fiscal 2013–2014, a total of \$3.6B in unpaid taxes was recovered (graph 3). And these data are for the Ministère du Revenu du Québec only; the federal government also does its share to recover unpaid taxes. Efforts are being made around the world to recover amounts that should be collected and more and more agreements to share information between states are being signed to achieve this.



### NEW TECHNOLOGIES: ALLIES OR FOES?

Do new technologies play a role in developing the underground economy? First of all, they could be considered as allies in the hunt to uncover transactions. For example, technology is used to track restaurant sales and any transaction completed online can be tracked. In addition, the new technologies cross-check information on individuals and companies much faster than when everything was done using paper trails. This facilitates information sharing between organizations that combat moonlighting and tax evasion. It also speeds up the search for information.

On the other hand, technology also speeds up communication for those seeking to operate under the state's radar. If anything, people who provide or seek services can get into contact with each other much faster at the outset of a transaction. Social networks and informal platforms provide exceptional showcases. People can then opt to continue interacting using a method of communication that leaves no trace or at least a scant trail. The multiplication of service offers between individuals for accommodations or transportation, on the fringes of official rules, raises a host of questions. When does this become illegal? What is the most appropriate measure? Are the sales figure, volume of transactions and operating mode the best indicators to confirm if an activity is legal? Much ink has been spilled to answer this question and states continue to grapple with this issue, while the service offering grows with each passing day.

### A MOVING TARGET

By its very nature, the underground economy is hard to grasp. We know that it plays a considerable role in Quebec's economy, even if it is difficult to measure with any degree of accuracy. New technologies are both allies and foes: they help track transactions, but they also contribute to the growth of informal networks. Trying to stem the outflows from the official networks seems very difficult to do with the tools currently in place. However, states around the world are not giving up—they intend to stem their losses. As far as economists are concerned, developing better tools and providing access to more data to monitor the underground economy and better measure its extent are the first steps in designing more targeted solutions to combat tax evasion.

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