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Chapter 2 Outsourcing and Economic Growth

■ Chapter Overview

Broadly defined, underground economic activity consists of transactions not reported or reportable to the government. Economists estimate that throughout the world, underground economic activities account for about one-third of all production. However, underground activities are not evenly distributed across countries. Much underground activity occurs in order to evade taxes. Countries with low marginal tax rates experience less underground activity because citizens have less incentive to evade taxes. Regulations on products or labor can also encourage underground activity. This chapter highlights some of the factors driving underground economics.

■ Descriptive Analysis

When Americans first think of the underground economy, they almost immediately think of the illegal drug trade. By definition, the drug trade is underground; buyers and seller purposefully attempt to hide their activities from the government. However, there are numerous other underground activities that commonly occur. As evidenced by a number of political scandals involving hiring domestic help, payments to workers “under the table” constitute a significant proportion of hidden economic activity. Indeed, in any country where something is banned or taxed there seems to be a black market for that good.

For obvious reasons, nobody knows exactly the size of the underground economy. Estimates of its size in the United States range from very little to about 30% with the most reasonable being around ten percent. The underground economy in Europe is thought to be larger, perhaps as much as 20%, with some countries like Italy exceeding 30%. Developing countries, especially those with few property rights, are likely to have a majority of the economies be hidden from the government.

The size of the underground economy between countries varies considerably. The source of this variation depends upon the marginal tax level, economic regulations, and often the ability for citizens to make purchases or transport goods to a different jurisdiction. A high marginal tax rate encourages citizens to hide income generating activities from authorities in hopes of evading taxes. Potentially, this explains the higher rate of European underground activity (where marginal tax rates tend to be high) relative to American levels (where tax rates tend to be low). A related issue not to be confused with this argument is tax avoidance. Tax evasion occurs when citizens illegally avoid paying taxes (i.e. not reporting their earned income) whereas tax avoidance occurs when citizens use legal loopholes to reduce their tax

burden. A high marginal tax rate increases both tax evasion and tax avoidance.

Market regulations may also induce higher levels of underground activity. Restrictions on firing workers encourage businesses to hire individuals “under the table” so as to avoid these restrictions. Long-term unemployment benefits may induce workers to work in the underground economy so as to not lose their benefits. Regulations increasing the marginal cost of hiring a worker may also contribute to increased use

of underground labor. For instance, requiring firms to provide health care to employees may induce firms to illegally contract with employees rather than legally hiring them.

Another form of underground activity is smuggling. Whenever two jurisdictions exist with different regulations or tax structures, one can imagine smugglers earning a profit by exploiting these differences. Cigarettes (between low and high tax American states), Cuban cigars, weapons, and drugs are common examples. There is considerable smuggling of petrol and diesel that occurs between Northern Ireland and Ireland the flow of which depends upon local tax rates and fluctuations in the value of the Euro and Pound. The British government estimates it lost 350 million Pounds worth of taxes because of smuggling cheaper Irish Petrol into Northern Ireland.

Finally, participation in the underground economy is best thought of in terms of opportunity cost and comparative advantage. When individuals lack mobility or skills to succeed in other areas or sectors of the economy, they will be more attracted to the underground economy when their economic circumstances deteriorate. Miller and Benjamin cite Ahmedabad, India as a case in point. When the local textile industry deteriorated, many workers without the ability to change locations or earn a living in a different career, turned to the underground economy including street vending, trash collecting, and recycling. The authors contrast this to residents of Buffalo, New York who, because of the completion of the St. Lawrence Seaway, has suffered a serious decline in economic activity. Rather than turning to the underground economy, residents of Buffalo simply departed for jobs in other areas of the country. Economic mobility allows individuals to substitute out of the underground economy when under pressure.

Finally, it is important to keep in mind that the underground economy is a wealth generating activity in much the same way that normal, legal economic activity is. In all but extreme cases, the underground economy relies upon trade that benefits both seller and buyer. As such, the underground economy is socially beneficial even when it is illegal or frowned upon by governments.

■ Chapter Answers

1. High marginal tax rates encourage citizens to evade taxes by participating in underground activities. Consider the extreme case of a 100% marginal tax rate, citizens would have no incentive to participate in legal work since all of their earnings would be taxed. One would imagine that in this case, all work done would be hidden from the government so employees could retain their earnings. On the other hand, a 0% tax rate would not cause any evasion; in this case citizens would retain all that they earned and have no additional incentive to hide their production from the government.

2. Laws that discourage employee termination likely increase hiring workers in the underground economy. These laws likely discourage some overall hiring as the total cost of a worker to a firm (including termination costs/uncertainty) is greater. However, some hiring does occur in the underground labor market to counter act this. Interestingly, workers hired in the underground economy may suffer from these types of laws since they are less well protected by other labor market safeguards (i.e. safety regulations, workers compensation, etc.).

3. From the individual's perspective, participating in the underground economy is a voluntary activity that presumably makes the individual better off—otherwise the individual would not participate in it. Regardless of the reason why, participating in the underground economy is illegal and puts the individual in jeopardy of the law. One can imagine the social ramifications having great differences depending upon the activity undertaken. For instance, hiring a domestic worker “under the table” and not paying the

associated taxes cheats the government out of revenue but increases the utility for the employer and employee. Selling drugs, on the other hand, has a negative externality on society and possibly forms or abets an addiction that one party to the transaction (the buyer) may really want to avoid.

4. A highly corrupt government, defined here as one that does not respect property rights, would have citizens more likely to participate in the underground economy. In these types of nations, a corrupt government may take the proceeds or capital of a citizen. In this case, citizens participating in the underground economy may not rise to the notice of such governments and therefore may be able to accumulate more wealth than if they were participating in the legal economy.

5. Yes. One can imagine that being paid “on the books” allows others in society, most notably the legal system, to recognize your job as legitimate. Legitimate work may be associated with legal protections such as workers compensation, protection from arbitrary termination, and the ability to use the job as collateral for loans. Many of these things are expensive for a firm that, in order to reduce expenses, may desire to pay “off the books.” In an underground economy, these things may be bargained over. In short, an employee may be willing to receive a wage above the market rate in exchange for being hired “off the books” and foregoing the benefits that come with being hired legally.

6. In either case, as long as the hiring (by the employer) and working (by the employee) was voluntary, then it is hard to imagine an employee systematically ending up worse off by taking either a “on the books” or “off the books” job. Of course, some jobs turn out badly for an employee but, presumably, if the employee knew of this in advance she would not have accepted the job to begin with.