



# The last frontier

**Shining a light  
on the black economy**



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# What is the black economy?



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Various definitions have been adopted around the world for what is commonly referred to as the black economy. Other terms include the shadow economy, cash economy and underground economy. The Commonwealth Government has established a Black Economy Taskforce. The Taskforce and the Australian Taxation Office (ATO) describe the black economy as:

“People who operate entirely outside the tax and regulatory system, or are known to authorities but do not correctly report their tax obligations.”<sup>1</sup>

Some definitions include illegal activities such as drug trafficking and money laundering while others are confined to legal activities that are unreported or under-reported, such as paying tradespeople in cash and restaurants accepting only cash payments.

In its interim report, the Black Economy Taskforce includes in its definition of the black economy:<sup>2</sup>

- businesses taking cash out of the till without recording it;
- businesses not lodging income tax returns and Business Activity Statements when they are legally required to do so;

- businesses paying employees cash in hand;
- people exchanging the proceeds of crime for clean money through money laundering; and
- people under-reporting income to increase welfare payments including family payments, unemployment benefits and the age pension.

In addition, illicit business activity, carried on by organised criminals, sits entirely outside the tax and regulatory activities. It includes the importation and distribution of illegal and contraband goods such as illicit drugs, tobacco products and hand guns.

1. Black Economy Taskforce webpage, at <https://treasury.gov.au/review/black-economy-taskforce/>  
 2. Black Economy Taskforce (2017, pp. 11-12).

# How big is it?

Through black economy activity, KPMG estimates that the Federal Government is missing out on more than \$5 billion per annum in revenue.

The Australian Bureau of Statistics (ABS) has estimated the underground economy – which excludes illegal activity such as drug trafficking – at 1.5 percent of GDP in 2011-12.<sup>3</sup> Applying this percentage to Australia's 2016-17 GDP of around \$1.7 trillion, the ABS estimate of the underground economy amounts to \$25 billion per annum.

To its estimate of the underground economy, the ABS adds an estimate of illegal drug trafficking, which it puts at 0.4 percent of GDP, for a total for what it describes as the non-observed economy of 1.9 percent of GDP, or \$32 billion in today's dollars.<sup>4</sup>

The black economy's adverse consequences are not limited to the tax and superannuation systems. However, it is on these parts of the social framework that the first-line impacts can most readily be identified.

The ATO periodically publishes data on components of the 'tax gap' – the gap between the amount of tax it considers it should collect and what

it actually collects. To date, the ATO data has been limited to particular components of the revenue base: Pay As You Go (PAYG) income tax, goods and services tax (GST) and income tax from large businesses (assessable income greater than \$250 million).

In 2017, the ATO published for the first time its estimate of the black economy's contribution to the PAYG income tax gap, amounting to \$2.08 billion for 2014-15.

Yet for a set of activities involving more than \$32 billion when illegal activity is included, it would be reasonable to expect that the annual aggregate gap in terms of the GST on sales, PAYG tax on wages, plus income tax on businesses and on self-employed profits, would exceed **\$5 billion**.

Table 1 presents a breakdown of KPMG's conservative estimate of Australia's black economy tax gap. It does not include any company income tax gap.

**Table 1: Estimated tax gap from Australia's black economy**

Tax type	Amount (\$ billion)
PAYG income tax <sup>5</sup>	2.1
GST <sup>6</sup>	1.2
Self-assessed <sup>7</sup> personal income tax	2.5
<b>Total</b>	<b>5.8</b>

3. ABS (2013).

4. ABS (2013).

5. Source: ATO tax gap report October 2017, based on 2014-15 figures.

6. KPMG estimate, based on black economy as 1.9% of ATO tax gap report's aggregate figure for GST taxable supplies for 2015-16.

7. KPMG estimate based on estimated gross gap of 15% in relation to non-PAYG withholding collections of \$38bn for 2016-17. By comparison, UK's most recent estimate of its corresponding gap is 20%. Further assumed that black economy comprises the same fraction (38%) as it does of the gross PAYG withholding gap.

# Why does it matter?

The Black Economy Taskforce provides a good summary of why the black economy matters:

“It provides unfair competition for honest businesses. It leads to the exploitation of more vulnerable workers. It increases the costs of providing government services because of people who don't pay their share of tax”<sup>1</sup>



Those individuals and businesses engaged in the black economy place themselves at a competitive advantage over their honest counterparts who pay their taxes and comply with government regulations. By operating outside the tax and regulatory systems, participants in the black economy do not pay the 10 percent GST, income tax, fringe benefits tax, capital gains tax or payroll tax, giving them a decisive pricing advantage over honest people and businesses.

A flourishing black economy is corrosive of ethics in the community. When honest taxpayers see their loss of business to dishonest competitors, they are faced with a choice of: “If you can't beat them, join them.”

The black economy is the last of the major tax bases that can yield significant government revenue. Relevant legislation also has a reasonable prospect of passing through Parliament.

Tradespeople who have a legitimate ABN and Tax File Number can be outbid for work by rivals who quote cash-only prices. Restaurants and cafes in localities where only cash is accepted will be under great pressure to do the same in order to offer competitive prices.

Workers operating in the black economy, receiving cash in hand as wages, are not protected by workplace laws and safety regulations and do not benefit from employer superannuation contributions. If they are on temporary work visas or are working illegally, they are vulnerable to threats from employers to have them deported.

Participation in the black economy causes leakage of government revenue. With a flourishing black economy, Commonwealth and state governments face added difficulty in balancing their budgets, obliging them to raise extra revenue from honest taxpayers, to reduce government services and income support for the disadvantaged or to run persistent budget deficits which must be financed by future generations.

As KPMG has pointed out in its submission to the Black Economy Taskforce, the black economy is the last of the major tax bases that can yield significant government revenue. Relevant legislation also has a reasonable prospect of passing through Parliament.

# What is being done about it?

The *2018 Budget* is an opportunity for the Commonwealth Government to take further steps to address the erosion of the tax base through the black economy.

The Commonwealth Government established the Black Economy Taskforce in December 2016 (and prior to this there were Phoenix and Serious Crime Taskforces established in 2014 and 2015). The Taskforce delivered its interim report to the government in March 2017 and a final report in October 2017. It is likely that the Treasurer will announce further measures in response to the final report in the *2018 Budget*. It is expected that this will include continued funding of the ATO to carry out compliance enforcement activity.

The Commonwealth Government has already followed through on its *2017 Budget* announcements and introduced legislation into the Parliament that would extend the taxable payments reporting system (TPRS) to the cleaning and courier industries. The same Bill also contains provisions that would make it a criminal offence to manufacture, supply or possess sales suppression technology items.

In September 2017 the Commonwealth Government announced measures to combat illegal company phoenixing activity, and Treasury also consulted on a range of further possible reforms to crack down on directors and advisers who carry out these schemes.

The *2018 Budget* is an opportunity for the Commonwealth Government to take further steps to address the erosion of the tax base through the black economy. Such initiatives would be relatively likely to receive parliamentary support, compared with other revenue measures that the government has proposed over the last 18 months.

# What more can be done?



We propose a limited amnesty for incorrect reporting, with subsequent higher penalties for those who do not take the opportunity given.

The Black Economy Taskforce's interim report identified a large number of possible actions to address the problem. KPMG has focused below on three measures which we expect could have a speedy and high impact, and has set out a further seven which would strengthen that initial impact over the medium term.

## 1. Additional funding for coordinated enforcement action against serious tax crime

The Commonwealth, state and territory governments should be prepared to show that they collectively have zero tolerance for the component of the black economy represented by "*those who operate completely outside the tax and regulatory systems*".

In the *2017 Budget*, the Commonwealth Government allocated \$32 million to the ATO for a 1-year extension of its audit and compliance activity in relation to the black economy. The Budget papers anticipated \$441 million in additional revenue to flow from this ATO activity.

The ATO has quite reasonably stated that it cannot "audit its way to success" in eliminating the revenue gap arising from the black economy. However, the projected return on investment (RoI) multiple of nearly 14 times<sup>8</sup> suggests that this component of the ATO's compliance activity warrants a much

greater allocation of funds, even if it does not wholly address the overall problem.

KPMG urges the allocation of \$100 million to \$400 million per annum to the ATO for additional enforcement activity. The revenue to expenditure ratio of the incremental investment would conservatively be at least 7:1 (i.e. additional revenue of between \$700 million and \$2.8 billion) and maybe substantially greater.

Additional state and territory taxes (for example payroll tax and land tax) would flow from these criminals being brought to account. Consequently, there is a strong case for the states and territories to collaborate with the Commonwealth Government to undertake a nationally coordinated initiative covering all Commonwealth, state and territory revenue streams.

## 2. Two-stage amnesty for incorrect reporting, with subsequent higher penalties

At the same time as allocating additional resources to combating serious tax crime, the Commonwealth Government can take further action in relation to those participants in the black economy who "*are known to authorities, but do not correctly report their tax obligations*".

8. Additional revenue of \$441 million divided by the additional allocation to the ATO of \$32 million.  
Source: [www.budget.gov.au/2017-18/content/bp2](http://www.budget.gov.au/2017-18/content/bp2)

The amnesty program could be combined with additional funding for the ATO to increase its compliance activity for this sector of the economy over the next 4 years. This would increase the risk of taxpayers being audited by the ATO if they have not entered the amnesty program, and consequently provide a greater incentive to take part.

**Stage 1** of the amnesty program would be focused on the under-reporting of income, the over-reporting of deductions, and the underpayment of PAYG income tax withholding and superannuation contributions by companies and other businesses (such as carried on by sole traders, partnerships and trusts).

**Stage 2** would be open to employees, who could voluntarily disclose under-reported income from prior years. These disclosures would also have potential consequences for the employer, including penalties for failing to operate PAYG withholding and for failing to make superannuation contributions. Stage 2 would therefore act as an additional motivator for businesses to take part in Stage 1.

To maximise its effectiveness, KPMG would see the Stage 1 amnesty program having the following features.

- It would cover disclosures relating to a maximum of the two most recently completed tax returns (or lodgment obligations), and would remain open until 6 months after the most recent of those due dates.
- Shortfall interest charge would be waived, and the maximum penalty would be 10 percent of the tax shortfall.
- The penalty amount would be refundable in circumstances where the taxpayer lodges all necessary returns on a timely basis for the following 3 years, and the ATO considers that those returns are satisfactory.

- Taxpayers who do not take advantage of the amnesty and are subsequently found to have incorrectly reported their tax obligations would be regarded as having underpaid tax due to recklessness or intentional disregard for the law, carrying a minimum penalty of 50 percent of the tax underpaid, in addition to shortfall interest charges. These taxpayers would be ineligible for a reduction in the penalty even if they voluntarily disclosed the shortfall post-amnesty.
- It would also be open to the Commonwealth Government to modify the tax laws such that taxpayers whose under-reporting was identified post-amnesty would be ineligible for certain concessions for a number of years after being audited.

### **3. Legislate to deny income tax deductions for cash payments**

The Commonwealth Government can change the taxation law to deny an income tax deduction for a business or an individual in relation to any cash expenses incurred in carrying on their income-earning activities.

The cost of the non-deductibility would be highly likely to outweigh any 'cash discount' that the supplier might otherwise offer.

A business or individual who pays cash to suppliers and employees is consciously acting as an enabler of the under-reporting of that income. If the Commonwealth Government can legislate such that it is overwhelmingly in the customer's best interest to make payment for goods and services electronically, then a market-driven trend towards more comprehensive and traceable recording of transactions should follow.

## Supplementary measures

The following measures would build on the momentum created from adopting our principal proposals.

**4. Strengthen the evidentiary requirements for eligibility to obtain an Australian Business Number (ABN),** in order that the ABN is only available to those taking genuine entrepreneurial risk. This would inhibit 'sham contracting' and support the proper operation of the PAYG withholding and superannuation contribution laws. A component of our proposed additional funding for the ATO can be directed towards this action item.

**5. Bring the current ASIC company register up to date and review it for accuracy.** The Commonwealth Government is considering measures to require transparency on the ultimate beneficial ownership of company shares. Prior to this, it should ensure that the current register maintained by ASIC is accurate.

**6. Include a clean tax history as a requirement for participating in Commonwealth, state and local government tenders.** Governments should only be giving work to businesses with a good record of tax compliance. The ATO should be empowered to corroborate the assertions of businesses that enter the tender process.

**7. Implement a government 'one stop shop' for all necessary business and employer registrations.** Making it easier to do the right thing will provide one less trigger for lapsing into a habit of under-reporting. It will also make oversight much more straightforward, and could extend to 'front end' revenue collection.

**8. Tie vendor rights to maintenance of invoice records and evidence of electronic payment.** The law could be modified to deny a vendor certain defences against a civil action, if the transaction is not appropriately documented. Additionally, a presumption of law against the vendor could be introduced for these circumstances. Our view is that targeting the vendor will achieve behaviour change more quickly than would targeting the consumer.

**9. Make any cash transaction involving more than \$10,000 illegal.** It is highly unlikely that any legally compliant, practical benefit could be obtained from conducting a transaction involving such an amount using cash. This further complements our third recommendation, and provides a deterrent for consumers who might otherwise be open to making large cash payments in return for a purported discount on goods and services.

**10. The Commonwealth Government should support the Business Council of Australia (BCA) supplier payment code of conduct.** This support could include making signing up to the code a pre-condition for entry to government procurement programs. It could also include funding for research into compliance with the code by signatories.



## References

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ABS (2013), *Information paper: the non-observed economy and Australia's GDP 2012*, 5204.0.55.008, 12 September, at: <http://www.abs.gov.au/ausstats/abs@.nsf/Latestproducts/5204.0.55.008Main%20Features102012?opendocument&tabname=Summary&prodno=5204.0.55.008&issue=2012&num=&view=>

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