Policy Forum: Comments on *Taxes and the Canadian Underground Economy*, by David E.A. Giles and Lindsay M. Tedds

**Editor’s note.** The underground economy has been the subject of much political controversy and debate, academic theorizing and study, and popular curiosity and anecdotes. How extensive is it? Has it been increasing? What leads individuals to cheat on their taxes? What are the appropriate or even possible government policy responses to tax evasion? Using a relatively new statistical methodology, David E.A. Giles and Lindsay M. Tedds attempt to answer these questions in their recent and important study *Taxes and the Canadian Underground Economy*, Canadian Tax Paper no. 106 (Toronto: Canadian Tax Foundation, 2002).

Giles and Tedds estimate that the Canadian underground economy in the mid-1990s was approximately 15 to 16 percent of gross domestic product (GDP). That is to say, about $130 billion of economic activity was going untaxed illegally in Canada. As the authors note, $130 billion is a large number. It is about the size of the combined GDP of British Columbia and Saskatchewan. If their estimate of the size of the underground economy is accurate, it would mean that the tax gap, or the amount of unpaid taxes, was about $44 billion in the mid-1990s, or about 13.5 percent of Canadians’ total tax liability.

Giles and Tedds also provide, for the first time in Canadian research, an estimate of the changes in the size of the underground economy over a 20-year period, from 1976 to 1995. They estimate that the underground economy grew from about 3.5 percent of GDP in 1973 to almost 16 percent in 1995. What caused this dramatic increase in tax evasion by Canadian taxpayers? One of the authors’ principal findings is that there is a strong association between increases in effective tax rates and increases in the size of the underground economy. They estimate that if Canada had reduced its overall effective tax rate by between 20 and 25 percent in 1994, which would have brought Canadian tax rates in line with those in the United States, the underground economy would have declined from 15.6 percent of GDP to about 12.5 percent of GDP.

We invited two tax policy analysts to comment on *Taxes and the Canadian Underground Economy*, and gave Giles and Tedds an opportunity to respond to their comments. Roderick Hill, to put the book in political context, surveys the causes of the recent interest in the underground economy. He shows that the explosion of articles on the underground economy in the early 1990s corresponded with the public backlash against rising tax rates, the introduction of the goods and services tax, and increasing concern over tobacco smuggling. Judging from the number of articles written on the subject, interest in the underground economy peaked in
1993 and again in 1999, and appears to have tailed off somewhat over the past two years. Hill also reviews the debate carried on in Canada during the 1990s as to whether the underground economy was closer to 5 or to 15 percent of GDP.

Hill then briefly explains and offers a critique of the authors’ methodology. Since the underground economy cannot be measured directly, Giles and Tedds attempt to infer changes in its size from changes in other measurable variables. Hill raises questions about the relevance of the various causal and indicator variables that Giles and Tedds use to infer the size of the underground economy, and asks whether the latent variable they measure is indeed the underground economy. Since the authors’ methodology can only measure changes in the size of the underground economy, Giles and Tedds had to rely on some other methodology to establish the size of the underground economy in a benchmark year, against which they would measure changes. Hill also points out the frailties in the methodology used to arrive at this benchmark estimate. Although Hill believes that Giles and Tedds “have probably done the most careful and thorough job possible,” he nevertheless remains skeptical of their conclusions, given the necessary limitations in the available data and their methodology. Furthermore, he is troubled by the lack of persuasive reasons as to why Statistics Canada’s estimate of the size of the underground economy—about 5 percent—is wrong.

Roger S. Smith begins his comment on Taxes and the Canadian Underground Economy by noting that the authors’ estimate of the underground economy in the mid-1990s—about 15 or 16 percent of GDP—is consistent with the estimates of previous authors, who reached their conclusions using a variety of methods. One of the many interesting features of the book is that Giles and Tedds, having estimated the effect of tax rate changes on the size of the underground economy, then simulate various tax policy changes and the effect they would have had on the size of the underground economy in the 1980s and 1990s. Smith argues that some of the estimates in these simulations do not appear realistic. Furthermore, he questions the appropriateness of running simulations using the “average” tax rate, as Giles and Tedds do, rather than the “marginal” tax rate, since most taxpayer decisions relating to tax evasion are made on the basis of marginal rates. Parenthetically, he argues that, given the rapid growth in the public sector in many industrialized countries over the past 30 years, some underground economic activity may have “potentially positive aspects,” and suggests that these aspects “deserved more attention from Giles and Tedds than they received.” Ultimately, because of the complexity of the problem of tax compliance and the limitations of the data, Smith concludes that tax policy makers are not likely to derive much assistance from estimates of the size of the underground economy that are inferred from macroeconomic data. He urges more cooperation between tax policy makers and empirical investigators using microlevel data, such as data drawn from individual tax returns.

In their reply to Hill and Smith, Giles and Tedds acknowledge the cogency of the comments but still believe their results are defensible, and provide a point-by-point rejoinder to the critiques. In light of the comments they have received from Hill and Smith, and other commentators, Giles and Tedds are undertaking further research on the underground economy in an effort to continue to refine and enrich our knowledge of this important phenomenon.