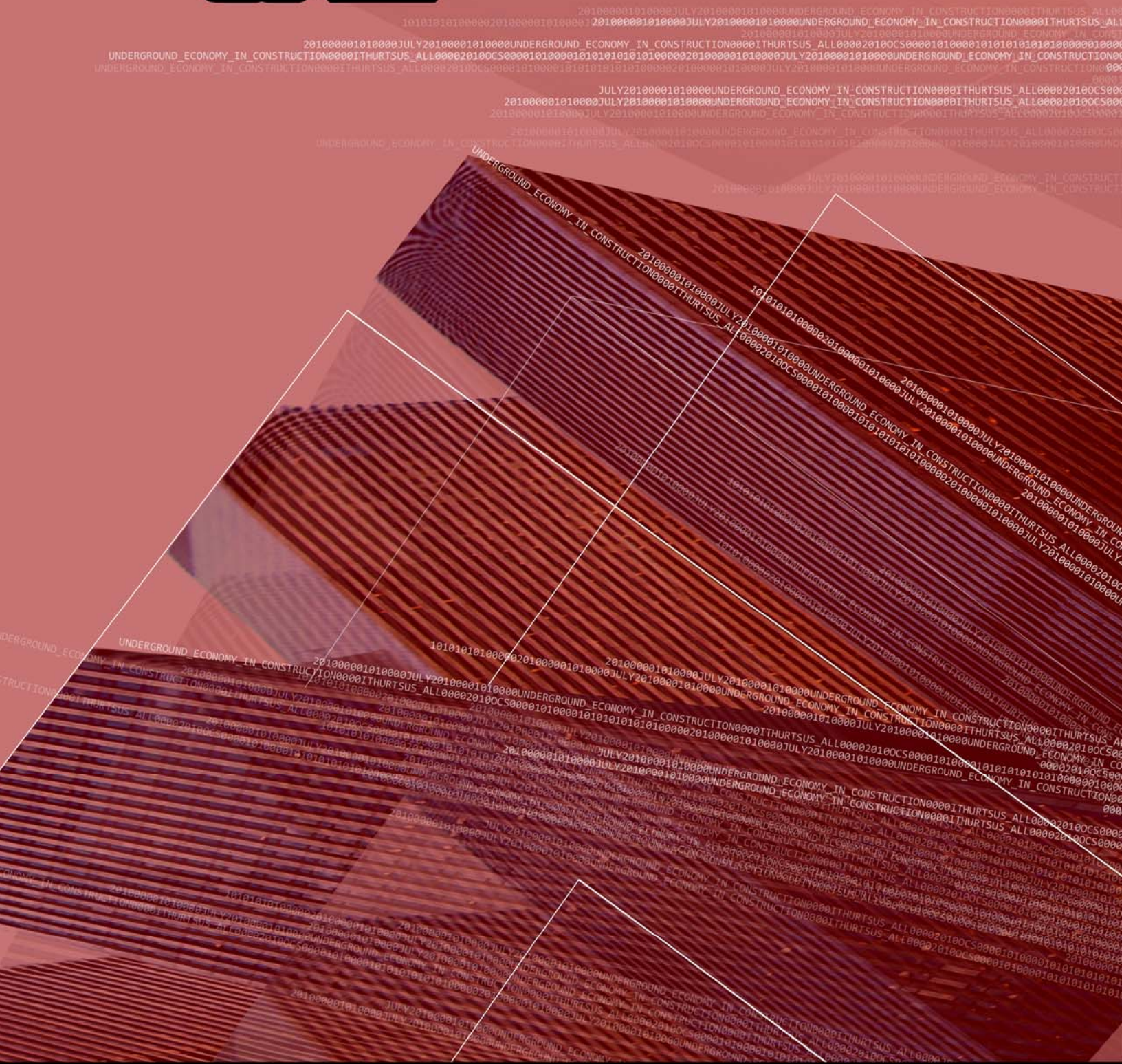


# Ontario Construction Secretariat



## Underground Economy in Construction - It Costs Us All

JULY 2010



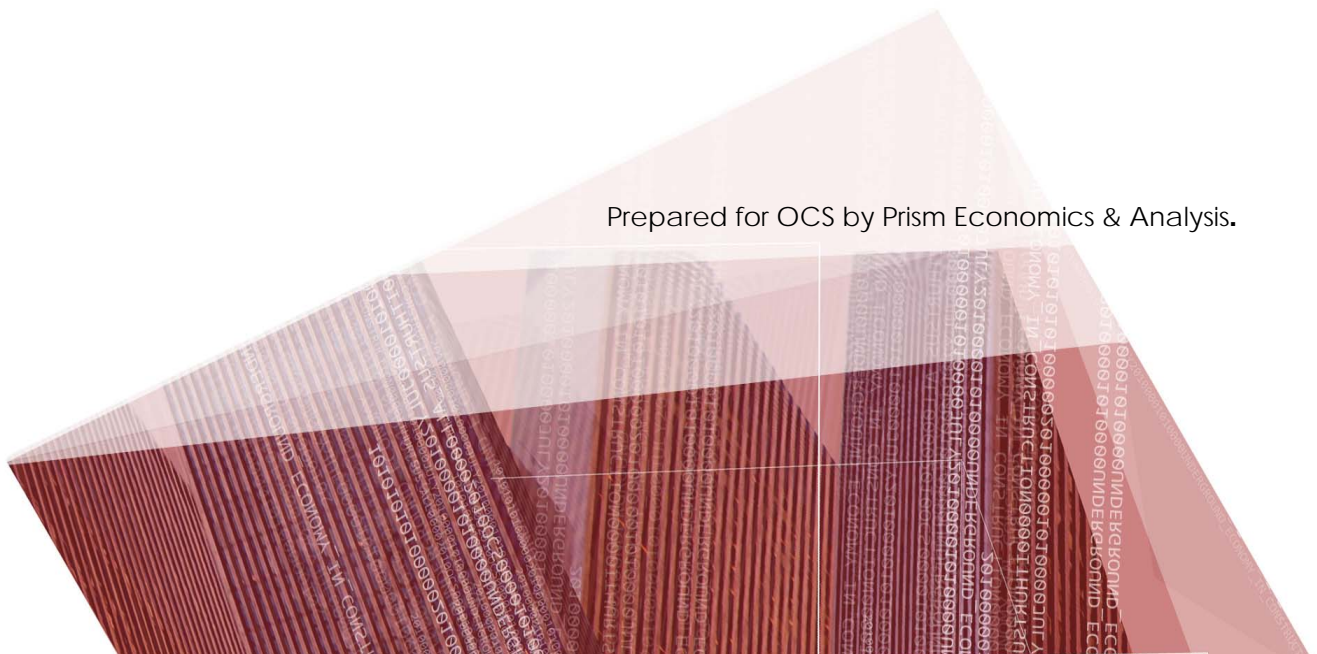


Ontario Construction Secretariat

# Underground Economy in Construction - It Costs Us All

JULY 2010

Prepared for OCS by Prism Economics & Analysis.



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## EXECUTIVE SUMMARY

Over the period 2007 to 2009, the annual estimated revenue losses to the WSIB, the tax system, the Canada Pension Plan, and the EI system from underground practices in Ontario's construction industry was in the order of \$1.4 billion to \$2.4 billion. Notwithstanding increases in enforcement by the Canada Revenue Agency, the Ontario government, and the Workplace Safety and Insurance Board (WSIB), underground practices remain a serious challenge for the construction industry in Ontario.

In the construction industry, the most important enabler of underground practices is the ability of contractors to improperly style their workers as 'independent operators' (i.e., sub-contractors), rather than as employees. Construction employers who characterize their work force as 'independent operators' evade their obligations to provide WSIB coverage, and to make Canada Pension Plan (CPP) and Employment Insurance (EI) contributions. Equally important, employers are not required to issue earnings statements (T-4 slips) to so called 'independent operators'. In turn, this sets the scene for widespread under-reporting of earnings. 'Independent operators' are the basis of more than 80% of the underground economy in Ontario's construction industry. There can be no solution to reining in the underground economy which does not tackle the 'independent operator' problem.

The media often focus on the 'cash economy'. While cash payments are an important contributor to underground practices, especially for evading the Goods and Services Tax (GST), the 'cash economy' pales in significance when compared to the 'independent operator' problem.

Three indirect indicators point to a continuation, or further embedding, of underground practices in Ontario's construction industry. First, the share of 'independent operators' in the employed construction labour force rose in 2009 to 22.2% from 19.7% in the prior year. Though lower than the peak of 24.2% in 1999, the trend is moving in the wrong direction. Second, the ratio of cash to purchases by households increased sharply in 2009. The implication is that the 'cash economy' also increased in size. And third, spending on residential renovations increased significantly. This sector accounts for around half of the underground economy in Ontario's construction industry.

Important efforts have been made by the Canada Revenue Agency, the Ontario government, and the WSIB to step up their enforcement efforts. This has had a positive impact. While the underground economy is still a major challenge for the construction industry, our estimates suggest that the share of construction work that is carried out using underground practices has probably levelled off. Enforcement appears to have stemmed the flow of new entrants into the underground economy, though it has not yet had a significant impact on those who already operate there.

There is a risk that the introduction of the HST will cause an increase in the amount of underground activity. This is not anticipated to be a significant effect as it will chiefly apply to cash-based transactions in the residential renovation sector where the practice is already widespread. The primary effect of the introduction of the HST on revenue losses will be to increase the amount of tax revenue that is lost from transactions that are already conducted on an underground basis. Had the HST been in effect, the losses to the provincial government would have been approximately \$290-\$375 million.

One of the most significant statutory changes is Bill 119 which will extend mandatory WSIB coverage to 'independent operators' and most 'executive officers'. However, Bill 119 will not take effect until 2012. Consequently the impact of Bill 119 is not evident in these estimates of underground activity.

*Bill 119 will have a significant impact, if it is effectively implemented, especially on the underground economy in the ICI sector.* The ICI construction industry, and especially the unionized ICI construction industry, has a strong interest in ensuring effective implementation of Bill 119.

Bill 119's impact on the residential renovation sector may be diminished owing to a provision that exempts homeowners from requiring proof of WSIB coverage and also exempts them from liability for unpaid WSIB premiums related to work done on their premises.

The scale of the underground economy in Ontario's construction industry continues to be a serious threat to labour standards and to a level playing field for contractors. The most important underground practice is classing as 'independent operators' workers who should be classed as employees. By styling workers as 'independent operators', contractors achieve an unfair and illegitimate competitive advantage that can range from 20% of labour costs to as much as 50%. As well, these contractors may also avoid or diminish important employer obligations under the *Occupational Health and Safety Act*. *The underground economy is so large that it contaminates the competitive environment by shifting competitive advantage to those contractors who evade their responsibilities as employers.*

The underground economy undermines the coverage of benefit plans and weakens support for apprenticeship and training. By shifting costs onto others, the underground economy increases the operating costs of workers and contractors who follow the rules. Even with the implementation of Bill 119, significant challenges will remain.



## 1. Background to this Report

This Report updates findings presented in earlier studies published by the OCS:

- *The Underground Economy in Ontario's Construction Industry* (1998),
- *Estimates of Revenue Losses to Governments as a Result of Underground Practices in the Ontario Construction Industry: 1995-1997 compared to 1998-2000* (2001),
- *Attacking the Underground Economy in the ICI Sector of Ontario's Construction Industry* (2004),
- *Impact of Fair Wage Policies on the Construction Industry* (2006), and
- *Estimates of Revenue Losses to Governments as a Result of Underground Practices in the Ontario Construction Industry: 2003-2005 Estimates compared to Earlier Estimates* (2007).

The most recent of these studies estimated that, in the period 2003-2005, total losses to governments and government agencies from underground activity in the Ontario construction industry ranged from \$1.6 billion to \$2.7 billion. The estimates presented in this report are averages for the period 2007-2009. *The central finding of this report is that underground practices remain a serious challenge for the construction industry, notwithstanding increases in the level of enforcement both by the Canada Revenue Agency and the Workplace Safety and Insurance Board.*

The most significant statutory change since previous reports has been Bill 119 which received royal assent on November 27, 2008. This amendment to the *Workplace Safety and Insurance Act* extends mandatory WSIB coverage to 'independent operators' and to most 'executive officers' of construction companies. These amendments provide the basis for significantly reining in underground practices in the construction industry. However, Bill 119 does not take effect until 2012. Consequently the impact of Bill 119 is not evident in the estimates that are presented in this report.

Formulating estimates of the size of the underground economy is inherently difficult. By definition, underground practices are not declared. The scale of underground practices can only be estimated using indirect procedures. Inevitably, these estimates require assumptions to be made. In this report, those premises have been made explicit so that individuals who have a different perspective on the construction industry will be able to gauge whether their assumptions would lead to greater or lesser estimates of the size of the underground economy.

This report draws on the methodology used in previous studies of the construction industry. However, for some variables, the report uses new estimation procedures and new data sources. In particular, the report takes advantage of employment estimates developed by the Construction Sector Council. This has the effect of focusing the estimates more sharply on trades occupations. The report also uses more recent data than was previously available, in particular on the input-output structure of the construction industry. For all of these reasons, the findings in this study are not directly comparable to the findings in previous studies.

## 2. The Nature of the Underground Economy in Construction

How the underground economy is defined depends on the questions that are being posed. There are three distinct, though overlapping, definitions of the underground economy. The definition used in this report is the 'Full Compliance Definition', though reference is also made to the other definitions.

### Economic Accounts Definition:

A Statistics Canada study, published in 1994, focuses primarily on the question, 'is there construction work which is not measured by the system of economic accounts?'<sup>1</sup> In that study, the term 'underground economy' had a narrow meaning, namely the portion of construction activity that was unmeasured. Construction work that was performed without declaring the associated income or without charging GST was not considered to be underground if the work was included in Statistics Canada's estimates of gross domestic product. Construction work was only considered to be underground if it escaped measurement in Statistics Canada's system of national economic accounts. In its 1994 study, Statistics Canada recognized that there was significant under-reporting of earnings and transactions in some segments of the construction industry, notably residential renovation. The question the study posed was whether this under-reporting of earnings and transactions led to a more systemic under-estimating by Statistics Canada of the total value of construction work undertaken in the Canadian economy. Given the role of building permits and the ability to estimate the volume of construction work by tracking the use of materials, it is not surprising that Statistics Canada concluded that only a small proportion of construction escaped measurement. Statistics Canada estimated that, in 1992, the upper boundary for *unmeasured* construction work was 9.0% in new residential construction and 13.9% in residential renovation. The study offered no estimates of the unmeasured portion of construction in the ICI and civil sectors of the industry, though the implication is that in these sectors, given the requirement for permits and approvals, the *unmeasured* portion was exceedingly small.

### Tax Evasion Definition:

In common parlance, the underground economy refers to earnings and expenditures that are not declared and which, therefore, are not taxed. The question that this definition focuses on is 'what are the revenue losses to governments and government agencies from undeclared employment income and undeclared construction transactions?' In popular discussions, this type of tax evasion is strongly associated with the use of cash to pay for construction services. For this reason, the most common view of the underground economy is that it is a 'cash economy'. Fixating on the 'cash economy', however, focuses too much attention on the residential renovation sector which accounts for no more than 12-15% of total construction work.

The 'cash economy' is an important contributor to the underground economy. However, the 'cash economy' is only the tip of the iceberg.

### Full Compliance Definition:

In the construction industry, by far the most important strategy for evading source deductions and statutory contributions is to style workers as 'independent operators', that is to say as sub-contractors, rather than as employees.

<sup>1</sup> Statistics Canada, *The Size of the Underground Economy in Canada*, by Gylliane Gervais, 1994 Catalogue No. 13-603E, No. 2

By improperly characterizing workers as ‘independent operators’, rather than employees, a construction employer ‘avoids’ the requirement to make employer contributions to Employment Insurance (EI) and the Canada Pension Plan (CPP). Moreover, pending the implementation of Bill 119, WSIB coverage is not required for ‘independent operators’. The avoided costs can amount to 20% of payroll costs, and more in those trades which have high WSIB premiums. Improperly styling employees as ‘independent operators’ also avoids the requirement to issue earnings statements (*i.e.*, T-4 slips). This, in turn, lays the foundation for the rampant under-declaring of income that is so common in some segments of construction.

How significant is under-reporting of income in the construction industry? *Reviewing data for the period 1985-1991, Statistics Canada estimated that, on average, in the construction industry, over 60% of the net income of unincorporated businesses was not reported.*<sup>2</sup> The under-reporting of income by so called ‘independent operators’ is a major source of the revenue losses to governments. What must be stressed, however, is that, in the main, *this revenue loss is based on construction employers styling their workers as ‘independent operators’ not on those workers actually being true sub-contractors.* Moreover, there is no necessary relationship between styling employees as ‘independent operators’ and the so-called ‘cash economy’. Workers who are styled as ‘independent operators’ are typically paid by cheque, not in cash. The companies that employ these ‘independent operators’ report payments to them as normal business expenses which the companies then deduct against business income.

Data from Statistics Canada’s *Labour Force Survey* shows that the practice of styling workers as ‘independent operators’ is widespread in the construction industry. In 2009, 22.2% of construction workers were classed as ‘independent operators’. Twenty years earlier, the proportion was only 11.2%.

*In the construction industry, evasion that is based on improper styling of workers as ‘independent operators’ accounts for the lion’s share of the underground economy. The so-called ‘cash economy’ represents a significantly smaller portion.* The key to enforcement is to rein in the practice of improperly styling workers as ‘independent operators’.

### 3. Indirect Indicators of the Underground Economy

Three indicators are suggestive of trends in underground practices:

- the ‘independent operator’ share of the construction labour force,
- the ratio of cash to household expenditures, and
- homeowners’ spending on repairs and renovations.

<sup>2</sup> Technically, an ‘independent operator’ is a self-employed individual who employs no other persons to work alongside him or her. In other words, an ‘independent operator’ is neither an employer nor an employee. As such, this individual could be either incorporated or unincorporated. The term ‘independent operator’ is used in worker’s compensation legislation. The term is not used in employment standards legislation or in labour relations legislation.

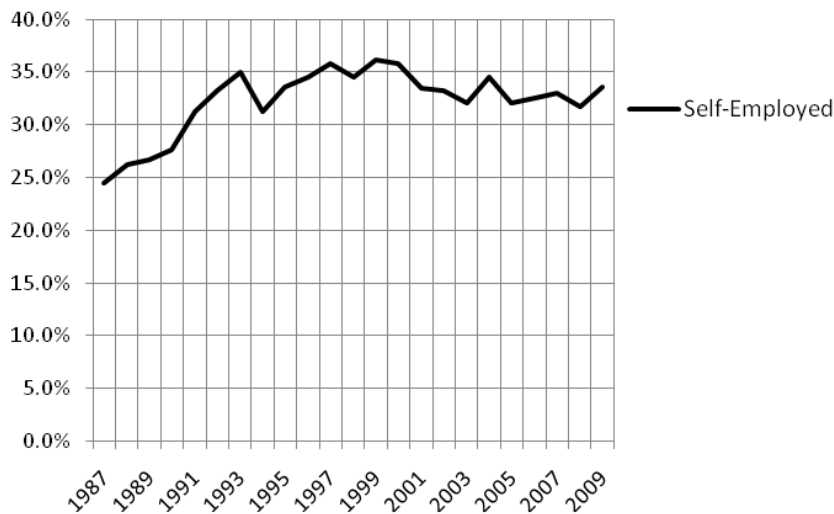


### Self-Employment and Independent Operators in the Construction Labour Force:

Self-employment is widely seen as correlating to, and contributing to, trends in the underground economy.<sup>3</sup> Figure No. 1 shows the trend in the share of self-employed persons in construction employment in Ontario from 1987 to 2009.

**Figure No. 1**

Self-Employed Share of Construction Employment - Ontario, 1987-2009



Statistics Canada, CANSIM 282-0012

As can be seen from Figure No. 1, the share of self-employed workers in the construction industry rose significantly in the late 1980s and early 1990s. This was a trend that had begun earlier, but appears to have accelerated after the introduction of the GST in 1989.

A closer examination of the self-employment trend reveals that *the preponderance of the increase in self-employment in the construction industry arose from the number of 'independent operators', i.e., persons who are self-employed and who do not employ others.* Figure No. 2 shows that while the share of 'independent operators' increased, the share of self-employed persons who employed other workers actually appears to have decreased.

In 1987, 'independent operators' accounted for 10.8% of the employed construction work force. In 2009, the 'independent operator' share was 22.2%. Figure No. 2 also shows that after declining from a peak of 24.2% in 1999, the 'independent operator' share fell to 19.7% in 2008, but then rose in 2009.

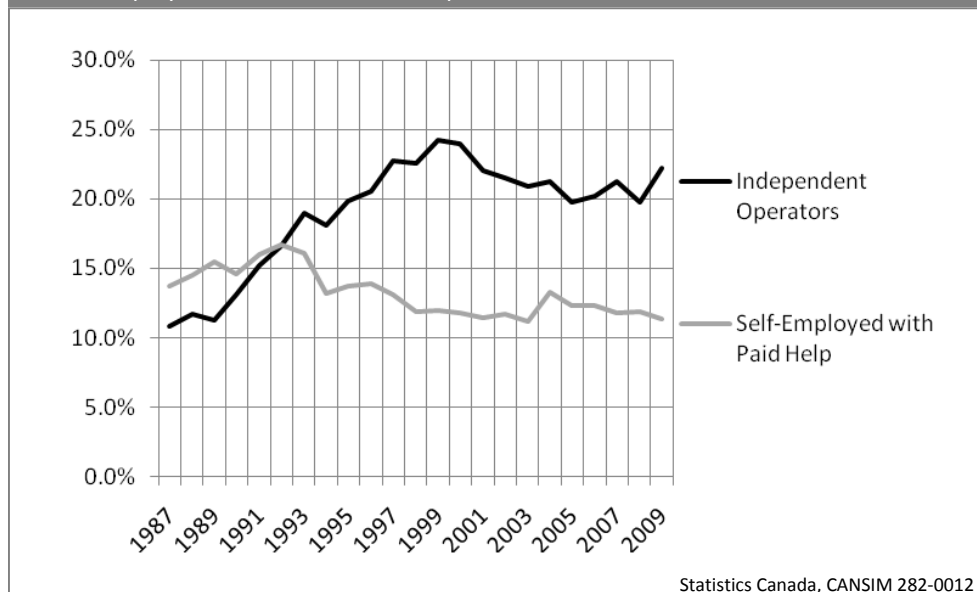
<sup>3</sup> Marc-Andre Pigeon, *The Underground Economy: Measurement and Consequences*, Library of Parliament, 2 November 2004, p 8 The role of self-employment is also cited by Lindsay Tedds (McMaster University), "The Underground Economy in Canada", 2005.

The pattern appears to be that:

- the 'independent operator' share was moving up prior to the introduction of the GST, but its increase accelerated thereafter;
- the increase in the 'independent operator' share was supported by weak employment conditions in the construction industry in the 1990s;
- as employment conditions improved, the 'independent operator' share declined somewhat, but also shows signs of having become deeply embedded in the construction industry;
- in 2009, when employment conditions weakened, the 'independent operator' share again increased.

**Figure No. 2**

Share of Construction Employment of Independent Operators and Self-Employed Persons with Paid Help - Ontario, 1987-2009



### Use of Cash:

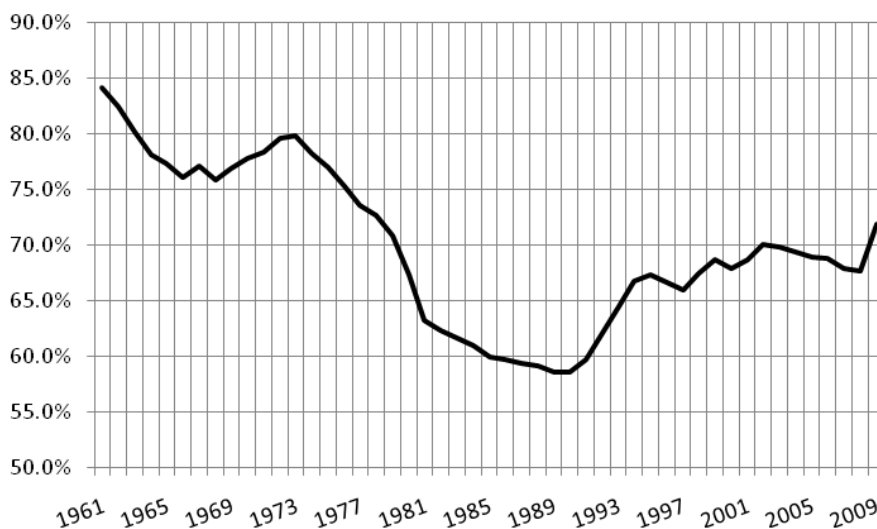
While the 'cash economy' does not account for the lion's share of the underground economy in construction, cash transactions are still an important piece of the story. Paying straight cash is a common way to avoid being charged GST. As well, a customer also knows that cash payments are unlikely to be fully declared as income by their recipient. Consequently, the customer expects a lower price. Paying cash is attractive mostly to homeowners, since businesses (including landlords) are able to deduct GST paid against GST received. Businesses also need receipts to support the deduction of expenses against income.

A useful measure of the role of cash is to compare the amount of currency outside financial institutions with the total value of expenditures by households. A fall in this ratio means that less cash is being used relative to the total amount of expenditures. In other words, households are paying for a greater proportion of goods and services by cheques, credit cards, debit cards, or other forms of electronic funds transfer. Conversely, an increase in the cash ratio means that households are using more cash relative to their total expenditures. Figure No. 3 shows the trend in the use of cash.



**Figure No. 3**

Ratio of Currency Outside Banks (Month-End) to Personal Expenditure on Goods and Services (Monthly) - Canada, 1961-2009



Statistics Canada, CANSIM 380-0002, 176-0020

Figure No. 3 shows that, as would be expected, that the cash ratio generally declined from 1961 until the late 1980s. This reflected the increased role of cheques and credit cards. With the subsequent introduction of debit cards, e-commerce, and other electronic funds transfer mechanisms, one might have expected the cash ratio trend to continue to fall or at least to stabilize. However, *co-incident with the introduction of the GST in 1989, the cash ratio rose sharply*. The use of cash continued to rise until 2002. The ratio then declined somewhat, but rose again, quite sharply, in 2009 when economic conditions deteriorated. *The cash ratio trend, it should be noted, is similar to the independent operator trend. Both trends are consistent with the view that underground practices ratcheted up with the introduction of the GST and became embedded.*

### Homeowner Spending on Repairs and Renovations:

Spending on residential renovation closely tracks spending on new construction in the residential sector. In part this is because both types of spending are strongly affected by the interest rate and general economic conditions, especially employment. Figure No. 4 shows trends at the national level. (Provincial data on renovation expenditures are not available in this data series.)

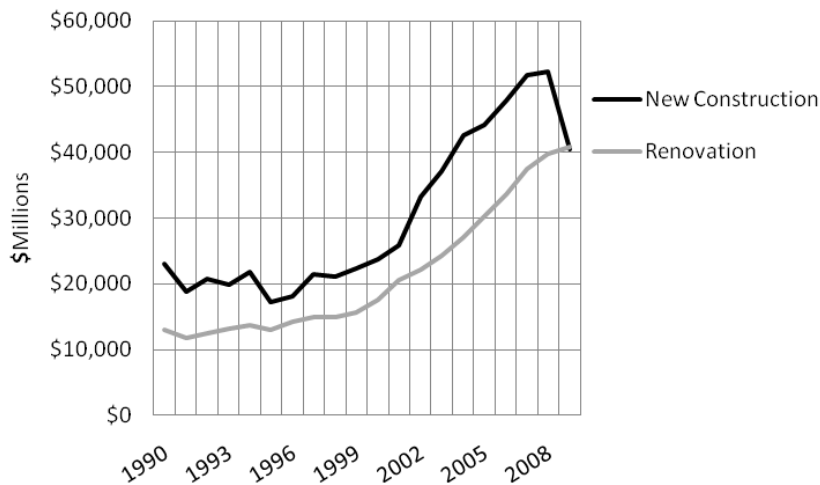
As can be seen in Figure No. 4, spending on renovation doubled over the course of the last decade. It is noteworthy that spending on renovation continued to increase in 2009, even though investment in new construction declined. This may be a consequence of the one-time federal tax credit for home renovations that was provided in 2009.<sup>4</sup>

The key message from Figure No. 4 is that there was a quantum increase in spending on renovations. Even if the propensity to use cash for these transactions declined, perhaps as a result of increased enforcement or the 'get it in writing' campaign of the Canadian Home Builders Association, it is likely that, in absolute terms, the amount of underground work increased.

<sup>4</sup> The Home Renovation Tax Credit was a one-time credit computed as follows for eligible expenses: (Eligible Expenditures up to \$10,000 - \$1,000) × 15%.

**Figure No. 4**

Ratio of Currency Outside Banks (Month-End) to Personal Expenditure on Goods and Services (Monthly) - Canada, 1961-2009



Statistics Canada, CANSIM 380-0002, 176-0020

### Summary:

There are three indirect indicators of underground activities, namely, (1) the share of 'independent operators' in the construction work force, (2) the ratio of cash to personal expenditures on goods and services, and (3) expenditures on residential renovation. As the preceding discussion shows, *all three indicators are consistent with an expected increase in the magnitude of the underground economy in Ontario's construction industry.* At the same time, it is also important to bear in mind that significant efforts have been made by both the Canada Revenue Agency and the WSIB to step up their enforcement. While not strictly comparable with previous estimates, owing to changes in methodology and data sources, *this report nevertheless supports a finding that there has been progress in reining in the underground economy. However, the most important change, Bill 119, will not take effect until 2012.*

## 4. Estimates of Employment by Sector and the Number of 'Independent Operators' and 'Executive Officers'

### Estimates of Employment by Sector:

The Construction Sector Council uses Statistics Canada data to estimate the distribution of investment spending and employment across construction sectors. These estimates exclude non-trades workers who comprise around 25% of the number of persons working in construction. In this report, we have followed the Construction Sector Council in excluding non-trades workers. This makes some of the estimates in this report non-comparable to earlier estimates which were based on all occupations in the construction industry. We have also used investment and building permit data to further disaggregate the Construction Sector Council's employment estimates.



Figure No. 5 shows that the employed skilled trades work force in the Ontario construction industry from 2007 to 2009 was approximately 300,000 workers. Figure No. 5 also shows the estimated distribution of that work force across the various sectors of the construction industry.

**Figure No. 5**

Estimated Trades Employment in Ontario Construction, 2007-2009 Average  
Based on Construction Sector Council, Building Permit and Investment Data

	Employed	Percent of Total
Residential	138,000	46%
New Construction	77,000	26%
Low-Rise	60,000	20%
High-Rise	17,000	6%
Renovation & Repair	61,000	20%
Non-Residential	162,000	54%
ICI	61,000	20%
Industrial	7,000	3%
Commercial	35,000	12%
Institutional	19,000	6%
Civil	49,000	16%
Repair (ICI)	52,000	17%
<b>TOTAL</b>	<b>300,000</b>	<b>100%</b>

### Estimates of 'Independent Operators' by Sector

The *Labour Force Survey* indicates that over the period 2007-2009, approximately 21% of persons working in the construction industry were 'independent operators'. While some non-trades persons undoubtedly are styled as 'independent operators', the practice of classifying workers as 'independent operators' is more common for skilled trades workers than for office workers. Our premise is that approximately 25% of trades workers are styled as 'independent operators' while only 10% of non-trades workers are so classified. These shares reconcile to the *Labour Force Survey* of 21% for overall construction industry employment.

Figure No. 6 estimates the approximate share of 'independent operators' for skilled trades employment by sector.

The following pattern is suggested by the estimates set out in Figure No. 6:

- The overwhelming majority (82%) of 'independent operators' are found in the residential sector.
- Residential renovation and repair accounts for approximately half of all 'independent operators'.

- Though accounting for only a modest share of ‘independent operators’, the ICI sector nevertheless has an estimated 13.5% rate of using ‘independent operators’ which is still a serious concern. Moreover, the incidence of ‘independent operators’ is likely to be much greater in some trades (e.g., painters, drywallers, floor coverers) than in other trades (e.g., the electrical and mechanical trades).

**Figure No. 6**

Estimated Distribution of ‘Independent Operators’  
in Skilled Trades Occupations in Ontario Construction, 2007-2009 Average

Sub-Sector of Construction Industry	Employed	Estimated Number of Independent Operators	Independent Operators as a Percent of Sub-Sector	Share of Total Number of Independent Operators
Residential	138,000	60,150	44%	82%
New Construction	77,000	23,550	31%	32%
Low-Rise	60,000	21,000	35%	29%
High-Rise	17,000	2,550	15%	3%
Renovation & Repair	61,000	36,600	60%	50%
Non-Residential	162,000	13,380	8%	18%
ICI	61,000	8,240	14%	11%
Industrial	7,000	140	2%	<1%
Commercial	35,000	5,250	15%	7%
Institutional	19,000	2,850	15%	4%
Civil	49,000	980	2%	1%
Repair (ICI)	52,000	4,160	8%	6%
<b>TOTAL</b>	<b>300,000</b>	<b>73,530</b>	<b>25%</b>	<b>100%</b>

### Estimates of ‘Executive Officers’:

In addition to exempting ‘independent operators’ from coverage, prior to Bill 119 the *Workplace Safety and Insurance Act* also exempted ‘executive officers’. The *Labour Force Survey* indicates that over the period 2007-2009, approximately 55,000 persons were classed as self-employed and incorporated. Approximately 37% of these individuals were also ‘independent operators’. That is to say, they did not employ any other persons. These individuals were therefore included in the earlier discussion of ‘independent operators’. The remaining 35,000 employed other persons. Consequently, their exemption from WSIB coverage was based solely on their status as ‘executive officers’, notwithstanding that a large proportion of these individuals also worked ‘on the tools’ or otherwise had cause to regularly be on construction sites.

It is not feasible to estimate the distribution of ‘executive officers’ across sectors, since there are no data that estimate the size of construction businesses by sector. However, it is likely that the incidence of



‘executive officer’ exemptions is proportionately greater in renovation, repair (both ICI and residential), and low-rise construction.

## 5. Estimates of Revenue Losses to WSIB

The principal causes of revenue loss to the WSIB are:

- improperly styling workers as ‘independent operators’,
- exemptions for ‘executive officers’ who are, in fact, on-the-job construction workers,
- non-registration of construction employers,
- deliberate misclassification of workers into rate groups with lower premiums, and
- under-reporting of actual payroll.

Over the past several years, the WSIB has stepped up its enforcement efforts through more aggressive auditing. These efforts have reined in the number of non-registering employers and reduced the incidence of deliberate misclassification of employees and under-reporting of payroll.

### Bill 119:

Bill 119, when it is implemented, will reduce the revenue losses from the current exemptions for ‘independent operators’ and ‘executive officers’. Bill 119 requires independent operators to take out WSIB coverage. The bill also tightens the loophole that currently allows many individuals to exempt themselves from coverage as ‘executive officers’. The changes set out in Bill 119 will take effect in 2012.

Persons or corporate entities that hire ‘independent operators’ are obliged to require proof of coverage (*i.e.*, a ‘clearance certificate’). Such persons and corporations are also liable for unpaid premiums as well as a fine. These obligations and liabilities, however, do not extend to homeowners. Consequently the liability and enforcement system is less robust in the residential renovation sector. As noted earlier, roughly half of all ‘independent operators’ work in residential renovation. This may result in many ‘independent operators’ in this sector continuing to evade coverage. *Nevertheless, Bill 119 is exceedingly important.*

*Bill 119, when it is implemented, will inaugurate a major improvement in the ICI sector where employers who improperly style their workers as ‘independent operators’ have had an unfair competitive advantage for far too long. Bill 119 will also significantly improve conditions in new construction in the residential sector.* Information sharing between the WSIB and the Canada Revenue Agency will also assist in ensuring compliance with both Income Tax and GST/HST requirements.

### Estimates:

Figure No. 7 sets out estimates of revenue losses to the WSIB from the ‘independent operator’ and ‘executive officer’ exemptions.

**Figure No. 7**

Estimated Revenue Losses to WSIB from  
'Independent Operator' and 'Executive Officer' Exemptions, 2007-2009 Average

No. of Exempted Independent Operators	73,500
No. of Exempted Executive Officers (who are not Independent Operators)	35,000
Total Exemptions	108,500
Average Earnings (based on 2006 Statistics Canada Input-Output Tables for Ontario Construction Industry, adjusted for 2.5% annual wage escalation )	\$45,300
Exempted Payroll	\$4.915 billion
Average Construction Premium (2007-2009, unweighted)	7.8%
Lost Premium Revenues – High Estimate	\$383 million
Lost Premium Revenues – Low Estimate <sup>5</sup>	\$268 million

The estimates in Figure No. 7 are higher than previous estimates. This is a result of three factors: (1) the inclusion of 'executive officers' who were not considered in previous studies, (2) the increase in employment compared to earlier periods, and (3) the increase in wages compared to earlier periods.

## 6. Estimates of Revenue Losses to the Income Tax System

### Undeclared Income - Self-Employed:

Figure No. 8 shows estimates for the amount of income tax revenue lost as a result of under-reporting of income by self-employed persons in the construction industry.

'Average earnings' encompass wages and salaries, supplementary income, and mixed income, but not operating surplus. Estimates are based on Statistics Canada's 2006 input-output tables with the estimates updated to 2009 using a 2.5% annual inflation factor. The 80% estimate for the taxable portion of 'average earnings' is a working assumption. Tax payable is based on 2009 rates.

The revenue loss to the Income Tax System depends on the portion of earnings received by self-employed construction workers that is not declared. Estimates are presented based on a range of assumptions from 10% to 60%. As noted earlier, Statistics Canada's estimates from data for 1985-1991 put the proportion of undeclared income at 60%.

<sup>5</sup> Low estimates are factored down by approximately 30% to introduce a greater degree of conservatism into the overall estimates.

**Figure No. 8**

Estimated Revenue Losses to the Income Tax System from Undeclared Remuneration of Self-Employed Workers in the Construction Industry, 2007-2009 Average

Self-Employed (all categories)	137,000
Average Earnings	\$60,599
Est. Taxable Earnings (80%)	\$48,479
Est. Tax: Federal	\$7,798
Est. Tax: Provincial	\$2,915
Total Tax	\$10,713
Total Tax Obligation of Self-Employed	\$1.468 billion
<b>Revenue Loss from Undeclared Earnings</b>	
10% of earnings undeclared	\$147 million
20% of earnings undeclared	\$294 million
30% of earnings undeclared	\$440 million
40% of earnings undeclared	\$587 million
50% of earnings undeclared	\$734 million
60% of earnings undeclared	\$881 million

### **Moonlighting' (Multiple Job-Holders):**

A second source of revenue loss to the tax system is the undeclared income of persons with regular jobs in the construction industry who also 'moonlight'. The rate of multiple job-holding in the construction industry, as estimated by Statistics Canada is 4.5%. Some workers, however, will not report their 'moonlighting' activities in the *Labour Force Survey*. A higher upper boundary estimate is warranted. For estimating purposes, we have used a 6.0% rate of multiple job-holding as the upper boundary estimate. We have also assumed that these individuals work approximately 40-80 days per year in their second jobs and that they earn around \$30 per hour. The \$30 per hour estimate is consistent with a conservative reading of Statistics Canada's input-output tables. The income tax liability for this work would be approximately \$39-104 million. We cannot say what proportion of these earnings is concealed. However, an estimate of 40-70% evasion of the tax liability is not unreasonable. This implies a loss to the tax system of around \$16-73 million

### **Unmeasured Construction Work:**

As noted earlier, Statistics Canada estimated that there is an unmeasured element of construction work. This is construction work that is *not* taken into account when GDP and employment estimates are formulated. Using 1992 data, the Statistics Canada study estimated that the upper boundary for *unmeasured* construction work in the residential sector was 8.1%. This would represent employment of approximately 11,000 persons. The estimated income tax liability on this work would be approximately \$118 million. Since the work is deemed to be unmeasured, it is likely that a high proportion of this income is concealed. Losses to the income tax system were likely in the range of \$59 million to \$94 million.



### Overall Losses to Income Tax System:

Based on the foregoing discussion, the range of potential losses to the income tax system can be summarized as follows:

**Figure No. 9**

Estimated Revenue Losses to the Income Tax System from Undeclared Remuneration in the Construction Industry, 2007-2009 Average (\$ Millions)

Losses from Undeclared Income of:	Low	High
Self-Employed	\$440	\$881
Moonlighters (Multiple Job Holders)	\$16	\$73
Unmeasured / Undeclared Construction Work	\$59	\$94
<b>TOTAL</b>	<b>\$515</b>	<b>\$1,048</b>

These estimates therefore suggest that losses to the income tax system are in the range of \$515 million to approximately \$1.0 billion. In round terms, roughly 32% of this loss applies to the provincial government, while around 68% applies to the federal government. *Ontario's losses, therefore, are approximately \$165 million to \$335 million.*

## 7. Estimates of GST Revenues Lost

GST is chargeable on both goods and services. Contractors who undertake construction work on a cash basis cannot escape paying GST on construction materials. Implicitly they pass this cost on to customers. Evaded GST is relevant only to the services portion of construction work. Furthermore, businesses have no interest in avoiding GST obligations since they can deduct their GST payments as input credits against GST received. GST evasion is confined, therefore, mainly to households. Since the last study, the GST has also been reduced from 7% to 5%.

Estimated losses from evading GST on residential repairs were \$39 million to \$58 million. For residential renovations, the estimated losses are \$168 million to \$210 million. Total estimated losses are \$207 million to \$268 million. It is likely that there was a reduction in evaded GST in 2009 owing to the availability of a tax credit for home renovations. Since receipts were required to support claims for this credit, homeowners had significantly less incentive to evade the GST.

The estimated GST losses were relevant only to the federal government. When Ontario implements the Harmonized Sales Tax (HST), the provincial government will also be affected by evasion. Had the HST been in effect, the losses to the provincial government would have been approximately \$290-\$375 million.

## 8. Estimates of CPP and EI Contributions Lost

For the period 2007-2009, the estimated magnitude of undisclosed earnings in construction is \$2.9 - \$5.6 billion. Contributions to the Canada Pension Plan owed on these earnings would have been approximately \$285-\$555 million. Employment Insurance contributions would have been \$79-\$153 million.

## 9. Estimates of Employer Health Tax (EHT) Loss

The primary loss of EHT revenues to government arises from persons who are classed as 'independent operators' and therefore do not appear on payroll. However, even if the earnings of these individuals were included in payroll calculations, roughly 70% of construction establishments would still have payrolls below the \$400,000 threshold that is exempt from EHT. Virtually all 'cash operators' in residential renovation would also fall into this exempt category. Revenue losses are estimated at \$8.0 - \$10.0 million.

## 10. Summary of Estimated Revenue Losses

Figure No. 10 summarizes the estimated revenue losses to the WSIB, the tax system, the Canada Pension Plan and the EI system from underground practices in the construction industry. The estimates suggest an overall loss in the order of \$1.4 billion to \$2.4 billion.

**Figure No. 10**

Estimated Revenue Losses to Governments and Government Agencies from Underground Economy Practices in the Construction Industry, 2007-2009 Average (\$ Millions)

	Low Estimate	High Estimate
WSIB Premiums	\$268	\$383
Income Tax <sup>6</sup>	\$515	\$1,048
GST	\$207	\$268
CPP	\$285	\$555
EI	\$79	\$153
EHT	\$8	\$10
<b>TOTAL</b>	<b>\$1,362</b>	<b>\$2,417</b>

<sup>6</sup> As noted above, the Ontario share of Income Tax losses is approximately 32% (i.e., approximately \$165 million to \$335 million).

## 11. Implications

The estimates set out in this report confirm that the underground economy continues to be a serious challenge for the construction industry in Ontario.

Differences in estimation procedures mean that the findings in this report are not strictly comparable to earlier studies. However, *the general import of the estimates in this report is that the increased enforcement efforts by the Canada Revenue Agency, the WSIB, and the Ontario Government have had a positive impact on reining in the growth of the underground economy.* Increased enforcement appears to have stemmed the flow of new entrants into the underground economy. *The underground economy's share of overall construction activity has probably stabilized.*

*Improper styling of workers as 'independent operators' remains the key enabling factor for the underground economy.* Had the 'independent operator' share of the construction work force remained at the 10-11% share that prevailed twenty years ago, the underground economy would not be anywhere close to the magnitude that it actually reached. *Until this problem is tackled, the underground economy will continue to contaminate the competitive environment in Ontario's construction industry.*

Bill 119, which extends mandatory WSIB coverage to 'independent operators' and 'executive officers' will significantly improve conditions when it is implemented. This is especially important in the ICI sector where underground practices pose challenges for most trades, but especially for painters, drywallers, and floor-coverers. *The unionized construction industry in the ICI sector has a particularly strong interest in ensuring that Bill 119 is effectively implemented.*



# Technical Appendix

## 1. Employment Estimates

The sectoral employment estimates in Figure No. 5 are based on employment estimates developed by the Construction Sector Council (CSC) with further disaggregation based on building permits, construction spending data, and the wage share of inputs, per Statistics Canada's input-output tables. These data are for trades employment only.

**Ontario - Employment Estimates, Construction Sector Council**

	2007	2008	2009	Average
Non-Residential Sector	157,020	167,490	163,770	162,760
Residential Sector	146,650	144,450	120,570	137,223
<b>Total Residential and Non-Residential Employment</b>	<b>303,670</b>	<b>311,940</b>	<b>284,340</b>	<b>299,983</b>
Industrial Maintenance	5,351	5,316	5,265	5,311
Commercial, Institutional, Residential Maintenance	57,440	57,857	58,410	57,902
<b>Total Maintenance Employment</b>	<b>62,791</b>	<b>63,173</b>	<b>63,675</b>	<b>63,213</b>
New Construction Employment	240,880	248,770	220,660	236,770
<b>Total Construction Employment</b>	<b>303,671</b>	<b>311,943</b>	<b>284,335</b>	<b>299,983</b>

The CSC estimates for non-residential construction were disaggregated into industrial, commercial and institutional building construction and civil construction based chiefly on the shares of these sectors in construction spending, per Statistics Canada CANSIM Table 029-0040, and 379-0025.

The disaggregation of residential employment between new construction and renovation is based on CANSIM Table 380-0010. The estimates of high-rise and low-rise construction employment are based on building permits per CANSIM Table 026-0001. Estimates of the value of residential repair construction are based on CANSIM 026-0009.

Wage ratios are taken from the national input-output tables, CANSIM – W level.

## 2. 'Independent Operators' / Executive Officers'

'Independent Operators' are self-employed persons (both incorporated and unincorporated) who do not employ paid help. This data is found in Statistics Canada *Labour Force Survey*, CANSIM Table 282-0012. Estimates of the incidence of 'independent operators' across sectors are judgement-based estimates. 'Executive Officers' are based on the number of self-employed persons who are incorporated and who have paid help. This is adjusted upwards slightly to allow for some individuals who are self-employed and unincorporated, but who have paid help. These estimates would be higher if 'partners' were taken into account.

## 3. Estimates of Revenue Losses to WSIB

The average earnings estimate is derived from the wage share of inputs in the input-output tables divided by employment.

The average construction premium is the unweighted average of the premiums for the construction rate groups.

## 4. Income Tax Losses

The average earnings estimate is derived from the wage share of inputs in the input-output tables divided by employment. It is assumed that 80% of these earnings are taxable. Tax rates are for 2009 from the Canada Revenue Agency website.

The estimated number of 'moonlighters' is a judgement estimate. The rate of multiple job-holding in the construction industry, per the Statistics Canada *Labour Force Survey* is 4.5%. We have raised this to 6.0% on the assumption that some workers do not report their 'moonlighting' activities in the *Labour Force Survey*. The upper and lower estimates for the number of days per year of moonlighting are judgement based. The \$30 per hour estimate is consistent with a conservative reading of Statistics Canada's input-output tables. Income tax evasion rates are judgement based. It is believed that a high proportion of moonlighting work is remunerated in cash and, therefore, not declared.

The estimate of unmeasured construction work is taken from the 1994 study by Statistics Canada referenced in the main report.

## 5. Estimates of GST Revenues Lost

As noted in the main report, the avoidance of GST is assumed to be limited to residential repair and renovation. Estimates for spending in these categories are taken from CANSIM Tables 380-0010 and 026-0009. The labour share is estimated to be 60%. This is a reduction from 70% which was used in previous studies. The assumed upper and lower boundaries to the underground share were 60% and 40% respectively. A 5% GST rate was applied to the non-materials portion of these expenditures.

## 6. Estimates of CPP and EI Contributions Losses

Contribution losses to CPP and EI were estimated as follows. The undeclared shares are judgement based.

	Income	Undeclared %	
		Low	High
Self-Employed	\$8,302,063,000	30%	60%
Moonlighters	\$124,800,000	40%	70%
Unmeasured	\$666,589,000	50%	80%
<b>Undeclared Income</b>			
Self-Employed		\$2,490,618,900	\$4,981,237,800
Moonlighters		\$49,920,000	\$87,360,000
Unmeasured		\$333,294,500	\$533,271,200
<b>TOTAL</b>		<b>\$2,873,833,400</b>	<b>\$5,601,869,000</b>
<b>CPP (9.9%)</b>		<b>\$284,509,507</b>	<b>\$554,585,031</b>
<b>EI (2.7%)</b>		<b>\$78,455,652</b>	<b>\$152,931,024</b>



## 5. Estimates of HST Revenues Lost

No. of Independent Operators	73,530
Percent Employed in Establishments with 8+ employees	29%
No. of Independent Operators who would be added to EHT liable payrolls	14,706
Average Earnings of Independent Operators (based on Input-Output Tables)	\$60,600
Potential Addition to EHT-Liable Payrolls	\$891,183,600
EHT Rate	1%
EHT Liability	\$8,911,836

## About OCS

The Ontario Construction Secretariat (OCS) was established in 1993 under provincial legislation to represent the collective interests of the organized building trades unions and their signatory contractors in the Industrial, Commercial and Institutional (ICI) construction industry. The OCS works, with our labour-management-government partners, to enhance Ontario's unionized ICI construction industry by developing relationships, facilitating dialogue, providing value-added research, disseminating information and promoting the value of unionized ICI construction.

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