

BRIEF ANALYSIS

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The Underground Economy

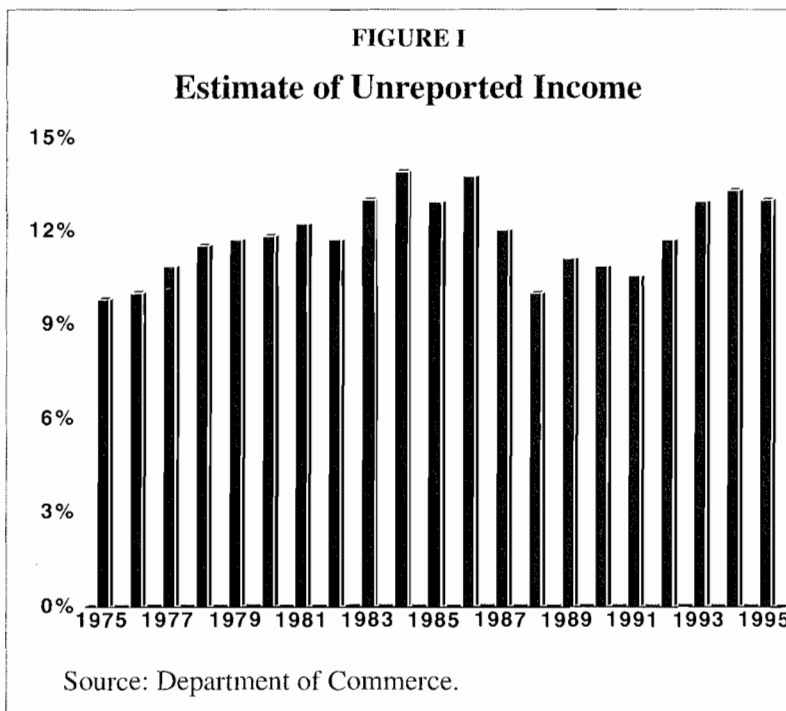
Internal Revenue Service Commissioner Charles Rossotti recently estimated that the federal government is losing \$195 billion per year in revenue due to the failure of people to report income and pay taxes on it. This is a substantial increase over the IRS's last published figure for taxes due on unreported income, a 1992 estimate of between \$93.2 billion and \$95.3 billion. Although Commissioner Rossotti did not explain why the amount has more than doubled since 1992, his estimate is consistent with other data showing substantial growth of the so-called underground economy. This term refers to economic activity that is unrecorded in the gross domestic product figures. It consists of illegal, criminal activities such as drug dealing, as well as unreported income in order to avoid taxation.

By its nature, the size of the underground economy is difficult to measure. However, there are some indirect ways to get a fairly accurate indication of its size. One way is to compare income reported to the IRS with other measures of income. Another is to compare the public's use of large-denomination currency.

Failure to Report Income. The IRS collects data on adjusted gross income (AGI) from tax returns — what people say they make. The Commerce Department calculates a measure of AGI from sources such as total wages paid by corporations and total interest paid by banks. Comparing IRS and Commerce Department data gives a good idea of how much income people are failing to report and pay taxes on.

In 1995 it is estimated that Americans failed to report \$630 billion in AGI on their tax returns. That year they paid 14 percent of their AGI in federal income taxes.

- Assuming they would have paid the same rate on their unreported income, this suggests that the federal government lost at least \$88 billion in individual income taxes alone in 1995.
- If that income were taxed at 22 percent (the average marginal tax rate for all taxpayers), the revenue loss rises to \$139 billion.



Looking at the amount of unreported income as a share of the Commerce Department's estimate of actual AGI gives us an idea of whether tax evasion has changed over time. As Figure I indicates, unreported income has indeed been on the rise, from 10.1 percent of AGI in 1988 to 13.1 percent in 1995. This may well be a response to the higher tax rates that were enacted in 1990 and 1993. As tax rates rise, hiding income becomes more profitable. Conversely, lower tax rates such as

those enacted in 1986 reduce evasion because the cost of reporting one's true income is lower.

Currency in Circulation. Another way to measure the underground economy is to look at the growth of currency in circulation, especially large bills such as \$100 bills. Since the underground economy operates almost exclusively in cash, unusual increases of cash in circulation are considered a valid indicator of its growth.

Figure II shows the growth of \$100 bills as a percentage of the value of all outstanding U.S. currency. As one can see, there has been a steady rise for many years.

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- According to the Treasury Department, \$100 bills have risen from less than 20 percent of the value of currency outstanding in 1967 to more than 63 percent in 1997.
- In 1997 total currency increased by \$31 billion — and \$30.2 billion of it was in \$100 bills.

Economists can calculate the size of the underground economy from currency data by looking at the real increase in currency per capita above some base period. The assumption is that law-abiding citizens will not ordinarily increase their day-to-day need for cash (in inflation-adjusted terms). Hence, any significant increase in cash per capita must be used in the underground economy. On this basis, Professor Edgar Feige of the University of Wisconsin recently put the size of the U.S. underground economy at between \$500 billion and \$1 trillion in 1993.

Of course, not all of this currency fuels growth of the underground economy here. Most, in fact, goes to grease the wheels of underground economies in other countries. According to the Federal Reserve, most \$100 bills printed by the Bureau of Engraving and Printing go abroad as soon as they leave the presses. In 1996, for example, almost 80 percent of the increase in currency is estimated to have been sent abroad.

Because so much U.S. currency circulates abroad, one cannot rely solely on the growth of currency as an accurate measure of the underground economy in the U.S. Taking the export of currency into account lowers Prof. Feige's estimate of the size of the U.S. underground economy by some \$400 billion.

The Role of the Euro. The European Union has recently decided to fight the encroachment of dollars into its nations' underground economies by printing 500 euro notes (about \$500), which will be much more

attractive to drug dealers and the like because the volume of cash necessary for large transactions will be reduced by 80 percent over the U.S. \$100 bill. The euro is the new European currency that will soon become the single currency of Europe, replacing the French franc, German mark and Italian lira, among others. Professor Kenneth Rogoff of Princeton believes that the European decision to print 500 euro notes is an explicit effort to compete for the business of the underground economy. (The U.S. Government has not printed notes larger than \$100 since

1946 and withdraws from circulation those that come into its possession.)

Conclusion. There is strong evidence that the underground economy is growing, distorting economic statistics and reducing federal revenues. It is a problem policymakers should pay more attention to.

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