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# New underground economy

**Richard W. Rahn**

The underground or "black" economy is rapidly rising, and the fault is mainly due to government policies.

Here is the evidence. The Federal Deposit Insurance Corp. (FDIC) released a report last week concluding that 7.7 percent of U.S. households, containing at least 17 million adults, are unbanked (i.e. those who do not have bank accounts), and an "estimated 17.9 percent of U.S. households, roughly 21 million, are underbanked" (i.e., those who rely heavily on nonbank institutions, such as check cashing and money transmitting services). As an economy becomes richer and incomes rise, the normal expectation is that the proportion of the unbanked population falls and does not rise as is now happening in the United States.

Tax revenues are falling far more rapidly at the federal, state and local level than would be expected by the small drop in real gross domestic product (GDP) and changes in tax law that have occurred since the recession began. The currency in circulation outside the U.S. Treasury, Federal Reserve banks and the vaults of depository institutions - that is, the currency held by individuals and businesses - has grown by 13.3 percent in the last two years, while real nominal (not inflation-adjusted) GDP has not grown at all, and real (inflation-adjusted) GDP incomes have fallen by more than 3 percent. With the growth of electronic means of payment and financial service providers, it would be expected that the currency component of GDP would fall, not rise.

The underground economy refers to both legal activities, such as often found in construction and services industries where taxes are not withheld and paid, and illegal activities, such as drug dealing and prostitution.

Countries such as the United States, Switzerland and Japan historically have had relatively small, nonreporting and/or illegal sectors, a typical estimate being 13 percent of GDP.

Most European countries have had somewhat larger underground sectors (typically 20

percent or so) in part because of the desire to escape higher tax rates. Italy and some of the other Southern European countries are believed to have underground sectors that account for 30 percent or more of all economic activity.

I recall an Italian finance minister telling a few of us at a meeting a couple of decades ago that, for policy purposes, he assumed that "the economy was 40 percent larger than what was reported." In some developing countries and/or highly corrupt countries, underground or "off the books" activities are estimated to be as high as 70 percent of all economic activity.

The FDIC report about the size of the unbanked or underbanked sector in the U.S. should be of concern because those who do not use the banking system often have to pay higher fees to cash checks, pay bills (e.g., money orders, etc.), or transmit funds.

People who keep their savings in cash at home rather than in banks make themselves easier prey for criminals and are more likely to lose their money to fire, flood, or just neglect. Not surprisingly, a majority (71 percent) of the unbanked have household incomes of less than \$30,000 per year.

There are many reasons people do not have bank accounts. Banks, because of the "know your customer" and other anti-money laundering regulations, make it difficult for nonestablished people, such as the young and transient, as well as legal and illegal immigrants, to open bank accounts.

Also, many of these same regulations are responsible for the rise in bank fees, which are a particular burden for low-income people. You can be sure that every time Congress passes some new law or the IRS implements some new regulation to "get tax cheats," much of the real burden of these compliance costs will fall on those least able to afford it, while those intent on finding their way around it will do so.

People also avoid having bank accounts because they are vulnerable to asset seizure, judgments, levies, etc. Increasingly, bankers and others who provide financial services are forced by governments to spy and snitch on their own customers, and this is a real turnoff for many people, which causes them to find other ways of maintaining financial privacy.

Many studies have shown that when people believe the taxes they are required to pay are reasonable and the political leaders tend to spend their tax dollars wisely, tax compliance rises, and vice versa. In the United States, there is increased evidence that many tax dollars are not being spent wisely and are often used to pay off political cronies.

Over the past year in particular, the public has become aware that many in Washington who

advocate higher taxes and argue that everyone has a responsibility to pay taxes are themselves not complying with the tax laws and regulations.

When you have a secretary of the Treasury and the chairman of the House Ways and Means Committee (the tax writing committee) accused of cheating on their taxes, it greatly undermines the moral authority of the tax collectors, making the common citizens feel like chumps and, hence, much more willing to try to legally avoid or illegally evade taxes themselves.

The evidence is unambiguous; governments cannot increase tax compliance and decrease the size of the underground economy by ever increasing and more onerous regulations.

It is no accident that those governments that allow their citizens a high degree of personal and financial liberty, including financial privacy, and spend taxpayer dollars wisely, honestly and competently, have much smaller underground sectors than corrupt and oppressive governments. Washington, take note.

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