



"OFF-THE-BOOKS" ECONOMIC ACTIVITY IN B.C.: WHO'S NOT PAYING THEIR FAIR SHARE?

HIGHLIGHTS

- British Columbia has the dubious honour of being home to Canada's sketchiest economy. B.C. has by far the largest proportion of hidden and unreported market-based economic activities – both legal and illegal – among the provinces.
- "Off-the-books" transactions were worth around \$11 billion in 2018, or 3.7% of provincial GDP. Although B.C. accounts for only 14% of Canada's population and 13% of national official GDP, it represents an outsized 18% of nation-wide hidden transactions.
- B.C.'s vulnerabilities are concentrated among individual employees and unincorporated businesses, particularly those involved in residential construction, property rental, unlicensed cannabis, unlicensed tobacco, and food and beverage service.
- Hidden economic activities may be costing British Columbians an estimated \$3.7 billion per annum in uncollected tax revenue. This includes \$1.6 billion of lost federal revenue and \$2.1 billion of lost provincial revenue.
- For comparison, \$2.1 billion would pay for one-fifth of provincial-level personal taxes, half of provincial-level corporate taxes, one-quarter of B.C. sales taxes, two-thirds of property taxes, or any of B.C.'s fuel, carbon, or property transfer taxes.
- The deep COVID-19 recession is placing extraordinary stress on the finances of households, businesses, and governments. Now more than ever, governments should ensure everyone is paying their fair share. They should address the tax and regulatory design and compliance flaws that allow hidden and unreported transactions to flourish.

A DUBIOUS HONOUR

British Columbia has the dubious honour of being home to Canada's sketchiest economy, according to latest data from Statistics Canada. Statistics Canada defines the "underground economy" (or "shadow economy") as market-based "economic activity or transactions in goods or services that are partially or entirely hidden from the government in order to evade paying taxes and other government reporting obligations (such as employment insurance and Canada Pension Plan contributions)." In principle, their definition includes all hidden

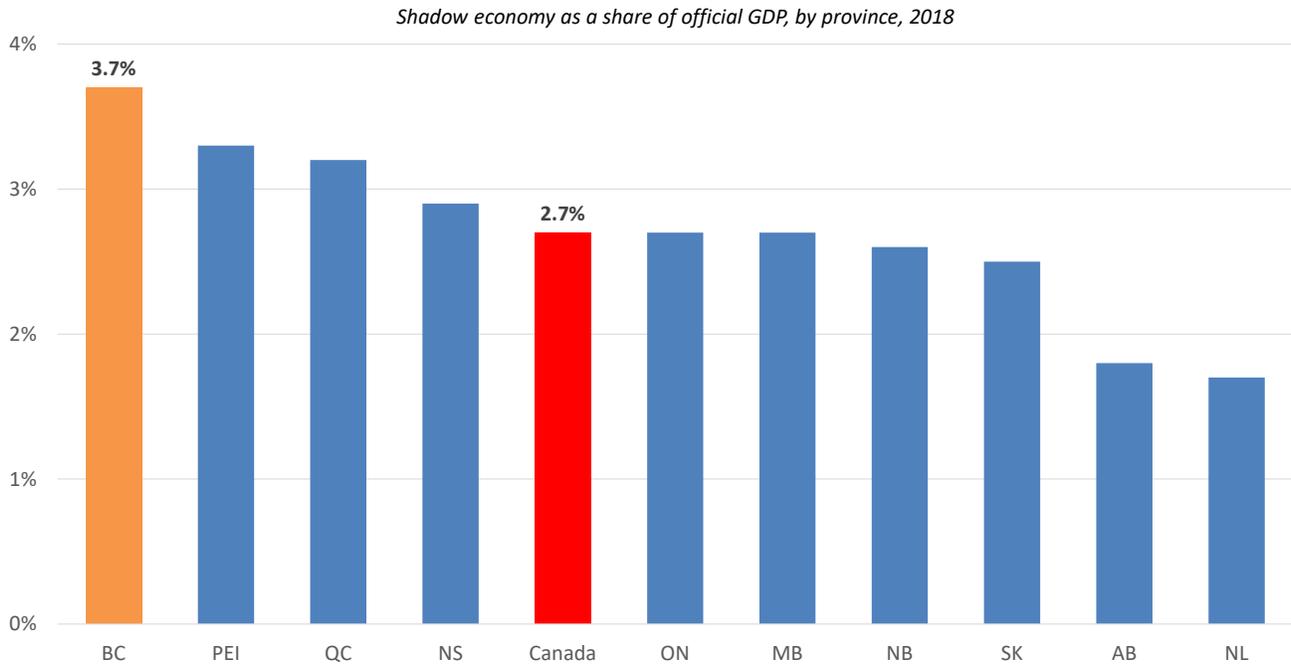
and unreported market-based transactions, regardless of whether they are legal or illegal. In practice, their estimate covers unreported legal transactions in all sectors of the economy, plus unreported illegal transactions in cannabis sector only.

B.C. has the largest proportion of hidden and unreported economic activities among the provinces. B.C.'s "off-the-books" activities were worth at least \$11 billion, or more than 3.7% of official GDP in 2018 (**Figure 1**).¹ In 2018, these types of transactions grew faster here than anywhere except Quebec (**Figure 2**).

Four provinces – Ontario, Quebec, British Columbia, and Alberta – account for the overwhelming majority (88%) of unreported transactions (**Figure 3**). B.C.'s contribution is disproportionately large, however. Although the B.C. accounts for 14% of the Canada's population and 13% of national official GDP, it represents 18% of nation-wide shadow economy GDP based on the Statistics Canada definition referenced above.

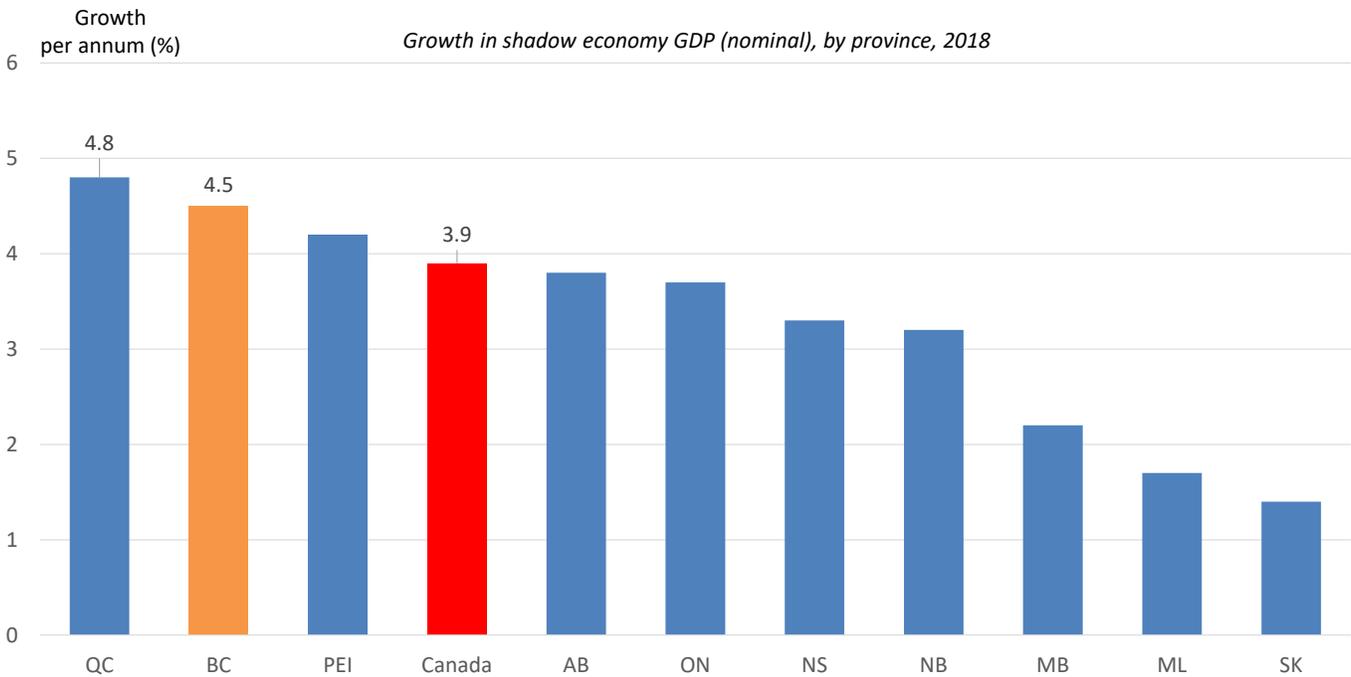
¹ Note that these estimates are likely understated because most illegal activities (other than illegal cannabis production) are unaccounted for in Statistics Canada data.

FIGURE 1: MORE TRANSACTIONS ARE KEPT "OFF-THE-BOOKS" IN B.C. THAN ANYWHERE ELSE IN CANADA



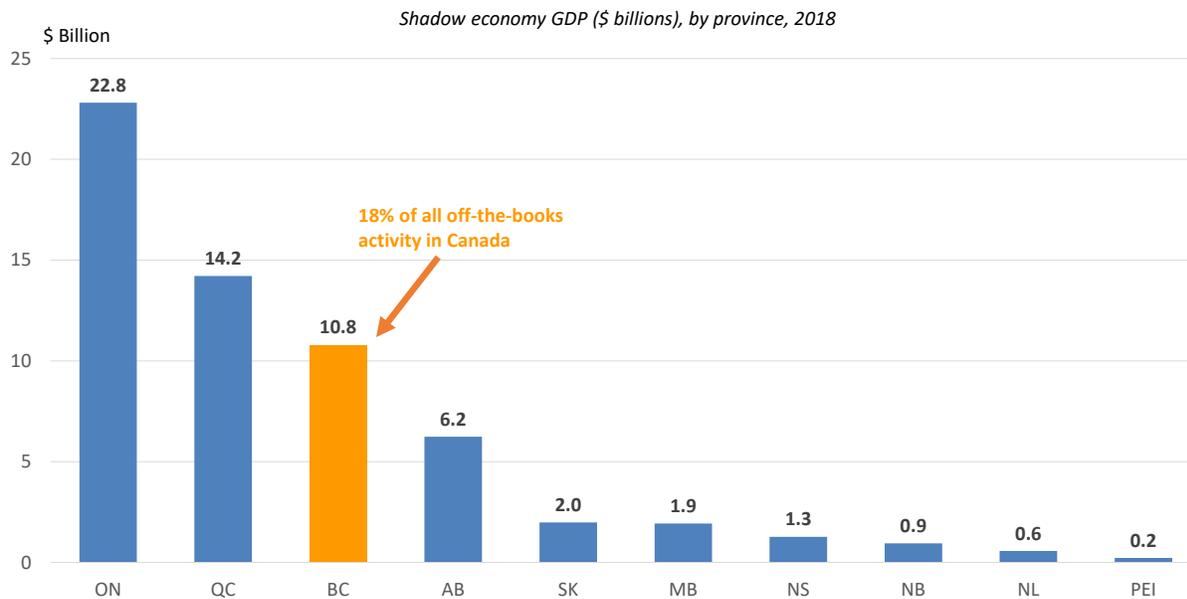
Source: Statistics Canada.

FIGURE 2: HIDDEN TRANSACTIONS ARE GROWING FASTER IN B.C. THAN ANYWHERE EXCEPT QUEBEC



Source: Statistics Canada.

FIGURE 3: FOUR PROVINCES ACCOUNT FOR 88% OF CANADA'S \$61.1B SHADOW ECONOMY



Source: Statistics Canada.

TABLE 1: EXAMPLES OF SHADOW ECONOMIC ACTIVITIES

Hidden Activity	Examples
Unregistered business	Businesses that do not register with the tax administration for income tax, sales taxes, or capital gains tax. They may still register with other agencies or service providers.
Under-reporting of business income ("skimming")	Legal businesses that fail to declare a fraction of their receipts on their tax returns. Under-reporting can range from businesses or sole traders that skim off some cash sales to large scale fraud.
Inflation of costs	Those who inflate tax deductible expenses, e.g. using false receipts or invoices or collusion with others.
Identity fraud	Use of fake identities to avoid tax liabilities or to claim refunds due to others. Also, commonly used to continue to claim benefits while working.
Phoenix companies	Companies that are created with the intention of becoming insolvent before paying tax and other bills (with the business being transferred but not the debts). Similarly, companies may strip assets and disappear prior to paying tax due
Moonlighters	People registered with the tax administration for some employment but not for all, e.g. someone with a part-time job paid by cash on top of regular employment.
Ghosts	Those unknown to the tax administration, never having registered for tax. E.g. informal market traders, day or seasonal labourers, providers of domestic services, and serious criminals.
Cross-border fraud	Those who carry out activities across border with the aim of exploiting gaps and being able to hide out of reach of another tax administration.
Employer fraud	Not registering workers with the tax administration or requiring such registration as a condition of employment; not complying with requirements to withhold tax or social security liabilities; employing illegal workers – e.g. those without a permit or underage; not carrying out identity checks; paying less than required minimum wages etc.
GST fraud	Claiming refunds or deductions for goods and services tax (GST) that has not been paid by the supplier, including through organized cross-border fraud.
Distance selling	Evading the payment of GST by selling into one country from another online without registration.
Money laundering	Bringing money from illegal activity into a legal business to make its origin appear legal.
Illicit trafficking	Smuggling of goods on which duty has not be paid or which are fake for sale informally or through established businesses.
Other illegal activities	Production and distribution of illegal goods (e.g. drugs) and services (e.g. prostitution), unlicensed activities (e.g. gambling), counterfeiting, fencing (resale) of stolen goods, bribery.

Source: Based on [OECD 2017](#).

WHAT ARE SHADOW ECONOMIC ACTIVITIES?

Shadow economic activities range from unreported business income or rent, off-the-books employment and undeclared tips, to illegal activities such as drug trafficking, unlicensed gambling, and money laundering (**Table 1**). Note that Statistics Canada's estimates of the shadow economy are likely an understatement, because in practice they do not capture most illegal activities other than illegal cannabis sales and production. See [Williams 2019a](#) and [Williams 2019b](#) for further reading.

WHERE ARE B.C.'S "OFF-THE-BOOKS" TRANSACTIONS THRIVING?

There are three ways to decompose shadow economy GDP by: income sector; expenditure sector; or industry sector. The analysis reveals three key findings.

Lesson #1: Individual employees and unincorporated businesses account for the majority of "off-the-books" income

Figure 4 shows B.C.'s shadow economy GDP by income sector. The three sectors are employee compensation, gross operating surplus of corporations, and gross operating surplus of unincorporated enterprises (e.g. small businesses and sole proprietors/self-employed). Gross operating surplus is roughly business profits with some adjustments.² Individual employees and small, unincorporated businesses are responsible for the vast majority (77%) of unreported activities.

B.C. has by far the largest proportion of hidden and unreported economic activities among the provinces.

Table 2 provides more detail. The top income sector is undeclared labour income by individuals, which represents \$4.1 billion (38%) of shadow economy GDP. Examples include undeclared tips and "cash-in-hand" wages, as well as individuals' undeclared rental income on properties and investment income. Unincorporated businesses are the next largest sector, accounting for roughly \$3.7 billion (34%) of shadow economy GDP. The principal channels here are unlicensed cannabis sales and production, skimming (i.e. under-reporting of business income), illicit tobacco, and "off-the-books" residential construction. The third sector is corporations, which account for \$2.4 billion (22%) of hidden GDP. The principal channels in this segment are through skimming and "off-the-books" residential construction.

Lesson #2: Household consumption and residential investment account for the majority of "off-the-books" expenditures

Figure 5 shows shadow economy GDP by expenditure sector. The vast majority of "off-the-books" expenditures are concentrated in household spending on consumption and residential investment:

- Household final consumption expenditure accounts for 56%

of official GDP (\$6.4B) but an outsized 60% of shadow economy GDP. **Table 2** shows consumption expenditures ranked by size. The top hidden and unreported expenditures are housing rents, food and beverage services, non-medical cannabis, tobacco, and alcohol.

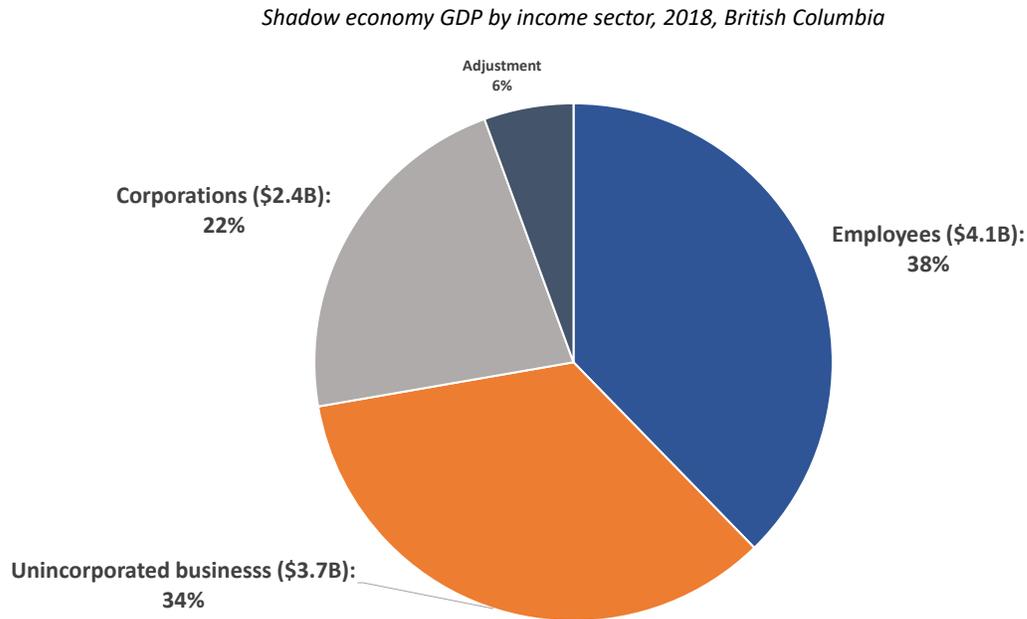
- Residential investment (i.e. new dwelling construction, renovations, and the costs of transferring property ownership) makes up only 7% of official GDP, but accounts for a vastly outsized 25% of shadow economy GDP (\$2.7B). This points to a significant leakage of (mostly) legal but unreported economic transactions that escape tax.
- Export and import expenditures account for a relatively modest 15% of shadow economy GDP (\$1.6B). The data does not give further detail but would likely include activities such as skimming, distance fraud, employer fraud, sales tax fraud, and cross-border fraud.

Lesson #3: Five industries account for three-quarters of "off-the-books" output in B.C.

Figure 6 shows shadow economy GDP by industry. Five industries account for three quarters of hidden output. Residential construction is by far the largest contributor (27% of shadow economy GDP, including cash-in-hand work), followed by retail trade (16%, including cannabis, tobacco and alcohol), rental/leasing, real estate, finance and insurance (12%), crop and animal production

² Compensation of employees (COE) is mostly cash wages and salaries, plus non-cash benefits paid by employers (e.g. contributions to health, dental, life and disability insurance and private pensions, and also to government plans for pensions, employment insurance and workers' compensation). Gross operating surplus (GOS) is the gross sales revenues of corporations /less costs of intermediate goods /less COE /less net taxes on production. Gross mixed income is constructed similarly to GOS, but recognizes that income paid to labour and capital is "mixed" since self-employed unincorporated business owners can arbitrarily pay themselves through salaries and/or dividends. See [Statistics Canada \(2016\)](#).

FIGURE 4: INDIVIDUAL EMPLOYEES AND SMALL BUSINESSES ACCOUNT FOR 72% OF HIDDEN INCOME



Source: Statistics Canada.

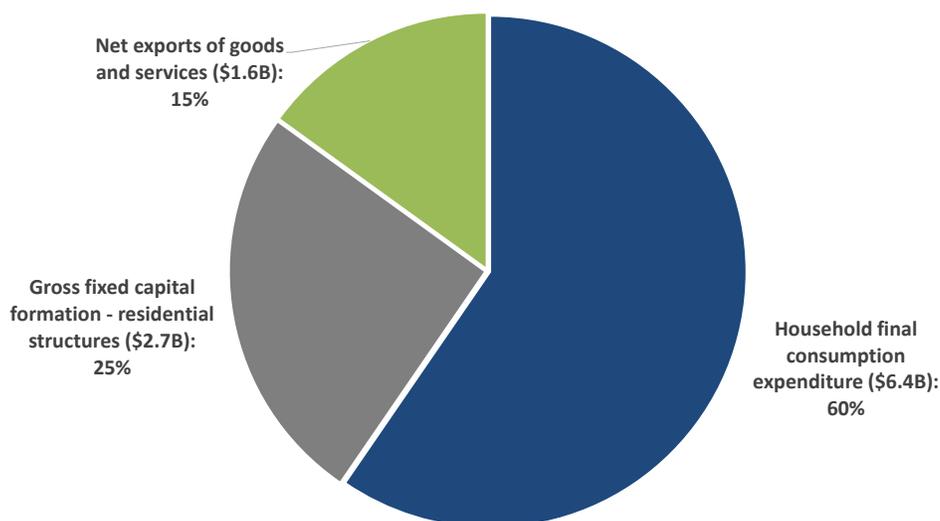
TABLE 2: SHADOW ECONOMY GDP BY INCOME SECTOR (ANNUAL, 2018, BRITISH COLUMBIA)

GDP by income sector	Shadow economy GDP (\$ millions)	Share of shadow activity (%)
COMPENSATION OF EMPLOYEES (INDIVIDUALS)	4,071	38%
GROSS MIXED INCOME (UNINCORPORATED FIRMS)	3,731	35%
Cannabis	1,463	14%
Tobacco	545	5%
Alcohol	226	2%
Rent, rooming and boarding	134	1%
Residential construction	486	5%
Skimming	877	8%
Adjustment	603	6%
GROSS OPERATING SURPLUS (CORPORATIONS)	2,391	22%
Construction	898	8%
Exports	264	2%
Skimming	1,230	11%
SHADOW ECONOMY GDP	\$10,796	100%

Source: Statistics Canada.

FIGURE 5: HOUSEHOLD CONSUMPTION AND RESIDENTIAL INVESTMENT ACCOUNT FOR 85% OF HIDDEN EXPENDITURES

Shadow economy by expenditure-based GDP sector, 2018, British Columbia



Source: Statistics Canada.

TABLE 3: A HANDFUL OF HOUSEHOLD EXPENDITURES ACCOUNT FOR MOST SHADOW ECONOMY GDP (TOP 15 HOUSEHOLD EXPENDITURE CATEGORIES FOR UNREPORTED SPENDING*, 2019, B.C.)

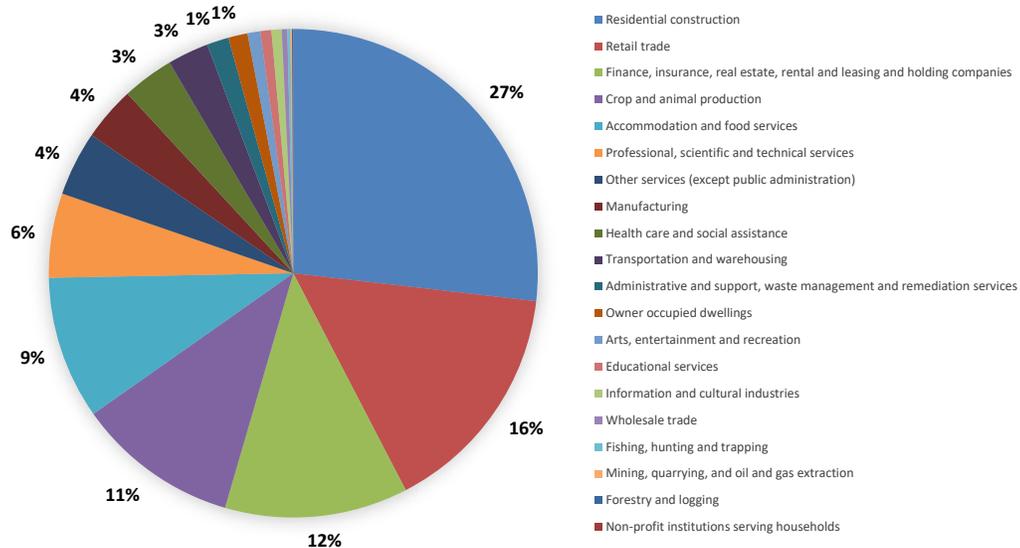
Household expenditure category (top 15)	Personal spending including taxes	Shadow economy GDP (ranked)	Percent relative to spending
	Current dollars (millions)		%
Paid rental fees for housing	12,406	1,327	10.7
Food and beverage services	11,501	1,221	10.6
Cannabis products for non-medical use	812	807	99.4
Tobacco	2,374	502	21.1
Alcoholic beverages	3,760	384	10.2
Operation of transport equipment	10,866	282	2.6
Personal care	3,536	274	7.7
Food	14,696	185	1.3
Other goods and services related to dwellings and property	4,016	165	4.1
Recreational and cultural services	6,912	164	2.4
Accommodation services	2,955	151	5.1
Other recreational equipment, garden products and pets	3,469	147	4.2
Education	3,794	116	3.1
Personal effects	3,779	114	3.0
Clothing	5,931	113	1.9
SUBTOTAL FOR TOP 15 CATEGORIES	90,807	5,952	6.6
% of TOTAL FOR ALL HOUSEHOLD EXPENDITURE	49%	93%	

Source: Statistics Canada.

* Note: Household consumption accounts for about 60% of total shadow economy GDP.

FIGURE 6: FIVE INDUSTRIES ACCOUNT FOR THREE-QUARTERS OF B.C.'S \$10.8B SHADOW ECONOMIC ACTIVITY

Shadow economy by industry-based GDP sector, 2018 British Columbia



Source: Statistics Canada.

TABLE 4: MOST HIDDEN TRANSACTIONS OCCUR IN FIVE BROAD INDUSTRIAL SECTORS

Industry	Shadow economy GDP	Shadow economy GDP share	Official GDP share
	<i>Current dollars (millions)</i>	<i>% of official GDP (ranked)</i>	<i>% of shadow economy GDP</i>
Construction	2,734	25%	8.8%
Retail trade	1,586	15%	5.7%
Finance, insurance, real estate, rental and leasing, management of holding companies	1,235	11%	24.3%
Agriculture, forestry, fishing and hunting	1,121	10%	2.2%
Accommodation and food services	965	9%	2.9%
Professional, scientific and technical services	569	5%	6.6%
Other services (except public administration)	436	4%	2.2%
Manufacturing	364	3%	6.7%
Health care and social assistance	348	3%	7.0%
Transportation and warehousing	277	3%	6.0%
Administrative and support, waste mgt and remediation	148	1%	2.4%
Arts, entertainment and recreation	86	1%	1.0%
Educational services	74	1%	5.2%
Information and cultural industries	69	1%	3.5%
Wholesale trade	37	0%	3.7%
Mining, quarrying, and oil and gas extraction	10	0%	4.3%
Utilities	0	0%	1.9%

Note: Table does not show owner-occupied dwellings, non-profit institutions serving households, or an adjustment item. Construction sector official GDP includes residential and non-residential construction; however, shadow economy GDP is fully attributed to residential construction.

Source: Statistics Canada.

Shadow economic activity could be costing British Columbians an estimated \$3.7 billion per annum in lost tax revenue.

(11%, including cash wages for farm workers), and accommodation and food service (9%, including undeclared tips).

Table 3 provides a more detailed breakdown and maps the data to official GDP by industry. Most hidden transactions occur in five broad industry sectors. Relative to their weight in official GDP, there are outsized contributions to the shadow economy from residential construction, retail trade, agriculture, and hospitality.

THE COSTS TO B.C.'S ECONOMY AND SOCIETY

The shadow economy imposes manifold costs on the vast majority of British Columbians. First, as noted above, shadow economy GDP was worth about \$11 billion in 2018, which translates to lost provincial tax revenue (estimated below). That revenue gap has to be made up somewhere. Consequently, a greater tax burden and/or more public debt must be shouldered by honest households and businesses to pay for public services. Second, the shadow economy distorts market competition, since dishonest firms and workers face lower costs than competitors who play by the rules. Third, a large and expanding shadow economy undermines public trust in the tax system, eroding social norms that

promote voluntary compliance. And finally, networks of non-compliant businesses hide and enable illegal activities that cause pernicious social harm.

HOW MUCH TAX REVENUE COULD BE AT STAKE?

Shadow economic activity could be costing British Columbians an estimated \$3.7 billion per annum in lost tax revenue – including \$1.6 billion lost at the federal level and \$2.1 billion lost at the provincial level. These back-of-the-envelope estimates are based on B.C.'s shadow economy GDP of \$10.8 billion in 2018, multiplied by the combined government revenue-to-GDP ratio for B.C. of 34.2% in 2018/19 (the last available pre-pandemic full year). The latter is the sum of the federal and provincial revenue-to-GDP ratios of 14.9% and 19.3%, respectively (see RBC's November 2020 [fiscal report](#)).

By comparison, based on B.C.'s 2019/20 budget (pre-pandemic), the lost \$2.1 billion at the provincial level could cover roughly:

- *One-fifth* of B.C.'s personal taxes (\$11 billion);
- *Half* of B.C.'s corporate taxes (\$4 billion);
- *One-quarter* of B.C.'s sales taxes (\$8 billion);
- *Two-thirds* of annual property taxes (\$3 billion); or
- *Any* of B.C.'s fuel, carbon, or property transfer taxes (about \$1-2 billion each).

To give another comparison, B.C.'s natural resource base (forests, natural gas and other resources) yields about \$2-3 billion annually

in royalties for the government. Recovering the revenue lost to the shadow economy would almost be like doubling B.C.'s natural resource endowment and the royalties earned.

On the one hand, this admittedly rough estimate could be an optimistic because “some hidden activity would always occur” and so in practice not all of this revenue could be collected. However, it's important to remember that networks of legal but non-compliant businesses and individuals provide the infrastructure and services to help hide illegal activities too – including drug trafficking and money laundering. Further, Statistics Canada's estimate of shadow economy GDP (\$10.8 billion) is only a partial estimate. Its estimate does not account for illegal economic activities, except those related to the cannabis industry. The true estimate of shadow economy GDP is therefore likely considerably larger than the figures reported here. It follows that taking action to bring hidden economic activities (both legal and illegal) into the realm of official GDP (i.e. “onto-the-books”) could result in a larger potential tax revenue gain.

CONCLUSION

B.C. has the largest proportion of market-based economic activities, whether legal or illegal, that are hidden and unreported among the Canadian provinces. They were worth at least \$11 billion, or more than 3.7% of official GDP, in 2018. Around 18% of all hidden transactions nationally take place in B.C. This is an outsized result given that B.C. represents only 14% of Canada's population and 13% of Canada's official GDP.

Hidden economic activities in B.C. could be costing an estimated \$3.7 billion per annum in foregone tax revenue. This includes \$1.6 billion of lost federal tax revenue and \$2.1 billion of lost provincial tax revenue. By comparison, \$2.1 billion would pay for one-fifth of provincial personal taxes, half of provincial-level corporate taxes, one-quarter of provincial sales taxes, two-thirds of property taxes, or any of B.C.'s fuel, carbon, or property transfer taxes.

B.C.'s "off-the-books" economic activities are concentrated among individual workers and unincorporated businesses, particularly those involved in residential construction, property rental, unlicensed cannabis and tobacco sales and production, and accommodation and food service. Actions taken by the B.C. government to address the shadow economy should start with these areas of vulnerability.

When more economic activity is hidden and unreported, the tax base becomes less broad and less resilient. The consequence is that honest businesses and households who fully declare their income are

burdened with higher tax burdens to make up the shortfall. They are also at a competitive disadvantage to businesses and workers that benefit from keeping some transactions "off-the-books". Networks of non-compliant entities also enable illegal activities that cause insidious social harm

The COVID-19 recession is placing extraordinary stress on the finances of households, businesses, and governments. To help pay for the pandemic, governments should review the tax and regulatory design and compliance flaws that allow or encourage transactions to be hidden and unreported. The significant and widespread costs of such activities should no longer be shouldered by the vast majority of honest individuals and businesses who fully declare their income. It's time everyone paid their fair share.

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