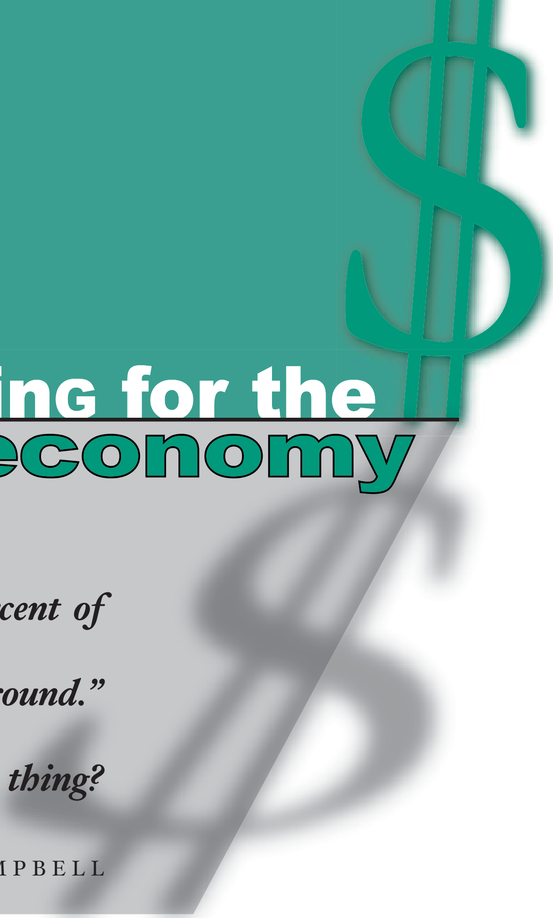
searching for the hidden economy



Economists believe as much as 10 percent of the U.S. economy is "underground." Is that such a bad thing?

BY DOUG CAMPBELL

Here is the brief, unremarkable story of how I recently came to participate in the underground economy:

Midafternoon on the iciest day this past winter, a man knocked at my front door. "Shovel your walk?" he asked. "Only $5."

Outside, it was a bone-chilling 15 degrees. "Sold," I said. A half-hour later I handed over a five-dollar bill and thanked him for saving me the trouble.

Officially, this was an unofficial transaction — off the books, with no taxes paid or safety regulations followed. (At least, I assume this hired hand didn't bother to report that income or register with the proper authorities.) As such, it was technically illegal. And, of course, it's the sort of thing that happens all the time.

The size of the official U.S. economy, as measured by Gross Domestic Product (GDP), was almost $12 trillion in 2004. Measurements of the unofficial economy — not including illegal activities like drug dealing and prostitution — differ substantially. But it's generally agreed to be significant, somewhere between 6 percent and 20 percent of GDP. At the midpoint, this would be about $1.5 trillion a year.

Broadly defined, the underground, gray, informal, or shadow economy involves otherwise legal transactions that go unreported or unrecorded. That's a wide net, capturing everything from babysitting fees, to bartering home repairs with a neighbor, to failing to report pay from moonlighting gigs. The "underground" label tends to make it sound much more sinister than it really is.

Criminal activities make up a large portion of what could be termed the total underground economy. Many studies have been done on the economics of drug dealing, prostitution, and gambling. But because money from crime is almost never recovered, many policymakers are more interested in portions of the underground economy that otherwise would be legal if not hidden from authorities. Things like shoveling walks.

Despite its intrigue, the informal economy's importance and consequences remain in debate. The reason: "You're trying to measure a phenomenon whose entire purpose is to hide itself from observation," says Ed Feige, an economist at the University of Wisconsin.

This uncertainty poses problems for policymakers. Without knowing the precise size, scope, and causes of the underground economy, how can they decide what — if anything — to do about it?

Was the man who shoveled my walk engaging in a socially positive or negative activity? Was I? Suffice it to say, some economists have dedicated their entire careers to answering questions about the underground economy — and still there is nothing close to a consensus about its size or description.

Elusive Definition

Friedrich Schneider, an economist at the Johannes Kepler University in Linz, Austria, defines the informal economy as: "All market-based legal production of goods and services that are deliberately concealed from public authorities for the following reasons: 1) to avoid payment of income, value added, or other taxes 2) to avoid payment of social security contributions 3) to avoid having to meet certain legal labor market standards,

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such as minimum wages, maximum working hours, safety standards, etc., and 4) to avoid complying with certain administrative procedures, such as completing statistical questionnaires or other administrative forms."

In Schneider's latest study, the U.S. informal economy — or "shadow economy," as he calls it — is pegged at 8.4 percent of GDP. His estimate was derived using a combination of two estimation methodologies: one that measures demand for currency and another a mathematical model that seeks to consider multiple causes of the underground economy as well as its multiple effects.

Other approaches include examining the discrepancy between spending and income, as claimed in tax filings; the gap between the official and actual labor force; and comparing electricity consumption with reported economic activity. Using a variety of methods, even the keepers of the national accounts, which produce GDP figures, try to tally the impact of the unreported economy in estimating the official economy.

Ed Feige, the University of Wisconsin economist, favors methods that study cash stocks and flows. His research focuses on the "unreported economy," which involves transactions whose purpose is to evade taxes. His latest work puts the 1993 unreported economy at $700 billion.

None of these approaches is perfect or precise. "To some authors, the whole exercise is doomed to failure," writes English economist Huw Dixon in a 1999 introduction to a series of journal articles about the underground economy. "If we have no direct measure, then indirect measures are likely to be no better than guesstimates, which should be taken at best as interesting novelties."

Given the level of doubt about the size of a nation's overall underground economy, it's no wonder that regional estimates are hard to come by. The Internal Revenue Service studies tax evasion on a national level and in 1998 quantified revenue losses at $195 billion — most of that believed to be the result of the transactions taking place in the underground economy. But there exists no state-by-state study of tax evasion, largely because politicians representing their districts don't want that kind of information released.

This makes it risky to attempt approximations of a region's underground economy. If you trust Schneider's work, you might make a simple extrapolation: The Fifth District's economy is valued at about $1 trillion a year, as calculated by adding up each "gross state product." That's about 10 percent of the overall U.S. GDP. So if the Fifth District's black market is in proportion with Schneider's estimate for the rest of the nation's, then we can estimate that the region's underground economy is worth about $84 billion.

Whether the informal economy is more active in rural or urban settings also remains to be settled. Shanna Ratner, an economic development consultant who studies informal economies in rural settings, thinks they're close to equal. Conditions like poverty and economic immobility — considered likely features of many informal economies — prevail in both inner-city and back-country environments. Farmers looking for a competitive edge are just as likely to hire illegal immigrants as inner-city warehouse managers.

Observers like Ratner are reluctant to judge those participating in informal economies, be they employers or hired hands. "I don't think it is in itself either a good thing or a bad thing," Ratner says. "It has to be viewed in context. When the informal sector results in activities that strengthen social capital, because they're relationship-based, one could argue that's a good thing. When the informal sector activities are illegal because they're harmful … then that's arguably a bad thing." In a 2000 paper about the informal economy, Ratner cited instances of home-based production (everything from arts and crafts to laundry) as a crucial means to "close the gap between wages and human needs and wants."

Looking for the Underground

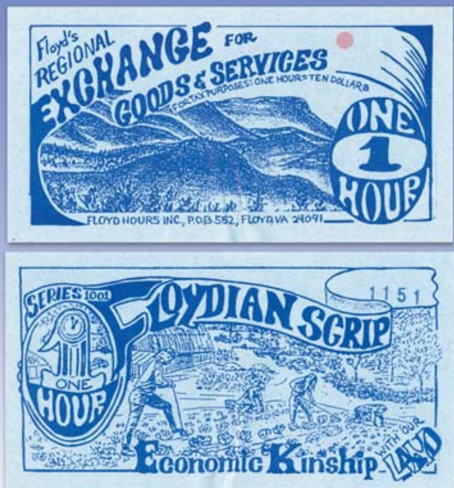
To get a better idea of how a full-fledged underground economy operates, I went to Floyd, Va. On paper, Floyd looks like just the sort of place where a rural-style informal economy should be thriving. Here is an Appalachian community with a rich history of barter. Writing about life just across the border in West Virginia, historian Paul Salstrom described it this way: "Appalachia's main economic anomaly was that distributive relations remained less monetized there; they remained composed more of bartering and borrowing." A short drive away is Abingdon, Va., home of the "Barter Theatre," founded in the 1930s as a place where local farmers could swap their crops for admission to a play.

There is no interstate coursing through Floyd. Its downtown is crisscrossed only by two-lane highways. Median family income in the county is $38,128 compared with $54,169 among all Virginia counties. Even in the relatively poor New River Valley, Floyd County stands out with its low taxable sales base, bank deposits, and high poverty rate. There has been a flight of manufacturing employers, creating more unemployed and underemployed people seeking work wherever they can get it, even if it's off the books.

David Rundgren, executive director of the New River Valley Planning District Commission, says on-the-side economies are part of Floyd's culture. "Throughout history these folks have been fairly independent and trading work with each other," Rundgren says.

For me, the big draw to this town were "Floyd Bucks" — Floyd's own currency. Officially called the "Floyd Hours," blue-colored bills were printed in 2002 by a nonprofit group whose aim was to "make a statement in support of our local economy," says Dawn Shiner, founder of Floyd's community currency effort. A "one-hour" bill is pegged to an estimated value of one hour's worth of labor, or $10. There are also quarter-hour bills valued at $2.50.

Informal economies do not require their own currencies. Indeed, most transactions in the informal economy



Locals call them "Floyd Bucks," but these bills are officially called Floyd Hours. A small group of residents in Floyd, Va., printed their own currency as part of an effort to keep business local.

probably are done in official U.S. currency, and those conducted in alternative currencies are supposed to be subject to taxes. And what I actually found in Floyd was an environment not unlike any small town across the United States: Sure, people are independent and will trade goods and services when it suits them, but U.S. currency and regulated work far eclipse the underground economy.

At the Harvest Moon, which locals refer to as the health food store, owner Margie Ryan says that in principle, she likes to barter whenever possible. In practice, it's not so easy, which is why she stopped accepting "Floyd Bucks."

"It's part of the overall culture of working together to get things done," Ryan says. "But everybody wanted to use those bills here, and I don't need so many labor hours. I need to pay my bills."

A quick survey of downtown retail establishments in Floyd revealed similar sentiments. From the hardware store to an art gallery, the answers were the same. A hostess at Mama Lazardo's Pizza summed it up: "I have 'em, but I have no way to spend 'em."

Shiner modeled the Floyd Hours after upstate New York's Ithaca Hours, the most successful community currency in the United States. More than $105,000 in Ithaca Hours have been issued since 1991, and an estimated 400 businesses in the region accept them. "Community currency systems are excellent tools to help revitalize local economies since they encourage wealth to stay within a community rather than flowing out of it," Ed Collom, a University of South Maine professor, wrote in a recent article.

Floyd Hours haven't enjoyed nearly that level of success. Shiner guesses that only $500 in Floyd bucks was ever printed. Originally, there was a directory of some 20 business establishments that accepted them; today, none are known to.

"In this culture it's hard to expect any of us to just use local currency," Shiner says. "It's a supplemental thing. It's a statement saying 'I believe in my region,' a way to facilitate more exchange and a way to help others know what's available in our region." The fact is, Floyd's currency, like its informal economy, is hard to detect.

The Other Path

Those concerned about underground economies point to nightmare scenarios like the one captured in Hernando de Soto's book *The Other Path*, which described how burdensome government regulations in Peru spawned an underground economy that encompassed 38 percent of GDP.

Enrique Ghersi, de Soto's coauthor in Spanish-language versions of the book, defined this informal economy as entailing "activities that do not intrinsically have a criminal content, but must be carried out illicitly, even though they are licit and desirable activities for the country … Thus, from an economic point of view, the most important characteristic of informal activities is that those directly involved in them as well as society in general benefit more if the law is violated than if it is followed."

Almost 20 years after describing Peru's plight, economists generally agree that the shadow economy is worse in developing nations, whose webs of bureaucratic red tape and corruption are notorious. For instance, Schneider in 2003 published "shadow economy" estimates (defined broadly as all market-based, legal production of goods and services deliberately concealed from the authorities) for countries including: Zimbabwe, estimated at a whopping 63.2 percent of GDP, Thailand's at 54.1 percent, and Bolivia's at 68.3 percent. Among former Soviet bloc nations, Georgia led the way with a 68 percent of GDP shadow economy, and together those nations had an average 40.1 percent of GDP underground. This contrasts with an average of 16.7 percent among Western nations.

Some of Schneider's estimates of the size of the underground economy are controversial; critics say that he has jumbled different definitions of the underground economy in his estimates and sometimes not matched measurement methods, thus making comparisons less meaningful. But few quibble with his reasons for paying attention to the underground:

- If it's growing, it may be a "reaction of individuals who feel overburdened by the state." As a result, they choose to dodge the taxes or safety regulations or licensing requirements that the state imposes, instead joining the underground. In this kind of world, the official economy declines, often leading to budget deficits and climbing tax rates.
- Official statistics — like GDP — may be rendered less useful if they don't really capture the breadth of economic activity.
- It could be used as an unfair competitive advantage. Employers who hire undocumented immigrants under the table, for example, enjoy cost advantages over firms that properly report their employees and pay taxes on them.

In a 2004 paper, the McKinsey Global Institute found that countries with big informal economies suffer productivity losses. That's basically because the smaller firms that participate in the shadow world never gain the scale and complexity of their official competitors, whose own operations are hampered by the existence of their under-the-table rivals.

"The powerful incentives and dynamics that tie companies to the gray economy keep them subscale and unproductive," researcher Diana

Farrell wrote. "Second, the cost advantages of avoiding taxes and regulations help informal companies take market share from bigger, more productive formal competitors."

Farrell's solution: Wake up, official economy! She advocates strengthening enforcement, eliminating red tape, and cutting taxes. "Persistent myths keep developing countries from addressing the informal sector," she writes. "Yet diminishing its size would, in almost every case, remove barriers to growth and development and generate sizable economic gains."

But What about Here?

Not surprisingly, the Internal Revenue Service has an interest in the underground economy. In recent papers, Kim Bloomquist, senior economist with the IRS, has aimed to shoot down theories that this nation's tax code is to blame for a large portion of the informal economy. Acknowledging that tax evasion is on the rise, Bloomquist asks the obvious question: "If neither increasing complexity nor a rising tax and regulatory burden can adequately explain the growth in noncompliant behavior, what else could account for this phenomenon?"

His short answer: There's been a general shift away from more visible to less visible sources of income. Where this plays out most frequently is in the wealthiest and poorest U.S. households. The middle class — people with 9-to-5-sort-of jobs — is extraordinarily well-documented, with few easy opportunities to avoid paying taxes. By contrast, high-income households collect a larger percentage of their income in the form of "nonmatchable" income, which is money not subject to third-party information reporting and withholding (like typical wages, dividends and social security benefits). Taxpayers in the top 5 percent of the income distribution account for more than 77 percent of this nearly "invisible" income, Bloomquist says.

On the other end of the scale, the poorest Americans are more likely to deal in cash and thus less likely to be subject to third-party reporting.

These trends worry economists like Bloomquist, especially as income inequality widens in the United States. "Further polarization of the nation's income distribution could act to undermine current and future tax-enforcement efforts," he wrote in a 2003 paper.

Meanwhile, the informal economy cruises along. Nobody is terribly exercised about scrip currency in Floyd. Neither myself nor the guy who shoveled my walk fear reprisal from authorities. And we are arguably better for it: There was an immediate demand for a shoveled walk and he offered the supply. Talk about efficient.

Feige, the University of Wisconsin economist, strives for clarity. He scorns studies that lump the unreported, unrecorded, and illegal economies together without explaining their distinctions. He believes much of the research on informal economies suffers because of authors' failures to stick to uniform definitions of what constitutes "underground."

And though he considers the problem of unreported, unrecorded, and informal economic transactions to be worse in developing countries, he is not so fast to write off the United States' experience as inconsequential. "Shifting the burden to honest taxpayers has significant implications," he says. Schneider, the Austrian economist, is of two minds about the U.S. underground: "A very difficult question," he says. "I think a shadow economy of 10 percent, which leads to additional value added has an overall positive effect on the welfare of the United States." But a case can be made that tax losses from even a 10 percent shadow economy are too great for the state to ignore, he adds.

In his 2003 book, *Reefer Madness: Sex, Drugs and Cheap Labor in the American Black Market*, investigative writer Eric Schlosser invokes Adam Smith's "invisible hand" theory that men pursuing their own self-interest will generate benefits for society as a whole. This invisible hand has produced a fairly sizable underground economy, and we cannot understand our entire economic system without understanding how the hidden underbelly functions, too. "The underground is a good measure of the progress and the health of nations," Schlosser writes. "When much is wrong, much needs to be hidden." Schlosser's implication was that much is wrong in the United States. If he had taken a more global view, he might have decided relatively little is hidden here. **RF**

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