

**BRITISH COLUMBIA BUSINESS INDICATORS****September 1994****The Size of the Underground Economy****Introduction**

Statistics Canada has released a study on the underground economy¹, a topic which has generated considerable interest in recent years, especially since the introduction of the Goods and Services Tax (GST) in January 1991. There have been a number of studies on the size of the hidden or underground economy in Canada, with some suggesting that underground transactions amount to as much as 25% of Gross Domestic Product (GDP). The studies use a range of methodologies, as well as different definitions of what is included in the underground economy. The Statistics Canada study calculated upper limits for each of the components of the underground economy and concluded that, in aggregate, its maximum size is 4.2% of GDP.

Estimates for Canada

The studies which have found that the size of the Canadian underground economy is in the 15–25% range are mainly based upon an approach which

uses a relationship between the stock of money in the economy and the level of activity in the underground economy. The definition of the underground economy used in these studies includes both legal and illegal activities.

The Statistics Canada study, on the other hand, uses a direct approach, in which for each income and expenditure component of GDP the maximum understatement due to unrecorded activity is determined, based on knowledge of the sources of information and statistical methods used in producing the National Accounts. The definition of the underground economy used in the study is “the value added (return to labour and capital) which is left out of GDP due to underground production, defined as **legal** economic production hidden from the authorities in order to avoid taxes and regulations”.

Some of the underground activity escapes taxation, but is nevertheless estimated by Statistics Canada and traditionally included in official GDP.

¹ Statistics Canada, *The Size of the Underground Economy in Canada*, Catalogue No. 13-603E No.2, 1994.

The maximum size of this **measured** part of the underground economy is estimated to be 1.5% of GDP. This would include some wages paid by households for domestic service and childcare, employees' tips, and some of the net income of non-farm unincorporated business including rental income.

The rest of the underground economy is **unmeasured** and excluded from published GDP. The upper limit of this part of the underground economy is estimated to be 2.7% of GDP. Statistics Canada concluded that among the various types of expenditure in the economy, only investment in residential construction and personal expenditure on goods and services could be significantly underestimated due to underground transactions; imports and exports could also be marginally affected. The other components of GDP, government expenditure, business investment in plant and equipment and inventories are not ones where underground activity is likely to occur.

Table 1 shows the upper limit of the size of underground transactions in the expenditure components of GDP. These transactions may take the form of 'under the table' activity or the 'skimming' of receipts on the part of legitimate businesses. Not surprisingly, the highest proportion of underground activity occurs in residential construction (8.1%), especially alterations and improvements. Personal expenditure would be at most 3.5% higher if all underground transactions were captured. The goods and services with the biggest change, in both absolute and percentage terms, would be motor vehicle parts and repairs, alcoholic beverages and tobacco products, meals in restaurants, accommodation, hairdressing, and domestic and household services.

Other Evidence

In addition to the estimates described above, which are based on data from the Income and Expenditure Accounts, Statistics Canada has also looked at underground activity from the perspective of industries where such activities are likely to occur. Each industry has been rated according to its 'exposure' to underground activity. Most industries, accounting for roughly 75% of economic activity, are either not exposed at all or very little exposed to such activity. The remaining industries, such as construction, retail and wholesale trade, and various business and personal services, are exposed to some underground activity. Even if this 25% of GDP were exposed to as much as 10% underground activity, this would only account for 2.5% of published GDP.

Another perspective on the size of underground economy is to look at the share of total activity accounted for by small businesses, since it is unlikely that the activities of medium and large corporations go unreported. Small business, including all unincorporated businesses, incorporated businesses with annual sales below \$1 million and all self-employed individuals, is estimated to account for 14% of GDP. Thus for underground transactions to represent 15% of GDP in Canada, the underground sector would have to be as large as the small business sector.

Most underground transactions are thought to relate to goods and services sold to households. If the 10.2 million Canadian households made under the table purchases that amounted to 15% of published GDP, this would mean purchases of \$10,500 per household per year. This average expenditure seems quite unreasonable. If one assumes,

however, that one third of households make under the table purchases of \$2,000 per year, one arrives at an estimate for underground purchases of 1% of GDP.

Finally, the underground sector is not independent from the 'above ground' economy. Income earned in one sector is spent in the other and vice versa. As a result, a boom in a large underground sector would be felt in the rest of the economy. The economic statistics for the last few years do not indicate that this type of growth has occurred.

Estimates for British Columbia

BC STATS has calculated a rough estimate of the maximum size of the underground economy in British Columbia by applying Statistics Canada's national

proportions of underground activity to the various components of income and expenditure in British Columbia. This procedure results in an estimate of the **measured** underground economy of \$1.5 billion in 1992, or 1.7% of GDP. Table 1 shows the upper limit of the underground transactions **missing** from the expenditure-based measure of GDP in 1992. For British Columbia, this upper limit is estimated to be \$2.6 billion in 1992, or 3.0% of GDP. The maximum size of **measured and unmeasured** underground transactions in 1992 in British Columbia was thus \$4.1 billion, or 4.7% of GDP.

Illegal Production

It should be noted that the above estimates of the size of the underground economy exclude the production of **illegal** goods and

Table 1

Upper Limit of Underground Activity Potentially Missing from Expenditure-based GDP, 1992

	Canada		British Columbia	
	Million \$	%	Million \$	%
Personal expenditure on goods and services	14,830	3.5	1,944	3.5
Durable goods	2,679	5.0	342	5.0
Semi-durable goods	1,430	3.8	179	3.8
Non-durable goods	4,527	4.1	570	4.1
Services	6,194	2.9	853	2.9
Government current expenditure on goods and services	0		0	
Government investment	0		0	
Business investment in fixed capital	3,578	3.2	691	3.2
Residential construction	3,578	8.1	691	8.1
New residential construction	1,883	9.0	442	9.0
Alterations and improvements	1,695	13.9	249	13.9
Transfer costs	0		0	
Non-residential construction	0		0	
Machinery and equipment	0		0	
Business investment in inventories	-15	0.6	-1	0.6
Exports	1,100	0.6	109	0.6
Merchandise	800	0.5	109	0.5
Non-merchandise	300	1.2	N/A	1.2
Less: Imports	1,003	0.5	174	0.5
Merchandise	1,003	0.7	174	0.7
Non-merchandise	0		N/A	
Gross Domestic Product at market prices	18,490	2.7	2,569	3.0
Final domestic demand	18,408	2.6	2,635	2.9

services, such as those associated with the sale of narcotics. Tobacco and alcohol smuggling, however, are considered to be part of the underground economy since the importation and sale of these products are normally lawful activities. Statistics Canada has estimated that illegal production accounts for no more than 1% of GDP.

—*Ruth McDougall, Economic Accounts*
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