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# Local economic governance in hard times: the shadow economy and the textile and clothing industries around Łódź and Naples<sup>†</sup>

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Areas of industrial decline, with poor quality local government and poor infrastructure, frequently find a kind of economic success through the shadow economy. But illegality imposes constraints on the kind of success that can be achieved. The study of such areas in central Poland and southern Italy reveals considerable similarities, despite the fact that the former was part of the former state socialist bloc, the latter not. In both regions, small and medium-sized textile and clothing firms were flourishing within the limits of the shadow economy following the collapse of large corporations in the area. There were, however, important differences. Italian public policy has provided some possible routes out of the shadow economy, and its distinctive governance, which has been taken advantage of to a limited extent by firms, while Polish policy continues to deny that the problem exists. Also, because of the presence of leading clothing brands elsewhere in Italy, southern Italian firms have access to routes for upgrading their activities that are largely unavailable to their Polish counterparts.

**Keywords:** governance, economic development, social norms, institutions, rational choice, shadow economy, social capital, corporate social responsibility  
**JEL classification:** C70 game theory and bargaining theory, D62 welfare economics: externalities, M14 business administration: corporate culture, social responsibility, O2 development planning and policy

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## 1. Introduction

Since the mid-1980s, growing attention has been devoted in the socio-economic literature to the analysis of the governance of modern capitalism, where governance indicates the various means by which the behaviour of actors within institutions is regulated, underlining how competitive advantages are produced and distributed (Campbell *et al.*, 1991; Boyer and Hollingsworth, 1997; Hollingsworth *et al.*, 2002; Crouch, 2005). The general institutional governance approach was at an early stage adapted to the study of economic sectors by Hollingsworth *et al.* (1994), but since then it has been extensively adopted in the analysis of various types of local economic systems, specializing in the production of both traditional goods (e.g. textiles and leather manufacturing), and more advanced ones (e.g. biotechnology) and services (e.g. television programmes; Crouch *et al.*, 2001, 2004).

This theoretical and empirical approach has been particularly useful for the understanding of the success of some regions. In particular, it underlined the role played by 'local collective competition goods', namely those goods (services, products) that firms use to improve their competitiveness. As much research has recently underlined, these goods are produced by some sort of co-operation between local public and private actors, such as local and regional government, trade unions, employers associations and local agencies. For this reason, the existence of a thick institutional tissue and of institutionalized forms of partnership is a relevant local competitive advantage (Amin and Thrift, 1997; Cooke and Morgan, 1998).

However, these strands of literature concerning local economic development and its governance in industrialized societies focus mainly on advanced, knowledge-rich, high-tech sectors. Particularly prominent in the research have been industrial districts in the Third Italy, Rhône Alpes in France and Baden-Württemberg in Germany, all regions characterized by strong institutions devoted to promoting economic competitiveness (Pyke and Sengemberger, 1992; Herrigel, 1996; Courault, 2000; Burroni and Trigilia, 2001). Less attention has been devoted to local development processes that are distinctive of regions and local systems with weak institutions, leaving out of consideration the many localities that stand no chance of developing in the aforementioned way.

This article focuses on this kind of backward territory, analysing the rise and decline of competitiveness in two weak European regions: the area around Naples in southern Italy, and that around Łódź in central Poland. Both areas had traditional strength in textiles and clothing, with a subsequent decline of established firms in these industries; both are regions of general economic weakness and high unemployment, with records of poor-quality local government; and both have histories of low trust and organized crime. There is also the major difference

that until 1991, Poland was part of the Comecon group of economies based on the state socialist system of the Soviet Union. As we shall see, even in areas with weak local government, fragmented trade unions and employers associations, and without any form of collective action for the production of territorial competitive advantages, there have been some institutional devices that favoured the economic competitiveness of local firms. We shall show that the shadow economy has been one of these devices.

By 'shadow economy', we refer to those activities that are in some form illegal, monetary and private, but which could be legal if they were carried out in accordance with prevailing regulations. For example, in the two regional sectors analysed here, we find cases with high tax evasion, or cases in which firms only employ workers illegally; in others, there are both regular and irregular workers; in others again all workers have a regular contract, but they are required to work overtime or receive a salary lower than the amount agreed. In some cases, the final firm is legal, but works with suppliers and sub-suppliers who have adopted forms of shadow economy. There can be cases that present irregularities in the distribution process such as the sale of goods through illegal channels (e.g. markets or peddlers without permits who do not declare their incomes); or legal vendors who under-report their taxable earnings. Thus, the concept of shadow economy is only a part of the broader definition of 'informal economy' that includes also those activities that are not provided for by the law, such as baby-sitting circles, or those activities that are illegal by themselves (Mingione, 1991); and the shadow economy is related in many different forms to the regular economy (Sik, 1994; Sik and Wallace, 1999).

As we will see, the analysis of the shadow economy can shed light on the process of economic growth of the two backward regions, offering a contribution to the socio-economics of local development. In particular, analysing the two cases, we shall underline three points that help us to a general understanding of the blurred boundaries between economy, society and the state in backward but fast-growing areas.

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

Second, we shall demonstrate that it is not true that the shadow economy is a system of economic transactions characterized by a low level of regulation. The shadow economy prevails in those areas where governance by the state (government and law) and by formal economic associations is weak, but at the same time,

transactions are characterized by an informal but very effective regulatory mechanism that has a clear impact on economic development and that is strongly embedded in the continuous interaction that takes place between local community and society.

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

In the following sections, the two cases will be described, paying attention to issues of governance raised by them and emphasizing the main advantages and constraints of a model of local development on the basis of the shadow economy. We shall show the social foundations of that economy, focusing on the kind of social relationships and trust relations that characterize it. There is finally a comparative discussion from which will be drawn conclusions on the governance mode of the shadow economy and on the successes and failures of policies addressed to reduce its role. More complete accounts of the two cases can be found in Kaminska (2006) and Valzania (2006)<sup>1</sup>.

## **2. The shadow economy in Central Poland and the area of Aleksandrów Łódzki**

Many sources suggest that the relative size of the shadow economy in the socialist and post-socialist transition countries has been larger than in developed market

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<sup>1</sup>In 2005 ca. 70 face-to-face interviews were conducted with local entrepreneurs; representatives of local authorities; representatives of the Municipality of the two case studies; representatives of regional authorities; researchers from the University; and experts from regional Chamber of Commerce and Industry. The interviews were semi-structured, with an interview guide based on an inventory of issues. However, the discursive nature of interviews was preserved, which allowed the interviewees to raise additional issues. Secondary sources were also extensively used in the research, using local newspapers, documents, and research reports, as well as documents from local public and private institutions, such as the local government or employers associations, and a secondary analysis of quantitative data was carried out.

economies (Kornai, 1993; Lackó, 1998; Schneider, 1997), and they stress the distinctiveness of the reasons for the emergence and perpetuation of the informal sector in the formerly centrally planned socialist economies in Central and Eastern European Countries (CEECs) and the Soviet Union (SU), as opposed to the market economies in developed countries (for a discussion, see Gërxhani, 2004 and Lackó, 1998). Four major factors triggering the emergence of the shadow economy in socialist countries can be distinguished: permanent shortages of even basic products on the official market; very narrow margins allowed for the legal private economy; low level of state-provided services; and lack of competition (Lackó, 1998, p. 131).

Following the collapse of the socialist political and economic system, with 'the disappearance of shortages, the emergence of competition, a gradually expanding market for services' (Lackó, 1998, p. 131) and the legalization of the activities of the private economy, the factors that had so far determined the functioning of informal economy in CEECs gradually lost importance: in the new context, many different forms of integration between the shadow and the official economy emerged (Sik, 1994; Sik and Wallace, 1999). Under the new, changing conditions of the transition to market economy, the most pronounced distinctive reasons for the shadow economy in CEECs are related to (Gërxhani, 2004):

- the tax regime: i.e. a high tax burden and a complicated tax system (Thießen, 2003); constantly shifting tax regimes, even with retroactive applicability (Kaufmann and Kaliberda, 1996);
- the institutional/legal framework: i.e. fuzziness of rules in transition; constant flux and weakness of institutional and legal frameworks in which state operations take place (Landesmann, 1998, p. 154; Gërxhani, 2004, p. 283); inefficient institutions (Marcouiller and Young, 1995; Johnson *et al.*, 1997);
- the quality of enforcement mechanisms: i.e. weakened state authority; limited financial and human resources in state administrative bodies; the consequent decrease of efficiency and effectiveness of the state in enforcing the tax regime (Landesmann, 1998, p. 154); the corruption and incompetence of government officials responsible for tax collection (Johnson *et al.*, 1998); the *laissez-passer* approach of the government towards the shadow economy (Gërxhani, 2004, p. 283);
- social attitudes: i.e. 'the conflict between the established economic and social norms in the past and the reaction to a new reality in the present' (Gërxhani, 2004, p. 283), reflected in 'incongruent' attitudes constituting an obstacle to the proper functioning of the newly established [capitalist] institutions (Elster *et al.*, 1998, p. 158): a lack of confidence in state institutions (Rose-Ackerman, 2001), which in the case of the shadow economy is

exemplified by changes in attitudes of (potential) taxpayers towards tax authorities (Landesman, 1998, p. 154).

In Poland, under the command economy of the 1945–89 period, the most common form taken by the shadow economy was unregistered work, carried out in addition to a principal occupation in a state factory or agricultural unit. The aggravation of the economic crisis in the 1980s produced growth in the proportion of total earnings accountable to the shadow economy from an estimated 5.9% in 1980 to 13.9% in 1988. Estimates of the relative size of the shadow economy in this period show a tendency to rise, from about 6% in 1983 to about 16.5% in 1986 (Kloc, 1998).

Since 1989, the shadow economy in Poland has grown. Kaufmann and Kaliberda (1996, p. 19) estimate in the early phase of transition (1989–94) that it remained at the level of about 18% of overall GDP. Current estimates suggest a figure of about 14% (European Commission, 2004; Główny Urząd Statystyczny [GUS], 2005), but the highest estimates come from Schneider (2002), who puts it at 27.3% of GDP.

A large part of the shadow economy is concentrated in manufacturing activities, and this is also the case in the region of Łódź, which has a long historical tradition in the textile and clothing sector. Since the early 19th century, when a textile and clothing industry was founded in the region, the economy of the Łódź area has been dominated by this sector, producing for local, national and Eastern European (mainly Russian/SU) markets throughout the vicissitudes of Polish history. During the Soviet period, it was almost totally dependent upon exports to the SU and other Comecon countries. As Dornisch (2002) puts it, '(t)he economic life of the region was subordinated to its international socialist allocative mission, with city and regional infrastructure only developed to the extent that it supported the regional industrial complex'.

Since 1989, the region's almost monostructural economy has been undergoing dramatic changes accompanied by an increase in the shadow economy. Following the collapse of the command economy, the area plunged into a deep crisis. Most of the over 300 high-volume, low-quality mass production units of the textile and clothing sectors were liquidated. Employment in light industry in Łódź declined by 46% by 1995 (Brzeziński, 1997). By 1993, the unemployment rate had reached 18.5%, 85 000 people, where it has remained since (Nowakowska, 1996; GUS, 2005). This collapse was followed by a decline in the industry's system of vocational training (Prysiński and Urban, 2005).

At the same time, this crisis was paralleled by an explosion of private entrepreneurship in the textile and clothing sector, with a revival of production in micro and small, occasionally medium-sized, firms. The new enterprises were mostly founded by the large number of workers who had lost or were expecting to

lose their jobs in state-owned textile companies. Almost all new businesses operated at least in part in the shadow economy: either they were not registered at all or had some (often large) share of their production and income undeclared, and employed many workers without contracts. The new companies would concentrate on: the production of clothing and hosiery; the import of raw materials and machinery for textile production; semi-processing, finishing of semi-products, packaging; and servicing the machinery.

Thus, the shadow economy played an important role in this process of economic recovery. A prime example of this trajectory is the municipality of Aleksandrów Łódzki (population 25 000) in the Łódź agglomeration. During the command economy period here, production was concentrated in a single plant, the 'Sandra' Hosiery Factory, which became one of Poland's largest producers and exporters of hosiery. The factory also served as a centre of social life in the municipality, maintaining technical schools, a kindergarten, a leisure centre, a clinic, a community centre with a hosiery museum, after-school and holiday activities for children and young people and housing for its workers. Under the command economy, the 'Sandra' factory was the only big employer in Aleksandrów Łódzki, even if a parallel shadow economy existed in the area, active especially in the 1970s and 1980s, decades marked by a deepening economic crisis. In that period also, private companies (although limited in numbers) started to emerge in the textile and clothing sector of the region.

After 1989, Sandra entered a restructuring process, with the various welfare services being dismantled. Employment fell from 2 500 in 1987 to less than 300 by 1997. In early 1999, the company was put into liquidation. In parallel, a large number of micro, family-run enterprises emerged, almost all active in the same products as Sandra. Most concentrate on production proper, many performing all phases of production, some specializing in particular ones—production of yarn, dyeing, packaging, distribution and sales. Most of these companies still use old machines, but a few (including the medium-sized enterprises) are more advanced technologically and have recently invested in new machinery.

All interviewees admitted that their success was due largely to the shadow economy (in some cases, 80–90% of the activity) that could thrive because of very few controls; the shadow economy favoured a high labour and costs flexibility triggering the competitiveness of local firms. The situation has now changed: only the few medium-sized enterprises are in a relatively good condition, though even their owners/managers express concerns about the future (relating mostly to the uncertainty of Polish politics and, consequently, the economy). In the early stages, the founders of most of these companies 'emerged' from the shadow economy as they attempted to target more demanding markets and focused on products relatively high in quality and design, which allowed them to achieve a certain level of competitiveness and now avoid direct competition with low-quality



imports from China or Turkey. Although they ‘mistrust’ the financial system, they have used bank loans and credits, thanks to which they have been able to make some investment and even introduce innovations. For example, many firms used these loans to modify the productive process and the activities of design in order to improve the quality of final products.

The condition of the micro and small companies (many of which openly admit to still having some activity in the shadow economy, though the official position of the provincial fiscal office is that no shadow economy exists in the area) is much worse. Most have not invested in recent years: they have not been able to accumulate capital but are—as they say—‘afraid of the banks’ and not willing to take loans. Their market has shrunk as the eastern borders are controlled, and cheaper Chinese, Turkish, and even Italian hosiery flood the Polish market. Most of these companies describe themselves as being ‘in a vegetative state’, with no prospect of improvement. Their situation seems to be typical of shadow economy enterprises in transition countries, as discussed earlier, with relevant difficulties in upgrading their competitive model.

Partly for the same reasons, institutional relations in the area are also weak. Very few companies (and then only medium-sized ones) contact chambers of commerce, information, and training centres, and then very rarely. There are no contacts with R&D institutions; innovations in design are in most cases ‘generated domestically’ (i.e. copying the neighbours and trends observed on TV). Levels of membership in professional associations are very low, the prevailing opinion among interviewees being that such membership is ‘useless’.

The municipality itself has not been particularly active in enhancing entrepreneurship and definitely not in promoting the hosiery industry. As the mayor put it, ‘hosiery has no future in Aleksandrów’; thus, the municipality has been trying to attract investment in other sectors (so far not very successfully). So while individual medium-sized companies advertize their products and try to develop their brands, no promotion of the sector as such is taking place, and there is no attempt at place branding or promoting the town as a centre for the industry. Firms and local authorities seem to live in two separate worlds, with very limited contacts. There are no policies for assisting firms to ‘emerge’ from the shadow economy.

In conclusion, in the early phase of transition, the governance environment of the Łódź economy was very weak. In the absence of strong formal institutions or even networks, the governance gap was filled by the institutions of the shadow economy (Burroni and Crouch, 2008). In the conditions of market instability, accompanied by constant flux in institutional and legal frameworks and almost no public policy to assist the region, this governance proved to be successful in enabling hundreds of enterprises to start up (thus re-creating the old economic structure and maintaining industrial specialization) and to operate with relatively good economic outcomes. Crucially, the low capital-intensity and

high labour-intensity profile of the industry have allowed these enterprises to absorb tens of thousands of unemployed workers, partially neutralizing the devastating effects of the crisis. On the other hand, perpetuation of the old economic structure has slowed down the process of diversification of the local production system and has preserved low technical and technological levels, with firms operating within very competitive niche markets with low levels of profitability. Strong price competition and constraints related to the 'embeddedness' in the shadow economy have led to a low propensity to innovate and have practically excluded firm development. Shadow economy governance has also hindered the development of cooperation networks between companies and links with the business environment, leading to a 'lock-in' of the companies.

The specific features of shadow economy governance have also hindered the production of local collective competition goods; participation in local decision-making processes has been impeded and the business environment has not been able to make the local authorities address their problems. As a result, Aleksandrów Łódzki seems to be a case of continuation of a path-dependent tradition in hosiery, with now only an accidental development trajectory.

### **3. The shadow economy in Southern Italy and the case of the Neapolitan area**

For many years, Italian national policy for dealing with the backward economy of the South concentrated on the encouragement of heavy industry funded by the state and the provision of public employment (Trigilia, 1992; Viesti, 2003). One outcome of the resulting dependence on the state was the creation of a clientelistic political and bureaucratic class with organized crime connections. During the 1980s, this situation had the consequence that political or even criminal entrepreneurship was favoured above economic, and the satisfaction of particularistic and family interests predominated over the production of general infrastructure or collective goods (Signorelli, 1988, p. 258; Trigilia, 1994).

A change came in the 1990s, when the need to improve state finances to enable Italy to enter the EU's single currency made necessary major reductions in the expensive but ineffective subsidies to the region. Paradoxically, this abrupt end to what had seemed to be its main socio-economic support rendered visible certain local systems of light industry (textile and clothing, leather, furniture, etc.).

Local production systems that had been obscured by large-scale industry and ignored by public finances became visible, exploiting their flexible specialization and taking advantage of the lira devaluations of the period to enter export markets. These areas lacked the institutional architecture that in the Northern part of the country favoured the competitiveness of industrial districts through local collective competition goods, but at the same time they relied heavily on

the shadow economy that triggered economic dynamism, increasing labour flexibility in terms of both organization and costs.

We concentrate here on the progress and continuing difficulties of this model of development in the area around Naples, the capital of the Campania region. At least until the early 1990s, the region was characterized by areas of low peripheral industrialization and an economically stagnant metropolitan area of Naples (Castronovo, 1980; Trigilia, 1992; Bevilacqua, 1996). The growth of local textile production systems was meanwhile developing apart from this, in peripheral areas such as Caserta, Salerno, Sarno and Nocera Inferiore. In the 1970s, this trend was strengthened by the transfer of activities by many firms from Naples itself to industrial areas to its northwest (Arzano, Grumo Nevano, Casalnuovo, San Giuseppe Vesuviano, Nola and later, parts of the Sorrento peninsula). By the end of the 1980s, several of these had developed into industrial districts of 'made in Italy' products. In particular, they acquired a reputation for producing personal goods (Bacùlo, 1997): clothing and shoes, swimwear, fabrics.

The success of these Campanian districts can be attributed to ambiguous characteristics. In contrast with the Polish firms discussed earlier, they have been able to benefit from their links to a sector that has been strong overall in Italy.

Furthermore, there has been considerable diversity in the degree of concentration and in the mean size of enterprises. There are local systems characterized by a large number of medium-sized enterprises with no leading firm (e.g. the clothing districts of Naples, such as San Giuseppe Vesuviano). Others also have some leading firm (e.g. the districts in the Northern areas of Naples, particularly in footwear); and there has been an emulation of historical leading firms such as the case of commercial enterprises linked closely to production (as at San Giuseppe Vesuviano).

Also relevant is the mobility of human resources, i.e. entrepreneurs and technicians who, after a learning experience in northern Italy, return to set up local firms, bringing home knowledge and professional experience.

In other respects, they have shared characteristics with their Polish counterparts:

- The production is based principally on lower prices than the market mean, a characteristic that certainly favours these areas in the early stages of development, before it becomes necessary to pay more attention to product quality.
- The fortuitous availability and exploitation of long-distance transport networks and infrastructure (not by chance, all these districts are situated near the motorway and away from the problems of congestion of much of the area).

- The continuing presence in the area of organized crime in collusion with some local economic and political interests.

But for our purposes, the most important similarity with the Polish case concerns the role of the shadow economy as an important resource to trigger the competitiveness of local firms. Also in this case, the shadow economy is strongly rooted in the region: according to EU estimates, it accounts for 40–50% of regional GDP (Vallone, 1996), which could even be an under-estimate given the methodological problems (Meldolesi, 1998a, b). According to the estimates of Istat (2003), Campania shows a high level of irregular employment (25.2%). In manufacturing, it is put at 20%, in construction 29%, services 25% and agriculture 43%.

These high levels indicate the existence of a kind of hidden society, with its own rules and customs, vital and operative, which guarantees the incomes of many people, families and entrepreneurs for whom it is often more convenient to remain this way and who are among the most strenuous opponents of change. In the most extreme cases, the local communities prefer to accept the protection of organized crime than accept a change. This was the case at Grumo Nevano after the forces of order closed a number of firms on account of shadow economy and fiscal evasion (Meldolesi, 2001).

The main forms are those concerned with the reduction of labour costs by avoiding taxes or paying below contractual minima, whether these result from managerial inadequacy, diffidence towards the state, or high levels of taxation. More abuse is found among those in work than those on assistance or benefit (Bacùlo, 2003). Firms in most areas, including those of high-quality production, are involved in employing off-the-books labour, whether this takes the form of sub-contracting to external workshops that are more or less legal or those that are completely illegal.

This situation of economic and institutional backwardness with high levels of shadow economy also characterized other regions of Southern Italy. To tackle this territorial cleavage, at the beginning of the 1990s the Italian state abandoned all direct exogenous action in support of economic development in order to activate instead a policy for territorial governance. The new set of policies was called *Programmazione Negoziata* (negotiated planning) and aimed at regulating public interventions via the involvement of a large number of local public and private actors to promote the rational and effective use of public funds (Magnatti *et al.*, 2005; Trigilia, 2006).

The basic philosophy of the programme concerns the importance attributed to the creation of an institutional environment for socio-economic development through a strong ‘bottom up’ role played by local actors, and local pacts for development and employment to stimulate a greater responsiveness to entrepreneurial

opportunities. The achievement of 'improved trust, coordination, common understanding and purposes' was the precondition to create new employment and improve labour market trends at the local level.

An important aspect of these policies has been the strategy for a so-called *emersione*—a process whereby firms in the shadow economy can gradually abandon illegal practices and enter the mainstream economy (Bacùlo, 2003; Burroni and Crouch, 2008). Such an approach requires prior recognition that a problem exists, and a willingness to tolerate firms remaining for some time in a 'halfway house'. While some of the policies being developed concentrate solely on the behaviour of individual firms, others recognize the need to address the general environment within which the shadow economy exists, and its own forms of governance (*ibid.*). This approach has continued until now with the establishment of the Integrated Territorial Plans (PIT—*Progetti integrati territoriali*). These share many basic features with *programmazione negoziata* instruments (a high degree of inclusion of local private and public actors and the promotion of institutional trust), but PIT are characterized by a stronger role for the regional government.

Campania and its capital city of Naples became involved in this process from the start, with attempts at constructing or reconstructing trust among local actors, involving them directly in processes of policy-making and in the circulation of information about the territory (for a full account of cases, see De Vivo, 2004). But even if many efforts have been made to facilitate *emersione* and to trigger local economic development in Campania, it seems that these new policies need to be improved: they were only in part able to reach their main goals, and a large amount of the regional economy is still characterized by the shadow economy, such as the case of S. Giuseppe Vesuviano around Naples.

The area of San Giuseppe Vesuviano has had a long mercantile history, and to this was gradually added the typical proto-industrial activities of craft production, eventually replacing agriculture and establishing a useful base of trust relations and entrepreneurialism. Within this context, the last century saw two moments that induced profound change: the immediate post-war period, when there was a strong development of commercial activity, leading the area to acquire national importance; and the 1970s, when SMEs in the textile and clothing sector started to be established.

San Giuseppe Vesuviano is an area in the periphery of Naples around the sides of the Vesuvius volcano, with a population of 110 000; there are about 10 000 firms either employing directly or providing work for around 100 000 workers that travel to work from many other contiguous local systems. According to Istat (2003) figures, in 2001, there were 693 clothing and textile firms with 2 500 employees, that is about 53% of total manufacturing activity, though the existence of the shadow economy makes it difficult to arrive at a certain figure.

A peculiarity of San Giuseppe Vesuviano is the small size of firms, with 93% of those in textiles having fewer than 10 employees, while 61% have fewer than five (essentially family businesses) and 45% have only one. It became clear in interviews that small size has become an openly discussed problem. It not only makes it difficult to build inter-firm alliances, but also aggravates problems of labour rights and security; unions are virtually absent from the area.

The economic activities of this area are affected by many irregularities comprising the so-called *sommerso totale* (totally hidden), masses of very small, competitively weak, textile and sub-contracting firms that occupy physical space but which are completely hidden from view. Alongside this, there is the semi-*sommerso* (partially hidden) of firms that are visible and legally established, but engaged in the evasion of taxes and social contributions as well as of work rules. The products themselves include some illegal trade, constituted by counterfeited or stolen goods, supported by a network of illegal itinerant merchants and street vendors. This is part of an entire irregular economy completely controlled by organized crime. Where services are concerned, the main problems linked to the shadow economy are the inadequacy of physical spaces, which lead to irregularities in the granting of licences and official authorizations, assisted by the lack of a proper plan, and the scarcity of banking and business services, which lead firms into the shadow economy in their search for funds.

As many of our interviews in San Giuseppe Vesuviano confirmed, part of the problem is the ambiguous role of the shadow economy. It had been important in assisting the rebirth, following the collapse of the state-assisted large enterprises, of the previously marginalized sector of clothing, textile and footwear SMEs. In the face of a situation completely different from that of the past, where an important competitive advantage has been the flexibility of production and labour, the local industry was able to reorganize itself, using the shadow economy to save on certain costs that had previously been covered by economies of scale, state financing, etc. This mode of governance has its precondition in a wide interpersonal trust and in informal but very effective communitarian mechanisms of regulation, in part related to organized crime. Alongside those who by definition do not want to conform to rules (because they are engaged in fiscal evasion or crime), there are those who are constrained to avoid rules because otherwise it is impossible to stay in business.

Thus, even if the shadow economy has been very important in supporting the first steps of economic development, this model has not been able to produce either tangible or intangible local collective competition goods, and many problems of the local environment remain unresolved: inadequate physical infrastructure; inefficient public administration particularly for formulating political and technical responses to economic challenges; the inefficiency of the banking system, which is poorly equipped for offering credit to firms and

sustaining enterprises at important moments; and the continuing presence of organized crime within governance and the economy, which extracts protection money from firms while reducing the sense of security of the community and inhibiting entrepreneurial activity.

In such a situation, firms are penalized at every point before they even start their activities. To cite just one of the most important constraints, they cannot get bank finance because they do not have guarantee funds. If they can get finance through the shadow economy, they can, paradoxically, start to conform with the law and thereby gain access to things such as EU support in times of difficulty. Many interviews underline that the most important problem is the impossibility setting up local collective competition goods in a local system dominated by the shadow economy.

In this context, in January 2005, the local institutions of the Vesuvian area—political, business and trade union alike—started a discussion at various levels for developing new policies for action. It was clear to both the regional industrialists' union and the Campania regional offices of the union confederation, CGIL, that a re-starting point needed to be the correct identification of districts. It was agreed that the current state of projects and financing should be monitored in order to evaluate what it would be feasible to sustain in the coming years. Both employers and unions agreed that in the current deep recession it would not be possible to continue with general or even sector-level interventions. The choices to make, therefore, were promoting territorial policies aimed at reducing the role of the shadow economy, developing the local infrastructure and training (and retraining) the work force. To date, it is too early to evaluate the success of these new initiatives.

#### **4. Concluding remarks**

Both the Polish and Italian cases demonstrate firms surviving and thriving in a difficult sector, within difficult economic, political and social environments, at a time when textiles and clothing are subject to the pressures of globalization; but both demonstrate the persistence of significant weaknesses. It was suggested at the outset that we learn different lessons from similarities and differences. Overall, our research suggests that the former should predominate. We should therefore be sceptical of accounts that attribute the Polish shadow economy to the state socialist legacy alone or the Italian one to the cultural specificities of the Mezzogiorno. In fact, the comparison underlines that there are blurred boundaries between economy, society and the state and that it is difficult to identify a 'single independent variable' that can explain the regional model in backward but fast-growing areas.

As we have emphasized, the emergence and rise of the shadow economy cannot be simply explained by economic pressures: it is strongly influenced by the weaknesses of public institutions, the high level of organized crime, the specific architecture of the institutional framework, the quality of enforcement mechanisms, the absence of institutional trust, a strong interpersonal trust, etc. In other words, the shadow economy is a phenomenon with strong and rooted socio-institutional foundations.

At the same time, the functioning of the shadow economy relies on informal but very effective devices of controls and sanctions that assist economic transactions among firms and workers. Thus, even if it is not controlled and enforced by the law, the governance of the shadow economy is strongly regulated by communitarian mechanisms that support its reproduction over time.

Finally, the comparison stresses that the shadow economy triggered economic development and the economic recovery of the two local systems after a period of crisis, supporting the rise of local SMEs, but that this governance mode has hindered the production of local collective competition goods for the upgrading of firms' competitive strategies. Thus, the two cases faced with a 'fast development trap', where swift economic growth based on the mix of low quality/low prices and a high level of shadow economy promoted an institutional environment that hindered the possibility of pursuing the so-called a high road of development, based on innovation and high-quality products.

The aforementioned points shed light on the main failures of public policies aimed at reducing the role of the shadow economy. In many European countries, these policies have usually been addressed by introducing new forms of control and sanctions. In particular, three types of policies have been broadly adopted in many EU countries to fight the shadow economy (Burroni and Crouch, 2008): those aimed at preventing the development of the shadow economy through general interventions directed at introducing economic incentives for those who decide to follow the rules; those that aim at reducing the incentives to have recourse to shadow forms of, primarily, labour through inspections and sanctions; pro-active policies that encourage firms to emerge from the shadows. These three strategies seem to overlook for the most part the fact that the shadow economy acts in a particular environment and that it is regulated by a well-defined mode of governance that distributes resources, mediates conflicts and orients and addresses the action of economic actors, even allocating certain kinds of local competitive advantages that actually favour a low-road competitiveness in local firms. Obscuring in this way the institutional foundations of the shadow economy, these approaches risk having an extremely limited effect on the phenomenon: in fact, as many studies have recently underlined, the success of these experiments seems to be very limited.



Their main weakness seems to be the idea that simply by introducing economic incentives and sanctions for individual actors, it is possible to reduce the level of the shadow economy. But if the shadow economy has collective and institutional foundations, this approach is doomed to failure. At the same time, as Burroni and Crouch (2008) have argued elsewhere, dealing with the shadow economy just by suppressing it is unlikely to be successful, as it involves removing from firms, individuals and whole territories some of the only governance, alongside the family, that keeps economic activity going. This is especially true when public authorities are at best inefficient and at worst corrupt and therefore unable to help provide the public institutional infrastructure that is vital to the market success of individual firms.

All this means that a policy strategy aimed at gradually modifying the governance architecture that supports the shadow economy could have better results especially in promoting emersion (the gradual abandonment of irregular practices and entering the mainstream economy). For this reason, proactive and step-by-step strategies, aimed at influencing the institutional set, reinforcing the role of local actors and the legitimacy of local government, reducing the role of organized criminality, promoting institutional trust, etc., seem to have more potential to reduce the role of the shadow economy. This incremental strategy could mobilize local individual and collective actors that now widely acknowledge that the shadow economy is producing a lock-in that dramatically obstructs the competitiveness of local firms and social cohesion.

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

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

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

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