

The Underground Economy

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Work in the Underground

There is a bustling and shadowy world where jobs, services, and business transactions are conducted by word of mouth and paid for in cash to avoid scrutiny by government officials. It is called the “underground economy,” which is as old as government itself. It springs from human nature that makes man choose between given alternatives. Facing the agents of government and their exactions, man will weigh the alternatives and may choose to go “underground.”

In the ancient world, most rulers were tyrants who commanded the laws and lorded over their subjects. They set just and “fair” prices for labor and commodities, and enforced them with arbitrary power and terror. The people either suffered degrading submission or sought escape in countless ways and directions. Many went “underground” or moved elsewhere in search of better conditions. They reacted to edicts of the Egyptian dynasties and the Roman emperors, as they did later to the mandates of their Medieval feudal lords. Immutable in his nature, man is forever acting on and reacting to the world around him.

In our era, man has again become a subject under the watchful eye of government. Guided by ancient notions and prejudices he depends on his rulers for mandates and directives. When government intervention fails to satisfy him, or even works evil, he is slow to relinquish his notions and prejudices. He may cling to them with tenacity and perseverance, but may seek to avoid the ill effects through circumvention, evasion, and escape. He may find his way to the “black market,” where economic transactions take place in violation of price control and ration laws. Or he may descend to the “underground” where political edicts are ignored and exactions avoided through word-of-mouth dealings and cash transactions.

The underground economy must be distinguished clearly and unmistakably from the criminal activities of the underworld. Government

officials and agents are ever eager to lump both together, the criminals and their organization with the producers in the underground. Both groups are knowingly violating laws and regulations and defying political authority. But they differ radically in the role they play in society. The underworld comprises criminals who are committing acts of bribery, fraud, and racketeering, and willfully inflicting wrongs on society. The underground economy involves otherwise law-abiding citizens who are seeking refuge from the wrongs inflicted on them by government. They are employers and employees who are rendering valuable services without a license or inspection sticker, or failing to report their productive activities to the political authorities.

Underground activities can be grouped into four main categories:

1. Economic activity yielding income that is not reported to the tax authorities.
2. Economic production that violates one or several other mandates, such as compulsory government licensing and rate making, inspection and label laws, labor laws, government regulations of agriculture, export and import controls, government control over money and banking, governmental control of energy production and distribution, and countless others. Violators may or may not evade taxes, but they all work illegally, hiding from swarms of government inspectors.
3. Productive activity by transfer beneficiaries who draw Social Security benefits or receive public assistance. Their freedom to work is severely restricted.
4. Productive activity by illegal aliens without residence status. They may pay income taxes and other taxes, but must remain underground for fear of deportation.

Hiding From Tax Collectors

A tax is a compulsory payment of income or wealth to the government to defray the expenses incurred in performing services and to finance income and wealth transfer to tax consumers. It impairs the economic conditions of producers and thereby reduces their ability to consume and invest. By reducing the returns from productive effort it lowers the marginal utility of such effort, and raises that of leisure. It makes many taxpayers prefer leisure to work.

It is difficult to estimate the magnitude of this shift to leisure in recent years of rising taxation. Many millions of elderly people have gone “into retirement” consuming their savings and idling their days away searching for fun and play. They have flocked to resort and retirement centers, especially in Florida, Arizona, California, and Hawaii, where they support thriving entertainment and amusement industries and kindle unbridled real estate booms. In reaction to ever-rising levels of taxation, younger workers may choose to work fewer hours and take longer vacations. Many may seek to reduce the number of weekly hours from forty to thirty-five, or even to thirty. Others may seek benefits that are tax-exempt, such as expense accounts, stock purchase options, club memberships, health care and insurance benefits, and countless other gratuities. They all are seeking escape and shelter from the tax collector.

In recent years millions of law-abiding American workers escaped by illegal methods; they joined the underground economy. High tax rates, soaring inflation, and a growing distrust of government led them to take this desperate step. No one can know with certainty just how many Americans actually participate in the underground. Yet it is common knowledge that vast amounts of goods and services are produced without being reported to government authorities, that the unemployment rate is a lot lower than the official rates of the Labor Department, and that the actual savings rate is much higher than commonly thought.

Taxation lowers the marginal utility of productive labor and reduces economic output; the underground economy raises the marginal utility of labor and increases economic output. But it does so at the risk of discovery by government officials and agents and potential retribution by the courts and penal institutions. The risk is directly proportional to the productivity of the underground worker. It is minimal for a common laborer who is earning a few dollars working “off the books” over weekends. His income-tax return may not even warrant an audit by IRS agents. But the weekend entrepreneur who may earn thousands of dollars of profits is a moving target for auditors and, when found to labor in the underground economy, a ready-made object of fines and imprisonment. It is easy to foresee the wrath of a federal judge and the cruel punishment he is likely to mete out to a businessman who evaded a million dollars in taxes.

The different degrees of risk of discovery and government retribution may explain the different intensities of underground activity. Millions upon millions of factory workers, painters, electricians, plumbers, cab drivers, farmers, and others whose risk exposure is minimal, are engaged in legal activities but fail to report part or all of their income to avoid paying taxes. Thousands of doctors, lawyers, accountants, contractors, restaurateurs, and small manufacturers are working “off the books,” trying to conceal income and evade tax exactions. But it is unlikely that many large entrepreneurs or their corporations are engaged in work on the side. They are rather visible not only to the IRS and its army of auditors and investigators, but also to many envious and resentful employees who eagerly report all irregularities to the authorities. It is difficult to imagine, therefore, General Motors or U.S. Steel engaging in subterranean activity.

There is little room for income tax evasion and underground activity where employers are forced to withhold taxes from wage and salary payments. Approximately two-thirds of federal individual income tax revenue is withheld by employers and transmitted directly to the U.S. Treasury. The employees never take possession of this part of income,

which thus is kept out of reach for tax evasion. And employers are rarely tempted to hold on to the withholdings because they are not employer property. Yet the withholding of taxes is enlisting ever more workers in the underground. While it may reduce their tax consciousness, it creates a visible difference between the after-tax income and untaxed underground income. With rising tax withholdings this difference tends to grow, which may tempt more and more workers to forego taxable employment and descend to the underground. A master electrician who may suffer the withholding of 30 to 40 percent of his earned income may substantially raise his net income and improve his level of living by working independently and “off the books.”

The underground economy is thriving wherever, in the judgment of taxpayers, the government exactions are exorbitant and unjust. It shuns written receipts, bank accounts, and other kinds of evidence that might reveal the activity. It makes a mockery of the popular forecast that the U.S. is headed toward a cashless society fueled by credit cards and electronic bank transfers. On the contrary, the underground, which is thriving on cash, is pointing towards a “cash only” economy where individuals shun all bank deposits. After all, the IRS, which has ready access to all bank records, usually begins its audits with bank deposit tests, and proceeds on the assumption that bank deposits are taxable income. It is quick to levy income taxes on all individual deposits, to impose fines and charge interest — unless the taxpayer can prove convincingly that his deposits were loans, transfers, or other “legitimate” receipts.

In the early years of federal income taxation when the rates were relatively low, it worked rather well for the U.S. Treasury. A high degree of taxpayer compliance characterized the American system. But rising tax exactions, together with soaring rates of inflation, caused public attitude toward tax evasion to change notably. The interaction between inflation and the progressive federal income tax system gradually weakened taxpayer compliance and encouraged underground activity. Inflation raises

nominal incomes and thereby pushes taxpayers into higher marginal tax brackets.

Since 1965 the marginal tax rate for a family of four earning the median income has risen from 17 to 24 percent in 1980.¹ By now it is probably approaching 30 percent although real income is declining steadily. For double-median incomes it rose from 26 percent to 43 percent and now probably stands at 50 percent despite the 1981 tax rate reduction. To avoid or limit the decline in levels of living many taxpayers partly or completely descended to the underground where the effective tax rate is zero.

In the coming years of raging inflation that is bound to follow the colossal budget deficits, the interaction between inflation and taxation may doom the regulated and taxed economy, but undoubtedly will fortify the underground economy.

¹ Barry Molefsky, "America's Underground Economy" in *Studies in Taxation, Public Finance and Related Subjects — A Compendium*, Fund for Public Policy Research, Washington, D.C. 1982, p. 303.

Circumventing Regulations and Licensing Requirements

Progressive federal and state taxation, in conjunction with soaring rates of inflation, provide an important motive power for underground economic activity. But the mainspring of the underground is yet more substantial and reputable than tax evasion. It is the inalienable right to life and property, which comprises the right to sustain both life and property through honest work. It is a basic right that precedes and supersedes all rules and regulations that would deny it. It takes precedence over minimum wage laws, license restrictions, union rules, and many other mandates that are denying the right to work.

There is no doubt that *the underground economy is essentially an employment phenomenon*. Where government causes disemployment the underground offers ample opportunities for employment. It offers jobs to the officially unemployable. It does so although it is besieged and harassed by government officials and their spokesmen in the media. It functions admirably although it is handicapped by a legal system that not only denies protection to its contract parties, but also threatens to fine and imprison them.

Minimum wage laws are nothing more than government orders to workers that they must not work for less than the stated minimum, and to employers that they must pay the minimum, or not employ at all. But such mandates may deny millions of workers the right to work, which is synonymous with the basic right to sustain their lives through their own efforts. What is a worker to do who lacks the training and experience to earn the mandated minimum? If he is young and healthy he may join the armed forces. If he is intelligent and industrious he may seek the training that may permit him to earn the minimum. But if he is short any one of these attributes the minimum mandates condemn him to an empty life on charity and public assistance. The underground economy offers to suspend his life sentence and promises new hope and opportunity.

Many Americans enter the labor market via the underground. As young children they may earn their pocket money through odd chores that make them think, and teach them to be attentive, industrious, and confident. Many parents are convinced that children should labor to be healthy and happy. But if they should work they probably violate some child-labor law. And if they should neglect to file an income tax return and fail to pay the levies, the children are actually working in the underground. Surely, there is a minimum amount that is exempt from income taxation. But the self-employment tax, which provides funds for Social Security and Medicare benefits, is levied on annual incomes of \$400 or more, or just \$1.13 per day. Many high school and college students are earning more than this.

In a climate of economic stagnation and decline the underground economy serves a useful economic and social function. It provides jobs to millions of willing workers, affords opportunities for learning and training, and teaches the importance of individual initiative. It constitutes an important safety valve that relieves discontent and tension in a world wracked by political disruptions.

During the 1960s and 1970s, the U.S. Government, in cooperation with the state governments, destroyed millions of jobs. It forcibly raised the cost of labor through sizeable boosts in Social Security levies, unemployment taxes, Workman's Compensation expenses, Occupational Safety and Health Act expenses, and many other production costs. The mandated raises inevitably reduced the demand for labor and added millions of workers to the unemployment rolls. The boosts also reduced the take-home pay of the remaining workers as market adjustments shifted the new costs to the workers themselves. Both effects, the rising unemployment and falling net wages, provided powerful stimuli to off-the-books employment.

The underground economy offers a new way of life that is very attractive to many young people. As the primary victims of stagnation and

unemployment they react against frustration and boredom by seeking off-the-books jobs, which may be irregular but profitable. After a while they learn to like their new freedom and lifestyle. They are turning a necessity into a new way of life that offers great opportunities to improve their skills, learn several trades and, at last, find self-fulfillment. Many of these young people on the edge of the regulated society are budding entrepreneurs who are earning not only labor income that is undiminished by tax withholdings and mandated costs, but also entrepreneurial profits. They are everywhere, in towns and in the country, and are numbering hundreds of thousands.

Underground producers revive economic life where government is disrupting and thwarting it. In many occupations state and local governments require licenses or other types of permits. These requirements are designed to favor some producers at the expense of others, and although they are imposed under the pretense of consumer protection, actually limit the freedom of choice and impair economic wellbeing. Permits and licenses reduce the supply of goods and services and raise prices. Unlicensed individuals observing the high prices may be tempted to fill the gaps through underground activity. In many cities, a shortage of medallioned taxis produces large fleets of so-called gypsy cabs to provide car service to the community. The gypsy operators must hide not only from the local police, but also from the tax collectors.

In most communities strict building codes and permit requirements make housing construction and renovation extraordinarily expensive. They are designed to favor “licensed” craftsmen, especially members of labor unions, at the expense of outsiders and the public. To avoid exorbitant charges and safeguard their economic conditions, many builders learn to do it themselves. Physicians and dentists, attorneys, accountants, professors and business executives may become carpenters, electricians, or painters in their own homes, often in violation of license and permit requirements. Or they may engage unlicensed craftsmen who make the

desired improvements without a government permit. Although no one can know the magnitude of this underground activity, it probably comprises more than one-half of all renovating and remodelling of owner-occupied homes. In larger, more visible projects its share is probably smaller. But there cannot be any doubt that underground construction constitutes a significant energizing part of the American construction industry.

Illegal self-employment is on the rise throughout the United States. For many people it is their sole occupation—for officially unemployed and retired workers, students, and housewives; for many it is a part-time occupation that provides supplemental income.

Countless Americans are forced to join the underground economy by the Fair Labor Standards Act, which limits the hours of regular work to 40 hours a week. Work in excess of these hours must be paid for at not less than 1 ½ times the regular wage rate. This mandate obviously reduces the demand for labor beyond 40 hours a week and severely limits overtime production. But there are millions of industrious Americans who are not content with working just forty hours per week. They prefer income over leisure time, more convenience and amenities for their families rather than idleness. Seeking fulfillment and happiness from work they may find work in the underground economy.

It is estimated that one-fourth of the American working population is engaged in double-jobbing.² While some declare their extra earnings and pay additional federal, state, and local income taxes and Social Security charges, many choose to overlook the extra take. They are laboring in the underground. Certain occupations and professions have a long tradition of “moonlighting.” Many teachers, policemen, firemen, and watchmen whose jobs make few demands on their physical strength hold supplementary jobs. After regular hours they are tutors, salesmen, construction workers, chauffeurs, truck drivers, and wear many other hats.

² The International Labor Office, *Information*, Vol.8, No. 5, December 1980, p. 5.

It is ironic that, in their classes, many teachers propagate the wisdom and virtue of government regulations, but in their private lives, they readily ignore the regulations and diligently moonlight off-the-books. Many policemen who on duty must arrest and prosecute violators of economic regulations, join the underground as soon as they sign off.

It is difficult to estimate the number of hours per week moonlighters spend on their second job. They probably work from a few hours on regular work days to ten or more hours on weekends, and forty hours during vacations. A National Education Association survey in 1981 found that 11 percent of teachers were moonlighting, up from 6 percent in 1971. A Texas NEA poll showed nearly 30 percent of teachers were working after class an average of 12 hours weekly.³

Some people are avoiding cash payment in any form. They are bartering one service or product for another. But barter usually violates license and permit requirements and invites tax evasion. A car dealer trades a jalopy for a plumbing or electrical job at his home. A dentist trades his services for a construction job at his home or an overhaul of his antique car. Organized barter groups and barter exchanges, which offer their customers a large variety of goods and services, advise their members that licenses and permits may need to be obtained and income taxes be paid on the value received in the exchange. But many who barter routinely ignore this advice.

Flea markets which are shops or fairs selling antiques, new and used household goods, clothing, curios, and the like, are thriving on the fringes of the regulated economy. They are growing in “backward” communities that choose not to impose government ordinances restricting merchandising, jobbing, vending, and peddling. They are prospering on the outskirts of “progressive” metropolitan areas that suffer from such restrictions. State governments like to raid the flea markets, exact sales

³ The *Wall Street Journal*, April 5, 1983, p. 1.

taxes, and impose heavy penalties on vendors who violate regulations or fail to collect sales taxes.

Countless homemakers operate profitable businesses out of their homes. They turn “garage” or “yard” sales into paying ventures by buying items at other sales and reselling them. On a nice day, from March to November, there may be more yard sales in progress than there are licensed business establishments in a rural community. Most sales openly violate zoning ordinances, license and permit regulations, reporting requirements, and, last but not least, fail to charge sales taxes and pay income taxes to the federal, state, or local governments. Few homemakers, if any, report their income from garage sales. Most are probably unaware that they are participating in the underground economy.

Reaping Transfer Benefits While Working in the Underground

The transfer society is a conflict society in which the political beneficiaries are ever eager for more benefits and entitlements, while the victims bitterly oppose every new exaction. The transfer battle is fought in all media of communication and education and on the floors of the legislature, where, in a democratic manner, the majority of representatives decide the issue.

Whatever we may say about the consequences of the transfer battle, there cannot be any doubt that the victims react by seeking to escape. They become refugees in their own country, dismayed and frightened, always on the run from agents of the transfer system. They seek to realize income that is tax exempt, qualify for deductions and tax credits, shift incomes to various types taxed at lower rates, try to get even by joining the lines of beneficiaries, or simply evade the burdens by going underground.

The beneficiaries and their spokesmen eagerly engage in the transfer battle. They applaud and elect the politicians who legislate the distribution by political force. But all their victories are just temporary as the political battle continues. In every session of the legislature, whether it is federal, state, or local, the transfer process needs to be fed by new appropriations and allocations, and new victims need to be found in order to bestow new benefits. Countless regulations need to be formulated and enforced in order to organize the distribution process.

Most government income security programs are based on a “means” test that determines eligibility and benefit levels. If earned incomes exceed a specific level the beneficiaries may no longer qualify for all or part of their benefits, which creates a powerful incentive for understating their incomes and working “off the books.” The underground economy thus reunites both victims and beneficiaries in a common effort to improve their economic conditions.

During the last two decades the Social Security System has expanded to

a vast distribution system upon which 54 million Americans depend for basic retirement and disability income and health care services. It now provides average federal benefits of \$10,000 per couple per year and finances average annual health care expenditures ranging between \$1,700 and \$2,200 per beneficiary under Medicaid and Medicare, respectively.⁴ But the beneficiaries lose 50 cents in benefits for every one dollar they earn through labor over a certain amount unless they are 70 years of age or older. To the beneficiaries this reduction may amount to an extremely harsh tax or penalty. It may discourage some people from seeking productive employment, preferring the pleasures of leisure over potential labor income. Other highly productive individuals, such as physicians, dentists, attorneys, and business executives, may simply ignore the entire system and continue labor as long as they are physically fit. Others yet may ignore the reporting requirements and conceal their labor incomes in order to collect their undiminished benefits. They are laboring in the underground.

A few beneficiaries actually report their earnings and suffer the reductions. In 1977, the Social Security Administration withheld benefits from 1.2 million recipients, or 12 percent of those subject to the earnings test, because of reported incomes.⁵ If twelve percent of recipients report some income and suffer painful benefit reductions, how many are understating their incomes or hiding them altogether?

Transfer payments by way of pensions, unemployment compensation, aid to families with dependent children, medical care, food stamps, and so on, provide powerful stimuli to off-the-books activity. Surely, they also may buy more leisure and act as a disincentive to work on the part of recipients capable of working. But they do not bar the beneficiaries from

⁴ Budget of the United States Government, Fiscal Year 1984, pp. 3-5.

⁵ Ligg, Barbara A., "Beneficiaries Affected by the Annual Earnings Test in 1977", *Social Security Bulletin*, December 1980, p. 4.

working as such, they merely discourage them from taking on-the-books jobs. Unemployed workers draw compensation that amounts to about one-half their previous wage or salary. While they are receiving compensation they may legally earn up to 40 percent of their weekly benefit rates through full-time or part-time employment. Any amount earned over 40 percent of benefits is deducted from their benefit checks. To remain eligible for benefits, unemployed workers must report all wages earned during the week for which benefits are claimed. Wages include cash, allowances for meals, lodging, tips, credit on purchases, and any other kind of payment received in exchange for work or services rendered.⁶

In the fanciful world of government statistics, the millions of unemployed workers receiving compensation never do a day's work. They are officially out of work, waiting to be called back to work, or searching for other employment. In the world of reality, many actually do work, but fail to report their income to the authorities. They work off the books, so as not to jeopardize their government checks.

There is a ready underground market for services by people drawing unemployment compensation. They are offering "home-related" services including lawn care, painting, carpentry, plumbing, electrical work, cleaning, washing, cooking, and babysitting. Surely some service workers dutifully report their earnings to the Office of Employment Security and consequently suffer benefit reductions. But many fail to report their wages to their claims interviewers and neglect to inform the IRS. They prefer to labor in the underground economy.

Urban slums are centers of transfer and strongholds of the underground economy. They are the homes of immigrant workers from foreign countries or from rural parts of the United States, of blacks from the rural South, or other minority groups, such as Mexicans, Puerto Ricans, and

⁶ Commonwealth of Pennsylvania, Department of Labor and Industry, Office of Employment Security, *Pennsylvania Unemployment Compensation Handbook*, UCP-1, p. 8.

Oriental. Labor legislation and economic regulation render them useless and unemployable; the underground economy welcomes them with many jobs and entrepreneurial opportunities.

Urban slums are areas in which economic legislation, regulation, and taxation have made economic production legally impossible. The minimum wage law prohibits the employment of most slum inhabitants. Labor legislation that bestows legal immunities and privileges on labor unions denies employment even to skilled minority workers. License and permit laws deny them the right to carry on any business. Zoning ordinances bar the construction of productive facilities. Rent controls and housing ordinances prevent the construction of new housing and the maintenance of old housing. Confiscatory taxation compounds the destruction by turning assets into liabilities and forcing many owners to abandon their property.

The slum situation is further aggravated by the inability of political authority to distinguish between budding underground activity that tends to spring forth throughout the slums, and juvenile delinquency and crime which are clearly associated with slum environment. Municipal costs for policing are significantly higher in slum areas than in other neighborhoods. But it is difficult to determine whether the policing effort is aimed primarily at the suppression of underground economic activity or the prevention of crime against persons and property. Since government fails to draw this important distinction it cannot be surprising that many juvenile delinquents are unable to make the distinction and, therefore, may move freely from one activity to another.

If it were not for underground production there would be little or no productive activity in urban slums. The underground springs forth from human nature despite all the obstacles which political authority may erect. It may even give rise to organized business activity in the form of partnerships and cooperatives that operate under laws of their own. Successful entrepreneurs may become slum employers who give jobs to

the unemployable and pay wages and salaries.

For employers the risk of detection and the severity of potential penalty are likely to be significantly greater than for underground workers. Employers must weigh the inherent risk against the pecuniary advantages which, in their judgment, compensate them for the risk involved, and the satisfaction they may derive from offering income and opportunity to otherwise “unemployable” individuals. While millions of able workers are officially unemployed, there are countless opportunities for capable entrepreneurs willing to ignore the rules and regulations that are causing the unemployment. In fact, there is no greater need than entrepreneurial activity that puts the idle labor to productive use rendering valuable service and earning labor income. While they may ignore the minimum wage mandate, underground employers do pay the market wage that reflects a worker’s contribution to production. They pay wages undiminished by payroll taxes, such as employer contributions to Social Security, federal and state unemployment taxes, and workman’s compensation premiums, and unshorn by income tax withholdings. Underground take-home pay, therefore, is often higher than that paid in the regulated labor market.

Made by Illegal Aliens

Few Americans fully appreciate the valuable contributions to their economic wellbeing that are made by illegal aliens. Millions of them are laboring in the citrus groves in Florida, California, Arizona, and Texas, in the fruit orchards in Oregon and Washington, the vineyards of California and the southeastern states, on the farms and ranches in Colorado, Wyoming, and Idaho, in restaurants, motels and hotels in New York, Chicago, and Houston, and in countless other endeavors from coast to coast. No one can possibly know their numbers, whether five, ten, or twenty million. But we do know that they all chose to enter the United States in violation of U.S. laws, and that, despite all laws and regulations, they are making a living by adding their productive efforts to our economic lives. Many are laboring in the underground economy.

Never in history did so many aliens enter the United States illegally as in recent years. It took the combined efforts of two powerful governments to create the mass migration: the Mexican government that ravished and impoverished its people and drove millions across the border, and the U.S. government that sought to stem the tide by making it illegal.

The Mexican government under Lopez Portillo wrecked willful economic destruction. It ruined the peso, confiscated the banks and the people's savings, wasted billions of dollars on nationalized industries, and created mass unemployment. Wrecking Mexican economic life, it set into motion a mass exodus of its poor and downtrodden people.

Estimating Underground Employment

The underground economy probably represents the most serious challenge and danger to all government planners and regulators. It defies their authority and control, escapes their tax exactions, misleads them in fiscal and monetary policy deliberations, and misguides them in other areas such as manpower, housing, welfare, and industrial policies. They would crush it with every means at their disposal. In totalitarian societies, underground workers when apprehended may be flogged, hanged, decapitated, gassed, or shot. In the United States, they may be fined and imprisoned. Numerous bills have been introduced to suppress underground activity by punishing employers for hiring illegal aliens, by removing the Social Security earnings test, and by withdrawing \$100 bills from circulation. In a free society without economic planners and regulators, there would be no regulated economy and no underground. All productive activity would be free.

Most analyses of the underground economy deal with the lost revenue that is slipping by federal and state tax agents. The Internal Revenue Service estimates that it is losing some 100 billion dollars a year. In desperation it is seeking ever more powers to search for income, prosecute tax evaders, and impose stiff fines and penalties. But despite all its efforts at intimidation and coercion the underground economy continues to grow and prosper as if it were driven by the very forces that seek to suppress it.

Sober reflection on underground economic activity casts serious doubt not only on official statistics and pronouncements, but on government actions and policies as well. The unemployment rate is probably the most politically sensitive economic indicator that stirs public opinion and affects public policy. But it is a spurious conclusion based on unrealistic assumptions and beliefs. The Bureau of the Census conducts a monthly interview survey of 56,000 households to determine the unemployment rate. If an individual admits to being engaged in work as an employee or

in his own business, he is considered employed. If he contends he is actively seeking paid employment, he is considered unemployed. In the May 1983, interview, 5,656 individuals, or 10.1 percent of the sample, claimed to be unemployed, which, according to the Bureau of the Census, makes for 11.2 million jobless workers in a labor force of 110.8 million, or 10.1 percent.

Do underground workers admit their work activity to the census interviewer? If they do not, the census data, especially the unemployment rate, is seriously flawed. An untruthful answer by just one percent of the 56,000 people interviewed would inflate the national rate by one percent, or 1.1 million. A deceptive answer by 10.1 percent would cast doubt on any and all unemployment. As no one can possibly determine the deception rate, no one can possibly know the true unemployment rate.

The U.S. Government, which until 1965 had sanctioned the employment of some 4.8 million Mexican farm workers under the Bracero Program, closed its borders at the moment of greatest Mexican need. The Immigration and Nationality Act of 1965 established bureaucratic controls for the protection of American workers from foreign competition. It gave all powers to the Secretary of Labor by authorizing him to certify, before any quota immigration visa can be issued, that there is a shortage of native labor and that the employment of an alien will not adversely affect the wages and employment conditions of American workers. Obviously, the Secretary of Labor has never issued such a certification for factory workers and agricultural laborers. However, he has welcomed thousands of professional people, artists and scientists who are filling the national quotas.

Many illegal immigrants find the underground economy most congenial. To minimize the danger of detection and deportation they hide from all government authorities. The underground offers the best shield of anonymity. But many are forced by American employers who are fearful of becoming accomplices to illegal employment and tax evasion, to pay

income and social security taxes. They are forced to emerge from the underground economy, but must continue to hide from the immigration authorities.

The apprehension rate of illegal aliens who surface from the underground is significantly higher than that of aliens who remain consistently off the books. The rate probably rises in direct proportion to alien surfacing and claiming the transfer entitlements of legal residents. The illegal alien who dares to claim unemployment compensation or public assistance, or sends his foreign-born children to public school, is jeopardizing his anonymity and inviting his apprehension. Most illegal aliens, therefore, find underground work congenial. But if employers force them to surface through withholdings of Social Security and income taxes, they tend to shy away from entitlement agencies, which after all are government authorities.

Millions of illegal aliens have expanded the overall dimensions of the underground economy. Even if only one-half or one-quarter are working off-the-books, the number is significant. It incites American labor leaders and their spokesmen in the U.S. Congress who are ever eager to find culprits for the unemployment they themselves create. They would impose heavy penalties on employers who hire illegal aliens, introduce national ID cards, issue government work permits, and deport as many illegal aliens as they could catch.

Other politicians who loathe the underground economy because it escapes their dominion are inclined to offer U.S. citizenship to illegal aliens. But they blithely overlook the pernicious effects of U.S. labor legislation. To offer citizenship is to subject the aliens to minimum wage legislation and labor market regulation that are causing mass unemployment, and to authorize them to partake of the transfer entitlements that are paralyzing the regulated economy. In short order, it would add five to ten million workers to the unemployment and welfare rolls, invite millions of dependents to join their parents in the U.S., and

trigger a tidal wave of new illegal aliens. And to the dismay of these champions of economic regulation, the underground economy would soon receive reinforcement not only from new citizens now drawing unemployment compensation and public assistance, but also from millions of illegal newcomers.

In most months less than half of the officially jobless collect unemployment compensation. Why don't they claim their benefits? Have they run out of their legal entitlement which, at the present, amounts to 55 weeks of full benefits?⁷ They may have fallen on public assistance or private charity. Or, they may be working off the books, but when the Census interviewer calls, are searching for employment. If countless individuals who are drawing unemployment compensation are also laboring in the underground economy, is it unreasonable to assume that many of the five to six million jobless workers without compensation are laboring side by side with the compensated workers? Their need for gainful employment and labor income may be as pressing as that of those with benefits. And there are countless opportunities in a labor market that is free from government regulations and controls.

Many individuals who indicate to their Census interviewer that they are self-employed may actually be laboring in the underground economy. At least, this was the finding of a special IRS study. It found that 47 percent of the workers who were classified as independent contractors did not report any taxable income. And 22 percent of independent contractors who were professionals failed to report any of their earnings.⁸ If so many failed to report any income at all, how many others neglected to report most or part of their incomes?

⁷ *Budget of the United States Government*, 1984, p. 5–120.

⁸ U.S. Congress, Joint Committee on Taxation. *Proposals Relating to Independent Contractors*, Committee Print, July 13, 1979, p. 20.

There cannot be any doubt that the underground economy offers permanent employment to millions of individuals. They live by the motto, which is also a fundamental principle of market economics, that anyone willing to work can find a job. Millions of illegal aliens live by that principle and prosper in their own way, which makes many more aliens want to follow in their footsteps. In the underground economy the alien workers cooperate with millions of American workers who permanently or irregularly, full-time or part-time, render useful services and earn underground incomes.

It is futile to speculate on the scope and size of underground economic activity. Despite the numerous attempts at measuring the unregulated economy by such eminent economists as Peter M. Gutmann⁹, Stephen M. Goldfeld¹⁰, Edgar L. Feige¹¹, and Vito Tanzi¹², we are left with an inadequate conception of the underground economy. But we may know through deliberation and observation that unreported, unregulated, and untaxed economic activity is causally related to the strictures of mandated reports, restrictive regulations, and confiscatory taxation. The pressures exerted by the latter force man to cease and desist, or to escape in the underground. We also know that the present trend toward all-round government control clearly points toward more underground activity. As the regulated economy stagnates or withers away the underground

⁹ "Are the Unemployed, Unemployed?", *Financial Analysts Journal*, v. 34, Sept–Oct 1978, pp. 26–29; "The Grand Unemployment Illusion," *The Journal of the Institute for Socioeconomic Studies*, v. 4, Summer 1979, pp. 20–29; "Latest Notes from the Subterranean Economy," *Business and Society Review*, Summer 1980, pp. 15–30.

¹⁰ "The Case of the Missing Money," *Brookings Papers on Economic Activity*, No. 3, 1976, pp. 683–739.

¹¹ *The Irregular Economy: Its Size and Macroeconomic Implications*, Madison, Wisc., University of Wisconsin–Madison, May 1979.

¹² *The Underground Economy in the U.S. and Abroad*, edited by Vito Tanzi, Lexington, Mass., D.C. Heath & Co., 1982, pp. 69–92.

economy endeavors to take its place.

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