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The Moral and Practical Dilemmas of an Underground Economy

Richard A. Epstein[†]

All sorts of activities, some desirable and some unsavory, are part of the underground economy. The physician who takes cash for a Saturday office visit is working off the books; so is the waiter who reports some but not all tips as income; so too is the maid who pays no taxes on her wages. But the underground economy is far more vast than these examples suggest, for it embraces much more than the unreported, unrecorded, or informal economy.¹ It includes industries that rely on illegal aliens and businesses that are completely outlawed, such as the trade in narcotic drugs. Indeed the trade in medicinal drugs belongs on the list, for medicines that are banned in the United States but licensed overseas are doubtless smuggled into this country for use by desperate patients. Surely one could multiply this list of examples many times over.

This Essay will not, however, try to describe the scope of the underground economy or the kinds of activities that compose it. Both topics raise empirical questions better left to specialists. Instead, this Essay will confront two questions. The first, addressed in Part I, is normative: Is an underground economy good or bad, and why? The second question, discussed in Part II, is a combination of normative and descriptive: Are the legal prohibitions on specific underground activities counterproductive? To understand how approaches to the underground economy work in practice, we must supplement our basic normative intuitions with concrete examples.

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1. These terms are taken from GREGORY K. SCHOEPPLE ET AL., SECRETARIA DEL TRABAJO Y PREVISION SOCIAL DE MEXICO & U.S. DEP'T OF LABOR, THE UNDERGROUND ECONOMY IN THE UNITED STATES 2,4 (1992), cited and discussed in George L. Priest, *The Ambiguous Moral Foundations of the Underground Economy*, 103 YALE L.J. 2259, 2259 n.1 (1994). Note that the Department of Labor finds some fine-spun differences among these three classes of activities. The unreported economy seeks to evade the tax code, the unrecorded economy avoids government statistical compilations, and the informal economy avoids licenses and other forms of administrative review. In truth, the differences among these forms of illegality are quite small, for in all cases the government has announced that the activity in question would be legal if the party in question were prepared to pay a price, either directly (by paying taxes and licensing fees) or indirectly (by complying with burdensome regulations and the like).

I. THE NORMATIVE DIMENSION

A. *A Parasitic Question*

The normative question has no easy answer. As the heterogeneous list of examples above indicates, a great deal depends on what activities are being driven underground and why. Furthermore, one needs some critical distance from the current legal system to ask the question. If one thought that all of our current laws were just and appropriate, one would have to condemn the underground economy as an unfortunate result of imperfect law enforcement. It is precisely because there is some tension between the world as it is and the world as it ought to be that the question—What, if anything, should we do about the underground economy?—has any bite at all. The underground economy is a challenge to the legal order by those who refuse to obey its commands. The simple but persistent question is: What alternative to the status quo should we consider? One path asks whether further coercion is required to make violators comply with the law.² The other path asks whether it is best to relax the norms, so that activities now underground will rise to the surface and receive the protection of the law.

There can be no uniform answer to these questions, for everything depends on which underground activity is the focus of attention. To proceed, we must set forth our initial assumptions about what conduct is right and wrong. The more laws there are on the books, the more people will deviate from them and the larger the underground economy will be. Allow free trade in ivory tusks, and there will no longer be an underground economy in the sale of ivory. Allow racetrack betting, and the bookie business will become respectable. Repeal a minimum-wage or maximum-hours law, and sweatshops will come out into the open. Legalize immigration (surely a related issue), and the Haitians and Mexicans will walk proudly through the front door instead of sneaking in through the back.

It would be a mistake, however, to assume that the way to eliminate the underground economy is simply to remove all legal prohibitions. The suggestion is a little like abolishing the institution of marriage in order to eliminate adultery. A world in which all conduct was legalized would not be a world in which all persons had equal liberty to pursue their private ends. Violence and fraud would reign in a lawless world, and human flourishing would likely be stunted if not destroyed. Uneasiness about the underground economy does not go so far that we are prepared to improve the operation of the market for hit men by enforcing their contracts in open court. Nor should we repeal all laws against toxic dumping so that midnight dumpers can freely

2. For a clear illustration of this approach, see Lora Jo Foo, *The Vulnerable and Exploitable Immigrant Workforce and the Need for Strengthening Worker Protective Legislation*, 103 YALE L.J. 2179 (1994).

pollute the nation's water supply. Nor would most people advocate state enforcement of cartel agreements to spare cartel members the cost of concealing their activities or rigging their markets.

None of these examples of liberalization looks particularly attractive; the choice of illustrations gives clues to the reasons why. The appropriate response to the underground economy depends upon what conduct should be illegal. But the issue is complex, because there is far more to the inquiry than a categorical distinction between legal and illegal conduct. There is also the broad range of questions about whether legal conduct should be subject to taxes or regulations so onerous that they drive the activity underground. To take a position on the underground economy, one must consider these intermediate positions as well.

At this point the discussion of the novel issues of the underground economy veers back into familiar paths. Answer first the fundamental questions of normative right and wrong, and the attitudes toward the underground economy come much more sharply into focus. My view of the size and scope of government activities deviates sharply from the outlooks and philosophies that dominate modern systems of government and regulation.³ I do not believe that a just society is one that has no coercive laws. I do think that the prohibition against force and fraud is the central component of a just order. The classical social contract theorists, although wrong about many details, understood the basic trade-off that marks the movement from a state of nature to a civil society: each person renounces his right to use force in exchange for a like promise from all other persons. Parallel arguments apply to fraud and defamation.

The verb "renounce" makes it appear as if each citizen accepts a single definitive set of terms, in much the same way that each person who buys a condominium or a share of stock accepts the rules of association or incorporation set out by the promoter. The social contract, however, is not a voluntary arrangement but a heuristic device. What drives the model is the confidence that each person who is forced to enter into this arrangement winds up better off, because he values his own life far more than the ostensible right to take the life of another individual. For these purposes, the law of restitution or quasi-contract offers a far better home for social contract theory than does the law of contract pure and simple. A system of collective coercion is therefore necessary to determine that portion of natural liberty that each person is required to surrender and to set the rights that each receives in exchange. Taxation and regulation are surely appropriate to enforce the basic deal: that is, to raise the revenues to organize police, defense, and courts. Yet even after the law imposes these modest limits upon absolute autonomy for all persons, the remaining area of liberty is vast indeed.

3. See, e.g., RICHARD A. EPSTEIN, *TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN* 281 (1985) (arguing that courts should strike down the full range of New Deal legislation).

A society of this sort has a strong system of tort law, and its most important component is that which we take for granted: the cardinal sin is deliberate trespass against the person or property of another. A second-tier norm prohibits people from using force to impede business or personal relations. The one difficult issue under this system is the treatment of contracts in restraint of trade. The best response to this problem is not to create either public or private rights of action against the wrongdoer, but rather to rely on public unwillingness to enforce these contracts, which will therefore collapse under their own weight. The set of rules necessary to support these legal institutions of tort and contract are not trivial. Tort covers pollution, and rules that regulate or tax the discharge or transportation of toxic substances may be appropriate, indeed necessary, where private rights of action are cumbersome and uncertain. Similarly, contract covers all forms of property and labor. The law often needs contractual formalities to prevent fraud or misunderstanding. And recordation is often desirable to prevent various forms of double-dealing that could otherwise undermine the security of transactions. No one should suppose that the laws necessary to regulate these arrangements are short or altogether simple. But they would be far simpler than they have become if the law focused on these two major goals: preventing aggression through tort law, and facilitating gains from trade through contract law.⁴

This world view leads to a massive contraction in the role of the state, and, as noted, makes the question of policing the underground economy far less intractable than it is in the status quo. This approach does not, however, answer all questions. The problems are twofold. First, the model of the minimal state does not speak clearly to the question of whether certain forms of conduct (e.g., prostitution or drugs) should be legal or illegal and, if legal, whether they should be taxed or regulated. Even the so-called minimal state is far removed from no state at all. Second, we do not write on a clean slate. We must make decisions in the context of ongoing government programs and concerns which cannot be easily changed or ignored. For instance, the strong case for immigration is complicated by the existence of welfare and free public education. In short, we live in a world of the second best. I suspect that some of the ambiguities of the underground economy would persist even in an ideal world, yet other issues become far more difficult in the world as it is currently operated.

B. *The Personal Dilemmas of an Underground Economy*

The previous discussion looked at the underground economy from a grand social perspective. It asked what legal rules society should adopt in order to

4. For an extensive defense of this world view, see RICHARD A. EPSTEIN, *SIMPLE RULES FOR A COMPLEX WORLD* (forthcoming 1995).

minimize the sum of the costs of allowing illegal activities and the costs of preventing them. At one level, this is an inquiry into the economic costs and benefits of driving, or not driving, certain activities underground. A narrow economic focus, however, misses much of the social dynamic of any ongoing government program. It is easy to assume that reforms touted as economically efficient must be morally suspect; why else would people go to such pains to trumpet the distinction between instrumental and moral values? This opposition, however, is not only overdrawn, but fundamentally misguided. The dangers that current overenforcement of legal norms creates are not only economic, but also moral. Overenforcement heightens the level of social demoralization and anomie, to the distress of liberals and conservatives alike.

One of the major problems associated with maintaining a just civil order is that of assurance. How do I know that, when I obey the law, other people will obey it as well? The issue here is not unique to large social arrangements; it infects each and every social arrangement that requires cooperative behavior among parties. The routine executory contract also involves mutual assurance that if *A* performs first, he can count on legal force to insure that *B* will perform thereafter. If the second stage cannot be secured then the first will not be undertaken; the entire arrangement unravels, and all potential gains from trade are lost. If *B* can obtain *A*'s performance under contract and then avoid the obligation for return performance, so much the better for her—in the short run. But strategies of this sort do not work twice, even if they work once. It is in the interest of all sides to have strong contracts, and strong contracts depend on public coercion.

Complex social arrangements are, if anything, more fragile than bilateral contracts, and it is here that the underground economy takes its moral toll. Let us suppose that two individuals are competing with each other. One prerequisite for a level playing field is that both parties be bound by the same legal rules and constraints. A system which requires *B* to labor under restrictions that do not bind his rival *A* is patently unfair and has consequent corrosive effects on moral sentiments. The formal law cannot tolerate such invidious distinctions. But the issue goes beyond the question of formalities and also reaches the question of compliance. Assume that there is a heavy tax or an inspection requirement imposed on *A* and *B*. The obligation is heavy, so *A* decides that it is better to venture off into the underground economy than to comply. He hires workers off the books or disposes of his solid wastes in a clandestine fashion, no questions asked. What now is *B* to do? We all know what the "right" answer is: *B* should continue to comply with the law because it is the law, and the breach of the obligation by *A* does not justify a parallel breach by *B*. Socrates would have insisted that all obligations are unconditional, such that *A*'s nonperformance of his duty does not excuse *B* from performing hers. *B*'s remedy (if there is one) lies in the effective enforcement of the law against *A*. Once *A*'s deviation from the law is

punished, *B* is left with the net advantage from compliance. *A* will know that this will happen and will not deviate in the first place, and the right equilibrium emerges.

It is a pretty picture, but it presupposes what we know is not the case. The system of enforcement is likely to be rickety and uncertain. *A* may well escape both the burden of the obligation and the sting of its enforcement. Crime now pays, and *B* finds herself at a competitive disadvantage because she has obeyed the law. She is now faced with the sort of dilemma that no citizen should ever have to face: comply with the law and be driven out of business, or cheat in order to keep up with the competition. What *B* will do is unclear. But if *C* and *D* decide to imitate *A*, then *B*'s position will soon become more precarious. And if they do not, then *B* has a chance to gain a big advantage for herself by imitating *A*. Either way, when large numbers are involved, the entire system starts to unravel, and everyone has a plausible social defense: "We had to do it to stay in business, in order to meet the competition."

How then will the public react to these excuses? A good deal depends on the perceived justice of the situation. If *A* and *B* decide to act illegally when taxes are low, when regulations are reasonable, and when contracts are fully enforceable, they are stripped of much of the rhetorical protection behind which they otherwise could take refuge. They start to look greedy rather than beleaguered. The set of informal social sanctions begins to undermine their behavior rather than prop it up. But if the rules in question are perceived as genuinely stupid and perverse, as all too many rules are, then public cynicism will undermine the moral force of the legal system, sapping just laws as well as unjust ones.

Society must, therefore, develop a moral climate in which we offer as few soothing excuses and rationalizations for illegal conduct as possible. To do that, government must avoid the excesses of regulation that have become part and parcel of the modern legal order. We must not pass laws that disrupt the operation of normal competitive markets. We must minimize the level of progressive and special taxes. We must ensure that fines for environmental and similar harms are in proportion to the harms caused, and not greatly in excess of the damage created. And we must stop the endless cycle of saying that the use of subsidy (treatment, protection, or whatever) justifies the need for coercive restriction at the opposite end. If the government took these steps, the question of the underground economy would not disappear; only the elimination of law could achieve so utopian a result. But because people would have greater respect for the legal rules, the underground economy would dwindle.

The levels of difficulty extend to yet another issue. What should public officials do when charged with the enforcement of a widely disobeyed law? It is cheap to pass a statute that imposes certain legal requirements on routine transactions, but it is costly to adopt a set of administrative procedures that can

curtail violations of the statute. Often, the individuals affected see little reason why they should be forced to comply in the first place. The leading illustration of this today is Social Security, where there is ample evidence of widespread noncompliance with the law but little direct enforcement against the violators. The parties to the transaction find it advantageous to keep the transaction off the books, since the taxes collected benefit not the employee⁵ but rather third persons, namely those who are already receiving Social Security funds. One could try to enforce the law comprehensively, but enforcing this obligation *ex ante* is problematic: The combination of taxes and administrative expenses could easily exceed the gains from trade (that is, the sum of employer and employee surplus), in which case the transaction would never take place. The government would not get its Social Security taxes and, in addition, would stand to lose revenues from the overall decline in economic activity and the rise in the level of welfare and unemployment compensation.

This crumbling tax system has some unhappy consequences. The first is the evident unfairness that results when some people comply with the tax and others do not. Compliance with the law will unravel. In addition, society faces the peril of official discretion or informal enforcement of the system. It is always possible for government officials to focus their attention on selected individuals who doth protest too much or who have had other run-ins with the government. Furthermore, the violations in question, while often not remediable within the legal system, can give rise to a set of informal sanctions that are far more devastating. For example, Zoë Baird was trapped by the system when her nonpayment of Social Security taxes was used to block her appointment as Attorney General. The inevitable sanctions amounted not only to the payment of the back taxes owed, but also to public humiliation and disgrace. The collateral consequence, namely the exclusion of many qualified persons from public service, is scarcely any better. It is fair to ask whether this system makes any sense at all. A rule that simply kept domestic servants off Social Security would avoid many of these consequences and would hurt only those individuals who hope to prosper off the contributions of others.

5. The basic problems with Social Security are, however, not anecdotal but structural. Because no one has any secure property rights to money that is paid into Social Security, political forces are able to redistribute massive amounts of wealth from the young to the old. As a result, this state-created Ponzi scheme may stop functioning before today's young workers grow old. I favor a system that allows individual workers and their employers to decide how much money to set aside and how to invest that money. But even if the government should make people save, it hardly follows that it should run any portion of the retirement fund. The government could require individual contributions to retirement funds run by private investment companies. I know that Fidelity and Vanguard will honor their obligations. I have no such confidence in the Social Security system.

II. EXAMPLES OF THE UNDERGROUND ECONOMY

I have already spoken enough in general language about the issue of the underground economy. It is now useful to give a few examples of how this approach might operate in various contexts. My approach is to begin with those cases in which some form of government intervention is appropriate, so that the issue of whether too many industries are being driven underground will receive a cautious and not a categorical approach. The first class of examples, in Section A, deals with the maintenance of various kinds of common property—public streets and sidewalks in the one case, wild animals in the other. Section B focuses on the question of the optimal form and level of taxation in light of the risks posed by the underground economy. Section C addresses the proper form of tort law, most specifically the prohibitions against pollution, in light of these same risks. The last two sections deal with quite different problems. Section D attacks the creation of *any* underground economy by either rent control or minimum-wage laws. Section E, most controversially and least completely, addresses the illegal market in drugs. It proposes not only the decriminalization of illicit substances but also the *removal* of the subsidies for drug addiction that our system mistakenly provides.

A. *Violations of the Commons*

1. *Street Vendors on Public Ways*

Regina Austin devotes her essay to a discussion of one form of the informal, but hardly underground, economy—the street vendors who operate often thriving businesses in such major metropolitan centers as Philadelphia and New York, or in smaller settings, such as Berkeley, California.⁶ Her approach focuses on race: Is the underground economy good for blacks? Austin notes that many blacks are shut out of mainstream businesses by poor education, racial prejudice, inability to raise capital, and inability to navigate the system of permits and requirements. With my general bias against regulations of all types, one might think that I should share Austin's unalloyed sympathy with the street vendors, albeit for somewhat different reasons.

In truth, however, the situation is complex. The streets and sidewalks of any city are part of a commons; they are not private property. The standard problem of the commons is to decide how its use should be allocated among many citizens. The issue is not all that different from one that arises in joint tenancy, where the question is how to allocate the benefits and burdens among

6. Regina Austin, "An Honest Living": *Street Vendors, Municipal Regulation, and the Black Public Sphere*, 103 YALE L.J. 2119 (1994).

co-owners, especially where the instrument creating the joint tenancy is silent.⁷ The law seeks to match contributions and benefits, so that a tenant in possession, for example, must normally bear the costs of repairs and taxes attributable to that property, relative to a co-tenant who is not in possession.

The question of allocation of costs and benefits of public ways is similar. The retail merchants who own or lease private property have to pay taxes, which go to the enforcement of a civil order that could (but need not) work to the benefit of the street vendors as well as the store owners. The government's inability to collect similar rentals from the street vendor results in an implicit subsidy of street vending, which in turn suggests that there will be too many street vendors and too few stores to support them. In the long run, viable businesses that contribute to the public welfare could go out of business if they are forced to compete on even terms with the vendors that they subsidize. Furthermore, street vendors often set up their booths in locations that block ingress and egress from retail stores, and some vendors harass prospective retail buyers, both of which count as unfair competition with the established stores.

Yet it is not clear what form the remedy ought to take. Saskia Sassen shows commendable ambivalence toward the underground economy when she argues that we should find ways "to induce an 'upgrading' of informal activities by bringing these activities within the regulatory framework while minimizing costs to entrepreneurs."⁸ Throughout her essay, Sassen shows the same reluctant admiration for the resilience of the underground that characterizes Austin's essay. Yet her own proposal downplays the cost of regulation. Any system of regulation will raise costs for the entrepreneurs. The social question therefore is not whether these regulations impose significant costs, but whether the costs that they impose are justified by the benefits that they create. In addition, we should be skeptical of claims that any system of government regulation can "upgrade" regulated activities. Merchants are better at self-improvement than the government is in guiding their efforts; the government need only safeguard property rights, to assure merchants that they will reap the fruits of their long-term investments.⁹ The effort to fine-tune regulations is likely to degenerate into a set of partisan pressures that will only hurt the very entrepreneurs whom Sassen wishes to help.

With all this said, the question is how one can apply Sassen's program to Austin's problem of the street vendors. A ban on all street vendors could be

7. Cf. 2 AMERICAN LAW OF PROPERTY § 6.14 (A. James Casner ed., 1952); *Mastbaum v. Mastbaum*, 9 A.2d 51 (N.J. Ch. 1939).

8. Saskia Sassen, *The Informal Economy: Between New Developments and Old Regulations*, 103 YALE L.J. 2289, 2302 (1994).

9. The problem of insecurity of property rights is evident in Eastern Europe, and it may account for the transitional difficulties from the old to the new social order. See Richard A. Epstein, *All Quiet on the Eastern Front*, 58 U. CHI. L. REV. 555 (1991).

far too extreme, notwithstanding their frequent misdeeds. Part of their success may result not from any unfair advantage but from their entrepreneurial ability to provide low-cost goods desired by loyal customers.¹⁰ A system that forbade harassment, that confined vending to discrete locations on business streets or in separate districts not abutting stores, that required vendors to pay for police protection, and that collected sales taxes could be far better than simply excluding vendors from the public way. I am not sure what mix of remedies is desirable, but I would reject Austin's racial focus. We must not bend the rules of public access and public support to favor members of one racial or economic group over another. Ideally, each party should bear a tax burden that is smaller than the benefits that the state provides to him, with the surplus divided in proportion to each participant's contribution to the overall public venture.¹¹ Thus, proportionality is the key to the treatment of public goods. But regardless of how well-proportioned taxes are to benefits, as long as some level of taxation is necessary to support public goods, we should expect some underground economy to survive.

2. *Elephant Tusks and Eagle Feathers: Prohibiting Trade in a World of Common Property*

The second illustration of the public goods problem comes from a very different quarter. Today, there is an international ban on the sale of ivory.¹² The logic behind the ban is clear: Elephants are an endangered species, much prized for the value of their tusks. The one party who kills the animal and sells the tusks in some secondary market reaps that value for himself. The basic intuition is that if the tusks cannot be sold, then the animals will not be slaughtered and the herd can be protected from extinction. Let us postulate that biodiversity is important, whether for instrumental reasons (more natural compounds from which to find medicines) or moral reasons (stewardship of the earth requires preservation of other species).¹³ The only concern here is with the means-to-ends argument: Does the prohibition on sale achieve the desired end?

A similar argument has been developed with respect to eagle feathers: a prohibition against their sale is justified as a way of preventing the endangered species from being shot.¹⁴ And in some cases the prohibition involves overkill (to use a bad pun), in that the ban extends to eagle feathers that were collected

10. See Austin, *supra* note 6, at 2123-24.

11. For a detailed defense of this proposition, see RICHARD A. EPSTEIN, *BARGAINING WITH THE STATE* (1993).

12. Mort Rosenblum, *International Ban on Ivory Trade Approved*, ST. PETERSBURG TIMES, Oct. 18, 1989, at 6A.

13. See generally EDWARD O. WILSON, *BIODIVERSITY* (1988).

14. *Andrus v. Allard*, 444 U.S. 51 (1979); see Susan Rose-Ackerman, *Inalienability and the Theory of Property Rights*, 85 COLUM. L. REV. 931 (1985).

from birds killed long before the prohibition was enacted. The reason here is that unless the sale of all eagle feathers is banned, hunters of new feathers will sell them as old ones and thus defeat the prohibition. The argument, quite simply, is that the dangers of underenforcement are greater than those of overenforcement, even if no compensation is tendered, say, to dealers who are overstocked with feathers purchased before the ban was enacted.

The question is whether either of these prohibitions on sales is justified. One argument against both prohibitions is that they create the opportunity for an underground economy. The obvious argument on the other side is that the price is worth paying. The prohibition is backed by legal sanctions, which, when imposed, should reduce the frequency of sales and hence reduce the killing of these endangered species. The question at the margin is whether the costs of increased enforcement are offset by the gain in species preservation, after taking into account the private satisfactions that are enhanced by the purchase of these natural goods. It is the kind of empirical question on which I cannot hazard a responsible answer.

Still, there is a second, conceptual inquiry, one that asks a more fundamental question about the ownership of elephants and eagles: Should that ownership be privatized? One answer is that each of these remains in the original commons, only becoming private property after being captured by some individual hunter. At this point we have a tale of the tragedy of the commons, with the real danger that eagles and elephants will go the way of the buffalo. If no ownership in the wild is the only viable possibility for wild animals, then the debate about the ban on sale surely asks the right question: Is the prohibition sensible in light of the risks of evasion? It is a mistake to assume that matters become easier as regulation becomes more stringent. Harsh regulations bring a different type of person into an industry, tougher and less cooperative than those who operate in ordinary market settings. Landlords in New York under rent control have a terrible reputation because they fight the state and their tenants at the same time. In Chicago, there is no folk culture of the horrendous landlord because the unfettered free market keeps the vacancy rate at five percent.

But must these animals remain subject to the rules of capture, or is there a possible way to provide them with owners in the first place? There is no uniform answer to this question. It is very difficult to find individual owners for eagles, at least in the wild, so the question turns on whether they are able to survive and breed in captivity, which seems difficult indeed. Similarly, for the whale, privatization is not a viable option.¹⁵ But elephants do not fly and hence can be held as private property on rangeland, where they can both survive and breed.

15. Edward Balls, *Trade Bans May Save the Whale, but Not the Elephant*, FIN. TIMES (London), May 24, 1993, at 6.

Once we have established that little bit of biology, the legal norms quickly switch around. It is one thing to prohibit the sale of goods that are made private only by raiding the commons. It is quite another to prohibit the sale of animals, such as Perdue chickens, that one can breed in captivity. Once the elephants are private property, their owners have the right incentives to take into account the long-term nature of the market.¹⁶ The inability to sell the ivory now translates into a diminished desire to raise elephant herds and to tend to them in the first place. The right response is to allow the sale of the ivory in order to encourage the preservation of the species.

The real problem, however, is still more complicated than this, for international organizations do not determine the property rights in animals within national borders. Tanzania, Zambia, Zaire, and the Sudan have no systems of private ownership of elephants and make minimal expenditures on their protection in public parks. As a result, more than 700,000 elephants were slaughtered by poachers during the 1980's.¹⁷ But Zimbabwe, South Africa, Botswana, Namibia, and Malawi do have systems of private ownership of elephants. They claim that they have herds that are too large and that their citizens can cull and harvest the excess animals without endangering the stock.¹⁸ The environmental movement has successfully supported an international ban under the Convention on International Trade in Endangered Species (CITES).¹⁹ As one might expect, the ban does not provide any compensation for countries that are genuinely hurt by the program, but only an exhortation for all nations to contribute funds to help stanch the loss of revenue from those countries that have respected the ban.²⁰ It is not surprising, then, that Zimbabwe has announced its refusal to abide by the international ban.²¹

There is a dynamic element that will in all likelihood shift the balance against the present ban. The international prohibition aids those countries without property rights and tends to harm those which have them by denying them the market return on their investments in the animals. In the long run, the continued existence of property rights systems is likely to be determined, at least in part, by any international prohibition on sales. We should therefore *lift* the ban, to encourage nations to adopt private ownership systems. The law need not endure the formidable problems of regulating the commons, for it is possible to take these animals out of the commons in the first place.

16. See *id.*; see also Randy Simmons & Urs Kreuter, *Wildlife Preservation: Save an Elephant—Buy Ivory*, WASH. POST, Oct. 1, 1989, at D3.

17. See Balls, *supra* note 15.

18. John Vidal, *How the Elephant Lost Its Way*, GUARDIAN, Apr. 3, 1992, at 2.

19. See Philip Weinberg, *International Protection of Endangered Species: The Steps that Should Be Taken*, 3 TOURO J. TRANSNAT'L L. 89, 96 (1992).

20. See *id.* at 98.

21. See *Defying Ban, Zimbabwe To Sell Ivory Stockpile*, J. COM., Dec. 16, 1993, at 3A.

B. *Taxation*

No discussion of the underground economy is complete without some mention of the issue of taxation, both broad-based and special taxes. Here the usual refrain is that high taxes drive various kinds of activities into the underground economy, so that the ratio of taxes paid to taxes owed decreases as the amount of the tax increases. The phenomenon here is not a minor one, nor is it confined to rich persons in high marginal tax brackets. The imposition of Social Security taxes on the first dollar of earned income is itself a sufficient spur for poor workers to flee into the underground economy. Morton Paglin's evidence in this volume suggests that around eight percent of the productive force in the United States operates in the underground economy, and that the ratio of consumption to reported income is highest for persons whose income places them in the lowest twenty percent of the populace.²²

The law has traditionally responded to evasion by imposing higher fines and sanctions on those who evade the system, a tactic that will at best achieve its desired end only in part. Some fraction of the population will cease the activity to avoid the tax (some Social Security recipients do stop working after they reach the level of income allowed under the Social Security system). Some fraction will make greater efforts to avoid the collection of the tax. And some will pay it.

In light of these consequences, what approach should the law take? One option is for public officials to dig in their heels: The law is the law, and those who evade deserve whatever sanction they receive. Since evasion is illegal, the government acts as though it does not take place, except that the government increases the penalties for violations. Proponents of this view would view any reduction of tax levels as a sign of moral weakness, a tactical concession to the illegal conduct of private parties. A second extreme treats the emergence of the underground economy as a manifestation of some pathology and thus wants to lower the taxes as soon as possible. But one must recognize the danger of too much of a good thing. The only way to eliminate tax evasion is to eliminate taxes altogether, for we can always find one person who would rather go underground than pay a dime in taxes. So the middle position is, in the end, the one that seems most defensible. It is necessary to trade off an increase in tax rates against an increase in the level of underground activities. It is doubtful that the optimal position is that which maximizes the total level of net taxes collected from the system—stopping short of that is probably best,

22. Morton Paglin, *The Underground Economy: New Estimates from Household Income and Expenditure Surveys*, 103 YALE L.J. 2239, 2249, 2251 (1994). In fact, the ratio of pre-tax income to consumption rises to the level of 1 to 1 only in the middle quintile. The high level of unreported income in the lower quintile does not include gains from nonmonetary sources. Rather, it reflects the far greater difficulty of collecting taxes from individuals who do not work in the mainstream, that is, those whose employers do not file W-2 forms.

if net social welfare is the proper function.²³ Such an approach recognizes that the removal of temptation is sometimes better than the imposition of heavy punishment for yielding to that temptation.

Yet there is another dimension to the question: All tax structures are not perceived to be equal. Often governments impose special taxes, directed at one industry or group of individuals, that are not justified by any reciprocal governmental benefits provided to that group. One example is a windfall profits tax on gains from the sale of crude oil or natural gas, where the tax revenues are spent for transportation, old age care, or general purposes. An even better example is the luxury tax on jewelry and yachts. Accordingly, the question of evasion has to be judged in some special way. The willingness to evade a tax is at some level a function of the perceived legitimacy of the tax in the eyes of those who are called upon to bear its burdens. On this score, broad-based, low taxes with few discriminatory barbs or special features are likely to be far better than steep progressive taxes or special assessments, both of which single out particular groups of people by wealth or by occupation. And for these purposes it matters relatively little whether those who are *not* subject to these exactions think them legitimate, for their sentiment will not influence the level of attempted evasion from the other side. So here the concern with the underground economy bolsters the case for flat taxes with no gimmicks, which I happily support on other grounds as well.

C. *Pollution Regulation*

There is a booming underground economy in waste removal—no questions asked and cash on the barrel head, please. But the response to this form of underground economy should be closer to that of common pool questions and less like that of minimum wages and rent control. The key point here is that an optimal legal system would not treat pollution as though it were a right, but as a tort, at least after it exceeds some key threshold amount.

Yet the celebration over proper regulatory ends does not exempt all aspects of our current regulatory regime from very sharp condemnation. The mere recognition that pollution is a tort does not give the state carte blanche in the means to cope with it. As a matter of initial principle, the damages that should be charged for pollution should be proportionate to the harm that it causes. The key qualification of this rule is that it is better to let the pollution go unchecked if the damage caused by its emission is smaller than the administrative costs of its rectification. The older common law rules responded

23. The simplest explanation is that the object of a system of taxation is not to maximize tax revenues but, rather, the sum of public and private surplus. Taxation should stop when the gains from the public expenditures are smaller than the private losses imposed. In most settings, the optimal level of taxation is low because there are only a few endeavors in which the government has a comparative advantage over the private sector.

in part to these concerns. A *de minimis* rule probably exempted from tort liability low-level emissions that caused harm to strangers.²⁴ The rules of joint and several liability tended to hold each defendant responsible for the pollution of all other independent tortfeasors and was not sensitive to the number of defendants whose conduct combined to cause the particular harm. Where only two or three parties are involved, the “rounding up” that follows from treating each polluter as the source of the entire harm does not create major dislocations. Joint and several liability may even compensate, albeit imperfectly, for the possibility that one or another of the wrongdoers may escape detection altogether.

But whatever the merits of these rules in traditional tort contexts, they have been carried over into Superfund with uncritical vengeance. Any level of pollution, however small, becomes the source of potential liability that vastly exceeds the harms that it causes. The government has successfully argued that a single defendant may be liable for all existing pollution at a site, even where its own discharges have been orders of magnitude lower than the natural background level of pollutants, and notwithstanding the polluter’s extensive investments in pollution-reduction technology.²⁵ The argument is often made that it is difficult for the government to apportion the losses among multiple tortfeasors. But that theoretical difficulty is not eliminated when the government forces one party to bear the full amount of damages in exchange for receiving the right to sue for an indemnity (not backed by government advantages in litigation) from parties who may be bankrupt or untraceable.

The net effect of these grotesque rules is a system of massive overdeterrence in which private parties are asked to spend thousands of dollars in order to avoid pennies’ worth of environmental harm. The horrible fit between the harm caused and the liability imposed creates an open invitation for massive evasive action. If one will be charged with heavy fines for losses one has not caused, then why not take the risk of dumping somewhat greater quantities of waste, no questions asked? The wrong set of prices for the pollution (not) caused could induce even honest persons to move into the underground economy for all the wrong reasons. The system should avoid these difficulties altogether by ratcheting down the consequences of trivial emissions and bolstering penalties for the discharges that cause substantial external damage. Why move heaven and earth to preserve the taint on conduct that produces no harm? Why force people into an underground market when midnight dumping is likely to produce far more uncompensated harm?

24. For the classical statement of the live and let live rule, see *Bamford v. Turnley*, 122 Eng. Rep. 27, 33 (Ex. Ch. 1862).

25. *E.g.*, *United States v. Alcan Aluminum Corp.*, 964 F.2d 252 (3d Cir. 1992) (holding that defendant could be held liable for all pollution damages, but remanding to determine if harm from discharges was divisible).

D. *Rent Control and Minimum Wages*

Analysis of the next class of examples of an illegal or underground market yields a rather different conclusion. The current system of rent control forces landlords to rent out their premises at prices far below the amounts that these units could command in an unregulated market. Likewise, minimum-wage laws set a floor on wages above that dictated by the interaction between supply and demand. Because we are not concerned with the maintenance of a public space or commons in these situations, the arguments made in the previous Section do not apply. No longer is it appropriate to express caution about the proper regulatory approach; the correct response here is to eliminate the problem of the underground economy by removing the relevant prohibitions.

The rent control situation is well understood and need only be addressed briefly here. The creation of a system of rent control creates enormous opportunities for under-the-table payments to bring supply and demand back into equilibrium. The gains that any individual landlord obtains from illegally renting one unit outside the framework of rent control is all the greater if the other landlords adhere to the prohibition. The difference between official and market prices creates not only queues for units, but also efforts to beat the system—perhaps by paying something under the table to the former tenant or the current landlord in order to get the key to the desired unit.²⁶ In addition, landlords often want to take their units off the rental market, either for owner-occupancy or for sale as a condominium. To stymie these attempts, the aggressive system of rent control makes taking units off the market illegal as well—often bringing innocent landlords into the net woven by the law until it becomes a crime for a landlord to occupy his own apartment.²⁷ Rest assured, however, that no one will ever impose restrictions on the price at which owner-occupied residences can be sold, for the voters will not restrict their own liberty, as opposed to that of a beleaguered landlord.

The question here is what gains there are from the restrictions on market freedom. I see none. In addition to the general moral corrosion that comes from uneven enforcement, the administrative costs of the system are high. Furthermore, the law generates perverse incentives, deterring the construction of new units, which may or may not fall under the regulation. Unlike the cases of natural resources, there is no risk of extinction that follows from an undue

26. See William Tucker, *It's a Rotten Life*, REASON, Feb. 1989, at 22, 22-23.

27. See William Tucker, *Anarchy, State, and Rent Control*, NEW REPUBLIC, Dec. 22, 1986, at 20, 20-21 (detailing the travails which Eric Segal experienced in prying Robert Nozick from a rent-controlled apartment). For the latest in the futile constitutional challenges to rent control, see *Gilbert v. City of Cambridge*, 932 F.2d 51 (1st Cir. 1991). Matters never stay still in the People's Republic of Cambridge. Recently an attempt to propose a statewide referendum to abolish rent control failed to meet the signature requirements to receive space on this year's ballot. See Peter J. Howe, *Bid To Ban Rent Control Appears Shy of '94 Ballot*, BOSTON GLOBE, Dec. 7, 1993, at 58. Here the politics differ, because citizens throughout the state have a far smaller interest in an open market in Cambridge than do the citizens of Cambridge.

respect for the common law rule of capture. Instead, there is an imperfection at the back end of the market that is not justified by the need to protect against any parallel imperfection at the front end of the market. Here is a case where the libertarian norms of free contract work at their strongest, which means that the underground market surrounding the leasing and conversion of rental units represents pure social deadweight loss without any offsetting gain.

Much the same can be said about the minimum-wage and maximum-hour laws, although again one must ask what the imperfections of the legal market turn out to be. If one believes that poor workers are exploited by subminimum wages and that this is an evil that a just society should avoid, then the situation is analogous to the case of wild animals under a rule of capture. The imperfections and costs that are induced by the vigorous enforcement of the labor laws are justified by the huge amount of immoral activity that they prevent. But if one sees low wages as an outgrowth of low productivity and as an opportunity for persons to get into the system, the moral perspective changes. There is no evil to prevent and nothing which justifies the costs.

The call for a renewed enforcement of the minimum-wage laws receives a passionate endorsement in Lora Jo Foo's contribution to this Symposium. Foo advocates the passage and tough enforcement of minimum-wage laws, as well as other forms of health and safety regulation, in order to stamp out the sweatshops that are chronic violators of the labor laws.²⁸ To the extent that her plea is for protection against various forms of intimidation and physical abuse,²⁹ there can be no quarrel with her position. But to the extent that her attack is in favor of strict enforcement of minimum-wage laws, or (with Christian Zolniski³⁰) for a prohibition against contracting out certain forms of unskilled work to independent contractors, it is misplaced.

In the course of her moving account of the garment industry in San Francisco, Foo chronicles a tale of unrelieved gloom. The industry is fiercely competitive, with large numbers of short-lived firms. The fees that they receive from the major garment designers and manufacturers are low and are offered on a take-it-or-leave-it basis. The expected life of one of these firms is just a bit more than one year, and often the principal owners of the firm are at risk of incurring heavy fines and penalties capable of putting a thinly capitalized firm out of business. Notwithstanding these risks and the constant turnover they generate, firms stay in business because the ranks of labor inspectors at the federal and state level are unable to control the huge number of small

28. Foo, *supra* note 2.

29. See *id.* at 2183-84, 2198-99.

30. Christian Zolniski, *The Informal Economy in an Advanced Industrialized Society: Mexican Immigrant Labor in Silicon Valley*, 103 YALE L.J. 2305 (1994). Zolniski notes the decline in real wages in the janitorial industry (from \$7.00 to \$5.50 per hour), which he attributes to subcontracting. *Id.* at 2313-14. But surely some large portion of the decline in wages is attributable to the massive influx of Mexican laborers seeking these positions.

shops that pop up in this underground market. The tough environment in which these small firms work, however, has a powerful effect on their labor force. Wages are low and violations of the minimum-wage laws are rampant. The jobs are often dead-end positions and carry with them no specialized training, no fringe benefits, and no prospects of advancement or promotion. In Foo's view, the entire sweatshop industry is so corrupt that the law should stamp it out unless the firms within it mend their ways by paying living wages to their employees.

This draconian prescription is a recipe for disaster for the very people whom Foo wishes to help. First, the revealed preferences of these workers are at variance with Foo's. She notes that federal and state labor agencies often require firms to comply with minimum-wage laws by issuing back pay to workers in excess of the agreed-upon wage. Yet once the inspectors disappear, the workers return the excess wages. Notwithstanding all of Foo's talk about intimidation, these workers are voluntarily abetting employers in evading the heavy hand of paternalistic regulation. They insist on the enforcement of their legal rights only after a firm has gone under, and then only in the unlikely prospect that it has sufficient assets to satisfy a judgment against it. The persistence of these firms shows that the industry contracts are not the result of surprise, misunderstanding, or fraud. It also shows that these contracts provide gains from trade to both sides of the bargain. The logic of voluntary exchange does not apply only to the rich and the well endowed, but to all workers regardless of their wealth.

Worse still, the spasmodic enforcement of the regulation *worsens* the very conditions that Foo deplors. One reason why this work is subcontracted out is to avoid the sting of regulation. Polo and Ann Klein will not allow themselves to be hit with fines for labor violations that will wipe out the business. So they transfer the obligation to thinly capitalized firms so as to reduce their downside risks. Limited corporate liability thus functions as a limitation on contractual liability in much the same fashion as it does in other areas where freedom of contract is restricted. Good empirical evidence suggests that thinly capitalized firms develop new, dangerous products so that larger companies can avoid the risk of huge tort judgments in an environment in which contractual limitations on damages are prohibited. The same forces are at work here as well.

Working conditions would almost certainly *improve* if the regulations were removed. Firms would no longer fear extermination through inspection. They could increase their size and stability. They could invest in training their workers because the firms would be more likely to survive long enough to reap the gains from their investments. They would no longer need to demand a discount in wages to reflect the uncertainty associated with the business. It is no reply to say that workers demand an increase in wages to reflect their uncertainty as well. The second fact does not negate the first, but only

compounds it and reduces the gains from trade available to both sides of the relationship. Here is one case in which *laissez-faire*, *laissez-aller* is surely correct. It is tragic that Foo advocates a set of legal reforms that hurt the very people whom she wishes to help.

E. *Illegal Drugs*

Thus far, I have concentrated my attention on the unreported or informal economy, but no discussion of the practical and moral dilemmas of the underground economy is complete without at least one forlorn stab at the illegal economy. To be sure, no one with any sense would wish to take a firm position on the trade in illegal drugs, which has led to a booming underground economy free of all taxation and regulation. But for academics without a well-developed sense of prudence, at least some general response is appropriate. For libertarians, the set of prohibitions looks like an obvious target: the government spends massive revenues in order to suppress private consumption choices that are no better and no worse than the preference for fine wine or fatty food. At the very least, there is much to be said in favor of a policy of legalization coupled with taxation, much as is done today with cigarettes. Legalization would reduce the level of private violence in the smuggling and sale of these substances, and taxation would provide needed public revenues to boot.

Yet the proposal, however attractive, runs into a blizzard of opposition by countless government officials and voters, who just want to say no. The underground economy is surely an issue; yet as before, it does not end the discussion but only begins it. One question that must be asked is what society will look like if legalization takes place. Are there sales to minors? Do we maintain the facilities for detoxification of people who overindulge with drugs? Do we allow employers to condition employment, or schools to condition admission, on the willingness to forbear from the use of drugs in the workplace and the school yard, or even in the home? It is not obvious that legalization will produce the desired levels of satisfaction if children, both young and unborn, are exposed to toxic poisons; if drug users act on aggressive impulses; and if huge portions of an otherwise intelligent population become inert. Perils run in both directions.

I have one heretical proposal about how to deal with the issue: Tackle both sides of the issue at the same time—the willingness to create the underground economy by making drug sales illegal, and the willingness to *subsidize* that economy by creating programs that provide assistance and rehabilitation to all those who suffer from drug use. Punish without excuse anyone who commits any independent crime, from murder to shoplifting, while under the influence of drugs, just as we do with alcohol. Punish the sale or distribution of drugs to minors. Punish drug use by pregnant women that results in damage to offspring (and think seriously about sterilization as a credible means to make

sure that it never happens again). Enforce all private agreements that limit the consumption or use of drugs, so that public enforcement is replaced by a private refusal to deal. Remove all other legal prohibitions on the sale and use of drugs. *And* refuse to treat without payment anyone who suffers ill effects from the voluntary use of drugs. It is an open question whether the removal of the penalties would be counterbalanced by the removal of the implicit subsidies for the use of drugs.

And subsidies there most surely are. Current drug policy provides that persons who are reformed alcoholics or reformed drug users are handicapped persons protected by the Americans with Disabilities Act.³¹ The net effect is to give an implicit subsidy to drug use by preventing other persons from refusing to deal with individuals whose past histories suggest that they will have troubled careers. There is no reason to have the state impose criminal sanctions on drug users. It is quite enough to allow private parties to administer their own business sanctions by cutting these individuals out of some fraction of the employment market. The net effect should be to increase the costs of various kinds of addiction and to reduce significantly the likelihood of its occurrence.

The same logic applies to medical care for those who have drug-related afflictions. Viewed *ex ante* this amounts to a subsidy for those who take drugs. So understood, the current policies externalize a very large portion of the cost to society at large. We thus have policies of massive punishment and policies with nearly as massive subsidies; each is run by a major bureaucracy committed to its own policy in isolation but unable and unwilling to look at the combined effect of the creation and then the subsidization of the underground market. A policy that removed most of the sticks and all of the carrots would likely create howls of protest and would surely result (as do current policies) in the death and suffering of many. But in the long term, the policy could work well if it reduced the number of people who become addicts in the first place. Ratcheting down on both coercion and subsidy looks preferable to today's futile effort to maintain both programs at a fever pitch and at public expense.

III. CONCLUSION

This brief tour of the underground economy has taken us into the dimensions of both the moral and the practical. At one level, it is critical to develop a strong view as to which activities should be declared illegal and which should not. The existence of the underground economy acts as a brake

31. Earlier law was tougher on recovering addicts in dismissal cases. *See, e.g.*, *New York City Transit Auth. v. Beazer*, 440 U.S. 568 (1979) (holding that New York City Transit Authority's dismissal of persons taking methadone as part of drug rehabilitation program did not violate Fourteenth Amendment's Equal Protection Clause).

on the enthusiasms of enforcement that might otherwise exist. There comes a point where the enforcement of the law becomes counterproductive. At that point, it is better to allow some activity to go underground than to tolerate the abuses of excessive enforcement and the dangers of concentrated power. In other instances, the mistakes are more fundamental, and activities that should remain legal are driven underground. It is difficult to distinguish these two classes of activities.

The question of the underground economy is the flip side of asking which activities should be legal and how illegal activities should be punished. If the theory of individual freedom, private property, and limited government with low and flat taxes is correct, it should shape our attitude toward the underground economy as it does toward everything else. But in too many instances the zeal of big government overcomes the limits of prudence, and we all suffer from driving too many activities underground.