U.S. News & World Report

The New Underground Economy

By RICK NEWMAN

March 18, 2013

Something fishy is going on in consumers' wallets.

Household spending has held up surprisingly well in recent months, even though new taxes have reduced paychecks and other problems are holding back the economy. Incomes haven't risen by nearly enough to explain the entire boost in spending. Nor has the use of credit cards.

When your teenager starts wearing expensive clothes and flashing bling he couldn't possibly afford through his part-time job, you start to wonder where the money is coming from. Some economists are asking the same question about consumers who seem more flush than they ought to be. The answer may lie in the large "underground" economy that doesn't show up in official statistics.

There are always some businesses and individuals operating on a cash basis to dodge taxes, evade regulations or conceal illegal activity. Economists now speculate that the underground economy may have swelled during the last few years, given all the people who can't find full-time work at decent pay.

"Severe recessions have historically driven jobless Americans into the shadow economy," writes **Bernard Baumohl of the Economic Outlook Group**. "We suspect the destructive nature of the last downturn and the prolonged weak recovery pushed a record number of people into that murky world of cash transactions."

Baumohl cites several unusual trends to make the case for a booming underground economy. First, retail sales since 2009 have been rising at levels typically associated with an unemployment rate of 6 percent or lower. But unemployment has been above 8 percent for most of that time.

"Many of those who have left the labor force since the last recession have managed to earn income in the shadow economy," he believes. "Their spending still shows up in the official retail sales and personal consumption data."

That may help explain one troubling trend—a sharp decline in the labor-force participation rate, which measures the percentage of the adult population considered to be either employed or looking for work. The participation rate has dropped from a peak of 67.3 percent in 2001 to 63.5 percent today. The last time it was that low was 1979. Some economists think this reflects a worn-out workforce resigned to long-term decline. But it might show a migration of workers from the official economy to the underground one instead.

Another clue to the underground economy comes from government data on the percentage of Americans who forego banking services, finding other ways to handle their money. The percentage of Americans who are "unbanked" or "underbanked" rose from 25.8 percent in 2009 to 28.3 percent in 2011. Some of those people may be low-income customers getting hit with a slew of new banking fees, forcing them to reject traditional banking. But others may be choosing to keep their money out of the mainstream financial system so that nobody checks up on them.

We tend to think of the underground economy as a place where Mafiosi and other types of criminals operate. But that's more or less a constant. The new underground economy may entail a lot of people doing honest work, such as freelancers and consultants who used to be full-time professionals, computer-repair people laid off from corporate IT departments, home remodelers benefiting from a revived housing sector, people running eBay business, and retirees earning a few extra bucks by running errands for busy parents. The Internet obviously makes it easier to work from home these days, another boon for the gray market.

Data from the IRS shows that total tax receipts from personal income dipped in 2009 and 2010, as would be expected in the aftermath of a tough recession. In 2011, the last year for which data is available, tax receipts rose by about 14 percent, as the economy recovered and more people went back to work. That's a healthy rebound, but some of that may have come, ironically, from government transfer payments, such as extended unemployment insurance, that temporarily boosted some people's income, On the whole, it's hard to tell if tax receipts are depressed as more people underreport their earnings.

Economists estimate the size of the underground economy at somewhere between 8 percent and 14 percent of total GPD, which could amount to as much as $2 trillion worth of economic activity. Authorities in California say off-the-books transactions cost the state $6.5 billion in lost tax revenue every year.

If the trend is similar throughout the U.S. economy, that would amount to roughly $50 billion in lost tax revenue for all 50 states combined, plus an even bigger chunk that Washington fails to collect. All told, that would be more than enough to completely cover the $85 billion in spending cuts—known as the sequester—that just went into effect. On the other hand, that's a lot of cash consumers end up keeping to spend on cars, appliances, restaurant meals and vacations—almost like a government stimulus program.

###