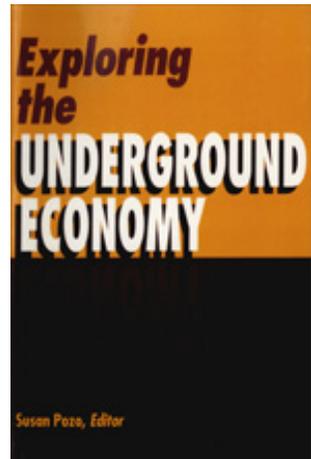


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Introduction

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Introduction

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Ask an academician, a government worker, a policy analyst, a politician, and a member of the general public what the underground economy is all about and you will surely get a wide variety of answers. This diversity is reflected in this volume, where six different papers about the underground economy—its many facets, its various consequences, and a multitude of interpretations—are presented.

Our fascination with the underground economy is as many-faceted as are our definitions of it, but it is safe to assume that we are intrigued with the underground economy in part because it is difficult to directly observe and directly measure. Whereas one can be reasonably assured of estimates of automobile production in the United States in a given year, we are less confident of the estimates offered for tax compliance, domestic marijuana consumption, the volume of illegal gambling, or the extensiveness of barter trade. Hence we dig deeper and ask, how were these numbers obtained? If alternative assumptions are made, how would the estimates change? Will a different methodological approach confirm or contradict these estimates?

Because of its nature, because participants in the underground economy hide their participation, direct measurement of the magnitude of underground economic production and participation is usually not possible. We normally have to find other methods, often relying on indirect measures to find traces of underground economic activity. In this book, alternative methods are used to track the underground economy, ranging from monetary measures to direct survey methods to experimental techniques.

The chapters by Edgar Feige and by Peter Reuter focus on measuring the size and volume of underground economic activity. Feige uses monetary techniques to measure the volume of unreported economic activity taking place. Previous studies estimating the size of the underground economy, which is presumed to bear some relationship to the level of unreported income, have used the currency ratio method. In

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this method increases in the currency-to-checkable-deposit ratio are assumed to be associated with increases in unreported income because individuals find it easier to camouflage unreported income if it is kept as cash. However, Feige notes that the estimates offered thus far using the currency-to-deposit ratio or some variant of it have assumed that all U.S. currency circulates domestically. We are continually reminded, however, that U.S. currency plays an important role in many foreign countries, as evidenced in part by its use in black and parallel-dollar-currency markets. Feige extensively examines what is known about U.S. currency holdings abroad to derive estimates of the proportion of U.S. currency that circulates domestically. With currency estimates taking into account the volume of overseas holding of U.S. currency, Feige is able to obtain and report estimates of the size of the underground economy using a variant of the currency-to-deposit ratio method that better reflects U.S.-only underground economic activity.

Reuter, on the other hand, takes a hard look at a specific subsector of the underground economy—the illegal drug market. This market is, to the best of our knowledge, the largest of all the illegal markets, and thus its size is of concern to those interested in learning about the extensiveness of the underground economy.

Reuter suggests that U.S. government estimates pertaining to the size of this market are grossly inadequate and inconsistent. He cleverly shows how individually scrutinized estimates can be shown to be implausible and how the collective estimates of related markets or variables within the market are inconsistent. Why are such poorly engineered figures offered to the public? Overall, they do not offer guidance for good policy making and hence do not result in alterations, improvements, or development of drug policy. They are often offered instead to legitimize policy decisions that are derived independent of good estimates.

Reuter notes that good estimates are important and that they could serve a valuable function in evaluating, for example, the effectiveness of policies to reduce illegal drug consumption or the scope of drug markets.

The papers by Richard Freeman and James Alm are concerned with criminal behavior of individuals. Freeman concentrates on youth, in an attempt to gain an understanding of what leads to criminal behavior. What policies could be implemented if we wish to reduce criminal

activity among our youth? Since criminal activity during youth seems to be associated with subsequent behavior and economic attainment, it is especially important to understand how our current economic policies may encourage or deter youth from engaging in crime. Freeman obtains data from the National Longitudinal Survey of Youth to undertake his investigation and arrive at conclusions regarding participation in underground activities.

Alm looks at a different category of criminal activity—tax evasion. He too asks how economic policy affects the degree of tax cheating that takes place. To get around the problem of getting individuals to truthfully admit the degree to which they cheat on taxes, Alm employs experimental methods to track tax compliance. Under these carefully controlled methods and with careful experimental design he is able to generalize how changes in the variables in the hands of policy makers can alter behavior, causing the general compliance rate to rise or causing tax cheating to increase.

The papers by Ann Witte and Alejandro Portes serve as an overview of the underground economy in the Americas. Witte's paper points to some of the ambivalent attitudes we have had regarding the underground economy in the United States over the past several decades. In many cases we argue that certain behaviors and participation in the underground economy are not acceptable. We do not always seem entirely convinced of this position, however, and we end up engaging in less enforcement. Witte suggests that what constitutes the underground economy has changed over time. Variations in enforcement serves as a precursor to real changes in institutions and laws pertaining to underground activity. There is significant fluidity in the definition of what is legal and what is not, and participation in the underground economy does not necessarily mean that one is "beating the system."

Portes adds another dimension or perspective to the underground economy discussion. This results from his studies of underground economies in Latin America. While there is reasonable consensus of what constitutes the underground economy in the industrialized economies, the consensus is less broad for those who study developing economies. This may be because of the more diverse form taken by the underground economy in less-developed countries, and perhaps because there is a less clear distinction between what we term formal and informal production in these economies. The linkages between the

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underground and aboveground economies are stronger in developing economies, making for more difficult delineation of the two categories of production.

Despite the additional challenges faced by researchers who measure the underground economy for developing nations, Portes offers estimates of the magnitude of this sector for many of the Latin American economies over the past several decades. He employs several different methodologies and concludes that there is considerable informal production taking place in these countries.

Though the underground economy is a somewhat elusive and variously defined concept, these studies suggest that a great deal is known. By using various approaches, economists and others have actually learned much about unrecorded and illegal production. Despite the diversity of approaches, many common conclusions seem to emerge. First, the underground economy is significant in size. Second, growth and persistence in the underground economy are not relegated to a particular historical period, geographic region of the world, or stage of development. Both developed and developing economies seem to be faced with significant underground sectors. Third, economic policy can play a significant role in determining whether economic agents participate to a greater or lesser degree in the underground economy.

Nonetheless, despite knowing a great deal about the underground economy, this collection of papers also brings to our attention that much has yet to be learned. Because of the diverse nature of underground economic activities, a variety of approaches is probably the best route to better understand the underground. Unlike many economic inquiries, it may be more appropriate and fruitful to employ economists (and noneconomists) from almost all the different specialties to add to our body of knowledge about the underground economy. Labor economics, macroeconomics, public finance, criminology, experimental economics, urban economics, and international economics all have contributed and have more contributions to make so that we can better understand the underground economy. The studies presented here attest to this.