The Other Economy

How Big Is the Irregular Economy?

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So much economic activity is excluded from the national income statistics that the macroeconomic judgments currently made by economists must of necessity be wrong.

At a recent meeting of the Midwest Economics Association, Joseph McKenna wrote "An Obituary for Macroeconomics," reflecting the growing sense of disillusionment within the economics profession with its now aging and seemingly feeble theoretical offspring. Keynes gave birth to a child prodigy over forty years ago but, as McKenna points out, the world today is very different from the world of depression *The General Theory* sought to explain. The economic world of the seventies is characterized by stagflation, and endless *ad hoc* modifications of a depression theory to explain it only satisfy the ostriches among us. To state matters simply, we appear to have no generally accepted macroeconomic theory which adequately accounts for our present economic malaise.

The growing lack of confidence in our ability to manage the economic system properly is reflected politically in the "tax revolt" phenomenon and in recent calls for general limitations on government spending.

There are two possible explanations for the inability of macroeconomists to respond adequately to the pressing needs of the day. Either our theories are defunct and we must await a new Keynes, or our data base is so distorted that we are misperceiving the economic realities in our midst. While I would welcome an economic messiah, I see none on the horizon, and thus turn my attention to the less lofty task of re-examining the official government statistics on which the entire macroeconomic profession relies, not only for the problems it is

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asked to address but also for the solutions it seeks to offer. As a starting point, the implications of what sociologist Louis Ferman has precisely described as the "irregular economy" merit close attention. I employ Ferman's neutral terminology advisedly in the hope of avoiding the evocative connotations of terms like "subterranean" or "underground," which lend themselves all too readily to journalistic sensationalism.

The term "irregular economy" is used to refer to those economic activities that go unreported or are unmeasured by the society's current techniques for monitoring economic activity. By convention, the GNP accounting framework systematically excludes illegal activities such as the narcotics trade, prostitution, fencing of stolen goods, gambling, and loansharking. Only that component of illegal activity which is covertly "laundered" back into legitimate business is unwittingly included in the official statistics. In addition, however, the GNP accounts underreport or totally exclude many activities they are designed to include, such as moonlighting, "off the books employment," skimming of retail sales, illegal alien employment, suspect inventory evaluations, covert rentals, and barter. A good many of these activities exist as attempts to evade taxes.

The irregular economy appears to have little respect for conventional geopolitical boundaries. Indeed, it is being increasingly noticed in almost all developed societies. The Swedes have a "hidden economy," the English their "fiddle," the Italians their "lavorno nero," the French their "travail au noir," the Japanese "hidden incomes"; even the Soviet Union has an "unofficial economy." The irregular economy has also received widespread journalistic attention in the United States since the publication of Peter Gutmann's highly provocative estimate that such activities in this country amounted to almost $200 billion in 1976. This estimate implies that a covert unrecorded economic sector the size of the entire economy of Canada exists *within* the overall U.S. economy. If this assertion is true, it demands immediate attention and study.

It is widely believed that the growth of irregular economies has been sparked by increased tax burdens partially induced by the progressivity of tax schedules in an inflationary environment and by the growth of government regulations which provide incentives for firms to circumvent costs of regulation by entry into the irregular sector. It has also been suggested that the painful experience of the Vietnam War and the lawless behavior of some of the nation's leaders during this period gave rise to a growing sense of cynicism and disillusionment, which has prompted individuals to circumvent the economic and legal conventions of society. These alleged causes are, however, undocumented and untested conjectures at best. The uncomfortable fact is that neither the scale, causes, nor implications of the irregular economy are well understood. In this article, I will review the current state of the art in assessing the magnitude of the irregular sector, and present a new methodology for determining its size.

To measure the magnitude of such activity directly would require microeconomic observations on each illegal activity and the aggregation of these observations into an overall total. For an economy whose modus vivendi is to avoid detection, such an approach is fraught with hazards, since law enforcement statistics typically are limited to arrest or seizure data and require an arbitrary blowup factor to arrive at the total volume of such activities. The other alternative is to take a macroeconomic approach and look for the footprints unwittingly left behind by the irregular economy in the macroeconomic data that are routinely calculated for other purposes. Such an approach is necessarily indirect and conjectural and all estimates are potentially subject to wide margins of error. It is crucial, therefore, to spell out all assumptions explicitly so that the sensitivity of the results to departures from those assumptions can be tested directly.

The Gutmann method

An obvious starting point is to review and assess the estimate that started the hubbub—Gutmann's estimate that the irregular economy amounts to $200 billion, or 10 percent of currently measured GNP. Four assumptions are key to his analysis:

1. The irregular economy uses currency as the exclusive medium of exchange.

2. The 1937-1941 period is an appropriate benchmark, that is, a period during which the irregular economy did not exist.

3. The ratio of currency to demand deposits prevailing during the "benchmark" period would have remained unchanged *except* for changes induced by the growth of the irregular economy.

4. The amount of income produced by a dollar

of currency in the irregular sector is identical to the amount of income produced by a dollar of currency or demand deposits in the official sector.

Given these assumptions, Gutmann's method is straightforward. He calculates the currency/demand-deposit ratio for the benchmark period (1937-41) to be .217 and estimates the amount of currency required for "legal" transactions in 1976 as that ratio times the actual demand deposit figure for 1976. The difference between the resulting estimate and the actual currency outstanding in 1976 then becomes his estimate of the cash used for irregular activities ($28.7 billion). Since "legal" currency plus demand deposits (estimated to be $275.3 billion) were needed to produce the measured GNP in 1976 of almost $1700 billion, Gutmann employs his fourth assumption to calculate that "illegal" cash was able to produce irregular income of $177 billion ($28.7 \times 1700/275.3$).

How reasonable is this procedure? Let us go through his assumptions in turn.

His first assumption is questionable, since there is congressional testimony suggesting that ill-gotten currency is often transferred abroad and then "laundered" by the creation of loans to American business. This in turn creates demand deposits, thus affecting both the numerator and denominator of the currency/demand-deposit ratio. It is also likely that even irregular purchases can be paid for by check with only little risk of detection by the Internal Revenue Service and even credit cards (ultimately paid for with checks) have now become institutionalized as a means of payment for some kinds of illegal service.

His second assumption is the most reasonable of the four, particularly in light of the fact that federal income tax rates used to be trivial compared to those of today, thus significantly reducing the incentive to underreport income.

His third assumption is distinctly harder to swallow. Philip Cagan's careful study of the currency/demand-deposit ratio suggests that over time it could be affected by a myriad of variables including the costs of holding currency and demand deposits, expected income, the volume of retail sales, bank failures, urbanization, travel, and irregular activities. This assumption leads Gutmann to ignore the effects of changes in all but the last of these variables during the 35 years between 1941 and 1976; and it is virtually impossible to determine either the direction or the magnitude of error that these omissions introduce without a careful multivariate analysis.

His fourth assumption, that a dollar of currency in the irregular sector generates the same income as does a dollar of currency or demand deposits in the official sector, leads almost certainly to an underestimation of the irregular sector. I suspect that the irregular sector is much more integrated than the regular sector is (that is, it requires a smaller number of financial and intermediate transactions to produce a dollar of final output). Moreover, the composition of output in the irregular sector is likely to consist of a larger proportion of services than that produced in the regular economy. As the official input-output accounts reveal, the industrial sector requires almost twice as many intermediate transactions to produce a dollar of final output as the service sector does. The heavy weight of services and the differential degree of integration could alone result in a doubling of Gutmann's estimate of the scale of irregular activities, since less cash is required to produce a dollar of final output in the irregular sector.

A preliminary exercise with a new methodology

The great American economist, Irving Fisher, argued that if one simply added all transactions paid for by cash and all transactions paid for by check, the resulting magnitude would represent a good measure of total macroeconomic activity in the society. Fisher's insights were unfortunately largely abandoned by the economics profession in their haste to follow Keynes. However, as I shall argue, his approach may well be the best way to uncover the trail left behind by the irregular economy in transactions data which were collected for very different purposes.

Total transactions in an economy can be measured by adding the volume of checking transactions (demand deposits times the average turnover of these deposits) to the volume of currency transactions (currency in circulation times the average turnover of currency). The basic building block of my analysis is the ratio of total transactions (PT) to observed income in a society—that is, between a general price index (P) (a composite of the prices of existing and newly created goods and services)

multiplied by the physical volume of transactions (T), and observed income (py) where p is the price index of newly created goods and services and y is real income.

Now, total transactions include both the regular and irregular economy, and are made up of intermediate transactions, final goods transactions, purely financial transactions, and transactions in the irregular economy. Observed income, in contrast, measures only the income counted in the official statistics. Since PT/py can be decomposed into $(P/P) \cdot (T/y)$, we can infer that any changes in the relationship between total transactions and observed income in a society must be caused by one of three factors:

1. A change in the prices of all goods and services relative to the prices of newly created ones, that is (P/P).

2. A structural change in the economy, reflecting a change in the ratio of the physical volume of financial transactions or intermediate transactions to final goods and services transactions (T/y). A rise in (T/y) reflects structural disintegration, whereas a fall in (T/y) reflects greater integration.

3. A change in the scale of transactions in the irregular economy.

If we analyze the time trends of each of the above in turn, we can come to some assessment of the role of the irregular economy in the overall scheme of things.

1. *Prices.* Obviously no single available price index properly measures the general price level. For our purposes, however, the Consumer Price Index (CPI) is an adequate first approximation, since it at least includes used cars and housing. For intermediate goods, I must for the moment rely on the now defunct Wholesale Price Index (WPI). And for newly created goods and services I use the GNP deflator. As Table 1 shows, both the CPI and WPI fell relative to the GNP deflator over the 1939-1978 period, suggesting that, other things equal, our ratio of total transactions to observed income should also have fallen.

2. *Structural changes.* The two most likely structural changes are a change in the volume of financial transactions or a change in the volume of intermediate transactions required to produce a given volume of final output (the degree of integration).

The volume of gross financial transactions is, unfortunately, not readily identifiable. It is, however, obviously a volatile variable in my schema in that the turnover rate for demand deposits in financial centers is certainly much more rapid than that for demand deposits in general. (The 1978 turnover rate for the financial center of New York, for example, was five times the average turnover rate of demand deposits in non-financial centers.) To remove this element from the analysis insofar as possible, I have used the published Federal Reserve turnover data which exclude turnover in major financial centers—New York, Boston, Philadelphia, Chicago, Detroit, San Francisco-Oakland, and Los Angeles-Long Beach (see 1977 Statistical Supplement to the *Survey of Current Business*, p. 101). The demand deposit turnover rate therefore reflects the lowest published turnover rate for so-called non-financial centers. The non-financial turnover rate was chosen so as to impart a conservative bias to my final estimate of irregular activities. A more refined calculation would require the construction of an independent time series estimate of the total volume of purely financial transactions, which is beyond the scope of the present undertaking.

Changes in the degree of integration with respect to intermediate goods, in contrast, can be estimated. Examination of a consistent set of input-output tables by two-digit industry code (by kind permission of Frank Gollop) shows that between 1948 and 1973 the volume of intermediate transactions as a fraction of total final transactions fell slightly (from .84 to .80). Leontief's initial work on the subject also included an input-output table for 1939. While his industry definitions are not strictly comparable to the more recent data, I still calculated from his data that the intermediate/final ratio was 1.88 for 1939. Even allowing a wide margin of error, these results suggest that the degree of integration has certainly increased between 1939 and 1973 and that the ratio of intermediate to final

Table 1

	Ratio of	
Year	CPI to GNP deflator	WPI to GNP deflator
1939	1.17	1.18
1976	1.02	1.17
1978	.95	N.A.*

Source: *Economic Report of the President*, January 1979.
*The wholesale price index has been discontinued due to errors of double counting.

goods, therefore, has fallen. Examining the detailed sectors of the input-output tables reveals that the agricultural sector has become less integrated due to the major requirements for fertilizers and machinery which now involve many more intermediate transactions for the sector. Since the size of the sector has been falling relative to total output, however, this disintegration has been offset by the growth of the service sector, which represents a highly integrated sector requiring relatively fewer intermediate transactions relative to final output. The financial sector also reveals a tendency toward greater disintegration, but the all-important industrial sector shows almost no change between 1948 and 1973.

It is difficult to imagine that input-output tables for 1976 and 1978, when available, will reveal a dramatic reversal of these trends.

Evidence regarding both price movements and changes in the volume of intermediate transactions, thus, point in the same direction. If the financial transactions remaining in my figures grew in rough proportion to income, then the ratio of total transactions to observed income would have fallen during the period since 1939.

But has it? My calculations suggest the opposite, as we shall see.

Let us go back to Fisher's basic insight, that the total volume of transactions in society (with the important exception of barter) can be measured by adding up all transactions paid for by currency or by check. The volume of checking transactions can be derived from knowledge of the stock of demand deposits and estimates of the average number of times per year that demand deposits turned over. This presents no empirical problem, because turnover figures for the United States have been regularly collected and published since 1919. Although no comparable estimates of currency turnover exist, we can still estimate the total volume of currency transactions by calculating the total number of times an average unit of currency changes hands before its quality deteriorates and it is retired from circulation. Robert Laurent has estimated that during the period 1890-1965 the number of physical transfers that a unit of currency could perform before retirement was approximately 125 turnovers. Since the Treasury Department keeps accurate records of the volume of currency redeemed in each year, the ratio of currency outside

banks to currency redeemed gives us an estimate of the average lifetime of a unit of circulating currency. (Not surprisingly, the average lifetime of currency varies with the size of the denomination, with one-dollar bills lasting less than two years on average and $100 bills having an average lifetime of approximately 22 years.) Then, dividing the total number of physical transactions a unit of currency can sustain before retirement by its average length of life yields an estimate of the average number of physical transactions or currency turnovers performed in any given year.

Table 2 shows the results of my calculations for

Table 2

Year	Total value of transactions (125 lifetime transactions), billions of $ (1)	Observed income as measured by GNP, billions of $ (2)	(1) ÷ (2) (3)
1939	934.9	90.8	10.30
1976	19,899.4	1,706.5	11.66
1978	27,277.9	2,106.6	12.95

Table 3

Year	Estimated official + irregular income, billions of $ (1)	First approximation to irregular economy (125) (2)	Second approximation to irregular economy (225) (3)	Percent irregular to total economy (225) (4)
1939	90.8	—	—	—
1976	1,932.0	225.5	369.1	19.1
1978	2,648.3	541.7	704.4	26.6

Data Sources: *Banking and Monetary Statistics; Economic Report of the President*, January 1979; Annual Reports of the Secretary of the Treasury; *Survey of Current Business: 1977 Statistical Supplement*.

1939, 1976, and 1978. As can be seen in column 3, the ratio of total transactions to observed income has increased over the period of study. Since price changes and degree-of-integration changes, as I have argued above, have been moving in the direction of lowering the ratio, the extent to which it has risen would seem to give us a rough estimate of the effect of my third possible cause for a change in the ratio—the growth of the irregular economy.

If we then take 1939 as our benchmark year—assuming no irregular activity before World War II—we can estimate the magnitude of irregular plus regular income in 1976 and 1978 by dividing the observed total volume of transactions in those years by the 1939 ratio. The results are shown in column 1 of Table 3. Subtracting measured income from the total yields an irregular economy of over $200 billion (or 13 percent of GNP) in 1976, and almost double that figure only two years later (column 2).

The foregoing calculations depend critically upon the assumption that the quality of outstanding currency did not change during the period under study. I am distinctly uncomfortable with this assumption in spite of the fact that it is the presumed responsibility of the Treasury Department to maintain a uniform quality of currency in circulation. I have been unable to find any direct evidence bearing on the issue of currency quality; however, evidence does exist suggesting that the quality of paper used to produce currency did not change between 1939 and 1957. In checking with the U.S. Bureau of Engraving, I discovered that fold tests had indeed been performed on paper currency as part of their quality control program, and data going back to 1934 revealed no changes in these folding test results between 1939 and 1957. However, in 1957 the Bureau began to add a melamine-formaldehyde resin additive that doubled the durability of the paper used to print currency. By the mid-1960s, a large percentage of the currency stock consisted of the stronger paper, suggesting almost a doubling of the number of physical transactions that currency could perform. This finding helps clarify Laurent's report that the average lifetime of a unit of currency based on redemption figures had almost doubled between 1939 and 1978. Laurent attributes this increase to the hoarding of large denomination bills which has indeed been growing at an alarming rate. However, in addition to the big bill phenomenon, there is a more direct explanation: namely, that the quality of currency improved dramatically and could thus do more work before retirement.

Raising the average number of physical transactions which could be performed by a unit of currency from 125 to 225, I recalculated my estimates of the irregular sector, as shown in Table 3, column 3. These calculations reveal that in 1976 the irregular sector was almost 22 percent of measured GNP and in 1978 the figure skyrocketed to 33 percent—suggesting a 1976-78 rate of growth in the irregular economy of 91 percent compared with a nominal rate of growth in the regular sector of only 23 percent. This exercise would seem to show that the irregular sector appears to be growing almost four times as fast as the measured sector of the economy.

Alternatively stated, the irregular economy is estimated to have been 19.1 percent of the total economy in 1976 and 26.6 percent of the total economy in 1978. These calculations suggest that the entire economy grew at a nominal rate of 18.5 percent in each of the last two years. Since inflation, as measured by the CPI, rose an average of 7 percent each year, this implies a real growth rate of more than 11 percent for the overall economy. During this period the money supply (measured by currency plus demand deposits plus savings deposits at commercial banks and checkable deposits at nonbank thrift institutions) increased by an average of over 8.5 percent per year, and the federal government produced the largest deficits in history. If these calculations reflect the true state of our economy, is it any wonder that the citizens of the United States are staging a tax revolt and are calling for a limitation on federal spending?

Technical caveats

The foregoing calculations are obviously in need of considerable refinement and I would not be shocked to discover that more elaborate econometric estimates of the irregular economy based on these methods could vary within a range of several hundred billion dollars. But will the final estimates be higher or lower?

The following modifications would produce lower estimates of the irregular economy:

1. The total volume of funds raised in all credit markets by nonfinancial sectors rose by approximately 34 percent between 1976 and 1978. If I attribute the entire rise in demand deposit turnover to the increased activity in credit markets, I reduce my 1978 estimate by $133 billion.

2. Although I excluded "financial centers" from my deposit turnover calculations, it happens that several included "non-financial centers" (particularly those of the sun belt region) are engaging in a growing volume of purely financial activity. Adjustments using more detailed disaggregated turnover series also reduce my estimate.

3. Recent financial innovations have probably induced a larger number of transactions between various types of liquid assets. Adjustments for such an increase again substantially reduce my estimate.

There are also, however, certain other modifications that would produce higher estimates of the irregular economy:

1. If the irregular economy had been 5 percent of GNP in 1939 rather than zero, as assumed in my calculations, my 1978 estimate would have become larger by $140 billion.

2. My calculations assumed that income velocity in the irregular sector was the same as that in the regular sector. If it is substantially larger, as I believe it may well be, this also substantially increases the estimate of income generated in the irregular sector.

3. The debit figures used to calculate deposit turnover exclude United States treasury checks payable at Federal Reserve Banks. As Garvy and Blyn point out, "the bulk of Federal Government payments are not reported in recorded debits." Since the denominator of the transactions/income ratio excludes government payments, whereas the numerator includes them, I have clearly underestimated the size of the ratio and this in turn implies an underestimation of the irregular economy.

4. A similar underreporting of the turnover figure arises from the fact that it is calculated by dividing debits by gross demand deposits (which include float). As Garvy and Blyn point out, "actual rates of net deposit turnover are thus significantly higher." Once again, use of a net figure would raise my estimate of the irregular economy.

5. The entire analysis has understated the size of the irregular sector by excluding all barter transactions. While I have no present idea of the size of barter, anecdotal evidence reported in the *Wall Street Journal* suggests that barter is now widely used by corporations, as well as individuals, as a means of settling payments.

I am sure that I have only scratched the surface of factors which affect the size of the irregular economy. I look forward to a heated debate over just how large the irregular economy has become. But I will stick my neck out here to predict that when the dust settles, there will be reasonable agreement that it is large enough to demand attention and it is still rapidly growing.

Some implications

If we take the foregoing estimates as informative, the unavoidable implication is that the key bodies of data on which the government relies to formulate economic policy are giving false signals.

First, if the irregular economy is growing faster than the official economy, and real resources are being shifted from the latter to the former—as a result perhaps of higher taxes, increased regulation, or simply greater uncertainty on the part of the public attempting to defend itself against the onslaught of perceived inflation—then clearly *the official statistics on income will grossly understate the true growth of the overall economy.*

Second, *official unemployment statistics are almost certain to overestimate the true situation.* Thus, policy-makers earnestly committed to "full employment policies," by maintaining stimulation to an economy they believe to be failing, may simply exacerbate the inflation situation in pursuit of a misspecified goal. Some $11 billion of government expenditures each year, for instance, are automatically triggered by increases in observed unemployment rates. If the data triggering these expenditures are overestimates of the true unemployment in the economy, this type of automatic stabiliza-

tion may result instead in automatic destabilization.

Third, *the official inflation statistics are themselves likely to be substantial overestimates.*

Workers in the irregular sector take home their total pay, whereas workers in the regular sector pay substantial taxes out of their gross wages. When the two labor markets are in equilibrium, wages—and thus prices—will be lower in the irregular economy. But, since the growth rate in the irregular sector seems to be higher than in the regular sector, the prices must be even lower than they would be if the growth rates were equal, in order to compensate formerly law-abiding citizens for the increased risk associated with irregular transactions. To make matters worse yet, the shifting of resources from the official sector to the irregular sector will reduce the growth rate of output in the official sector faster than demand for these goods may fall, with the result that the prices in the official sector will be observed to be rising still faster than the rate that would prevail if the two economies were in equilibrium.

What picture do our official statistics paint of our economy in the past decade? It is an economy characterized by "stagflation"—slow growth in the face of high unemployment and high inflation —the most vexing current problem for the economics profession and policy-makers alike. While a myriad of largely ad hoc theories have attempted to arrive at models which will produce stagflation results, there is still a gnawing feeling that stagflation flies in the face of most received economic doctrine. My results make me suspect that stagflation is, in part, a statistical artifact resulting from systematic biases in our official statistics that arise from collecting and reporting data on a continually declining fraction of total economic activity.

If this is the case, the implications are of the greatest importance not only for the magnitudes we must watch in making macroeconomic policy but also for the whole range of policies connected with the distribution of income and the efficiency with which the economy produces and allocates resources. We have almost no idea who the major participants are in this large irregular economy that exists unmeasured in our midst, nor who its winners and losers are. We thus have no idea how far off our tax and transfer system is from meeting its intended equity goals. We do know, however, from Ferman's pioneering survey of irregular activities that it would be highly premature to assume that ghetto youths or welfare recipients are the primary beneficiaries of this irregular income, anecdotal evidence concerning "hustling" notwithstanding.

Let me be clear about what I am claiming. I do not deny that we are experiencing serious inflation in certain sectors—food, energy, housing, and medical care being the prime examples. What I am asserting is that the true inflation rate, which would include all goods and services produced by the economy (regular and irregular), is clearly below the reported rate and that the true inflation we are experiencing may be more akin than has so far been recognized to a traditional demand pull inflation due to an overheated total economy which includes both sectors. There is no question in my mind that the falling dollar and the supply shocks induced by the OPEC oil cartel are real factors, but these shocks to the economy have probably been reinforced by well-intentioned government policy, which seeks to maintain an adequate rate of growth in real income but which is misled by its own statistics concerning the extent and the nature of the economic slowdown.

The irregular economy also has major implications for economic efficiency. Barter, of course, is a highly inefficient means of conducting economic intercourse, entailing high costs of transactions and information gathering. Irregular monetary transactions are also likely to entail substantial information costs leading to a significant decline in productivity when total time expended in conducting the exchanges is correctly measured. In short, a large irregular economy has major implications for stabilization policy, income distribution, and the efficiency with which the economic order seeks to fulfill its prescribed functions.

I wish to note that I began this investigation suspecting that the irregular economy was smaller than previous estimates had suggested. I am now convinced that the irregular economy is indeed of staggering proportions and growing rapidly. It is, moreover, a phenomenon affecting all the developed nations of the world. It is my hope that more refined estimates and a deeper understanding of the full implications of the irregular economy for stabilization, distribution, and efficiency will motivate a reexamination of our conventional data base and will perhaps induce significant changes in our current national accounting conventions. This pro-

cess has already begun—witness the dropping of the wholesale price index due to its problems with double counting, and the preliminary Report of the National Commission on Employment and Unemployment Statistics which examines the official data on labor statistics. The Current Population Survey data show that the nonresponse rate on the income question has been rising steadily in recent years and now has reached almost 20 percent. Finally, comparisons between adjusted gross income derived from tax returns and income data reveal that $60 billion of "measured" income went unreported to the Internal Revenue Service in 1976.

I am optimistic that a data base appropriately modified to include the irregular sector will permit a reconciliation of some of the anomalies that have plagued the economics profession in the past decade. Such a data base will, I confidently hope, lead to a more realistic perspective on the nation's distribution of income and provide a more reliable foundation on which to rest the formulation of public policy. This stands as one of the major challenges to our profession. I suspect that when it is completed, we shall discover that our nation's economic health is far better than has previously been believed. Moreover, a return to policy decisions based on reliable data is sure to improve the prospects for the future.

What policy implications follow from this analysis of the irregular economy? First and foremost, we must devise policies that will substantially broaden both the data base and the tax base to include at least a significant portion of what has become the irregular economy. By so doing, we will not only arrest its growth rate but perhaps shrink its size. Because the irregular economy escapes taxation it can now easily compete with the regular sector. By reducing taxes in the regular economy and taxing the irregular economy correspondingly, we can reduce the incentives to enter it, increase the penalties for its current participants, and reward the compliant taxpayer with a richly deserved tax break.

We must also seriously contemplate legalizing the production of illegal goods and services as currently defined. This process has already begun in the area of gambling and has received considerable support in the area of marijuana use. Legalizing the production and distribution of illegal goods and services will free presently employed law enforcement agents, who can then be retrained to become tax law enforcement agents, without necessarily increasing overall enforcement expenditures. By significantly reducing the incentives to join the irregular economy and by substantially increasing the costs of participating in it through taxation we can, I believe, not only arrest its growth, but perhaps more significantly reestablish a sense of justice and equity in the tax administration which is perhaps the only way in which tax reform—long called for, but tenaciously resisted politically—can become a legislative reality.

Total government tax receipts now amount to 32 percent of total GNP. If an additional $500 billion of irregular GNP can be reintroduced into the structure of our tax system, we could reduce overall government tax receipts to only 28 percent of total GNP and still completely eliminate the current budget deficit. Such a move would do wonders to puncture inflationary expectations and would, I believe, significantly reduce the rate of inflation. A strengthened dollar would not be far behind, nor would it require massive interventions in the foreign exchange market.

Is this all pie in the sky? I doubt it. By constructing a more realistic data base to reflect the economic realities of our present situation, we gain the advantage of an informed macroeconomic policy. By broadening the tax base, simplifying the tax code, and ensuring equity of tax treatment, we can reestablish some semblance of confidence in government administration and significantly reduce the incentives for special interest groups to badger legislators into yet another special exemption. By widely disseminating scientific findings on the health hazards of drugs and prostitution, as we now do for smoking and food additives, we can create an informed public with the free choice to determine its own consumption pattern.

If we can arrest the accelerating inflation, strengthen the dollar, and reduce taxes on the compliant taxpayer, surely this is a proposal that at least merits serious scrutiny. Much, of course, depends upon how large we believe the irregular economy to be, and how readily we can regularize it. I, for one, believe it to be large enough to merit our attention and responsive enough to economic incentives to cause it to retreat as quickly as it has advanced. After all, the power to tax is the power to destroy.