

Issue: Underground Economy

Underground Economy

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## Is it hurting U.S. economic strength?

### Executive Summary

In the wake of the 2007-09 financial crisis, the underground sector has become a sizable part of the U.S. economy – perhaps as much as 10 percent. Many policymakers believe off-the-books work retards growth by denying tax revenues to governments, depressing wages, hurting competition and leaving workers vulnerable to abuse. Others argue that it's a wash because a big share of any earnings go back into the economy as spending. They also see potential benefits: Workers gain flexibility and independence, and startups get breathing room. Currently, several states are cracking down on underground work as they face budget crunches. Economists, however, are divided over the potential impact of President Trump's policies. Some say his tougher stance on illegal immigration will push more work underground, but others say his plans to reduce regulation and cut taxes could lead to a contraction of the informal economy.

Among the key takeaways:

- Informal economies tend to be bigger in developing countries and to shrink as societies modernize.
- Some economists see the underground sector as a nursery of future economic growth.
- Unregulated or unlicensed work can give businesses that cut corners an unfair market advantage, penalizing employers and employees who play by the rules.

### Full Report



Investigators suspect underground activity is prevalent in New Jersey because of data showing construction workers in that state are three times more productive than elsewhere. One study found that employers had deliberately understated their payroll by about 23,000. (Per-Anders Pettersson/Getty Images)

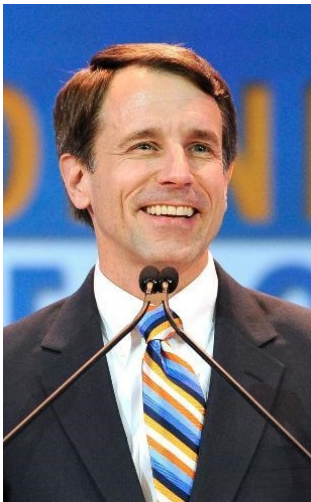
Megan G. earns \$55,000 a year working full time at a marketing and business development job in Tallahassee, Fla. A few nights a week, however, she heads out to a second gig she found through Craigslist, where she's paid cash off the books to clean an Airbnb condo. The extra money helps cover day care for her 5-month-old son.

"It almost feels shameful" to be working as a maid under the table, says the 27-year-old mother of two, who asked that her full name not be printed. "But I know a lot of people doing similar things. It's like this dirty little secret that has somehow become the norm."

Megan may feel uncomfortable being part of the underground economy—economic activity that takes place outside of the tax and regulatory environment—but she has plenty of company. The ranks of this twilight world range from dishwashers and domestic workers who accept half their wages in cash to the self-employed and others trying to make ends meet.<sup>1</sup> It also includes accountants, lawyers and other professionals who work on the side.<sup>2</sup>

Fueled in part by the 2007-09 recession and a plodding recovery, the nation's underground sector has grown to as much as \$2 trillion of the nearly \$19 trillion economy.<sup>3</sup> And that's just the off-the-books work done by otherwise law-abiding individuals like Megan, analysts say.<sup>4</sup> Black-market activities such as illegal drugs and sex trafficking add an estimated \$625 billion to that total, but economists generally exclude illicit goods and services from their estimates because they're not taxed or included in gross domestic product (GDP).<sup>5</sup>

Economists and policymakers differ on the merits—or drawbacks—of the underground economy. Many policymakers argue it hampers the overall U.S. economy by lowering tax revenues, hurting competition and warping economic data. Lost tax revenues affect government at all levels by reducing funds available for services. The Internal Revenue Service estimated the gross tax gap – the amount of federal income taxes that should have been paid but wasn't – at \$458 billion a year during the period 2008-10.<sup>6</sup> To put that in context, the federal budget deficit in 2016 was \$552 billion.<sup>7</sup>



Dave Jones: "The underground economy is not a victimless crime."

In addition, unregulated or unlicensed work can give businesses who cut corners an unfair advantage in the market, penalizing employers and employees who play by the rules. Lawsuits against sharing platforms in the gig economy such as [Uber](#) and [Airbnb](#) underscore the frustration that traditional businesses feel competing against players who use independent contractors to avoid the costs and obligations that come with traditional employees. Taxi companies resent the fact that Uber and [Lyft](#) drivers don't have to pay for licensing medallions. Hotels cry foul that Airbnb, the online service that enables people to rent out rooms, can get around traditional lodging regulations and taxes.<sup>8</sup>

Paying workers under the table also leaves them vulnerable to exploitation, because they often receive lower wages than on-the-books employees and go without benefits such as Social Security, unemployment insurance or workers' compensation. As California Insurance Commissioner Dave Jones said after investigators discovered \$78.5 million of unreported payroll at two Los Angeles garment manufacturers in 2015, "The underground economy is not a victimless crime."<sup>9</sup>

For the consumer, the underground economy can mean a product or service isn't up to code or worse. And the underground economy skews employment statistics and other data, which can distort economic projections that policymakers, business officials and investors rely on to make decisions.

At the same time, underground or "informal" work does serve a function, according to some economists. In addition to helping shore up income during a downturn, it provides easy entry into the labor force for first-time jobseekers, such as teenagers babysitting or mowing lawns; or to those who need income but have difficulty finding employment through traditional job markets. It also offers flexibility and independence to people who are more comfortable with a gig-economy life, says Demetra Smith Nightingale, a fellow at the

Urban Institute, a Washington think tank.<sup>10</sup>

In fact, Smith Nightingale adds, thanks to outfits such as Uber, economists are now realizing that a lot more people prefer contract or nonstandard employment. "The gig economy," she says, "is really bringing this into the open."

In a nation that prides itself on innovation, working off the books may be the only way many cash-strapped entrepreneurs and home-based businesses get their ideas off the ground, Smith Nightingale says. In a 2012 International Monetary Fund (IMF) report, economist Anoop Singh and her coauthors called the informal sector "the nursery of future economic growth within the formal economy."<sup>11</sup>

Colin C. Williams, a professor of management at Sheffield University in England, has done extensive research on how many entrepreneurs in the West often do most or all of their business off the books until they are established – and sometimes even after that. In his 2006 book, "The Hidden Enterprise Culture," he described the vital, but little explored, culture of entrepreneurship that takes place in the underground economy and how some governments, by being overly punitive, actually discourage innovation

"To deter underground work is often to stifle precisely the enterprise culture that governments wish to foster," Williams wrote.<sup>12</sup> A more viable policy option, he said, would be measures that make it easier to for these businesses to move into the formal economy. That may even require adopting "a deregulatory approach to startups in some cases to allow this sector to act as an incubator to new business ventures," he said.<sup>13</sup>

In addition, even though the government is losing tax revenues, some economists argue that two-thirds of earnings are being pumped back into GDP as spending, providing stimulus to the formal economy.<sup>14</sup>

## Understanding the Underground

Informal economies tend to be bigger in developing countries and contract as these societies modernize. In a 2015 report for the Federal

Reserve Bank of St. Louis, economist Paulina Restrepo-Echavarría estimated the average size of the underground economy to be about 36 percent of GDP in a developing economy, compared with about 13 percent in a developed country.<sup>15</sup>

Corruption also plays a role in many countries. In Zimbabwe, where President Robert Mugabe's regime has lurched from one crisis to another, the underground economy is now nearly the size of the formal economy and employs all but a small percentage of the country's workers, according to the government.<sup>16</sup>

Estimates for the United States usually run from 8 to 10 percent of GDP, but experts debate these numbers as well. Edgar L. Feige, an economist at the University of Wisconsin, Madison, who has been studying the underground economy since the 1970s, says measuring it is more art than science. "Remember," he says, "this is economic activity that people have to hide from observation."

For this reason, surveys and questionnaires are of limited use because people aren't eager to admit they evade taxes. Economists also look at retail sales data, bank accounts, dollars in circulation and even electricity consumption for their estimates.<sup>17</sup> For example, during and after the 2007-09 recession, the underground economy grew as people tried to find work. This showed up in retail sales, which rose even though the official unemployment rate was high, according to Bernard Baumohl, chief economist with the Economic Outlook Group, a research and forecasting firm based in Princeton, N.J. "This was hidden from the federal government," he says, "but it became obvious when everyone went out and spent money."

Similarly, investigators in New Jersey were tipped off to possible underground activity in 2014, when official employment figures made New Jersey construction workers appear to be three times more productive than their counterparts anywhere else in the country. Upon closer inspection, it turned out that employers had deliberately understated their payroll by an estimated 23,000 workers, according to research done by economists Oliver Cooke, Deborah Figart and John Froomjian of Stockton University in New Jersey.<sup>18</sup>

Feige says he uses a model that calculates a nominal GDP based on transaction volume and compares it to official GDP. Like most of his peers, he focuses on unreported income on legal activities. Working with fellow economist Richard Cebula of the University of Jacksonville, he estimates that 18 or 19 percent of income is never reported, an amount he estimated at \$2 trillion in 2011 but says he now adjusts to between \$1.6 trillion and \$1.8 trillion.

A 2010 report by the World Bank, which estimated the underground economies in more than 100 countries between 1999 and 2006, put the U.S. figure at 8.6 percent of GDP.<sup>19</sup> That was slightly more than Switzerland, which came in with the smallest underground sector, but less than Britain at 12.5 percent or Canada at 15.7 percent.<sup>20</sup>

## Fighting Back

Some call for combating the problem through changes in government policy, such as in banking regulation. One factor facilitating the underground economy is the number of people who don't have bank accounts. According to the Federal Deposit Insurance Corp. (FDIC), the federal agency that insures bank accounts, in 2015 7 percent of U.S. households were unbanked and 20 percent were underbanked. This happens for a variety of reasons, including high opening balance requirements, reporting regulations that spook some customers and fears that banks aren't safe.<sup>21</sup>

Reacting to a 2009 FDIC report about the rising number of individuals without bank accounts, Richard Rahn, an economist and former senior fellow at the libertarian Cato Institute in Washington, called for lowering taxes and easing banking regulations, which he believed were causing many people to keep their money at home.<sup>22</sup> "The evidence is unambiguous," he wrote. "Governments cannot increase tax compliance and decrease the size of the underground economy by ever increasing and more onerous regulations."

The other obvious tool is enforcement. The IRS currently lacks the manpower to pursue the majority of tax evaders due to budget constraints, according to its own oversight board, the Treasury's Inspector General and the Government Accountability Office.<sup>23</sup> That looks unlikely to change, given President Trump's proposal to slash the agency's funding by \$239 million in his proposed budget.<sup>24</sup>

But in 2011, the agency began working with several states on misclassification of employees as independent contractors. This is consequential because companies must pay employment taxes and contribute to workers' compensation and unemployment insurance funds for employees, but not for contractors. The U.S. Departments of Labor and Treasury started a similar crackdown the same year. As a result, 37 states formed multi-agency task forces that aggressively went after funds lost to the underground economy.<sup>25</sup>

In California, the nation's most populous state, the underground economy employs an estimated 15 to 17 percent of the labor force and totals as much as \$140 billion, costing the state as much as \$28 billion in lost revenue annually, according to the Employment Development Department.<sup>26</sup> State investigators have focused on misclassifications, unregulated work and wage payments made in cash or barter.<sup>27</sup> They've had success in citing violators, but collections have been more difficult due to "insufficient resources for enforcement," according to a report by a state oversight commission.<sup>28</sup>



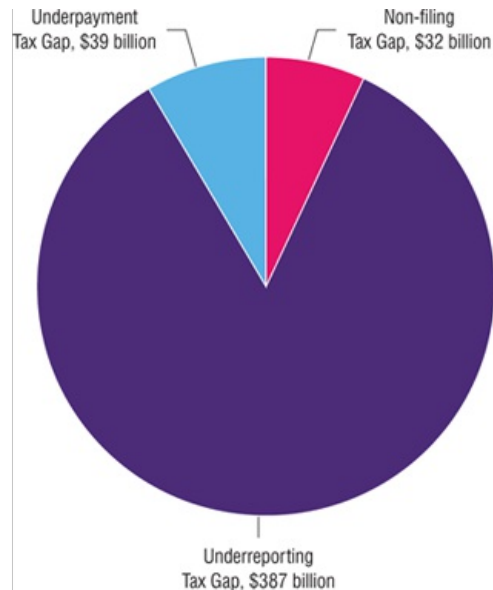
Colin Williams: "To deter underground work is often to stifle ... the enterprise culture."

Christine Baker, who heads the California Department of Industrial Relations, says that despite such limitations, she believes the state's active pursuit of fraud and criminal charges has taken out major violators and proved to be a deterrent. "We will never have enough bodies to go after this, but we can be strategic," she says. State task forces have targeted a variety of industries, including agriculture, automotive, car wash, construction, garments, manufacturing, roofing and recycling.

According to Mike Lee, the tax branch chief overseeing compliance efforts for California's Employment Development Department, no particular industry stands out. "Low wages seem to be what they have in common," he says. "If you have low wage earners, that's more conducive to the underground economy. They're less sophisticated and it's easier to take advantage of them."

## Most of Tax Gap Came From Underreporting

Average annual gap was \$458 billion from 2008 to 2010



Note: The non-filing tax gap and the underreporting tax gap are updated estimates. The underpayment tax gap is an actual amount.

Source: "Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2008–2010," Internal Revenue Service, April 2016, <http://tinyurl.com/kbysgji>

Underreporting of taxes owed was responsible for about 84 percent of the tax gap – the amount of federal income taxes that should have been paid but weren't – for tax years 2008 through 2010, the most recent for which data are available. The remainder came from those either not filing taxes on time or not paying the full amount on time. It is estimated that about 11 percent of the gap may be collected eventually.

Other states, including New York, Massachusetts and Oregon, have been similarly proactive and had success in enforcement. In New York alone, investigators have identified nearly 140,000 instances of employee misclassification since August 2007 and discovered nearly \$2.1 billion in unreported wages over the same time period.<sup>29</sup>

Some of New York's most significant results have come in the area of unemployment insurance (UI) fraud. As of Dec. 31, 2014, the state's UI Trust Fund had a deficit of about \$1.53 billion. Through task force and legal efforts, the state inspectors were able to secure employer payments for undeclared workers that essentially restored solvency to the system, according to state officials.<sup>30</sup>

Stockton University's Cooke says New York has been so good at curbing underground activity that New Jersey is starting to feel the fallout as people cross the state border to try to work off the books. "It helps if your state is willing to invest the resources," Cooke says, noting that none of the dozen bills proposed in the New Jersey Legislature to address the underground economy have made it to the floor.<sup>31</sup>

One of the bigger challenges, experts say, is keeping up with technology and social media, both of which facilitate underground activities and have helped the informal economy expand. With so many employment sites, government agencies find it difficult to monitor job listings. "Craigslist has a history of [running ads for] this kind of work," Cooke says, adding that some states have set up teams to periodically audit social media and other sites. Investigators also monitor online auction sites and swap meets.<sup>32</sup>



Economist Richard Rahn calls for less taxes and regulations.

## Closing the Tax Gap

An obvious way to shrink the underground economy would be to work on closing the tax gap by promoting increased tax compliance, experts say. But here, too, there are limitations. In a study by the Congressional Budget Office and Congress' Joint Committee on Taxation, analysts found that certain measures designed to reduce the tax gap were not cost-effective and would actually increase the budget deficit. For example, proposed tax simplification would have resulted in more people qualifying for the earned income tax credit, including many who had erroneously claimed it in the past. So even though compliance improved, the net result would be a decrease in the amount of taxes collected, according to the report.<sup>33</sup>

The research on tax cuts' effectiveness is mixed as well. There's ample evidence that underground economic activity often rises when taxes go up. One study found that the shadow economy grew 1.4 percentage points when the tax burden rose 1 percentage point.<sup>34</sup> In another report, economists estimated it would increase by 11.7 percentage points if businesses perceived the tax burden had become more onerous by 1 point on a scale of 1 to 7.<sup>35</sup>

But what happens when taxes fall is harder to ascertain. When the last of the tax cuts enacted under President Ronald Reagan were taking effect in 1988, for example, many analysts were surprised that this didn't seem to improve compliance. In the end, economists discovered that many workers who hadn't paid taxes came to regard cheating as a way of life. They also feared detection if they suddenly started paying.<sup>36</sup>

Most economists believe that a variety of factors, including social norms and how people feel about the government, affect tax compliance. In 2014, University of Jacksonville economist Cebula found that government policies and perceptions of corruption can have more of an impact on whether a person files taxes than tax rates. In fact, after President George W. Bush cut taxes in the early 2000s, Cebula noted, tax evasion went up. It turned out that the unpopular war in Iraq brought down compliance, he found.<sup>37</sup>

Some studies have even found that higher taxes can encourage tax compliance. "The contention is that the higher tax rates lead to stronger revenues and better public goods provision, including a more robust legal environment, thereby encouraging firms to operate in the official sector," Singh and co-authors Sonali Jain-Chandra and Adil Mohammad wrote in a 2012 paper.<sup>38</sup>

## Outlook

With the U.S. unemployment rate back under 5 percent, and Trump promising to cut taxes and roll back regulations, many analysts, such as The Economic Outlook Group's Baumohl, expect the informal economy to contract. "I definitely wouldn't be surprised to see it shrink a bit as the job market improves," he says.

Others aren't so sure. They say the administration's hard line against illegal immigration will drive more workers underground. "Will that lead to more people being paid off of the books?" says Silva Mathema, a senior policy analysis with the Center for American Progress, a liberal think tank based in Washington. "It could. And employers might be emboldened by the crackdown" to take advantage of employees.

Even Baumohl remains open to the idea that some who left the formal economy during the 2008 recession may find they prefer the flexibility and freedom of working off the books. "Those people who went to work at the flea market or as Uber drivers may decide they like the lifestyle and not go back," he says.

Some believe Trump's low approval ratings among Democrats and independents and his controversial policies on immigration and trade are going to hurt compliance. Feige says he's already noticed an uptick in noncompliance from 2015 through 2016. He attributes this to the presidential election and the cynicism surrounding it. "I think it was partly caused by the sense of chaos people were perceiving in Washington," he says. "Neither [major-party] candidate was popular."

Some economists see a possibility of an increase in tax avoidance or evasion if dissatisfaction continues. Kenneth Rogoff, a Harvard University economist and the author of the book "The Curse of Cash," is particularly worried about the president's pronouncements on trade. "If Donald Trump incorporates a border tax or higher tariffs, the underground economy will get bigger," he says. "It would hugely expand tax evasion."



Bernard Baumohl

## About the Author

Kathleen Murray is a longtime business reporter who writes frequently about wage and employment issues. Her articles have appeared in The New York Times, The Washington Post, Forbes, CBS Moneywatch and

## Chronology

<b>1600s-1700s</b>	Colonial Americans exchange musket balls, wheat and deer skins as part of a thriving informal economy.
<b>1863</b>	Southern women riot with “clubs, axes and brooms,” crying for bread in Richmond. Most Southerners survive the Civil War by trading and bartering for goods in the underground economy, amid chronic shortages caused by the South’s lack of industry, manufacturing and currency.
<b>1917</b>	After the United States enters World War I, Americans plant more than 5 million “Victory Gardens” as an informal economy develops around produce. The effort is spurred by timber baron Charles Lathrop Pack’s National War Garden Commission.
<b>1920</b>	The imposition of Prohibition in the United States drives the manufacture and sale of alcohol underground, joining opiates, which were first restricted in Illinois in 1897, and other narcotics.
<b>1930s</b>	Bartering makes a comeback during the Great Depression due to a shortage of money, with people trading for food and other services.
<b>1941-45</b>	Shortages during World War II lead to a thriving black market for sugar, clothing, gasoline, tires and other goods.
<b>1980</b>	The U.S. underground economy grows to its highest level since World War II, according to economist Vito Tanzi, at between 4.5 percent and 6.1 percent of gross domestic product (GDP). Tanzi attributes the trend in part to rising marginal tax rates.
<b>1997</b>	A hot new toy, the Beanie Baby, fetches up to \$1,000 apiece in the underground economy.
<b>2011</b>	The Internal Revenue Service hires 200 new investigators and teams with the Department of Labor to crack down on the misclassification of employees as contractors. Microsoft and Time Warner are caught in the net.
<b>2009-13</b>	The underground economy edges upward to its highest point since the 1930s, 10 percent of GDP according to some economists, during the very slow recovery from the Great Recession.

## Resources for Further Study

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## The Next Step

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## Organizations

### Federal Deposit Insurance Corp.

550 17th St., N.W., Washington, DC 20429  
877-275-3342

[www.fdic.gov](http://www.fdic.gov)

Federal agency that keeps statistics on the percentage of people who don't use banks and are more likely to be in the underground economy.

### Internal Revenue Service

1111 Constitution Ave., N.W., Washington, DC 20224  
202-622-5000

[www.irs.gov/uac/compliance-enforcement](http://www.irs.gov/uac/compliance-enforcement)

The nation's tax collection agency.

### International Monetary Fund

700 19th St., N.W., Washington, DC 20431  
202-623-7000

[www.imf.org](http://www.imf.org)

This international organization is a good source of research on economies large and small.

### Little Hoover Commission

925 L St., Suite 805, Sacramento, CA 95814  
916-445-2125

<http://www.lhc.ca.gov/>

[littlehoover@lhc.ca.gov](mailto:littlehoover@lhc.ca.gov)

California's independent state government oversight agency does research on the underground economy.

### Organisation for Economic Co-operation and Development

1776 I St., N.W., Suite 450, Washington, DC 20006  
202-785-6323

[www.oecd.org/Washington](http://www.oecd.org/Washington)

International organization that works to promote economic policies and to alleviate poverty. Also created a handbook to help economists measure underground economies.

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