The governance problem of the shadow economy

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1. Introduction

Most studies of local economic development and its governance in industrialized societies focus mainly on knowledge-rich, high-tech sectors. Less attention has been devoted to regions and local systems with weak institutions. Research for this project focused on this kind of backward territory, analysing the rise and decline of competitiveness in two weak European regions: the area around Naples in southern Italy, and that around Łódź in central Poland. Both areas were traditional strong in textiles and clothing with a subsequent decline of established firms in these industries; both are regions of general economic weakness and high unemployment, with records of poor-quality local government; and both have histories of low trust. Even in such areas there have been some institutional devices that have favoured economic competitiveness: but the shadow economy has been one of these, creating problems for law and order.

By ‘shadow economy’ we refer to those activities that are in some form illegal, monetary and private, but which could be legal if they were carried out in accordance with prevailing regulations. Examples are high tax evasion, or firms employing workers illegally; in others there are both regular and irregular workers; in others again all workers have a regular contract, but they are required to work overtime or receive a salary lower than the amount agreed. In some cases the firm itself is legal, but suppliers and sub-suppliers operate in the shadow economy. There can be cases that present irregularities in the distribution process such as the sale of goods through illegal channels (for example, markets or peddlers without permits who do not declare their incomes); or legal vendors who under-report their taxable earnings.

Three points emerging from the research help us to a general understanding of the blurred boundaries between economy, society and the state in backward but fast-growing areas.

- First, many non-economic factors contribute to the emergence and rise of the shadow economy, such as specific social networks among local entrepreneurs; wide availability of strong social capital; absence of institutional trust; high level of organized crime; peculiar role of local and regional governments and of unions and employers associations. These socio-institutional foundations of the shadow economy show why explanations of this phenomenon based only on economic variables cannot help fully to understand it.

- Second, it is not true that the shadow economy exhibits a low level of regulation. While governance by government and law and by formal economic associations is weak, there is an informal and often very effective regulatory mechanism that has a clear impact on economic development, and that is strongly embedded in the continuous interaction that takes place between local community and society.

- Third, there is a twofold relation between shadow economy and economic competitiveness. On the one hand, a governance system based on the shadow economy has strengths that boost the competitiveness of local firms: the high level of informality favours a model of labour organization characterized by high internal flexibility between workers and also between final firms and sub-suppliers. It ensures lower labour costs, whilst community regulation conveys those features of enforcement that are necessary to the functioning of any economic system without recourse to gov-
erment and law. On the other hand, this is a short term competitiveness that depends on medium- and low-quality products, medium variability of production flows, and very low costs. In particular, its competitive capacity is undermined by its low ability to produce more sophisticated tangible and intangible local competition goods such as multi-service centres, formal professional training processes, or information technology (Crouch et al, 2001, 2004).

2. Łódź

Our work on clothing and textile production around Łódź dated back to the early phase of the transition from state socialism. The governance environment of the economy was very weak. In an absence of strong formal institutions or even networks, the governance gap was filled by the institutions of the shadow economy (Burroni and Crouch, 2008). In the conditions of market instability, accompanied by constant flux in the institutional and legal framework and almost no public policy to assist the region, this environment proved successful in enabling hundreds of enterprises to start up and to operate with relatively good economic outcomes. Crucially, the low capital- and high labour-intensity profile of the industry allowed these enterprises to absorb tens of thousands of unemployed, partially neutralizing the devastating effects of the crisis.

On the other hand, perpetuation of the old economic structure slowed down the process of diversification and preserved low technical and technological levels, with firms operating within very competitive niche markets with low levels of profitability. Strong price competition and constraints related to the ‘embeddedness’ in the shadow economy led to a low propensity to innovate and practically excluded firm development. Shadow economy governance also hindered the development of cooperation networks between companies and links with the business environment, leading to a ‘lock-in’ of the former. Participation in local decision-making processes was impeded and the business environment was unable to make the local authorities address their problems.

3. Naples

In southern Italy too, the shadow economy has been very important in supporting the first steps of economic development in clothing and textiles in areas that have historically lacked entrepreneurial activity. But again the model has not been able to produce local collective competition goods, and many problems of the local environment remain unresolved: inadequate physical infrastructure; inefficient public administration particularly for formulating political and technical responses to the economic challenges; the inefficiency of the banking system, which is poorly equipped for offering credit to firms and sustaining enterprises at important moments; and the continuing presence of organized crime within governance and the economy, which extracts protection money from firms while reducing the sense of security of the community and inhibiting entrepreneurial activity. In such a situation, firms are penalized at every point. For example, they cannot get bank finance because they do not have guarantee funds. If they can get finance through the shadow economy they paradoxically start to conform with the law and thereby gain access to such things as EU support in times of difficulty.

In this context in January 2005 the local institutions of the area around Vesuvius – politi-
cal, business and trade union leaders – started to develop new policies for action. They wanted a process for correctly identifying industrial districts, their productive specialisations and their needs in terms of local political economy. It was agreed that the current state of projects and financing would be monitored to evaluate what it would be feasible to sustain in the coming years. They wanted to promote territorial policies aimed at reducing the role of the shadow economy, developing the local infrastructure and for training (and retraining) the work force. They started to make use of national policies for *emerisone*, that is for enabling firms gradually to emerge from the shadows. If firms have to choose between remaining illegal or immediately shedding all their past practices, the latter course requires them to give up the supports that they were achieving from the shadow economy before they have learned to make use of those available to legal firms.

4. Concluding remarks

Both Polish and Italian cases demonstrate firms surviving and thriving at a time when textiles and clothing are subject to the pressures of globalization; but both demonstrate the persistence of important weaknesses. With the exception of the Vesuvius cases, our research suggests that similarities predominate over differences in the two cases. We should therefore be sceptical of accounts that attribute the Polish shadow economy to the state socialist legacy alone or the Italian one to the cultural specificities of the Mezzogiorno. In fact, the comparison underlines that there are blurred boundaries between economy, society and the state and that it is difficult to identify a ‘single independent variable’ that can explain the regional model of growth in backward but fast-growing areas.

The functioning of the shadow economy relies on informal but very effective devices of controls and sanctions that assist economic transactions among firms and workers. Thus, even if it is not controlled and enforced by the law, the governance of the shadow economy is strongly regulated by communitarian mechanisms that support its reproduction over time. It must also be credited with triggering economic development and the economic recovery of the two local systems after a period of crisis, and supporting the rise of local small and medium-sized enterprises. However, it then hindered the production of local collective competition goods for the upgrading of competitive strategies of firms. Thus, the two cases faced a ‘fast development-trap’, where swift economic growth based on the mix of low quality/low prices and a high level of shadow economy promoted an institutional environment that hindered the possibility of pursuing the so-called high road of development, based on innovation and high quality products.

In many European countries public policy towards the shadow economy has been concerned with control and sanctions. In particular, three types of policies have been broadly adopted: those aimed at preventing the development of the shadow economy through general interventions directed at introducing economic incentives for those who decide to follow the rules; those that aim at reducing the incentives to have recourse to shadow forms of, primarily, labour, through inspections and...
sanctions; and pro-active policies that encourage firms to emerge from the shadows. These strategies for the most part overlook the fact that the shadow economy is regulated by a mode of governance that distributes resources, mediates conflicts and orients and addresses the action of economic actors, even allocating certain kinds of local competitive advantages that favour a low-road competitiveness of local firms. As Burrioni and Crouch (2008) have argued elsewhere, dealing with the shadow economy just by suppressing it removes from firms, individuals, and whole territories, some of the only governance that keeps economic activity going. This is especially the case when public authorities are at best inefficient and at worst corrupt, and therefore unable to help provide the public institutional infrastructure that is vital to the market success of individual firms.

All this means that a policy strategy aimed at gradually modifying the governance architecture that supports the shadow economy could have better results especially in promoting emersione, as the Vesuvius cases suggest. This incremental strategy could mobilise local individual and collective actors who are starting to acknowledge that the shadow economy is producing a lock-in that dramatically obstructs both the competitiveness of local firms and social cohesion.

This brings us to the implications of those differences that we have encountered between the two sets of cases. These are of two kinds. First, Italian public policy, unlike Polish, is not ‘in denial’ concerning the extent of the shadow economy, and has developed some imaginative approaches towards it, limited though they are. Experiments are taking place in some Italian districts with new, participative forms of local governance that in principle rival those anywhere for innovation and enterprise. Polish authorities, with far less experience of open government behind them, perhaps understandably remain in denial.

Second, there is also considerably more willingness in Italy to accept that the textile, clothing, and footwear sector has an important role in the economy, and that it is worthwhile attending to its infrastructural and public policy needs. Again, this is not surprising, given the global strength of northern and central Italian brands, though until the 1990s policy towards the Mezzogiorno concentrated on building large plants in heavy industry. It is only recently that the greater potential of partnerships between SMEs in the Mezzogiorno and these leading firms from other parts of the country has been realized.

The strategy has clearly been to move upmarket into quality, brand-name niches – a strategy that itself requires coming to terms with the shadow economy. Is it feasible for small Polish firms, which lack a national reputation and contacts with national brand leaders and their knowledge bases, to embark now on such an approach? Or, a contrario, are Polish policy-makers well advised to keep these industries marginalized, leaving the Italians to face inevitable failure in the face of global cost pressures that press on the textile and clothing sector more than any other? It is not possible to resolve these larger issues here. Nevertheless, there is something general to be learned from the approach to the governance of local development that is being pursued in some parts of Italy. Governments at different levels are working with business and labour organizations to explore what public policy can achieve to assist firms in various sectors, ranging from (at a minimum) dealing with their own corruption, to establishing good physical infrastructure, to exercises in local branding and competence-raising. This is the new global agenda for public intervention in economies, replacing the static defensiveness of protectionism with actions that aim at helping firms improve quality at every stage.

### Bibliography