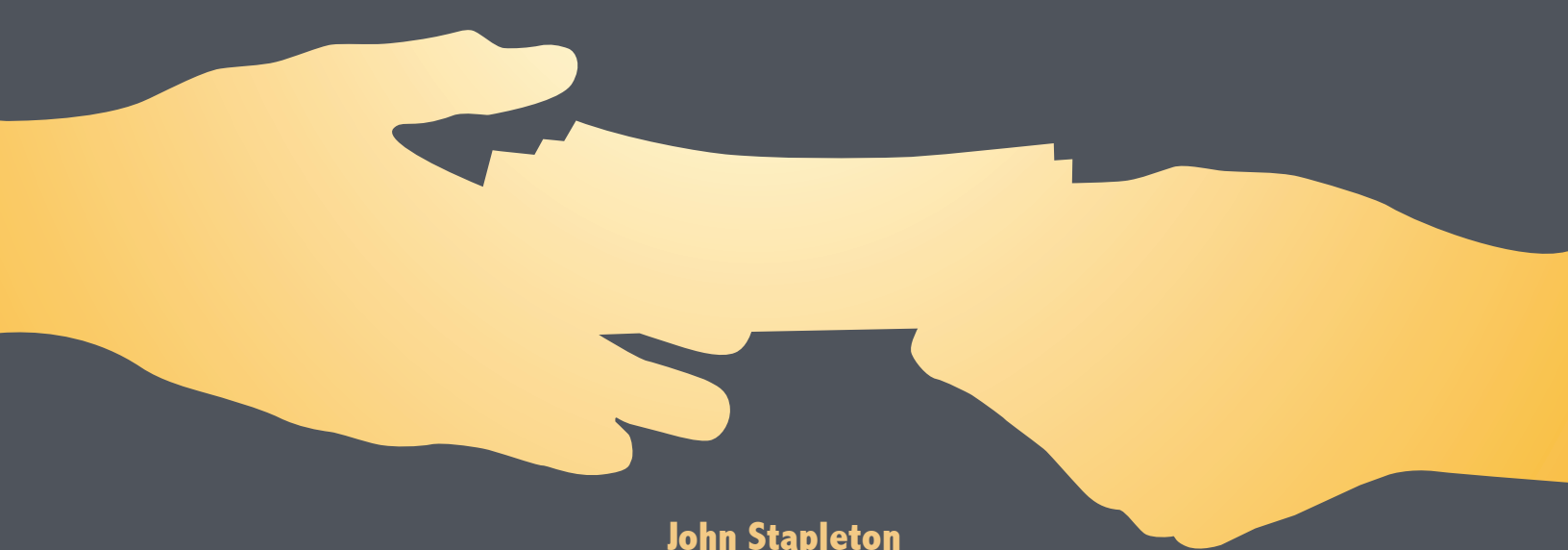




Low-income adults in the informal service economy

**Tax cheats...or survivors and
community builders?**



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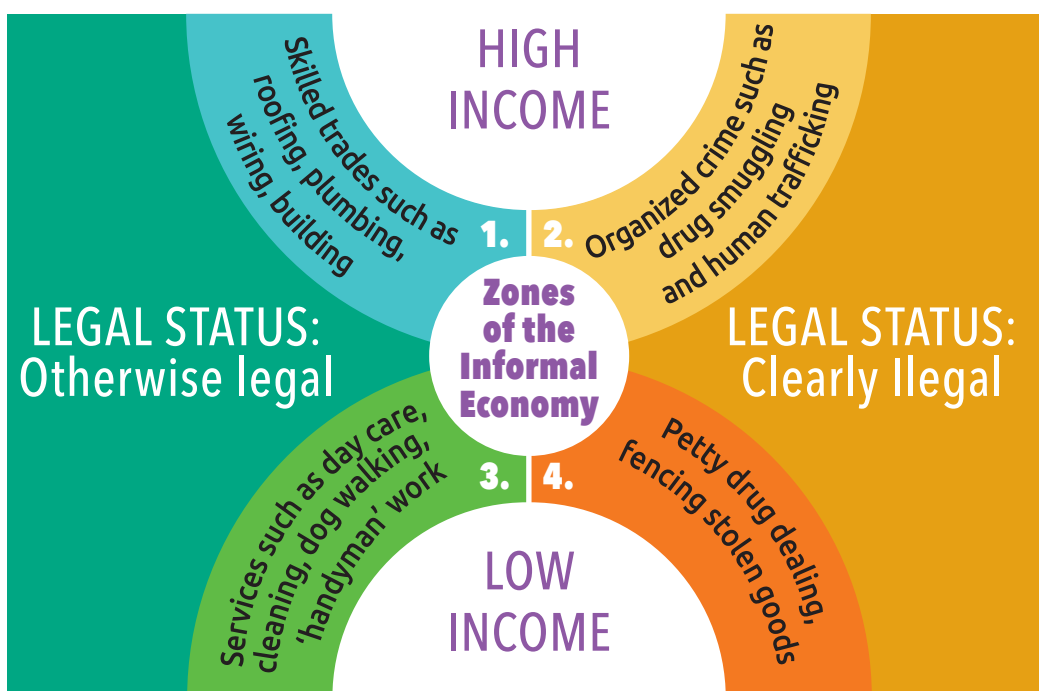
The focus of this paper

In 2014 and 2016, West Neighbourhood House in Toronto (formerly St. Christopher House) conducted two rounds of research into the local informal economy with support from the Metcalf Foundation.

The research approach was to build relationships with people who had lived experience of the informal economy, and at the same time to consult with policy experts, in order to see how the growing “clandestine” economy was affecting the community, particularly low-income people.

From a policy perspective, there was interest in how this activity affected government coffers, including both uncollected revenue in the form of taxes and savings on expenditures in the form of foregone credits and benefits that are triggered by tax filing. West Neighbourhood House published two reports on the project’s findings.¹

The underground economy can be divided into four zones. In the diagram below, we give examples of some of the activities in each zone and their legal status. Some are clearly criminal and some would ‘otherwise’ be legal, if they were performed formally and not for cash:



1. <http://www.westnh.org/programs-and-resources/public-policy-work/informal-economy/>

In this short paper, we seek to illuminate activities in Zone 3 of the informal economy, where low-income people both provide and consume untaxed goods and services that would 'otherwise' be legal. We call this the low-income, informal, service economy.

Informal service work is qualitatively different from illegal work done in other zones of the underground economy. Here are three reasons why:

- 1.** Every dollar received in the informal economy is paid voluntarily. No one is forced to pay under the table. The person who chooses to purchase work in the informal economy is usually buying a service that is available in the formal economy at a higher price.
- 2.** The buyer pays for informal services largely out of after-tax money. That is, the buyer is not paying with illegally obtained money.
- 3.** Low-income service providers quickly spend their informal incomes in the formal economy. They pay rent, buy groceries, pay school fees for their children, buy clothing, pay sales tax, and repay debts such as student loans and back taxes. This is not as often true in the illicit informal economy, where funds tend to remain in the illicit market.

Members of the project team informally interviewed more than 140 low-income people over the course of the West Neighbourhood House project. All of them had lived experience of the informal service economy. The picture they got from talking with participants did not resemble the rather lurid accounts of the underground economy that we are used to seeing in the mainstream media.²

They found that a majority of low-income people who take part in the informal economy do so willingly. Although they understand that there are risks involved in not declaring income to the government, they have discovered that participation in the formal economy can make their lives precarious in other ways.³

This paper tells the stories of some of these people and outlines the pros and cons of the economic choices they are making.

2. See, for example, <https://globalnews.ca/news/2773718/canadas-underground-economy-is-thriving-so-are-you-contributing/>

3. A smaller group wanted to transition out of the informal economy but did not know how, or could not find any viable way to do so. John Stapleton discusses some of the issues facing this group in a companion to this paper titled "A fortune left on the table: Why should low-income adults have to pass up government benefits?"

2

Social crime? Or savvy survival strategy?

Sandra is a single parent living in Toronto with her ten-year-old son. She works at two jobs. As an employee of a fast food restaurant, she makes about \$15,000 a year, which she declares on her taxes. For cash under the table, she works as a cleaner and a weekend child minder, receiving another \$15,000 a year.

The Sandra that the federal and provincial governments see is living in poverty. The real Sandra is living above the poverty line. The Sandra that governments see is required to pay no income tax, although she does contribute \$244 a year in EI premiums and \$569 to CPP. This Sandra gets \$9,238 in refundable tax credits.

The Sandra that government sees has a net yearly income of \$23,425. The real Sandra takes home \$38,425.

What would happen if Sandra did not work under the table and received all of her \$30,000 pay in the formal economy? She would pay \$3,156 in income tax for the year. She would get \$7,742 in tax credits from the federal and provincial governments. She would pay \$488 in EI premiums and \$1,311 into CPP. If Sandra's \$30,000 income were all realized in the formal economy, her net income would be \$32,787.

Sandra is better off by \$5,638 making half of her income in the informal economy. The Canadian income tax system receives \$3,156 less than it otherwise would. And it pays her \$1,496 more in refundable tax credits.

Many would see Sandra as a misbehaving tax cheat. But there is another way to see her. We want to show you a Sandra who is not only a net contributor to the economy but also a net contributor to governments. There are some good reasons to spare the Sandras of the world our indignation and save it for, say, Canadian corporations using offshore tax havens.⁴

THE BENEFITS AND DRAWBACKS OF THE INFORMAL SERVICE ECONOMY

If Sandra did not work under the table, she and her son would be living in poverty. The reality is that Sandra cannot find another formal economy job that pays \$15,000 a year. But if she could work entirely in the formal economy at \$30,000 a year, her income would straddle current poverty measures for a family size of two.

The reality is, informal work provides earners an opportunity to escape poverty that

4. In 2016, the Toronto Star reported on a Canadian company, Gilден, that does \$1.3 billion in business and reduced its tax bill by \$384 million through the use of offshore tax havens. <https://www.thestar.com/news/world/2016/06/17/offshore-tax-avoidance-fixing-it-made-it-worse.html>
It would take tens of thousands of cheating Sandras to equal just one tax year's tax evasion by the many corporations that, like Gilден, were recently identified in the Panama Papers – and there just aren't that many Sandras out there.

is not as easily accessible in the formal sector. In Sandra's case, her informal income combined with her formal earnings puts her well ahead of all current poverty measures for a family of two.

Society benefits from Sandra working in the informal economy, because she, and people like her, do not incur the 'cost of poverty'. In Canada, these costs are incurred because people who are poor cost our health and court systems more, and put less into our tax system because of lost educational opportunities and subsequent success in the labour market.⁵ Some researchers⁶ have placed the cost of poverty in Canada as high as 5% of GDP.⁷

To say that informal work lifts Sandra out of poverty is not to say that there are no drawbacks. She has fewer income security options than those working in the formal economy. If she loses her job, she will get only \$158 a week in EI. If she had earned all of her \$30,000 income in the formal economy, she would receive \$317 a week in EI.

Moreover, Sandra is contributing only 43% of what she would contribute to CPP if her informal work were formalized. Her retirement income would be much higher if all of her income were formal. And let's not forget that Sandra's EI and CPP footprint on employers is much smaller because employers incur no EI and CPP costs in the informal economy.

In other words, Sandra is trading off her advantages in the present with what she may lose in the future. Indeed, when her son is older, she may well choose a different employment path.

In the present, however, Sandra is enjoying a considerably better quality of life than she otherwise would. For example, she can now pay for school fees, over-the-counter medicines, and non-listed medical procedures. She can afford to pay for a weeks' vacation and a day camp for her boy during summer.

Moreover, she is able to make regular payments toward her student loan debt and is reducing her high-interest credit card debt.

Given all this, let's rethink our attitudes toward low-income adults in the informal service economy. Maybe we should just let Sandra live her life.

5. <http://openpolicyontario.com/wp/wp-content/uploads/2016/11/Cost-of-Poverty-R10-Final-forweb.pdf>

6. Plante, C. & Sharp, K. (2014). Poverty costs Saskatchewan: A new approach to prosperity for all. Saskatoon Poverty Reduction Partnership. Available from:
http://vibrantcanada.ca/files/povertycostssaskatchewan_povertycosts_2014_s.pdf

7. <http://www.statcan.gc.ca/tables-tableaux/sum-som/l01/cst01/econ15-eng.htm>

3

Tax cheats or community builders?

Barsha arrived in Canada at the age of 67 from Bangladesh to be near her son, Rafi, and his young family. Rafi, wanting to make sure she was able to build new connections in her community, found her an apartment in a high-rise that is a landing place for many new immigrants from Bangladesh.

Barsha had worked as a teacher back home, but does not work in Canada. Her income is limited. She will be eligible to receive Old Age Security benefits once she has lived here for 10 years. Until then, she will rely on financial support from Rafi. She knows he has a young family and tries to limit her spending as much as possible.

Barsha pays \$1300 a month for her one-bedroom unit, including utilities. She has several problems in her kitchen that she needs fixed. She is not really sure what these services will cost, and does not know where to look. Finding a good price to contract out her kitchen renovations is a way that Barsha can contribute to her family's budget.

Luckily, Barsha lives in a community where everyone helps each other out. Her neighbors include a young family of four. The mother, Nainitha, stays home to mind their pre-schooler and the father, Sam has a full-time job.

To make extra cash, Sam does handyman work in the community for cash. While Sam knows there are ways to formalize this work, the process for doing so is complicated, and with his full-time job and young family, he's too busy to find out. Also, he believes working informally keeps his overhead down and enables him to lower his prices for neighbors like Barsha.

It would be daunting for Barsha, whose English is poor, to research contractors outside of her community. She has heard about Sam's work from others and trusts that he will do a good job and give her a good price. Also, informal, cash-based exchanges are common in Barsha's home country. She does not feel any sense of stigma or shame about the transaction.

Sam charges Barsha \$500 to complete her kitchen repairs. In the formal economy with a general contractor, it would likely have cost her twice as much. Barsha knows she is taking a risk with Sam, as there is no formal recourse if something goes wrong with the repairs. But Barsha also takes a risk finding a mainstream contractor, who could exploit her lack of English and lack of knowledge about the value of the repairs and overcharge her.

THE OUTWARD RIPPLES OF AN INFORMAL TRANSACTION

What Barsha and Sam are doing becomes very interesting when we view it in a wider frame. They are contributing to the much-needed development of social capital within an immigrant community.

Because of this transaction, Barsha has developed a deeper relationship with her neighbours. She knows the extra cash Sam makes from his handyman work pays for his daughter's after-school program, where she is learning how to play soccer and meeting other kids in the neighbourhood. It also enables Sam's wife Nainitha, who is pregnant again, to manage the household and spend quality time with their toddler.

*For so many new Canadians,
the barriers to entry into the
formal labour market are high.*

There's more. Sam and Nainitha do not have their parents in Canada yet. Barsha is able to help with the kids and with cooking from time to time. And when Barsha's son Ravi and family come to visit, Ravi and Sam begin to form a relationship, as do the moms and children. Ravi has been in Canada for much longer than Sam and has connections in his field. He can expose him to jobs with higher wages.

A 2013 report by the Wellesley Institute noted that the informal exchange economy among individuals living on the margins allows for the development of a common identity in an otherwise foreign environment.⁸ This shared community identity has plays an important role in shaping the well-being and capacity of people like Sam and Barsha as they integrate successfully into a new society.⁹

For so many new Canadians, the barriers to entry into the formal labour market are high. They lack the networks, fluency in English, relevant work experience, and some reasonably fluid way to turn their education and experience into recognized Canadian credentials.

Without informal exchange networks, many new Canadians would not find the means needed to start integrating into Canadian society.

8. <http://www.woodgreen.org/Portals/0/PDFs/Shadow%20Economies.pdf>

9. <https://www.canada.ca/en/revenue-agency/news/about-canada-revenue-agency-cra/tax-alert/reducing-participation-underground-economy-canada-revenue-agency-2014-2015-2017-2018.html>

DO BARSHA, SANDRA, AND SAM “HURT ALL CANADIANS”?

In 2014, the federal government unveiled their Underground Economy Strategy. It was designed to:

“Reduce the social acceptability of, and participation in, the underground economy in order to protect the fairness and integrity of the tax and benefit system”¹⁰

More recently, a 2016 Global News report singled out consumers of the underground economy as contributing to a problem that is “costing the government billions in unpaid tax income... and hurts all Canadians”¹¹

Just as in Sandra’s case, to consider this question we need to carefully locate Barsha and Sam’s transaction in that service zone of the informal economy where most low-income people operate. Yes, Barsha avoided paying \$65 in HST. Yes, Sam likely will realize \$2 – \$3000 extra per month through his informal handy work around the building, costing government up to \$4,680 in tax income each year.

(We gently direct the reader’s attention once again to footnote #3, where we briefly discuss Gilden, just one of several Canadian companies that managed to reduce their tax bills by many millions in one year through the use of offshore tax havens.)

WHAT HAPPENS IF WE ‘CLEAN UP’ THE INFORMAL ECONOMY OF THE POOR?

What would happen if the Canada Revenue Agency suddenly found the means and the personnel to swoop down upon people like Sandra and Sam and prosecute them for their unreported income?

*We don’t know how much informal service work would disappear, but it is quite likely that a **significant percentage** would be **lost** through what economists call ‘substitution’ – that is, **not purchasing a service at all.***

Sandra would be forced to stop her informal service work, thus reducing her income to the point where she re-joins the ranks of those living in poverty. On top of her other debts, she will be struggling to pay a CRA tax penalty. No more summer camp for Sandra’s son.

10. <https://www.canada.ca/en/revenue-agency/news/about-canada-revenue-agency-cra/tax-alert/reducing-participation-underground-economy-canada-revenue-agency-2014-2015-2017-2018.html>

11. <https://globalnews.ca/news/2773718/canadas-underground-economy-is-thriving-so-are-you-contributing/>

If the CRA sternly shut down Sam's informal Mr. Fixit business, would people like Barsha start paying much larger amounts into the formal economy for future repairs? Probably not. We don't know how much informal service work would disappear, but it is quite likely that a significant percentage would be lost through what economists call 'substitution' – that is, not purchasing a service at all.

*The reality is, the formal and informal economies are **held in balance**.*

For instance, they might do it themselves instead. Or they might not do it at all. The collapse of a little side business like Sam's in a low-rent building might mean that small parts of the community's infrastructure just get more and more run down, less often fixed, more often trashed.

We all know where that goes.

The reality is, the formal and informal economies are held in balance. The formal economy confiscates, taxes, and sets rules. It benefits the well-to-do, but penalizes the poor. The informal economy is a waste of time for most of the well-to-do but often the only possible option for the poor.

The West Neighbourhood House research taught us to think again, and think carefully, about the lived experience of low-income people in the non-illicit, informal economy.

As public policy makers, let's try to get a more realistic perspective on the costs of these minor transactions to our society. It would be both costly and ineffectual to invest in efforts to reduce informal economic activity among the poor without parallel efforts to remove the barriers to entry into the formal economy.

While we're waiting for those barriers to come down, maybe we should just let Sandra and Barsha and Sam get on with their lives.

About the authors

John Stapleton was a member of the management team for the informal economy project at West Neighbourhood House. He is Principal of the social policy consultancy Open Policy Ontario and an Innovation Fellow with the Metcalf Foundation.

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