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Statement by

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Member

Board of Governors of the Federal Reserve System

before the

Subcommittee on Oversight

of the Committee on Ways and Means

United States House of Representatives

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I appreciate the opportunity to appear before this subcommittee to discuss the recent study by the Internal Revenue Service on unreported income. In view of the technical issues involved in this study, I have asked some staff members from the Federal Reserve System to be present today. Mr. Chairman, I would like to introduce to you and the other members of the subcommittee, Mr. Jared Enzler, Mr. Richard Porter, Mr. James Stull and Mr. William Wallace from the Board staff and Mr. Robert Laurent from the Federal Reserve Bank of Chicago, who will answer any technical questions that you may have.

Activities giving rise to unreported income, whether earned from legal or illegal sources, have been called the underground economy. The scope and nature of the underground economy has an important bearing on U.S. tax policy and also may be relevant to the understanding of developments in the economy and financial markets. For these reasons, the Board welcomes any efforts that may be made to measure the extent of the underground economy.

Underground activity by its very nature is difficult to measure directly. As a result, economists have resorted to various indirect methods of estimation. One much-discussed method which is evaluated in the IRS study--and one which I understand that you would like us to comment upon--uses the ratio of currency in circulation to demand deposits to extract estimates of the size of underground economic activity. According to this approach, movements in this ratio from its value in the years 1937-1941 have been interpreted as reflecting changes in the underground economy exclusively. However, there are significant analytical and measurement problems in drawing inferences about underground activity on the basis of movements in the ratio of currency to demand deposits.

First of all, even though the Federal Reserve's data on currency and demand deposits are highly accurate and measured on a consistent basis over time, there are no reliable estimates on what portion of the U.S. currency in circulation is held in the United States and what portion is held abroad. U.S. currency balances may be held abroad as a store of wealth and, in a few countries, such balances evidently even serve as a major medium of exchange. Therefore, fluctuations in the currency ratio may reflect changes in economic and political conditions abroad.

Apart from variations resulting from currency held abroad, movements in the currency to deposit ratio also reflect domestic above-ground economic activity. In fact, as the IRS study noted, research by the Federal Reserve staff indicates that both the trend and cyclical movements in the currency to deposit ratio over most of the 1960s and 1970s can be explained adequately by movements in real income and consumption expenditures, prices, and interest rates -- variables which are recognized as important determinants of currency and deposit holdings.

Since mid-1974, however, the currency to deposit ratio has moved up more sharply than can be accounted for by movements in those determinants. The increase in the ratio appears to be a result of a downward shift in the demand for demand deposits and not an upward shift in the demand for currency. Currency holdings continue to be predicted accurately by movements in real consumption expenditures, prices, and interest rates. The weakness in demand deposit growth, on the other hand, appears to be associated with a variety of new developments in the money market. For households, innovations such as NOW accounts, ATS accounts, and money market mutual funds have become increasingly important substitutes for demand deposits. For business firms, sluggish deposit growth has reflected the growing use of cash management techniques and deposit substitutes such as security repurchase agreements.

Thus, there are plausible explanations of the post World War II rise in the ratio of currency to deposits which do not rely on the growth of an underground economy. I do not mean to imply that the underground economy does not exist or that currency is not used more extensively as a medium of exchange for underground transactions. The point is that other factors affect the currency to deposit ratio, and they must be taken into account when separating above-ground currency holdings from underground currency holdings.

Moreover, even if this separation could be accomplished with precision, it is by no means clear what magnitude of underground GNP is associated with underground currency holdings. Presumably, underground currency holders are somewhat restricted from exchanging currency for demand deposits or for interest-bearing assets. Therefore, it is quite possible that the income velocity of underground currency is less than that of above-ground currency, where there are no restrictions on such exchanges.

Finally, whatever the advantages and problems with the currency-based approach to estimating the underground activity, it is obviously useful to try to estimate underground activity directly, as the IRS has done in its study. The approach taken by the IRS appears to be helpful and merits careful consideration.

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