The Role of the Underground Economy in Italy's Economic Performance

Laura Castellucci

The working of the Italian Economy up to the “Euro year” 1999

Three structural factors:

- Export led growth model as a source of the “economic miracle”,
- Expansionary (“Benevolent”) fiscal policy,
- Restrictive Monetary Policy.

- + one: the **<u>Underground Economy</u>**

Measuring the underground economy

- By using an indirect method, i.e the adjusted Tanzi monetary equation.
- By using the direct method, i.e. tax evasion
- By using the statistics of the labour market

- the share of the Underground Economy has been fairly stable since 1970

⇒ Natural Rate of Underground Economy

The South vs. the Center-North

Dualistic Economy:

NOT

two areas at different development stages

BUT

<u>two different realities</u>

- Two <u>different</u> phenomena, NOT two different sizes of the same phenomenon.
- i.e. U.E. as tax evasion: U.E. is larger in the South although fiscal incentives have always been in place

Measuring Underground Economy

- An attempt to measure U.E. in the South and in the Center-North independently.
- demand for irregular workers by the firms
- relevant regressors:
  - rigidity of the labor market
  - expected penalty as a measure of state "credibility"

⇨ Result: credibility is more important in explaining UE in the S than any other variable

The Natural Rate of Underground Economy

NRUE: the underground economy varies with cycle, tax rates, social security wedge but is remarkably stable around its mean

No government succeeded in fighting Underground Economy; why?

- Government failure,
- Underground Economy might play a positive role in terms of:
  - employment
  - tax revenue

Underground Economy and Social Welfare before the Euro

- 1970-1985: U.E. associated with tax revenue gains,
- end of ‘80s- early ‘90s tax amnesties
- 1993: Maastricht treaty coming into effect

⇨ U.E. showed a 2-3% increase

<u>Underground Economy as a substitute for the no longer feasible “benevolent” fiscal policy.</u>

Structural roots of the Underground Economy

The stability of U.E. calls for “structural” explanations:

- Small, non-technological firms
- low “credibility” of the state
- high inefficiency in public administration
- a “bureaucratic approach” to public organization, resulting in high *rent-seeking* incentives.

After the Euro year (1999)

Though the Underground Economy should be fought for equity reasons, it may have produced positive welfare effects in the past,

<u>BUT</u>

- Circumstances substantially changed after the Euro year

Are the potential "benefits" from the Underground Economy still there?

PROBLEMS

- Overall Italian Economic Performance is growing poorer
- Traditional “remedies” are no longer available:
- Budgetary policy is constrained by the stability pact
- Devaluation is no more viable

Risk of resorting to the Underground Economy to alleviate economic problems.

Potential“benefits” from the Underground Economy are no longer likely:

- Small and non technological firms make the economic environment more suitable for U.E. but less and less capable of competing in the international arena

- UE combined with a low rate of growth of GDP does not produce tax revenue “gains”

- Italy is losing ground in international competitiveness

Policy Suggestions:

- Increase government “credibility” through the probability of detecting tax evaders
- avoid tax amnesties which greatly reduce the (subjective) probability of being detected
- use the carrot&stick more suitable to each part of the country (no effect from favourable tax treatment in the south)
- finally ……pay heed to our findings, in particular: a reduction in social security contributions has little or no effect in trimming underground economy

Conclusion and Policy Implications

- Will the UE be with us? **<u>Yes</u>**, unless:
- the government does commit to fight the UE
- on the base that no potential gains can be expected

……. unhappy end……..

The absence of a commitment by the government to fight the Underground Economy would enhance the "weaknesses" of the Italian Economy:

– lack of innovation
– mature goods
– little technological content