

**The impact of the “*Underground Economy*” upon the availability of credit and local growth in Southern Italy: the Naples case.**

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## 1. INTRODUCTION

Each year there are enormous numbers of cash transactions in the market without government observes and regulations. This phenomenon is known as the “*underground economy*” and “*shadow economy*”. Most societies use various measures in the form of punishment, prosecution, economic growth, and education in an attempt to choke back these underground or shadow economy activities (*Schneider and Dell’Anno, 2010*).

According to *Öğünç and Yilmaz (2010)*, there is no agreement on the definition for underground economy (UE). In most literature, this marginalized category of economy was called unofficial, shadow, black, grey, hidden, unobserved and irregular economy (*Alderslade, Talmage and Freeman, 2006*).

Since there is a plethora of names suggestive of different situations, this paper would employ *underground economy* (UE) or *shadow economy* (SE) as a standardize terminology to facilitate the discussion.

According to *Gyllys (2005)*, the disarray in these elusive socio-economy categories in term of terminology and concept could lead to huge cognitive losses due to difficulties in “naming” a defined concept that has different contents and comprehension.

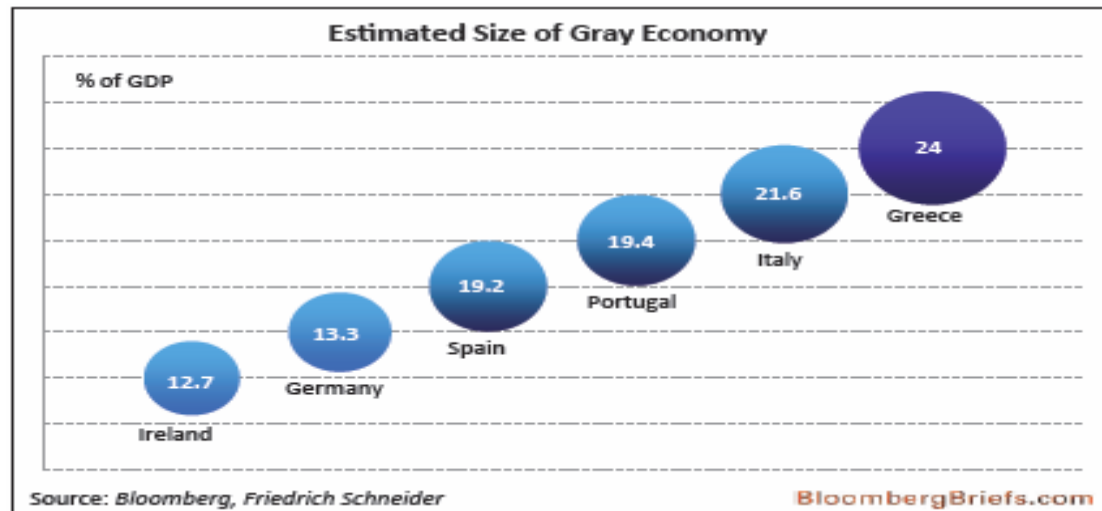
As noted by *Smith and Christou (2009)*, this marginalized category of underground or shadow economy activities represent an economically active market. Majority of researchers have drawn a general recognition that underground economy and crime are collaborated (*Muzafar and Eng, 2011*).

However, it is argued that underground economy should not be associated 100% with illegality (*Frey and Schneider, 2013*). There is still a great deal of legitimate occupations and business transactions contributing to the underground economy with their income generated but not reported accordingly to the government concerned.

The starting point of this research is the fact that almost every State has a dual economy. Besides economic activities that are registered officially in national account (*healthy economy*), some people prefer to offer or demand goods and services in the nonofficial sector instead (*unreported activities*). This second type of economy

compounded with *illegal*<sup>1</sup>, *unrecorded*<sup>2</sup>, and *informal*<sup>3</sup> activities create the world of *shadow* or *underground economy* in each country.

Figure 1.



Source: BloombergBriefs.com

Gathering statistics about who is engaged in underground activities, the frequencies with which these activities are occurring and the magnitude of them, it is crucial for making *effective* and *efficient* decisions regarding the allocations of a country's resources in a specific area.

Unfortunately, it is very difficult to get accurate information about these underground (or *shadow*) activities on the goods and labour market, because all individuals engaged in these activities wish not to be identified.

Hence, the estimation of the shadow economy activities, and the aim of this research can be considered as a scientific passion for "*knowing the unknown*".

Shadow economic activity is problematic for several reasons.

One of the purposes of government is to provide the legal framework within which economic activity takes place; and societies with good institutions prosper. But when it comes to shadow work those legal institutions are bypassed: contracts can often be unenforceable; economic relationships can become marred by violence; and it can become very difficult for businesses to expand because they then come to the attention of the authorities.

<sup>1</sup>Illegal drugs dealing, black market of the currency exchange, money laundering, unlicensed money lending, illegal gambling prostitution and pornography

<sup>2</sup>Activities that avoid institutional conventions that define the necessary requirements for the report to governmental agencies for statistics

<sup>3</sup> Revenue that generated by economic agents that operates informally

A large shadow economy also means that tax rates are higher for those working in the formal economy.

Furthermore, as is shown in this piece of work, there is a relationship between the size of the tax burden and the size of the shadow economy.

As such, understanding the shadow economy has important policy implications. Firstly, there is a need to create an environment in which economic activity can easily be formalized – where there are as few regulatory impediments to formalization as possible.

Secondly, at a broader level, the shadow economy provides a further argument for the need to educate people about the purpose of taxation so as to improve tax morality and hence compliance.

Thirdly, there is a need to ensure that the tax system itself is not of a scale and design such that it encourages shadow economic activity.

When it comes to measuring the shadow economy there are a number of challenges. Several methods are used in practice and they tend to give different results. Survey measures, for example, tend to understate the size of the shadow economy because, even in the most carefully controlled of circumstances, people do not like to admit to shadow work, and sometimes they persuade themselves that they are not really undertaking shadow work.

Newer statistical techniques have been developed that provide more credible evidence about the size of the shadow economy, and the measures derived from these techniques can then be calibrated using variables, such as the amount of cash in an economy, which are known to be related to the extent of shadow economic activity.

The size of the shadow economy has not varied dramatically over the last decade or so, if anything it has decreased slightly, at least until the outbreak of the euro crisis. The number of participants in the shadow economy is also very large: perhaps 30 million people in the EU alone.

Because of the relationship between the size of the shadow economy and the level of taxation, there is a danger of a vicious circle being created in certain circumstances.

If the tax burden rises, we might get more shadow work, lower tax receipts, and then yet higher tax rates as the government tries to raise more revenue from a smaller tax base.

This may cause yet further increases in the shadow economy, and so on. Of course, this vicious circle can be reversed and turned virtuous if the right policies are pursued.

A further factor influencing the size of the shadow economy is ‘*tax morale*’.

If people think that the tax system is becoming less fair and that their neighbours are dodging tax, they are more likely to work in the shadow economy too. This can also contribute to the vicious and virtuous circle effects.

As such, successful policies to tackle the shadow economy are of some significance. When it comes to trying to reduce its size, it is interesting to note that policies focused on deterrence do not tend to be especially successful. The shadow economy is pervasive and made up of a huge number of small and highly dispersed transactions. Furthermore, if we rely on deterrence to reduce the shadow economy we may stamp out the entrepreneurship and business formation that go with it.

Such policies have been successful in various countries with high benefit-to-cost ratios.

Although quite a large literature<sup>4</sup> on single aspects of the hidden economy exists and a comprehensive survey has just been written by different analysts, the subject is still quite controversial, as there are disagreements about the definition of shadow economy activities, the estimation procedures and the use of their estimates in economics analysis and policy aspects. Nevertheless around the world, there are strong indications for an increase of the shadow economy and little is known about the negative impact of the shadow economies on the OECD<sup>5</sup> countries in recent years. For instance, in Italy the size of the shadow economy labour force is relatively large, 30 per cent to 48 per cent in the southern part of the country.

In the city of Naples where firms hide part of their activity and accordingly cook their book in order to avoid tax obligations may therefore be unable to arise external finance in the official credit markets. The same constrains could also be at work for other sources of financing, such as recourse to the capital market, although this is not really an option for small and medium sized firms, among which those operating informally are mainly concentrated.

Both demand and supply effects play a significant role, unambiguously pointing to a negative relationship between credit granted and size of the shadow sector.

On the other hand irregular firms do not demand credit because they cannot provide

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<sup>4</sup> See for example, survey type publications by FREY – POMMEREHNE (2004); THOMAS (2002); LOAYZA (2000); LIPPERT – WALKER (2013); SCHNEIDER (1994a, 1994b, 1997, 2005,2013); and GERXHANI (2003)

<sup>5</sup> On 14 December 1960, 20 countries originally signed the Convention on the Organization for Economic Co-operation and Development: AUSTRALIA, AUSTRIA, BELGIUM, CANADA, CZECH REPUBLIC, DENMARK, FINLAND, FRANCE, GERMANY, GREECE, HUNGARY, ICELAND, IRELAND, ITALY JAPAN, KOREA, LUXEMBOURG, MEXICO, NETHERLANDS, NEW ZEALAND, NORWAY, POLAND, PORTUGAL, SLOVAK REPUBLIC, SPAIN, SWEDEN, SWITZERLAND, TURKEY, UNITED KINGDOM, UNITED STATES

assets that are eligible as collateral or meet the minimum disclosure requirements to be risk-assessed in the official credit markets.

The problem faced by irregular firm in raising funds is also often referred to as a reason for the anti-cyclical behaviour of the underground economy. The scarcity of capital available to informal entrepreneurs makes it more difficult for them to invest, sometimes forcing them to use low productivity technology, thus depressing economic growth during expansionary phases as well. This is the reason why in Naples businesses that are credit constrained can be locked into an irregularity trap and never realize its productive potential.

Household access to credit can also be affected by the size of the underground economy. Irregular workers may be unable to provide banks and other financial institutions with the documentation that support their ability to service the debt (e.g. payslips).

Furthermore, in areas like Naples with high levels of irregularity it is likely that an above average number of dwellings will not fully comply with the relevant laws and not be eligible as collateral. On the other hand, there are several channel which the underground economy can influence the size and structure of the financial industry.

There are many studies and researches conducted in order to describe the relationship between the illegal activities and the shadow economy.

However, this *specific research* aims not to quantify the size of shadow economy individually and how it is connected to the illicit in different countries in Europe, but to highlight that without a healthy economy the “*credit market*” is badly affected.

Consequently, local Business has not access to credit, and investments are penalized, all these drawbacks produce inefficiency and growth stagnation.

The study will be based in the city of Naples, biggest city in Southern Italy.

The *importance of the topic* lives in the fact that it gives a real picture of the consequences of the shadow economy in Southern Italy and the related costs to the credit riskiness of the Bank system in Naples. It will also highlight the difficulties in getting access to credit from a local Business perspective.

*Saunders* (2007) describes the research question as a key driver behind the research process. Therefore it is important that the research questions are clearly defined in accordance with the objectives of the research.

The central *research question* of this study aims to answer is:

***Does the “Shadow Economy” or “Underground Economy” affects the credit market (from a Bank’s perspective) in Naples? : Evidence from the local growth.***

This study will also address the following research *sub-questions*:

1. ***What are the characteristics of shadow economy in Naples?***
2. ***How is the local Business affected?***

Conclusions from this research might be viewed by managers in financial Institutions, and local Business’s with the goal to let the *real economic cancer* be known as the main reasons of economic stagnation in Naples.

## 2. LITERATURE REVIEW

### INTRODUCTION

The research will focus on a number of relevant literature reviews on the specific topic mentioned previously, although, the shadow economy contains a wide variety of theories that will not be covered by the researcher.

The main themes are *credit risk (NPL)*<sup>6</sup> and *access to credit* for a firm, moreover, causes of the underground economy will be found in *organized crime, tax regime, local regulation, unemployment* and *self-employment* in Naples.

All themes are reported in the literature review part except for the *shadow economy* that has already been introduced.

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<sup>6</sup> NPL, not performing loans

## 2.1 NOT PERFORMING LOANS AND ACCESS TO CREDIT

The main hypothesis suggests that availability of credit together with the terms and conditions of lending are important in determining the size of a shadow economy. Thus, it seems appropriate to focus on indicators of the impact of the shadow economy on the bank system in Southern Italy.

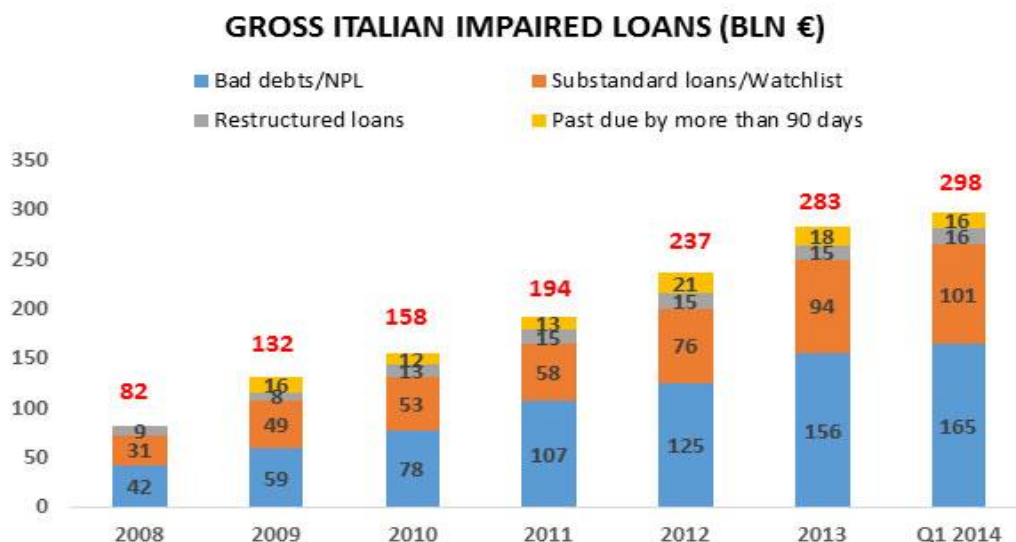
The non-performing loans (NPL) of financial institutions are considered as a significant issue in the context of Italy.

*Sergio* (2012) in a study of non-performing loans in Italy found evidence that, an increase in the riskiness of loan assets is rooted in a bank's lending policy adducing to relatively unselective and inadequate assessment of sectorial prospects.

Nonperforming loans in Italy have tripled since 2007, reaching a historical peak. NPLs in Italy cover four categories: "bad debt" (*loans in a state of insolvency*), "substandard," "past due," and "restructured" loans (Figure 2). NPLs have grown at around 20% annually since 2008, topping €333 billion in June 2014 (24% of GDP or 16.8% of total loans).

Figure 2.

The growth of impaired loans in Italy's banking system until Q1 2014. At the time, NPLs stood at €165 billion – now they are towering at nearly €194 billion.



In Naples, The worst NPL category, ("*sufferance*") or "bad debt", has increased the

most and now accounts for more than half of total NPLs.

In fact, compared to the European average, the NPL ratio in Italy is more than four times greater<sup>6</sup> and has increased at a much faster pace.

The pace of NPL “*write-offs*” has also slowed. The average time for writing off a bad loan has increased to over six years<sup>7</sup>, from just less than four years before the crisis. In 2013, on average less than 10% of bad debt, despite already being in a state of insolvency, was written off or sold. The bad debt write-off rate varies significantly across the major banks, with banks with the highest NPL ratios featuring the lowest write-off rates.

The slow pace of write-offs is an important factor in the rapid build up of NPLs. Write-offs or sales to third parties are one of the most efficient and quickest means of removing bad assets from banks’ balance sheets.

Italian banks, on the other hand, tend to hold on to NPLs, while pursuing internal collection and loan restructuring efforts. In normal downturns, this strategy has allowed banks to gradually reduce NPLs as the flow of new bad debt declines with the recovery.

However, with the prolonged recession, the inflow of new NPLs has remained high while write-off rates have not increased significantly, leading to a large backlog of bad debts.

High NPLs depress bank profitability and constrain new lending.

On the revenue side, NPLs generate a “*negative carry*,” as they do not produce cash interest revenues; yet require funding at market rates. This in turn pushes up interest rates on performing loans to compensate for the lost revenue. Holding NPLs also tie up human and operational resources and involve legal and administrative costs, which could be used to support new investment.

NPLs, even if adequately provisioned, also absorb valuable bank capital, which if released, could support fresh lending.

In large Italian banks, NPLs, even if adequately provisioned, absorb valuable bank capital.

Calculating the **cost of capital** for holding NPLs depends on the credit risk approach.

- For banks using *standardized methods*, the capital charge for NPLs amounts

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<sup>7</sup> Bank of Italy (*BoI*) Financial Stability Review, April 2013 and IMF Detailed Assessment of Observance of Basel Core Principles for Effective Banking Supervision, December 2013, page 120 (*stressing the age of the NPL portfolio in Italy*).

to 12% of risk weighted assets but only applies to NPLs that are inadequately provisioned or not collateralized. Most mid-sized and all small Italian banks follow standardized methods.

- Under the *internal ratings-based models (IRB)*, the capital charges on NPLs depend on the risk approach.
  - a) For banks under the Basel II *IRB Advanced (IRBA)* approach, the capital cost for NPLs is twofold: (1) a capital deduction for the provision shortfall between Basel II expected losses and IFRS accounting provisions. This capital deduction is known as the “*IRB shortfall*”<sup>8</sup>; and (2) a capital charge for gross NPLs (i.e., even if adequately provisioned), based on banks’ internal models. All large Italian banks (UniCredit Group, Intesa San Paolo, Monte dei Paschi di Siena, Banca Popolare, and Ubibanca) are under the *IRBA* approach.
  - b) In contrast, banks under *the IRB foundation (IRBF)* approach are only required to deduct the “*IRB shortfall*.” There is no other capital charge on NPLs. In Italy, only two mid-sized banks follow IRBF methods.

Based on the example of the largest Italian bank, NPLs are estimated to tie up more 6% of capital and if sold, could free up significant resources for new lending. The capital cost of holding NPLs can be approximated through the recent disclosure on “*noncore assets*” (NCAs) by the largest Italian bank, UniCredit Group (UGC). In June 2014, UGC reported €81 billion of NCAs absorbing €2.7 billion of capital, i.e., 6% of UGC’s CET1<sup>9</sup> (*Common Equity Tier 1 - Basel III*).

If the bad debts from the NCAs were sold at book value, the capital released could amount to €1.6 billion, possibly supporting up to €56 billion in new lending.

This is a crucial point in a city like Naples where the cost of funding is really high, weak asset quality may be an important factor in explaining Italian banks’ higher CDS spreads and lower market valuations compared to banks in the rest of Europe. Because probabilities of default and loss given default are highly correlated, higher NPLs in an economic downturn lead to lower recovery values and larger credit losses. There is also empirical evidence that banks with worse asset quality are more

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<sup>8</sup> The amount by which a financial **obligation** or **liability** exceeds the amount of cash that is available.

<sup>9</sup> NCAs include bad debts and problem loans, i.e., performing loans with higher risk. They absorb €33.4 billion of RWAs (*Risk Weighted Assets*). One third of UGC’s NPLs is not reported as NCAs, therefore not included in this capital calculation. Hence, it represents a low base estimate for large banks.

sensitive to sovereign distress, pushing up *risk premium*<sup>10</sup> in the real economy. High levels of NPLs exacerbate this sensitivity by raising the range surrounding possible future losses.

Furthermore, a few recent papers have included the banking sector in a general equilibrium model with a shadow economy. *Dabla-Norris and Feltenstein (2005)* model the cost of operating underground in terms of limited ability to borrow from the banking system.

Usually the exclusion from the official financial markets is mentioned among the costs that firms bear from being informal.

*Antunes and Cavalcanti (2007)* also propose a general equilibrium model where the benefit from being formal is a better access to outside finance, since projects and assets in the irregular sector are not adequately documented, they cannot be turned into capital or cannot be used as collateral for a loan.

The access to finance requires entrepreneurs to disclose credible information about their activities through formal documentation, this requirement may be impossible to oblige to for many informal producers who lack proper bookkeeping of their operations.

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<sup>10</sup> The return in excess of the **risk-free of return** that an investment is expected to yield. An asset's risk premium is a form of compensation for investors who tolerate the extra risk - compared to that of a **risk free asset** - in a given investment.

## 2.2 LABOUR MARKETS AND LOCAL REGULATION

As *Giles and Tedds* (2002) state, there are two antagonistic forces, which determine the relationship between the unemployment rate and the shadow economy. On one side an increase in unemployment should imply a decrease in the black economy as the underground economy is positively related to the growth rate of GDP and the latter is negatively correlated to unemployment.

On the other side some “*official*” unemployed spend a portion of their time in working in the black economy, thus there is a positive correlation.

*Tanzi* (1999) writes than “*the relation between the shadow economy and the unemployment rate is ambiguous*”.

He remarks that very heterogeneous workers compose the labour force of “*hidden economy*”. A part of those is classified as unemployed because they are components of the official labour force, the other part of hidden workers is composed by retired people, illegal immigrants, minors or housewives who are not part of the official work force, furthermore, there are people who have at the same time an official and unofficial job.

In this sense, the official unemployment rate is weakly correlated with the shadow economy.

Moreover, according to *Schneider and Williams* (2014) illicit work can take many forms. The underground use of labour may consist of a second job after (or even during) regular working hours. A second form is shadow economy work by individuals who do not participate in the official labour market. A third component is the employment of people such as illegal immigrants who are not allowed to work in the official economy.

Empirical research on the shadow economy labour market is even more difficult than research on the value added in the whole shadow economy because it is difficult to determine how many hours an average shadow economy worker is actually working. Shadow economy work can involve anything from a full-time shadow economy job or self-employment without payment of taxes to a few hours of child-minding or bar work every two or three weeks.

To understand the shadow labour market, it is worth asking why people work in the shadow economy. In the official labour market, the costs that firms and individuals have to incur when hiring somebody are increased by the burden of tax and social

insurance payments, as well as by regulation. In some OECD countries, for instance the “*Mezzogiorno*”<sup>11</sup>, these costs are greater than the wage effectively earned by the worker – providing a strong incentive to work in the shadow economy.

The economic gap between Italy’s prosperous north and its depressed south (*Mezzogiorno*) has widened so much that the difference between Lombardy near the Swiss Alps and Campania Region is wider than that between Germany and Greece.

With the latest recession, a whole chunk of the South’s productive structure has disappeared, head of forecasts at research institute “*SVIMEZ*”, which seeks to promote industry in the south. “*The process of decoupling that began in 2001 has quickened and it may now take many years to get back to a growth pace similar to the north.*”

Reliable and consistent information on total non-wage costs is difficult to obtain and no-wage costs can vary depending on the level of pay, benefits being received and other factors. As such, averages do not necessarily indicate the incentives that are faced by specific groups when deciding to work in the shadow economy.

Work opportunities are available above all in the informal sector, if not unregistered or even illegal, yet the breadth of the informal sector shouldn’t be taken as proof that unemployment is overestimated: informal work in Naples is not of the same kind as that found in the Northeast of Italy.

It is unskilled, precarious and poorly paid. Informal manufacturing activities have transformed themselves from traditional crafts what used to be an urban subsistence economy – to a sweatshop system of production, which is not direct towards medium-to-high or innovative sectors of the market, but to residual ones, such as the market for unauthorized imitations (*knock-offs*) or second quality goods. In this context, work in the informal economy does not provide a substitute for a formal job.

The Neapolitan Emergency Social Intervention Service recently counted about 1600 homeless people in Naples, who represent the most extreme stratum of poverty and exclusion. This population, by definition, cannot be assigned to any single area of the city, but it is well known that they are concentrated around the main stations, especially “*Garibaldi Square*” and “*Campi Flegrei*” (in the Northwest of the city).

A survey of 150 homeless people found that they are mostly Italian (53%), between 25 and 50 (66%), and men (85%). 40% are unemployed, 17% have lost their job and

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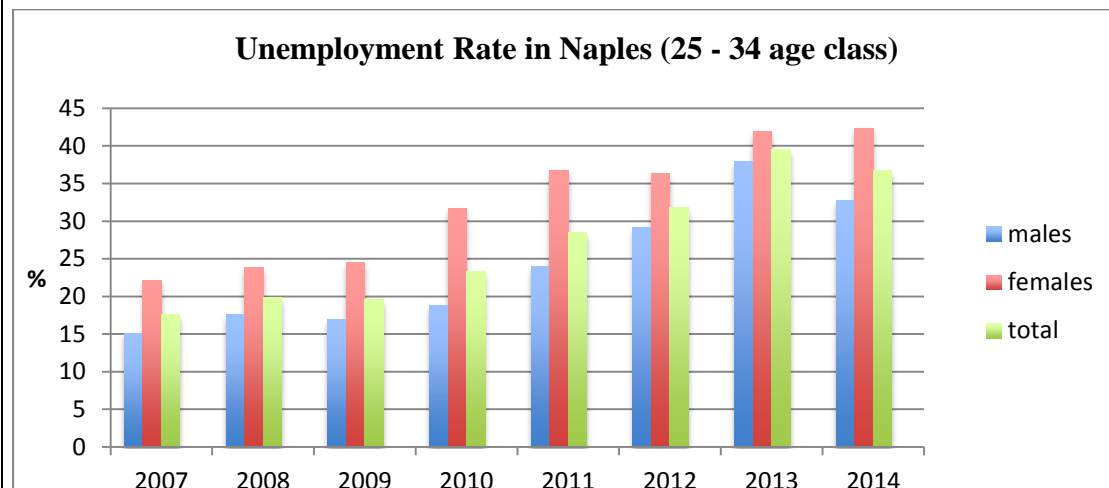
<sup>11</sup> Southern Italy includes also Sicily and Sardinia Islands.

40% have a very small income from occasional or undeclared jobs.

In terms of unemployment and exclusion from the labour market, Naples leads the country with over 40% of the labour force inactive. This is particularly serious for young people; further, women make up 42.4% of the registered unemployed. Unemployment, however, varies according to the single neighbourhoods. Some, such as the Northeast periphery, are hit badly; the dormitory quarters such as “*Scampia*”, “*Miano*” and “*Piscinola*” offer few work opportunities, while others suffer from a deindustrialization process that has not provided any alternative development.

Other areas with high unemployment rates are the central quarters (“*Stella*”, “*S. Carlo*”, “*Mercato*”, “*Pendino*”), where the absence of jobs is related to the disappearance of artisan and manufacturing activity and to their migration to areas outside the city limits.

Figure 3.



Source: Istat.it 2014

It is widely held that unemployment figures should be adjusted to account for undeclared employment. Nonetheless, field work has not revealed much in the way of employment opportunities in addition to those declared, and, except for criminal activity, informal work is usually discontinuous and cannot be compared to regular employment, nor considered a stepping stone towards a normal job.

Finally, it is also important to mention that in a city like Naples *self-employment* the rate of self-employment as a percentage of the labour force is considered as a determinant of informal economy.

According to *Bordignon – Zanardi* (2007), the significant diffusion of small firms and the large proportion of professionals and self-employed respect to the total

workforce<sup>12</sup> are the most important characteristics that distinguish the Italian productive system from the other economies of Western Europe. The higher the rate of self-employed the larger is the shadow economy, *ceteris paribus*.

One further institutional factor that can explain the poor performance of the labour market is product-market regulation.

This factor has nothing to do directly with the labour market, but can have indirect effects, as it creates an environment conducive to bad employment prospects. The preliminary results of recent studies on this topic show that the combination of Product Market Regulation (PMR) with EPL produces negative effects on employment (*Nicoletti 2012*).

The indicators that have been taken from these studies and are proposed in the table describe the regulations restricting market mechanisms and international trade. These indicators make it possible to rank countries on the basis of an increasing level of unfriendliness to competition. The indicators cover barriers against entry into the market, public ownership, price controls, and government involvement in business operations, administrative burdens, market concentration, and vertical integration.

Italy's regulatory environment is much stricter than that of the average European country. While barriers against trade and international investment have been gradually eliminated during the process of European integration, economic regulations at home are very restrictive, and include widespread public control of the business sector, legal limitations to competition in a wide range of service markets, administrative controls over certain prices, and restrictions on the provision of some services.

Lack of competition in the product market is likely to have harmed Italian consumers significantly by preventing the prices of some services from declining as fast as in other OECD countries. Data taken from the European Central Bank show that the prices of telecommunications, gas, and electricity in Italy were still above the Euro area in the year 2000. These mark-ups on costs, which keep prices at high levels, play the same role as the tax wedge: they increase the distance between the labour costs paid by firms and the real consumption wages of employees.

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<sup>12</sup>According to OECD estimates for 2013, the ratio of self-employed to the total workforce, net of farm workers, was **26,7% in Italy** as compared to 8,4% in Germany, 8,8% in France, and 13,1% in the United Kingdom. Companies with more than 100 employees at the end of 1980s accounted for just a little over 20% of the total workforce as compared to over 80% in the UK and Germany. [*ISTAT-2013*]

Some reforms have taken place in recent years. The regulatory environment has been changed, but not enough. In the field of administrative regulations, burdens and requirements have been reduced, in particular for start-ups.

Some liberalisation of telecommunications has taken place, but at a slower pace than in other European countries. Steps have been taken also in electricity and gas to ensure access to competitors in the market, but on the whole, competitive pressures are still much lower than in other EU countries.

Regulation leads to a substantial increase in labour costs in the official economy. But since most of these costs can be shifted on to employees through lower wages in the official economy, such regulations provide incentives for people to work in the shadow economy, where they can be avoided. Of course, where it is illegal for migrants to work – or very difficult for them to obtain permits – it becomes highly likely that they will work in the shadow economy, especially as they may not be able to legally claim welfare benefits.

*Johnson* (1997) reports empirical evidence supporting their model, which predicts that countries with higher regulation of their economies tend to have a larger shadow economy. They conclude that it is the enforcement of regulation, which is the key factor determining the burden on firms and individuals and which drives workers into the shadow economy: regulation that is not enforced is less relevant.

*Friedman* (2010) arrives at a similar conclusion. In their study every available measure of regulation is significantly correlated with the share of the unofficial economy and the estimated sign of the relationship is unambiguous: more regulation is correlated with a larger shadow economy.

## 2.3 TAX REGIME AND TAX MORALE

In almost all studies, the increase of tax and social security contribution burdens is one of the most main causes for the increase of the shadow economy. Since taxes labour-leisure choices and also stimulate labour supply in the shadow economy, or the untaxed sector of the economy the distortion of this choice is a major concern of economists. The bigger the difference between the total cost of labour in the official economy and the after-tax earnings (from work), the greater is the incentive to avoid this difference and to participate in the shadow economy.

Since this difference depends broadly on the social security system and the overall tax burden, and tax morale, they are key feature of the existence and the increase of the shadow economy.

Moreover, a number of theoretical models have evolved to determine the relationship between tax evasion and tax rates, although such models fail to provide unanimous predictions regarding the impact of tax rates on evasion.

An old seminal paper by *Allingham* and *Sandmo* (1972) provides a positive relationship between tax rates and evasion, although this depends on particular assumptions about risk aversion and the penalty for tax evasion.

By contrast, some models, consistent with this “*portfolio approach*”, are able to generate unconventional wisdom such evasion being reduced by high tax rates.

In particular, *Yitzaky* (1974) shows that increases in tax rates will reduce evasion whenever the punishment for evasion is dependent on the value of taxes evaded. In general, in the *Allingham* and *Sandmo* approach, an increase in the tax rate may increase, decrease, or leave unaltered the level of evasion depending upon the degree of the absolute risk aversion (substitution and income effects), and the way the penalty is set.

Moreover, calibrating the basic *Allingham* and *Sandmo* model with reasonable values for the enforcement parameters and for risk aversion suggests that it would be a rational choice for taxpayers to evade a lot more than they appear to do. Economics scholars have devoted considerable effort to improving the basic model of tax evasion so as to reconcile evidence with theory, as well emphasized in the literature reviewed in *Slemrod* and *Yitzhaki* (2000).

The traditional economic approach needs to be enriched to take into account

deterrence effects and tax morale determinants as well as their mutual interactions (see, amongst others, the surveys of *Andreoni* (1998), *Torgler* (2007), *Feld* and *Schneider* (2010)).

According to *Feld* and *Frey* (2007), tax compliance is driven by a psychological tax contract that entails rights and obligations from taxpayers and citizens on the one hand, but also from the state and its tax authorities on the other. Taxpayers are more inclined to pay their taxes honestly if they get valuable public services in exchange. However, taxpayers are honest even in cases when the benefit principle of taxation does not hold, i.e. for redistributive policies, if the political decisions underlying such policies follow fair procedures. Finally, the treatment of taxpayers by the tax authority plays a role.

If taxpayers are treated like partners in a (*tax*) contract instead of subordinates in a hierarchical relationship, taxpayers will stick to their obligations of the psychological tax contract more easily. *Kirchler* (2007) presents further comprehensive discussion of the influence of such factors on tax compliance.

Although the traditional economic theory on tax evasion derives ambiguous predictions as to the tax rate impact on tax evasion, and despite the substantial focus on these issues in policy analyses on tax evasion, surprisingly little is known about these problems from empirical studies. However, the evidence provided in a macroeconomic setting is quite homogeneous in claiming the positive effect of the tax rate on shadow activities (*Schneider* 2002; *Giles* and *Tedds* 2002; *Davis* and *Henrekson* 2004). The evidence is less clear when considering tax evasion.

This is due to the fact that data are not available on an international basis and it is difficult to collect even for OECD countries.

Collecting unobservable variables is a difficult task although in some circumstances the tax authorities, at the state level, might not be willing to reveal how intensively tax concealment is taking place. In this respect, Italy<sup>13</sup> is an exception, since the large size of tax evasion and the time series evolution are witnessed by several sources of information.

In addition to the macroeconomic evidence of the tax rate-tax evasion relationship, there is some micro-founded research, which emphasizes the fact that the main cause

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<sup>13</sup> Italy has four primary taxes: **two** for businesses and corporations, the **value-added tax** (VAT), and the **personal income tax**.

of tax evasion is the high tax burden. For instance, *Fiorio and Zanardi (2006)*, using the results of the Survey on Household Income and Wealth (Bank of Italy), show that almost half of the respondents (46%) in 2004 claimed that tax evasion was caused by too high tax rates. Additional explanations of the non-compliance were: the misuse of tax revenues by the government (45%); a strategy of cost squeezing aimed at business preservation/survival (41%); the excessive cost of compliance (25%); the perceived low risk of detection (53%).

Furthermore, it is worth stressing that while the micro founded approach emphasizes the tax rate-tax evasion causality (the demand for evasion), in a macroeconomic framework this relationship can also be reversed (*Basile 2010*).

For instance, according to the Italian Treasury Minister (MEF 2009), tax evasion is claimed to be a serious constraint for managing fiscal policy since this phenomenon, and its magnitude, precludes the pursuit of “*optimal*” tax rates on the part of government<sup>14</sup>.

Of course, placing the tax evasion problem within a general equilibrium framework is much more useful for understanding the macroeconomic consequences of tax policy and the relationship with tax evasion. It allows joint investigation of taxes, tax evasion and other macroeconomic variables, and in particular enables labour supply and compliance-related effects of tax change to be explored (*Busato and Chiarini, 2004 - 2009 ; Papp and Takats 2008*).

In addition to the incentive effects discussed before, the efficiency of the public sector has an indirect effect on the size of the shadow economy because it affects tax morale. As *Feld and Frey (2007)* argue, tax compliance is driven by a psychological tax contract that entails rights and obligations from taxpayers and citizens on the one hand, but also from the state and its tax authorities on the other hand. Taxpayers are more inclined to pay their taxes honestly if they get valuable public services in exchange.

It is important to note, however, that taxpayers may well generally be honest even in cases when they do not derive direct benefits from the public services on which their

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<sup>14</sup> Interestingly, in its annual report on tax evasion, the Italian ministry of economy (MEF 2009) claimed that the main causes of the low level of compliance in Italy were: the economic structure of the productive system, characterized by a very strong presence of small and medium sized firms and self-employed; the organization of the revenue collection system; the social pact between the tax payer and the State. One of the strategies adopted to pursue a reduction in tax evasion by small firms is investigated in *Arachi and Santoro (2007)*, who focus on a major innovation in the field of tax auditing of self-employed workers and small firms: “**Studi di settore**” or “**business sector analyses**”.

taxes are spent. In other words, taxpayers will tolerate redistributive policies if the political decisions underlying such policies follow fair procedures.

Finally, the treatment of individual taxpayers by the tax authority plays a role.

If taxpayers are treated like partners in a tax contract instead of subordinates in a hierarchical relationship, taxpayers will stick to the obligations of the psychological tax contract more easily.

Furthermore, the empirical evidence on these arguments reported by *Feld* and *Frey* (2007) presents a comprehensive discussion of the influence of such factors on tax compliance. Regarding to the impact of tax morale on the shadow economy, there is scarce and only recent evidence.

Using data on the shadow economy obtained by the “MIMIC<sup>15</sup>” approach, *Torgler* and *Schneider* (2009) report the most convincing evidence for a negative effect of tax morale on the shadow economy.

They particularly address causality issues and establish a causal relationship from tax morale to the size of the shadow economy.

This effect is also robust when additional explanatory factors and specifications are included. These findings are in line with earlier preliminary evidence by *Körner* (2006). Using survey data, *Feld* and *Larsen* (2005, 2009) likewise report a robust negative effect of tax morale in particular and social norms more generally on the probability of respondents conducting undeclared work.

Interestingly, the estimated effects of social norms on the shadow economy are quantitatively more important than the estimated deterrence effects. *Van Eck* and *Kazemier* (1988) also report a marginally significant effect of tax morale on participation in the shadow economy.

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<sup>15</sup> MIMIC approach is classified as a model approach, which can be used to estimate the size and the trend of the shadow economy.

## 2.4 ORGANIZED CRIME

In Italy, according to *Alexander* (2005), all of the four ma as are based in the area known as the “*Mezzogiorno*”, in the south, where incomes and standards of living are generally lower, illiteracy higher, and earthquakes are larger and more numerous than in other parts of the country.

In 1946, following the end of World War 2, large-scale land reforms were instituted much later than in the prosperous north and a fund was initiated by central government to stimulate social and economic development for the South. From these and other development initiatives, billions of dollars for development support from the Italian and United States governments, the World Bank, and the European Commission “disappeared”. It has become impossible to separate the *criminal organizations* from political corruption in this region of Italy. From an historical perspective, mafia-type organizations operating in some regions of southern Italy (*the “Mafia” in Sicily, the “Camorra” in Campania*<sup>16</sup>, and *the “Ndrangheta” in Calabria*) were born with the Italian state itself, about 150 years ago, and survived different stages of economic and social development.

The extent and enormous scale throughout Italy, of criminal fraud and corruption in the management of public works construction is revealed as intended and premeditated. In 2005 public works infrastructure was declining in spite of declared national policy to achieve the contrary.

This comparison of built infrastructure values against government public works expenditure per region, shows southern Italy as having received more public works finance over the years, even though it has less infrastructure, the city of Naples is the most corrupt region spending four times more per infrastructure unit than the least corrupt region. The difference is interpreted as a measure of corruption: the regions that did not get what was paid for are those where politicians and bureaucrats were siphoning-off public money before and during the construction process.

In contexts of this kind, where endemic criminal fraud and embezzlement have become entrenched, almost traditional and in some areas, a tourist attraction, it would be difficult for any relatively small-scale building contractor to behave honestly – if, after paying his backhanders, such a contractor could afford to do so.

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<sup>16</sup> The “*Camorra*” is one of the most dangerous organized crime in Europe and it is based in the city of Naples.

Organized crime is commonly perceived as the main obstacle to the economic development of several regions around the world (*Pinotti, 2014*).

Criminal organizations in Naples are usually involved in a wide range of illegal activities: they supply illicit goods and services to a variety of consumers; they practice extortion and other predatory activities against other individuals and firms operating in the economy; finally, they offer private protection in contexts where state enforcement is absent or limited (*Mastrobuoni, 2013*).

According to the scholar *Sales (2012)*, from a social point of view, the “*Camorra*” is considered a way and a price to be paid in order to reach balance and stability, which cannot be achieved in a different way because of the city conditions.

In fact, the *Camorra* governs the social confusion and settles the illegality that overwhelms the limits of the city. In this manner, the sub-privileged classes themselves begin the “*introverted rebellions*” that occur inside and dissolves the justification for a possible social riot. Like this, the free practices of illegal activities are tolerated and even protected by the authority. For the spreading of productive activities, the wealth outside from the metropolitan context, the *Camorra* has lost its specific urban traits and so it has become also an international phenomenon, in the last decade.

The detailed settlement of criminality in the State-district as, like “*Forcella*” (fork), “*Sanità*” (health) and in vast geographical zone, like “*Scampia*” and “*Secondigliano*<sup>17</sup>”, are sources of direct earning of criminal models, criminal techniques and diverting values. This zone is the first socialization agency for the young people and has a principal role in the formation process of young identity. But more often, some studious individuals think that these are the reasons that the origin to affiliation of new recruits, true successors of “*muschilli*<sup>18</sup>” because they are always in need of cover roles and tasks that can make them feel like part of the organization. In fact, the *Camorra* try to entrust the younger people with different duties: first they will use them as drug couriers, then make use of them for other illegal activities from robbery to murders. Only the best younger protégés will be admitted into the *Camorra*

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<sup>17</sup> “*Scampia* and *Secondigliano*” are districts located in the north area of Naples; a famous book “*Gomorra*” by Roberto Saviano describes the real socio-economics circumstances in this area.

<sup>18</sup> *Muschilli* is the nick name of youngs people utilized by *Camorra* for its illegal activities mainly as drug couriers.

society.

The local criminals have also been invaded by a foreign presence. The activities of these foreign groups are conditioned by Camorra approval. For example, Albanians, Nigerians, and Romanians are dedicated to prostitution exploitation and the drug trade, collaborating with Campania's clans. Other foreign groups, like the Chinese and Ukrainians, run the black works, where individuals work in illegal conditions. They also evade the laws about conditions, place, and time of work, exposing their clandestine fellow-countrymen to exhausting shifts just to keep down the market costs.

The tendency of Camorra to pursue the financial circuit to be more and more profitable has permitted the Camorra to leave their urban roots, by projecting it in the national and international context.

It is also important to emphasize the emergence of operative bonds in order to run individual deals among Camorra clans with representatives of Sicilian and Calabria clans. These bonds are a connection to international relations to control foreign markets through gangster token roots in foreign States such as Spain, Belgium, Holland, Romania, and Latin America. According to *Sales* (2012), the *Neapolitan Camorristi* businessmen are involved in different types of criminal market and urban violence. This is the most important feature of Camorra. Although, this prompted the internationalization of the Camorra phenomenon, the organized crimes appear to have strongly local traits, or "*napolicentrico*<sup>19</sup>".

The Camorra is a local-global crime group. It is national and international, but always central to a city district.

According to *Barbagallo* (2014), Camorra moves 100 billion Euros a year and controls whole markets. It behaves in a very fine way using professional intermediaries and firms, which give up, totally or in part, to pressures made by criminal groups behind them. Camorra has become in these years, an economical and social power, which controls politics and society overall because it provides jobs at all professional levels: from the low level employees to the most important professionals. Finally, the increase of the illegal opportunities is characterized by the present passage of the criminal underworld to the Camorra as a business, which has offered prospective of easy and quick earnings to young people.

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<sup>19</sup> City Centre.

It is not superfluous add that the juvenile crime is connected to the fact that Naples is the European city presenting the higher rates of compulsory education's evasion. The Neapolitans live in the illegal economy, which they perform a precious function with a huge negative impact on the local growth.

## 2.6 CONCLUSION

In the introduction of this research it is shown the meaning of *shadow economy*, and the different shapes of it.

Then, in order to answer the principal research question is vital to describe the characteristics of the shadow economy, and how they affect the Bank system and Business in Naples.

The literature reviews have shown briefly the main inputs<sup>20</sup> of this research, even though, there are more factors<sup>21</sup> to take in account in order to describe the real economic scenario in Naples.

*Taxation, local Criminality, Credit Risk, Access to Credit, Regulation, and Unemployment Rate* are all outlined as main factors, and all included in the literature reviews.

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<sup>20</sup> Characteristics.

<sup>21</sup> *Cash Holding* as part of not recorded activities, *corruption*.

### 3. METHODOLOGY

#### INTRODUCTION

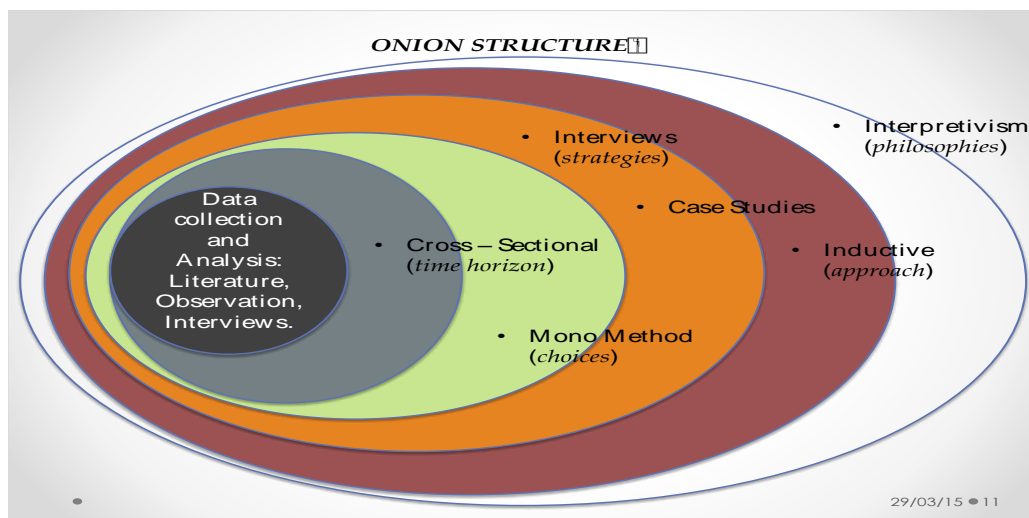
Research is the process of collecting, analysing, and interpreting data in order to understand a phenomenon (*Leedy & Ormrod, 2001*).

The research process is systematic in that defining the objective, managing the data, and communicating the findings occur within established frameworks and in accordance with existing guidelines. The frameworks and guidelines provide researcher with an indication of what to include in the research, how to perform the research, and what types of inferences are probable based on the data collected.

The three common approaches to conducting research are quantitative, qualitative, and mixed methods.

The *nature of this specific research* is exploratory and open-ended. Three have been interviewed in-depth. Participants were asked to respond to general questions and the interviewer was able to explore their responses to identify and define people's perceptions. Therefore a *qualitative methodology* has shown, even though, an empirical approach is also shown. Using the *research onion* see Figure 1, this will map and develop the *research methodology* for this study. This will show a suitable *research approach*, the relevant *strategy* and *philosophy* as well as the *technique* involved in the collection and analysis of the data. In this chapter will be shown all steps of the specific *Onion Structure*.

Figure 4.



Source: Davide Esposito

### 3.1 RESEARCH PHILOSOPHY

Interpretivists consider that there are multiple realities (Denzin and Lincoln, 2003). Since ‘*all knowledge is relative to the knower*’ interpretivists aim to work alongside others as they make sense of, draw meaning from and create their realities in order to understand their points of view, and to interpret these experiences in the context of the researchers academic experience (Hatch and Cunliffe, 2006), and hence is inductive or theory building.

The focus of the researcher is on understanding the meanings and interpretations of ‘*social actors*’ and to understand their world from their point of view, it is highly contextual and hence is not widely generalizable (Saunders, Lewis and Thornhill, 2007).

The philosophy in this research will be **interpretivism** because it describes social economic circumstances in Naples.

Typically, the human behaviour in a context where the shadow economy is deep-rooted would be one of the main analysed topics.

After that, an interpretation of experiences and perceptions within the financial Institution, and local Business are shown in order to bring the researcher to a conclusion.

## 3.2 RESEARCH APPROACH

It is important also to classify the research approach in terms of whether it is inductive or deductive. *Saunders* (2007) differentiated between these two types of the research design. First, the **deductive** approach – known as testing a theory, in which the researcher develops a theory or hypotheses and designs a research strategy to test the formulated theory, second, the **inductive** approach – known as building a theory, in which the researcher starts with collecting data in an attempt to develop a theory. The current research is shaped with using inductive research design. *Saunders* (2007) also noted that the inductive approach gives the chance to have more explanation of what is going on. In fact, this specific study starts the process by exploring and collecting data from different source and by using multiple sources of evidence: interviews, direct observation and document analysis in an attempt to develop a **conclusion** in compliance with the final **theory**.

The specific **observation** will be the local growth in Naples, and how it is affected by the shadow economy. Consequently, **analyse** the impacts on the local financial system (*from a Bank's perspective*), and the difficulties to access to credits (*from a Business's perspective*).

The **hypotheses** to be tested are:

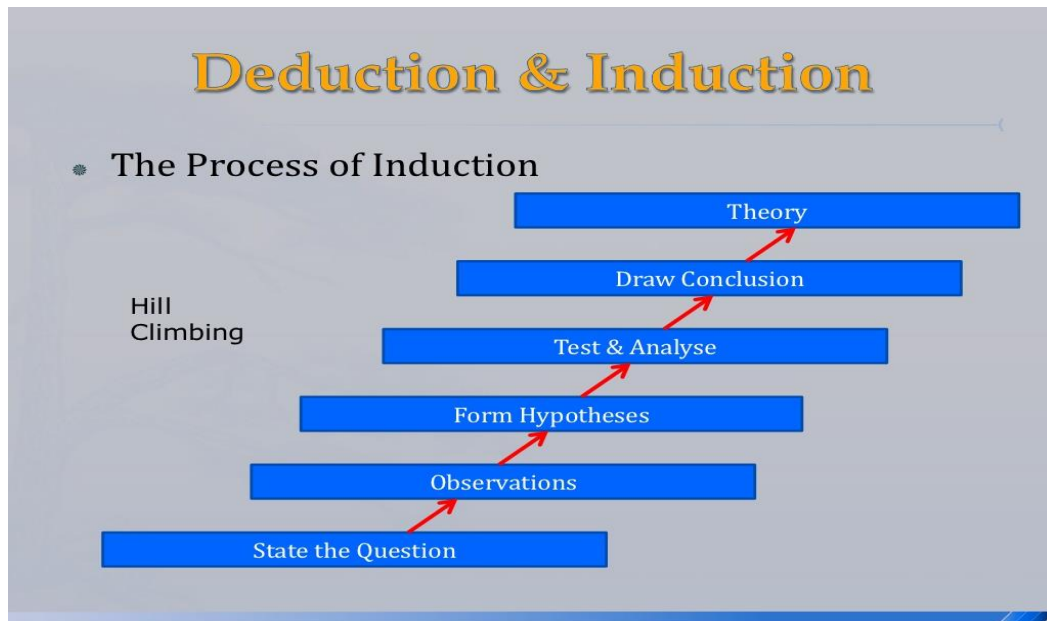
**What happens if we have a healthier economy?**

**What are the advantages of having a better access to credit?**

**What are the advantages of having less money tied up for the local economy?**

The process that will be shown is described in Figure 2.

Figure 5.



Sources: [slideshare.net](http://slideshare.net)

### 3.3 RESEARCH STRATEGY

Following the *Onion Structure* in page 9, the research strategy is a methodology that helps the researcher to investigate the research issue.

According to *Saunders* (2003), research strategy is a general plan that helps the researcher in answering the research question in a systematic way. This study uses **case study** as a research strategy to explore and discover a current phenomenon in Naples.

The phenomenon is the shadow economy and the impact on the local growth.

The choice of a case study research strategy had been attributed to a number of reasons. Case study has a distinctive advantage over other research strategies when “how” or “why” questions are being posed to discover a current phenomenon and when the researcher has little or no control over the events (*Yin*, 2003).

Moreover, *Gray* (2004) confirmed that a case study approach is particularly useful in revealing the casual relationships between the phenomenon and the context in which it takes place.

This is very important because the shadow economy is higher where the environment is very corrupted for example, showing strong relationship between the phenomenon and the context in which it takes place.

However, the case study approach has not been widely accepted as a reliable, objective and legitimate research strategy. One of the most critical criticisms directed to this approach related to the difficulty in generalizing the findings to a larger population (*Yin*, 1994; *Thomas*, 2003).

Therefore, it is essential to define a boundary around the phenomenon. In order to tackle the problem a *multiple-case designs* has been adopted to investigate the underground economy from two different prospective, financial Institution and local Business.

Finally, the current research will be supported by **interviews**, **direct observation** and **document analysis** with the aim to look at the problem from different perspective.

All this justifies the **mono-method** choice because it will show single qualitative information from face to face interviews (*participants in the study*), then they will be supported by secondary statistics data in order to be analysed.

### 3.4 SAMPLING

Whether probability or non-probability sampling strategy is chosen, the sampling frame should be relevant, complete, precise and up-to-date (*Denscombe, 1998*).

**Probability sampling** implies that each one in the population has an equal chance to get involved in the sample (*Corbetta, 2003*).

While a **non-probability** approach reflects that the chances of each person to be chosen in the sample is unknown but the features of the population are used as the main measure for selection.

These methods are extremely useful under certain conditions, particularly when the research question seeks an in-depth investigation of a small population or when the researcher is performing a preliminary, exploratory study (*Schutt, 2006*).

This research will show a non-probability approach where at least **three people** will be interviewed from three different backgrounds, Banks, local Business and a lecturer at the University of Naples.

Under non-probability sampling the organizer of the inquiry purposively choose the particular units of the universe for constituting a sample on the basis that the small mass that they so select out of a huge one will be typical or representative of the whole (*C.R. Kothari, 2004*).

The research will reduce as much as possible the errors related to “***samples of convenience***”, therefore, the subjects are not selected because they are easiest to interview for the study, but because they are representative of the entire population.

### 3.5 DATA COLLECTION

Having explored the nature and purpose of qualitative research in the previous paragraphs now it is important to explore which methods of data collection must be used in this qualitative research.

It is already shown how the researcher aims to collect data in this specific study; however, a little description must be given in order to justify the selected method.

The most common sources of data collection in qualitative research are **interviews**, **observations**, and **review of documents** (Creswell, 2009; Locke, Silverman, & Spirduso, 2010; Marshall & Rossman, 1999).

This research will present primary data through **personal interviews**.

In addition, the research methods literature (i.e. May, 1997; Saunders, 2003) has largely identified three different forms of interviews (structured, semi- structured and unstructured interviews).

Dawson (2002) argued that the **semi-structured** interview is perhaps the most widespread type used in qualitative research.

In this kind of interview, the researcher pre-establishes a set of questions to know more information about specific issues and sometimes identify new issues that were not originally part of the interview.

For instance, a few questions can be:

- *Are the non-performing loans related to the black economy (to a Bank Manager in Naples);*
- *Or, what are the main consequences of the shadow economy from a microeconomic point of view in Naples (to the lecturer at the University of Naples).*

Analysing the single answer the researcher would be able to locate new issues useful for the study.

Moreover, flexibility must be shown during the interview session in which the researcher can add or remove questions from the schedule based on the result of each interview.

Also, Saunders (2003) indicated that the investigator is not requested to follow a specific order of questions but can vary the order depending on the flow of the conversation.

Semi-structured interviews give the researcher the opportunity to ‘investigate’ for more detailed information by asking the respondent to give more clarification to his answer; therefore, it stands to reason that semi-structured approach is chosen.

This is significant for those who adopt a phenomenological approach because a prime concern is focused on understanding the meanings that the respondents ascribe to various phenomena (Saunders, 2003).

However, an **ethical issue** to be concerned is that interview are influenced by the level of awareness and the emotional state of the interviewee, so that a possible distortion to data may occur as a result of the interviewee being anxious or annoyed at the time of the interview. To avoid having a large data, the research should maintain his own knowledge and let the interviewee flow.

Finally, the steps that will be followed for each interview by the researcher will be:

- An **introduction** stating the name, position and institution of the researcher;
- An **explanation** of the aim of the research to formalize the interviewee with the research topic;
- This brief introduction will be followed by asking the interviewee about his/her **position and responsibility** as a way of collecting more details, and
- Creating a **good atmosphere** to conduct and record the interview.

### 3.6 DATA ANALYSIS

*Gray* (2004) identified two main approaches for analysing qualitative data: **content analysis** and **grounded theory**. The former method attempts to identify specific categories and criteria of selection before the analysis process starts, while in the second method (grounded theory), no criteria are prepared in advance. All the measures and themes come out during the process of data collection and analysis. Hence, it can be recognized that grounded theory is an inductive approach and content analysis is more deductive.

In addition, *Strauss* and *Corbin* (1998) defined grounded theory as a theory that is discovered, developed and provisionally verified through systematic data collection and analysis of data pertaining to that phenomenon.

In regards to the current study, the data obtained will be analysed by using the constant comparative method, which yielded from the **grounded theory approach**. The analysis process starts with transcribing, **coding**, categorizing the data into different sets and then comparing them in order to produce a theory.

Afterwards, the researcher will critically analyse the similarities and differences of the formed categories with the aim of finding out the actual meaning of the data. The themes used in the result chapters would emerge from the questions posed and the analysis process.

### 3.7 RESEARCH ETHICS

Ethical issues are present in any kind of research. The research process creates tension between the aims of research to make generalizations for the good of others, and the rights of participants to maintain privacy.

Qualitative research involves data that are recorded in narrative descriptions, not numbers. Researchers use qualitative methods to observe and describe conditions rather than control them.

Participant and nonparticipant observations are integral components of qualitative research and are used widely in the fields of education, sociology, and economics. Each presents unique ethical issues in regard to consent, privacy, and deception (*Brinkmann & Kvale, 2005; Haverkamp, 2005*).

Furthermore, in the context of research, ethics refers to the appropriateness of your behavior in relation to the rights of those who become the subject of your work, or are affected by it (*Saunders, Lewis and Thornhill, 2007*).

Therefore the purpose of the research being undertaken is clearly communicated to all respondents before any research took place allowing respondents time for consideration.

In this specific study the main factor to take into account are:

- **Consent**: participants should be informed about the nature of the study;
- **Protection of participants**: avoiding distressing question, participants might not give a response in this case;
- **Debriefing**: this may involve providing participants with written information describing the study;
- **Confidentiality**: this means that the research must take care to anonymous data that obtains from participants, say in interview studies;
- **Data storage**: collecting data from participants who are not anonymous, then special precautions to ensure that the data is stored appropriately to ensure the participants' anonymity.

## 4. FINDINGS

### 4.1 INTERVIEW 1

The first interview was conducted at the University of Naples “*PARTHENOPE*”, in this specific place the researcher achieved the Bachelor’s Degree in Economics in 2008 therefore it was taken in consideration as the best place to start the project.

The first candidate is a lecture from the above University; her name is “*Maria*” and she teaches Microeconomics, Development Economics, International and Comparative Labour, and Labour Economics. The first questions will be general the others specific to the city where the research is based on.

**Q1. Shadow economies are difficult to define, especially because of the challenges in measuring them. How would you describe a shadow economy?**

Since the term ‘shadow economy’ comprises numerous economic activities, it is difficult to provide a universal definition. For example, one has to consider the role of goods and services produced and consumed within the household, ‘soft’ forms of illicit work (*moonlighting*), illegal employment and social fraud, as well as criminal economic activities. In general, the shadow economy can be seen as the result of decisions of individuals to act outside of official norms and formal institutions for economic activity.

*Shadow economies* are part of *underground economies*. An underground economy consists of all private economic activities that are not included in the calculation of the gross national product (*GNP*), but nevertheless contribute to added economic value. The underground economy can be separated into a legal and an illegal sector. The legal sector can then be specified as the self-sufficient economy (household sector and informal sector) and the illegal one as the shadow economy or hidden economy (irregular sector and criminal sector).

For “*Maria*” these activities are not registered for **three** reasons:  
(1) According to international custom, the activities are not included in calculations of GNP;  
(2) Insufficient collection methods result in some transactions not being recorded

fully or at all in the national account statistics;

(3) The added value in a transaction is not readily apparent; therefore it cannot be recorded.

**Q2. What is the major challenges regarding the measurement of shadow economies? How can some of these challenges be overcome?**

There have been several studies providing information about illicit work, in addition to annual estimations that measure the size of the shadow economy in more than 150 countries based on macroeconomic methods. However, the results of these studies differ greatly due to the application of different estimation techniques and variations among the definitions and assumptions used by researchers.

Consequently, international comparability cannot be assured. It is also difficult to compare national shadow economies since variables (such as tax burden and unemployment rates) are estimated differently from state to state. Moreover, illicit work is by nature carried out in secret. Therefore, it can only be detected indirectly (for example, in interviews), if it is possible. In a City like Naples organized criminality such as the “*Camorra*” can be so dangerous that people in this area live in the “*code of silence*”.

Macroeconomic estimation methods have also been criticized on various grounds. Regardless of these limitations, some international studies have been conducted, and comparable trends can indeed be observed, even though different estimation methods have been applied.

Differences in empirically determined estimates of the size of the global shadow economy could be explained to a certain extent by theoretical differences in approach. Even though the techniques may not be able to give an exact result, they can render visible a few clues. Some approaches allow for an estimation of the development of the shadow economy over time. As the bases of the different approaches vary, there are clear differences regarding the estimation of the size of the shadow economy.

Yet, comparing methodologies gives the reader an idea as to whether or not the estimations are plausible. When entirely different approaches lead to similar outcomes

or when disparities can be explained by comparing methodologies, then more reliable results can be obtained by combining study approaches.

**Q3. The term ‘*shadow economy*’ often carries a negative connotation. However, some experts like author *Robert Neuwirth* argue that shadow economies are an inherent part of the global economic system and not necessarily bad. Do you agree?**

Indeed, activities in the shadow can have positive and negative impacts for an economy. Illegal and semi-legal activities are in general undesirable for official institutions. Because the growth of the shadow economy is caused by a rise in the overall tax and social security burden, together with institutional sclerosis, an increase in underground activity erodes the tax and social security bases. The result is a further increase in the budget deficit or tax rates, additional growth of the shadow economy, and a gradual weakening of the economic and social foundations of collective arrangements.

This is a vicious circle with a negative outcome. But, a growing shadow economy can be seen as the reaction of individuals who feel overburdened by the state and who choose an ‘*exit option*’ rather than a ‘*voice option*.’ Apart from physical or economic migration into other countries, the shadow economy is an important ‘*exit option*’ and can limit the power of the “**leviathan**” state. If taxpayers are dissatisfied with the public goods offered for the amount of taxes paid in their country, they can emigrate, in the underground or abroad. The possibility of engaging in shadow economic activities limits the taxation authority of the government; the shadow economy forms an endogenous boundary. And they should force the government to improve institutions.

**Q4. How do you define the *underground economy* in Naples or Southern Italy?**

The “underground economy” is an awkward subject for both economists and policy makers. Economists find it difficult to define and to measure, while their main explanations of it are highly partial. Indeed, they produce extremely diverse estimates of the underground economy in the same country, depending on the definitions and the method used. By contrast, explanations of the phenomenon at the theoretical and

empirical levels are usually restricted to the heavy weight of the tax burden and to excessive regulations. Policy makers are discomfited by the fact that the underground economy is detrimental to tax revenues and, more generally, to social order, whereas it is able to generate employment and income.

A step towards better understanding and management of the problem of the underground economy is to consider it in connection with the structure of the economy, whether this is advanced or less developed. Estimates agree that the underground economy is most widespread in the less developed countries, and, within the OECD, in Greece, Italy, Spain and Portugal. Even though, "*Maria*" has shown in her studies that this connection is not always founded, in fact, tax burden is not only particularly heavy in Greece and in Italy, it is also heavy in the Scandinavian countries, and even in Austria which displays a very low incidence of underground economic activity.

But the most striking evidence concerns the South of Italy compared to the rest of the country. In fact, the City of Naples is characterized both by a less developed economic structure and by a more widespread underground economy, although, they are subject to the same tax system and regulations as the Northern regions.

These facts can be explained if we look at the different forms assumed by underground activity. In the Mediterranean countries or regions, the non-registration of labour is standard practice for both firms, though to different extents, and private employees, who otherwise are faced by unemployment with no social benefits available. The economic structure thus mainly consists of small firms, which can compensate for technological inefficiencies by low unregistered labour costs.

By contrast, in the Northern countries or regions of Europe and in the U.S. unregistered work is typically of secondary importance, and those who are already employed often pursue it.

Therefore, one may state the stylized fact that a widespread underground economy is associated with inefficient techniques, few and small units and low output; and conversely that a small proportion of underground activity in the economy is linked with more efficient techniques, more and larger units, and a greater output.

It might be thought that development, and hence the reduction of the underground economy, is an automatic process. However, this does not seem always to be the case. Analysis of convergence among per capita GDPs in the European regions clearly

shows that many poor regions tend to stagnate, or even that they form a low-income club of regions.

Even more clearly, recent trends in many regions of Southern Italy, together with the persistent, if not increasing, diffusion of underground practices, suggest the existence of an **underdevelopment trap**.

**Q5. How do you define the “*underground economy behaviour*”, and what do you mean for “*underdevelopment trap*”?**

As far as I am concerned, the phenomenon of the underground economy is recognized as important by empirical studies, which also reveal that it is not evenly distributed, but is more widespread in less developed areas such as Naples. In fact, in my previous studies, I attempted to explain the different coexistence of the underground economy with the official economy in a more developed area with respect to a less developed one.

Unfortunately, underground economic behaviour is very heterogeneous, and difficult to observe, so that it cannot be easily stylized.

Nevertheless, a few plausible hypotheses can be put forward regarding some important features of this phenomenon.

Firstly, in Naples, firms hire unregistered labour mainly, but side by side with official employees.

Secondly, firms use the two different kinds of labour more as complements to each other than as substitutes. This is because official labour implies a more stable relationship with the entrepreneur, so that greater efficiency may ensue.

Thirdly, entrepreneurship is important in explanation of the abandonment by a firm of small-sized and low-productive processes largely based on unregistered labour.

Fourthly, entrepreneurship depends, in a given area, on individual ability, which may be very heterogeneous, and across different areas, on the density of enterprises, which is likely to give rise to positive externalities. In particular, the literature on industrial districts emphasizes the importance of a critical density, which generates acceleration in economic development.

On the basis of these hypotheses, my model proposed in my piece of work is able to substantiate the following results:

- An equilibrium both micro- and macro-economic exists when firms find it convenient to employ both unregistered and official labour;
- The degree of regularisation by each firm depends on entrepreneurship and on the relative fiscal burden; in particular, the better the entrepreneur's ability, the greater the demand for official labour, thus implying a more efficient and large firm;
- In the macro-economic equilibrium the number of firms, their size, the overall productivity and output are determined as well;
- If a critical density of enterprises exists, two stable equilibrium can be determined: a "good" equilibrium where the economy is populated by many firms, with high productivity and output and low degree of labour regularisation; and a "bad" equilibrium with the reverse features, which can thus be termed an underdevelopment trap;
- The possibility of escaping from the underdevelopment trap, or at any rate of increasing the level of regularisation and overall efficiency, derives from policy measures designed to improve entrepreneurship, especially when the improvement is evenly distributed;
- By contrast, tighter fiscal controls have overall perverse effects if entrepreneurship is particularly scarce.

These results are of particularly relevance to the debate on the underground economy in the Southern areas of Italy. In fact, these results suggest that an economy may fall into an *underdevelopment trap* when underground activities are particularly convenient, although not exhaustive but rather complementary.

The best policies suggested are those intended to improve entrepreneurship, especially through educational policies. The policies directly targeted on combatting the underground economy, like tighter controls and penalties, appear to be effective only when entrepreneurship is sufficiently developed and evenly distributed across firms.

Therefore, in order to reduce the underground economy, the most effective policy is to make registered labour more convenient, rather than to make unregistered labour less convenient.

The best strategy appears to be that of combatting underdevelopment, rather than underground activities as such.<sup>22</sup>

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<sup>22</sup>A very recent paper on the effects of the underground economy on unemployment reaches an analogous conclusion. By adopting a very different model *Boeri and Garibaldi* (2000) conclude that the best policy for reducing unemployment is to raise overall productivity or to combat it directly, rather than to increase penalties on the underground activities, which may have perverse effects.

## 4.2 INTERVIEW 2

The second interview in this research aims to discuss openly about the main problems in access to finance by firms, how does it impact on the local growth, and if shadow economy is a real issue from a bank's prospective.

The interviewee is called "Matteo" and he worked for UniCredit Group in Naples for more than 11 years. At the moment "Matteo" is Professor of Corporate Finance at the University of Sannio in Benevento (Italy).

### **Q1. Which are the main difficulties in access to finance of Italian firms in Naples?**

Access to finance is one of the most important problems for Small and Medium Enterprises (*SMEs*) in Southern Italy; here we don't need to forget that mostly small and medium companies create the Italian's wealth.

Italy performs well below the EU average, with signs of increasing deterioration.

Problems continue in the wider interest rate spreads between small and large loans and the absence of private equity and venture capital investor, particularly for early-stage investments.

Despite the efforts realized from Government to sustain new and traditional forms of financial instruments, Neapolitan *SMEs* still suffer from a chronic and structurally difficult access to finance. The main problems are:

- The increased administrative rigidity of banks in providing loans, and;
- The higher differential rates between large firms and small and medium firms, even though, in Naples large firms are in a small percentage because most of them migrated in the north part of the country in the last decade. Banks are more concerned to give loans and other financial instruments to bigger companies because they are able to prove better recovery from the "*financial sufferance*".

## **Q2. Do you define this as an indirect financial exclusion?**

Unfortunately yes, a person is considered *financially excluded* when they have no access to some or all of the services offered by mainstream financial institutions in their country of residence or do not make use of these services.

For instance the study '*Financial services provision and prevention of financial exclusion*' (Réseau Financement Alternatif 2008) establishes a list of basic financial services considered essential to daily life: a bank account to receive income; a transaction account to make payments from; a savings account to store money; and access to unsecured credit to manage temporary cash shortages and unexpected expenses.

Access to banking (and transaction banking services in particular) is considered a basic necessity in most developed countries. The provision of transaction banking services is key to accessing other financial services such as credit and savings.

Lack of transaction banking services runs parallel with social exclusion, as people are not able to receive salaries or remittances, pay bills by direct debit or use safe means of payment such as cheques or cards. This distorts their access to broader economic opportunities and increases their risk of poverty.

In a city like Naples where black economy is so long-lasting Banks not have any tracks of financial transactions penalizing the local firms and local growth.

Is demonstrated theoretically and empirically that cash holdings reduce innovative firms' dependence on external financing and, therefore, it reduce the accessibility to credit for investments.

Credit is the main financial tool that enables access to goods or expenditures that oversize the monthly budget, such as equipment goods. Lack of access to, or use of, credit impacts on access to the minimum national standard of living, and can stigmatize people. '*Credit excluded*' people, i.e., those who are refused access to credit by mainstream lenders, are exposed to informal moneylenders who loan money at extortionate rates. Lack of access to appropriate and flexible credit impedes the averaging out of financially difficult periods and may lead to over-indebtedness.

In fact, most of the Neapolitans leave on micro-loans given by other financial institutions different than Banks, not only, those are also related to big criminality association such as "*Camorra*" that financing to local people.

It is understandable why crimes such as extortion and usury are so common in this City.

However, It is important to acknowledge that financial exclusion is not an absolute concept (*excluded or not*), but a relative one, rather like poverty, with degrees of exclusion. People vary as to the extent of their engagement with specific services, and they also vary in terms of the number of types of financial products to which they have access. It is, therefore, useful to use the term ‘financially excluded’ for those who lack all products and ‘marginally’ excluded for those who have limited access.

### **Q3. What are the main causes of financial exclusion?**

Several factors are considered major causes of financial exclusion in Naples.

As far as I am concerned they can be broadly grouped into three categories: **societal, supply and demand factors.**

A range of social factors has been identified as having an impact on people’s access to, and use of, financial services. With the increasing diversity of financial institutions and services caused by the liberalization of financial services markets, it is hard to gain a general overview of the sector and the opportunities available. Studies also reveal a strong correlation between levels of income inequality (measured by the *Gini coefficient*) in a country and the incidence of financial exclusion. Furthermore, in Naples factors such as structural labour market, criminality, and social life style attitude, increase people’s vulnerability to financial exclusion. The regulatory context, together with government social and economic policy, also needs to be considered.

Supply factors take into account a financial institution’s criteria for accepting a client, the fees it charges for access to its services and its requirements (e.g., its risk assessment procedures). These can lead a bank to refuse services to a person and can act as a strong deterrent to a potential client seeking a particular financial service. Supply factors encompass the geographic location of the institution, which in several cases is a primary cause of financial exclusion.

On the demand side, the potential client’s priorities, concerns and cultural context need to be taken into account. This is crucial in understanding a person’s personal and psychological relationship with money and how they view the financial sector.

For instance, in Naples savings exclusion is the result of the lack of a habit of saving money in a bank or an unwillingness to deal with banks because of negative past experiences or prejudice; this is referred to as ‘self-exclusion’.

#### **Q4. And, what are the main consequences of financial exclusion?**

Two main dimensions of financial exclusion consequences under the umbrella of **socio- economic consequences** on affected people can be determined.

First, financial exclusion can generate **financial consequences** by affecting directly or indirectly the way in which the individuals can raise, allocate, and use their monetary resources.

In Naples, more than 38% of the population has not bank account at all face difficulties dealing with cheques made out in their name by a third party. Often they have to pay the cheque cashed and in some countries there are networks of cheque cashing companies whose main purpose is to offer this service and avoid taxes. Lacking a transaction bank account with payment facilities can make payment of bills costly.

Moreover, the cost of banking services bought separately is generally higher than those accessed within a stable relationship with the bank. Consequently, occasional payments of utility bills, payment of taxes, bank transfers to third persons, cashing cheques and money orders at the banking counter are more expensive for those who are not customers of the bank. Therefore there are relevant negative economic consequences of dealing occasionally with banks, not only of using alternative commercial profit-oriented financial services providers.

Finally, as I said before, people in Naples that are unable to get credit from banks or other mainstream financial providers often have to use intermediaries, mostly illegal, where the charges are higher and the terms and conditions may be inferior, sometimes paying with their lives.

Secondly, **social consequences** can be generated by financial exclusion.

These consequences are affecting individuals’ patterns of consumption, the way they participate to economic activities or access social welfare and the distribution of incomes and wealth. They impact the way in which people behave both in terms of

purchase decisions and the way in which they choose to spend their time, as well as their overall quality of life.

Evidently, those lending from illegal financial service providers experience the most negative consequences. In Naples, the “*Carabinieri*<sup>23</sup>” highlighted that one of the major risks associated with borrowing from illegal lenders arises when borrowers find themselves in financial difficulties with lenders likely to use violence and intimidation.

Moreover, in some places, having to pay in cash generates the feeling that the money is not clean or has been stolen. People concerned by this situation can feel humiliated by it and lose their self-esteem.

The consequences of financial exclusion on the individual and the society must not be underestimated. Those unable to access finance for enterprise development or personal consumption have greater difficulties in integrating socially and economically.

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<sup>23</sup> The *Carabinieri* is the national military police of Italy, policing both military and civilian populations.

### 4.3 INTERVIEW 3

The last interview, before the final conclusion and personal reflections, is conducted at the association called “*Movimento dei disoccupati organizzati*” (organized unemployed movement) in Naples. The researchers chose this specific place because come across people that are not totally unemployed, but they live in precarious circumstances. Most of them work temporarily earning just a small amount of money per week, money that are essential to sustain their families’ spending.

“*Enrico*” is one of those and he showed availability for a quick interview during the researcher’s stay in Naples, the area where the interview took place is one of the poorest. The researcher travelled to “*Scampia*<sup>24</sup>” in order to understand how people in this part of the City, qualified as “*Slum*”, live.

*Enrico* is a typical long term unemployed man is in his forties, married and with 3 children, living in an extended family household (with other relatives). His educational level is low (at best, a middle school certificate), although, Enrico displayed great understanding of the real situation in the area, and great interest in economy thanks his will to help local people. His family of origin, instead of being a source of support, is often in need of support itself and therefore a further burden. He generally lives in public housing, either paying rent or squatting, and maybe not even paying for utilities such as gas, electricity and water. Social services are rarely called upon, and the solution for economic problems is considered to lie in finding an odd job or asking for help from the family.

#### **Q1. Enrico why do feel excluded and how do you describe the economy in this area?**

Labour market is serious throughout Naples but Scampia is particularly badly affected.

In Scampia 61% of the active population is unemployed — a figure that is above the average for the municipality. The percentage of active population is also higher in Scampia due to the younger average age of the population, whilst the employment

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<sup>24</sup> **Scampia** is a modern suburb in the north of Naples. It is the territory of the “*Di Lauro*” crime family, which controlled the drug trade, and most other illegal activities in the area. Scenes from the movie Gomorrah were filmed in the neighbor-hood.

rate is low. It is not surprising that the percentage of active population is higher than the average for the municipality whilst the employment rate is lower.

There are around 364 production units counted in Scampia by the 2011 census, only 25 are manufacturing businesses and offer employment to a total of 487 people. There are 268 commercial enterprises, employing 486 people.

I believe also that the role of the informal economy in the area is a real problem, it is not decidedly marginal and it is a consequence of the totally carelessness of the State. Informal economy regards mostly to improvised sales points underneath staircases or in apartments, where food products or, less frequently, clothing or stationary of little value can be bought.

For instance, I bought a van that I use for transporting people and goods. Here in the district I have a lot of friends, so when they need something they come to me and tell me to go to a certain place and pick something up, and I do it. Sometimes I don't work for a few days but generally I do one job a day; the money depends on the trip and the goods. But I feel happy because "I'm not starving to death!!!!"

In general, even if we live below the poverty line, most of the people in the sample manage to meet their basic needs, and limit their expenditures when they are making less money.

Home electronics are limited to TVs and radios, no one has a bank account, a credit card or savings, and average consumption is already very low.

Purchases are limited to food, and here, too, little is spent, since only the children eat meat and receive new clothes.

The real issue which me and my mates in the association is trying to fight is the total absent willingness from the local institutions to invest in culture and in higher control from the local police force, since these people are often socially isolated, with few contacts outside their family. Isolation is worsened by the lack of playgrounds in the neighborhood, or other meeting places, and by the deep-seated fear that comes from the high crime rate.

Unfortunately, there are no hopes for us if a real and responsible actions in this direction are not taken.

Limited access to the different kinds of public assistance shows how little the families know about the programs that might help them, in addition to revealing how ineffective the institutions are in having a real impact on neighbour-hoods where serious deprivation exists. The unemployed themselves have a rather negative

perception of the quality of welfare assistance available, which they consider both difficult to obtain and insufficient.

I get a monthly cheque for Euro 413 for socially useful work. On the pay slip it says unemployment benefit; that's the only time in the month I remember I'm on assistance – for the rest of the time I just feel that I'm an exploited worker because they don't pay contributions.

The typical single mother is a widow, 45 years old.

Her family of origin is large, with economic difficulties, and her educational level is extremely low (probably she has not completed primary school), since the cultural patterns see girls as helpers for their mothers in family care and housework.

The absence of qualification or professional skills profoundly affects her position on the job market, and she is typically employed in home-based work for small factories (footwear, socks, clothes, gloves).

Lack of sufficient income is aggravated in several cases by other problems (drug addiction, handicaps, imprisonment, alcoholism), which can accumulate to create precarious situations of serious social exclusion.

The majority has been living in Scampia since the eighties, when they moved into public housing after the earthquake, and they do not pay rent or utility for the apartment. Their condition of poverty is linked to the absence of their husband (due to either death or separation), which adds to a pre-existing condition of economic instability.

**Q2. Apart from the State, do you have any other explanations of the social discriminations in the area?**

Mainly, Scampia's poor inhabitants suffer from double discrimination: from **their neighbours belonging to higher social classes**, and from **the rest of the town**. The former finds expression, for example, in the fact that lower-middle class and middle class inhabitants, who live in better quality housing built by private co-operatives, often tend to live apart from the rest of the district, as is clearly shown by the enclosure of some buildings (protected by iron railings, video cameras and other security systems), or by the distribution of children in schools: the higher classes tend to avoid to close relationship with low income families, which on their part find difficulty in accessing certain schools due to their children already being branded as

deviants or potential criminals.

**“External discrimination”**, i.e. that made by the rest of the town, depends principally on the district’s bad reputation: research conducted over the past decade show how women from Scampia encountered greater difficulties in finding a job, because of prejudice against the district they lived in (employers were afraid that they could give information to criminals about family movements or contents of the house) and because of the greater difficulty in coming to work on time because of the distance and the poor public transit connections.

Finally, a third form of discrimination has to be added to the above two, a sort of **“self-discrimination”**, deriving from the widespread practices of social differentiation towards the other inhabitants of the area, with the effect of increasing the degree of social exclusion: “...If they ask you where you live and you say *“Viale della Resistenza”*, then that’s the end of it ...”

As I mentioned before crime rate in Scampia is very high too, also due to the high presence of prisoners and ex-prisoners amongst the inhabitants, and makes the area a dangerous one, especially at night.

In spite of the high rate of poverty in the neighbourhood, Scampia does not represent a ghetto, and the unstable proletariat classes live side by side with families of regularly employed workers. The presence of the latter type of inhabitants from one point of view represents an advantage for the whole area, since they are the most active in political and community life, taking part in and starting up initiatives for change in the district. But at the same time this social composition leads to a very huge distance amongst different social classes and to very few social contacts and thus of social networks, which might provide an opportunity for mutual help.

### **Q3. What is the main support for the families in Scampia?**

In my opinion, it is the social co-operatives, associations and informal groups linked to the parishes that play an important role in guaranteeing first aid to needy families: forms of supervision or support for schooling, activities of a cultural and recreational nature.

In Scampia the experience of discrimination has paradoxically determined systematic practices of social differentiation towards the other inhabitants of the area, so that the degree of social exclusion is increased.

All this penalizes neighbour-hood and relational networks among the families. Segregation is also clearly encouraged by the architecture of the buildings. The idea of reproducing the structure of street life has actually turned into a tragic caricature of it.

The inside areas designed for social life have been progressively abandoned to the point of becoming a real social danger (because of the risk of being attacked or because the actual buildings are unsafe).

My family is settled in the “*Vele*<sup>25</sup>” in an emergency, having moved there from the city centre, have cut off their neighbour-hood ties rather than strengthened them. Together with economic problems, poverty and unemployment, a cultural crisis has arisen.

The old way of social control linked to forms of protection decided by the community has been replaced by more unstable relationships in a physically hostile environment. Even in places where relational or neighbour-hood networks remain or have been reconstructed, these are unable to guarantee any kind of social capital as the people involved have very little to offer in terms of information, useful contacts, faith in the institutions.

It seems to me that there’s very little mutual support between families. But then it’s a problem of personal survival. People have got hardened in their relationships.

I think that it was intentional that people shouldn’t have any chance of meeting — just think about in these buildings that house 570-600 families — that’s 4-5000 people — there isn’t one space where it’s possible to gather for any sort of community life. There have been no social centres; so living here is like a prison sentence. But they knew all this. It’s all part of the politics that found their inspiration in grassroots struggles.

I could say that it’s closed and that depends on the structure of the buildings, which makes communication impossible. Then there is the harmful effect caused by social and economic aspects — poverty, exclusion, being made into scapegoats.

But there is another element I would insist on: emigration. The uprooting of your own culture, this mixing of the cards added to being pushed out into a marginal position —

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<sup>25</sup> The *Vele di Scampia* (English: Sails of Scampia) is a large urban housing project built between 1962 and 1975 in the Scampia neighbor-hood. However, various causes have led to what is now regarded as a ghetto. Right after the earthquake in 1980, many families in the area were left homeless. Many of these families without shelter started to occupy the apartments illegally. Tolerated and ignored by the government, more people started to occupy the buildings including criminals.

these are two terrible aspects.

Because not only do you take a person and move him somewhere else but you also put him down in the middle of other, harmful situations and where?

Right on the outskirts of the city!!!!

#### **Q4. Is there any anti-poverty policy in Italy for the people of *Scampia*?**

In Italy, the main anti-poverty policies are indirect, and not all the individuals and categories that benefit are in economic difficulty. Although many policies have a significant impact on poverty, there are few real “antipoverty” policies.

Italian welfare policy does not make a very good distinction between pensions and assistance; the former consumes 81.5% of all expenditure.

There are two approaches to fighting poverty. The first is a confused and stingy system of welfare payments, while the second is more generous and is based on the principle of insurance, so that only those who have paid into the pension system can collect.

The weak welfare system, which reaches only those who have made pension payments, means that the very means to fight exclusion are the weakest where they are most needed.

Current welfare measures with some impact on poverty are: the “social wage”, the “social pension”, the minimum pension, disability pension, subsidy for permanent medical assistance, special disability pension, family subsidy, national rental subsidy, tax break for renters, services for the disabled, maternity payments, family subsidies for those with more than 3 children, minimum wage integrators (RMI), subsidized health care co-payments.

Nevertheless, most of the welfare measures are insufficient.

Even the recent rise of the minimum pension to Euro 516/month did not affect all those who were entitled to it, and the elderly without pension rights often live below the poverty threshold unless they are married and can live with relatives.

And yet the elderly and the disabled are the best protected in the Italian welfare State, since current measures have little to offer for many other categories, such as unemployed, homeless, drug addicts and youth.

However, welfare payments and those for the handicapped are pitifully small (Euro 204 monthly in 2011), and are available to those who make less than Euro 282 a

month.

The impact of these payments depends on the beneficiary: if he or she is married or lives with family members, the sum can be a useful contribution; for the single disabled they are absolutely insufficient.

## 5. EMPIRICAL ANALYSIS AND CONCLUSIONS

### 5.1 EMPIRICAL ANALYSIS

The best model in order to describe how shadow economy empirically works is the “*The Model Approach*”, however, many are the approach for measuring shadow economy, and most of them are complex to define. The aim of the research is not to show mathematically the size of shadow economy in Naples, but it is important to take in to account just a simple model to understand better how different variables contribute in the shadow economy.

The pioneers of this approach are *Frey and Weck* (2003), *Frey and Weck - Hannemann* (2004), who applied it to cross-section data from the twenty-four OECD countries for various years. Before turning to this approach they developed the concept of “*soft modelling*”, an approach that has been used to provide a ranking of the relative size of the shadow economy in different countries.

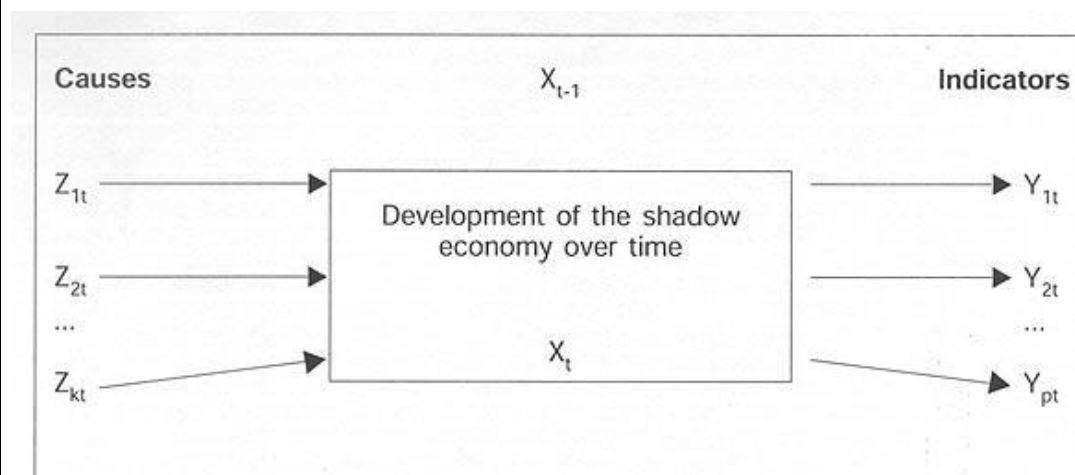
Most of the methods estimate the size and development of the shadow economy consider just one indicator of all effects of the shadow economy.

However, its effects show up simultaneously in the production, labor, and money markets. A more important critique is that some of the monetary approach studies consider just one cause, the burden of taxation. The model approach explicitly considers the multiple causes of, as well as the multiple effects of, the shadow economy.

The empirical methods, quite different from the one discussed, are based on the statistical theory of unobserved variables, which considers multiple causes and multiple indicators of the phenomenon. A factor-analytic approach is used to measure the hidden economy as an unobserved variable over time. The unknown coefficients are estimated in a set of structural equations within which the unobserved variable cannot be measured directly. The DYMIMIC (*dynamic multiple-indicators multiple-causes*) model consists in general of two parts, while the measurement model links the unobserved variables to observed indicators. The structural equations model specifies causal relationships among the unobserved variables. In this case, there is one unobserved variable, the size of the shadow economy. It is assumed be influenced by a set of indicators for the size of the shadow economy, thus capturing the structural dependence of the shadow economy on variables that may be useful in predicting its movement and size in the future.

The interaction over time between the causes  $Z_{it}$  ( $i = 1, 2, \dots, k$ ), the size of the shadow economy  $X_t$  and the indicators  $Y_{jt}$  ( $j = 1, 2, \dots, p$ ) is shown in figure 6.

Figure 6: Development of Shadow Economy over Time



Source: Bloomberg

Causes of the following three types have been identified:

- (a) The burden of direct and indirect taxation, both actual and perceived. A rising burden of taxation provides a strong incentive to work in the shadow economy;
- (b) The burden of regulation as a proxy for all other State activities. It is assumed that increases in the burden of regulation give a strong incentive to enter the shadow economy;
- (c) The tax morality (citizens' attitudes towards the State), which describes the readiness of individuals (at least partly) to leave their official occupations and enter the shadow economy. It is assumed that a declining tax morality tends to increase the size of the shadow economy.

A change in the size of the shadow economy may be reflected in the following indicators:

(a) Development of monetary indicators. If activities in the shadow economy rise, additional monetary transactions are required.

(b) Development of the labour market. Increasing participation of workers in the hidden sector results in a decrease in participation in the official economy. Similarly, increased activities in the hidden sector may be expected to be reflected in shorter working hours in the official economy.

(c) Development of the production market. An increase in the shadow economy means that inputs (especially labour) move out of the official economy (at least partly). Such displacement might have a depressing effect on the official growth rate of the economy in Naples.

*Giles, Linsey* and *Gupsa* have undertaken the latest use of the model approach. They basically estimate a comprehensive (dynamic) MIMIC model to get a time-series index of the hidden/measured output of New Zealand or Canada, and then estimate a separate cash-demand model to obtain a benchmark for converting this index into percentage units.

Unlike earlier empirical studies of the hidden economy, they paid proper attention to the non-stationary, and possible co-integration of time-series data in both models. This MIMIC model treats hidden output as a latent variable, and uses several (measurable) causal variables and indicator variables. The former include measures of the average and marginal tax rates, corruption, real income and the degree of regulation in the economy. The latter include changes in the (male) labour force participation rate and in the cash/money supply ratio. In their cash-demand equation they allow for different velocities of currency circulation in the hidden and recorded economies. Their cash-demand equation is not used as an input to determine the variation in the hidden economy over time. It is used only to obtain the long-run average value of hidden/measured output, so that the index for this ratio predicted by the MIMIC model can be used to calculate a level and the percentage units of the shadow economy. The latest combination by *Giles* of the currency demand method and the MIMIC approach clearly shows that some progress in the technique used in estimating the shadow economy has been achieved and a number of critical difficulties have been overcome.

There are many obstacles to be overcome to measure the size of the shadow economy and to analyse its impact on the official economy, although some progress has been made.

The present approach has shown that while it is difficult to estimate the size of the shadow economy, it is not impossible. It has been demonstrated that with various methods, such as the currency demand method, the physical input method and the model approach, some insights can be provided into the size and development of the shadow economy in Italy (Naples). The results achieved through the use of these methods give the general impression that, in Naples, the shadow economy has become remarkably large.

In summary, there appears to be no best or commonly accepted method; each approach has its specific strengths and weaknesses as well as specific insights and results. Although the different methods provide a rather wide range of estimates, there is a common finding that the size of the shadow economy has been growing over the recent decade in most transition countries and in all the OECD countries studied. A similar finding has emerged for the shadow labour market, which is attracting growing attention because of high unemployment in European OECD countries.

Furthermore, the results of the present approach show that an increasing burden of taxation and social security payments, combined with rising State regulatory activities, and illegal activities are the major driving force for the growth of the shadow economy in Naples.

According to some studies, a growing shadow economy has a negative impact on official GDP growth, but other studies show a positive impact, hence, much more research is needed. Finally, shadow economies are a complex phenomenon, present to an important extent even in industrialized and developed economies. People engage in shadow economic activity for a variety of reasons, the most important of which include government actions, in particular, taxation and regulatory measures. With those two insights goes a third and no less important one: a Government that wants to decrease shadow economic activity has to first and foremost analyze the complex and frequently contradictory implications of its own policy decisions.

## 5.2 CONCLUSION

As it is showed, measuring the shadow economy is extremely difficult. Nevertheless, it is possible using modern statistical techniques to estimate its size with a reasonable degree of confidence.

The size of the shadow economy might have surprised some readers if they had seen these estimates two or three years ago. The evidence suggests, for example, that the shadow economy constitutes more than 30% of local income in Naples, Italy. The recent euro crisis, however, has shone a spotlight on problems in different countries with regard to tax collection and compliance and the problems are now more widely known. In fact, in Naples in the last decade the size of the underground economy tended to grow due to the fiscal pressure.

The causes of the shadow economy include tax and social security burdens, tax morale, the quality of state institutions, labour market regulation, the level of transfer payments and the quality of public services. The first two in this list are empirically substantially more important than the others.

The level of shadow economic activity does not necessarily cause direct reductions in economic welfare. Economic activity is, after all, economic activity. Whether it is declared or not it still raises people's incomes. The money earned in the shadow economy is often immediately spent in the formal economy. It is therefore important not to try to stamp out the shadow economy by stamping out the economic activity that goes with it – throwing the baby out with the bathwater, so to speak. This is an important consideration when we look at potential solutions.

While the size of the shadow economy might surprise some people, perhaps even more surprising is the number of people involved and how widespread is the acceptance of shadow work.

As an example of its scope, it is notable that about thirty million people undertake shadow work in the EU; around half of all construction workers in Southern Italy undertake shadow work; and over 80% of Neapolitan find shadow work acceptable – at least in some circumstances. This is the case of *Enrico* and many others in Naples, they find the underground activity the only way to survive due to the lack of assistances in Scampia.

Not only, also *Maria* mentioned that: a growing shadow economy can be seen as the reaction of individuals who feel overburdened by the state and who choose an ‘*exit option*’ rather than a ‘*voice option*.’

The researcher question at this point could be: “*Ok I agree with you, but what if everybody pays taxes equally without evasion*”, maybe a better assistance would be provided. Unfortunately, no all scenarios can be included in one research and more doubts can distorts the final results.

When it comes to thinking about policies to reduce the shadow economy, the disaggregated evidence on those involved has to be considered carefully. In fact, there is little evidence that illegal immigration is a significant contributory factor to the shadow economy in general, in fact illegal migrants constitute a relatively high proportion of total employees in Italy, and most of them in Naples are also exploited.

One important split is that between the unemployed and the employed. If the unemployed mainly undertake shadow work, policies should mainly focus on the welfare system.

Welfare-to-work schemes might help reduce the incentive to undertake shadow work while receiving benefits, for example, as would income disregards. On the other hand, if shadow work is mainly undertaken by the employed, it is important to ensure that the tax and business registration systems encourage compliance rather than make compliance difficult.

The situation differs in different parts of the country. In the North regions, shadow work is much more common among the employed than among the unemployed.

In Naples, shadow work tends to be more or less equally common among the employed and the unemployed in terms of numbers of people involved, though the unemployed undertake a greater amount of shadow work.

What really struck the researcher was the fact that even if people in Naples live in economic difficulties, from their cloths and standard of life, nothing let him think a really bad situation as it is described. Maybe in Naples to live in shadow activities is also something related to the mentality, as if it is normal in order to achieve a high standard of life.

In general, the problems lie with the legal systems that make it difficult for businesses and individuals to register their activity. Indeed, in some sectors, informality in business and employment relationships can effectively become the norm. The main focus of the detailed discussion and policy recommendations relates to Italy, but also

to OECD countries. Though it has been presented an analysis of the extent of the informal economy in less developed regions of Italy, it does not take this further.

When it comes to addressing the shadow economy, we can think in terms of ‘meta’ solutions or in terms of detailed policy recommendations. As mentioned earlier, an increased tax burden can lead to an increase in the size of the shadow economy and reduced state revenues. This, in turn, reduces the quality and quantity of publicly provided goods and services and an increase in tax rates for firms and individuals. This is what really stops Naples making progress in the long term.

These factors may lead to lower tax morale and a need for still higher tax rates. Reversing this vicious circle could be an important policy and, when thinking about the size of public spending and taxation as a proportion of national income, the relationship with the shadow economy should not be ignored. There are, however, much wider considerations, of course, when setting the overall level of taxation, and we do not consider the aggregate tax burden in any further detail as a potential policy measure to deal with the shadow economy.

Marginal tax rates, other non-wage costs and benefit withdrawal rules may be more relevant policy instruments than the aggregate tax burden, especially when addressing shadow work among those in employment. There is a high level of such costs in the EU – averaging 39 per cent for individuals in the bottom half of the income spectrum. In Italy the “*low wage trap*” is especially large: individuals moving from low to median wages lose a high proportion of any wage increment in taxes or lost benefits. This is another problem that should be examined when considering how to reduce the size of the shadow economy.

Other research also shows that shadow economies are smaller in countries with fewer laws and regulations combined with consistent enforcement, and where there is less bribery and corruption in the economic system. Italy is well known for its high complexity regulation, and this has a huge impact on investments and local businesses that are struggling at the moment.

This provides a further argument for ensuring good-quality legal institutions. At a more detailed level, however, governments should put more emphasis on legalizing certain shadow economy activities or on making formalization much easier.

Such “*pull*” measures should be applied in Naples – so called because they pull shadow work into the formal economy rather than try to eliminate it – are of three types: preventive measures that seek to prevent entry into the shadow economy;

curative measures that seek to move those currently engaged in shadow work out of this sphere and into the legitimate realm; and measures that seek to improve commitment to tax morality.

For instance, business start-up loans given by relatives and friends could also be brought into the formal economy by copying the “*Rich Aunt Agatha*” scheme used in the Netherlands. This scheme allows small loans to be provided without taxes and ensures that a small business can set off on the right footing. This is very important because, once a business has evaded taxes, formalizing the business can be quite difficult through fear of penalties for past evasion. Amnesties could also be a very promising policy initiative in dealing with this specific problem. Amnesties cannot be used frequently and predictably, but they should be in the policy toolkit. Such amnesties tend to have a high return-to-cost ratio.

The existence of administrative corruption in Naples also affects the conventional positive relationship between tax rates and revenue mobilization.

Programs to reduce administrative corruption and improve the bureaucracy (including, but not exclusively, enhancing tax administration) may have larger payoffs in the local area.

Similarly, regulatory reforms are likely to have significant payoffs. Elimination of socially unproductive regulations, instituting a one-stop firm registration process, implementing simplified, transparent and market-based environmental regulations are all likely to result in reduced corruption and bribery, less overall regulatory tax burden on the firm, better revenue mobilization and more firms staying in the official economy.

The shadow economy is more pervasive than is perhaps widely thought, its measurement is difficult and successful policy solutions are not always easy to implement. This monograph, however, has suggested how to turn the tide. It is necessary to have high tax morale combined with a tax system that is coherent and works with – rather than against – the grain of human nature. This relates not just to the size of the tax burden, but also to the particular incentives that apply to specific groups within society when they undertake more work or earn more money. In addition, a range of more detailed policy approaches can be taken.

In many senses these “*micro-measures*” are “*win-win*” policies in that they cost relatively little money and just involve ensuring that there is a sensible regulatory and legal framework within which business should operate. If this monograph starts to

encourage governments to adopt such approaches, then it will have achieved its objective.

## 6. PERSONAL REFLECTIONS

Personal reflections also aim to describe the limitations during this research, and they should be identified and anticipated before the study process, this aims to minimize the effect of the limitations.

The first limitation in this specific study has been the **time constraint**, due to the dynamic socio-economic environment under consideration, managers, lecturer and business people often have large workloads, these factors indicates that time management has been as issue to not underestimate.

In terms of research **validity**, *Ritchie* and *Lewis* (2003) indicated that the validity of research is conceived as the precision or correctness of the research finding.

*Arksey* and *Knight* (1999) and *Winter* (2000) identified two different dimensions to the concept of validity, namely internal and external validity. Internal validity ensures that the researcher investigates what he claims to be investigating. External validity concerned with the extent to which the research findings can be generalized to wider population.

In terms of the current research, validity is achieved by undertaking multiple methods to investigate the problem from different angles and strengthen the validity of the findings.

It is considered to select case studies to cover the entire issues related to the study and decrease the probability of generalization.

However, qualitative research often depends on the individual judgment of the researcher and is heavily dependent on the researcher's interpretation, therefore, it tried to be as much accurate as possible.

**Reliability** and **availability** of data or information has been the real potential limitation of the research.

*Ritchie* and *Lewis*, 2003 asserted that the reliability of the findings depends on the likely recurrence of the original data and the way they are interpreted.

In an environment where organized crime is so high (*the powerful Camorra in Naples*), it has bees a big problem for the researcher to gather relevant information.

He travelled three times to Naples in order to find the right candidates, but all of them at beginning looked sceptics. Even with special permissions the researches barely found three candidates available, although, they wanted to be interview anonymously.

The researcher comes from Naples too, and he comes across many stumbling blocks that let him think how Neapolitan still live in fears and silence.

The sociological impact of the Camorra on the local people has been so striking for the researcher.

The Camorra has rooted not only in crime field but also inside the relationships with society and Neapolitan, Campania and national politics. Sometimes, there has been the perception that the Camorra hasn't existed, hidden among the masses, in its cultural and social roots, as a form of spread illegality, finally to re-emerge through discontinuous and irregular relationships with property owners, politics and institutions, with a mercenary goal.

The Camorra has never respected the politics, local institutions, and even local people, indifference to its ideologies but not the single politicians as some of them have provided privileges to the clans of the Camorra, in exchange for votes or support. The Camorra mercenary tradition has centred its efforts on the sectors that have made the Camorra reach endless economical advantages.

The Camorra has never cut its social roots in which it has founded a real phenomenon of mass governing the disorder.

Nowadays, despite of the changes in the economical and social conditions of the classes that traditionally represent it, the Camorra keeps on surviving through a form of modernity that supports it, a kind of living together that gives the Camorra strength and support.

There is no doubt that before to describe how wide is shadow economy in this area, the main causes related to tax, local regulation, tax morality and other economic causes, is imperative to fight the real cancer in this territory, that is the criminal organization.

The Camorra must be fought through an adequate politics of development and international actions. For example: the public administration Reform, the definition of differentiated funds for the South. The *Censis*<sup>26</sup> has studied the transparency of the public administration and the spread of the culture of legality: the situation hasn't improved yet over these years. The delays and the ineffectiveness of the public apparatus are presented more and more accentuated in the Southern Italy. As result there are serious consequences on the economy and vitality of the business.

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<sup>26</sup> Social Investment Study Center in Italy

The increase of the illegal opportunities is characterized by the present passage of the criminal underworld to the Camorra as a business, which has offered prospective of easy and quick earnings to young people. It is not superfluous add that the juvenile crime is connected to the fact that Naples is the European city presenting the higher rates of compulsory education's evasion. The Neapolitan young live in the illegal economy in which they perform a precious function. He is educated to take part in the Camorra. The market of illegality and crime is increasing because the deviance is the rule in some urban contexts, in which it is possible to learn techniques to commit a crime. In these contexts the illegal and crime activities are not submitted to sanctions, they are valued. These remarks induce to face the wider and complex problem of responsibility of intellectuals and culture with reference to prevention and fight against the organized crime and sub-cultural background.

There is much evidence of more and more increasing commitment against the illegality. Even the local press is not always coherent and specialized in commenting the news about the phenomenon of common and organized crime. The local daily press gives information to the people about the Camorra in superficial ways, waking emotional reactions, without inducing a serious reflection. The problem doesn't only affect culture or the intellectuals from Southern Italy. It is a national problem that asks for a strong effort in the fight against the Camorra in order to spread and root an organic culture of legality.

From what said, there are clear evidences that all these problems damage Naples, the regional economy and the territory; actually with a deeper sight to the problem we can assume that the damage of the regional economy, especially if seen in terms of opportunity costs, represents a big loss for the entire Italian economy, by considering how much the saving and the production which the regional economy of the Campania could give to the national economy, because of the uniqueness of the resources of the territory.

Here, more than 2000 years ago, Campania was colonized by Ancient Greeks and was part of *Magna Grecia*<sup>27</sup>. During the Roman ere, the area maintained a Greco Roman culture. The main city was Naples. Campania is still rich in culture, especially in regard to gastronomy, music, architecture, and full of ancient sites, such as *Pompeii*, *Herculaneum*, *Paestum* and *Velia*. The name of Campania itself is derived from Latin,

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<sup>27</sup> Was the name of the coastal areas of Southern Italy.

as the Romans knew the region as “*Campania felix*”, which translates into English as “*fertile countryside*”. The rich natural sights of Campania make it highly important in the tourism industry, especially along the *Amalfi Coast*, *Mount Vesuvius* and the island of *Capri*, therefore the solving of the problems in this City is, thus, an interest of Italian economy, not just a regional affair.

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