Measuring Italy's Underground Economy¹

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E conomists have always concerned themselves with the unintended effects of human action. Indeed, economics can be defined as the study of such unintended effects.² Politicians seldom pay attention to such secondary effects, concentrating instead on the immediate, intended consequences of their decision. A good example of this contrast is provided by the wonderful story of a little town in Abruzzi, Italy, that was plagued by a large number of vipers. The local politicians thought it wise to attempt to solve the problem by offering a reward for any viper killed. The unintended effect of their action was — as any economist could easily have predicted — an increase in the supply of vipers: peasants started breeding vipers in their basements.

When it comes to finding a way around the law, the size of the unintended consequences of political decisions depends, of course, on many factors, not least the quantity and quality of legislation. But it also depends on cultural factors, such as the ingenuity of the people, their willingness and capacity to evade the law, the history of the country, and so forth. In this regard, it is fair to say that Italy is second to none. The twentyfive centuries of Italian history can be viewed as the struggle between the shrewdness of legislators and the ingenuity of the people in frustrating their efforts.

It is a testimony to the victory of the Italian people over their rulers that so many "new" laws are nothing more than the reinstatement of already existing laws that have never been enforced. Their continuous defeat, on the other hand, has not prevented legislators from continuing in their efforts. Indeed, the

1. This article is a revised version of a paper presented to the Mont Pelerin Society in September, 1980. The money/income hypothesis was suggested to me by Professor Milton Friedman and Professor David Meiselman. I am grateful to Ciro de Falco and Michael O' Connor, of the U.S. Treasury office in Rome, for statistical assistance.

2. In Italian, this can be summarized by a rather appropriate acronym: L. e. n. in. – leggi degli effetti non intenzionali.

| TABLE 1 | | | | |
|---------|------------------------|------------------------|--|--|
| | M ₁ / Y (%) | M ₂ / Y (%) | | |
| 1958 | 28.6 | 58.2 | | |
| 1959 | 30.7 | 62.5 | | |
| 1960 | 31.8 | 65.1 | | |
| 1961 | 32.8 | 66.8 | | |
| 1962 | 34.2 | 69.4 | | |
| 1963 | 34.9 | 69.9 | | |
| 1964 | 34.2 | 69.3 | | |
| 1965 | 36.1 | 72.9 | | |
| 1966 | 38.4 | 77.5 | | |
| 1967 | 38.8 | 78.4 | | |
| 1968 | 40.8 | 81.5 | | |
| 1969 | 42.7 | 83.0 | | |
| 1970 | 46.2 | 82.8 | | |
| 1971 | 50.6 | 87.5 | | |
| 1972 | 55.8 | 94.5 | | |
| 1978 | 56 7 | 95.2 | | |
| 1974 | 54.1 | 93.0 | | |
| 1975 | 51 5 | 97.5 | | |
| 1976 | 49.9 | 97.1 | | |
| 1977 | 49.9 | 96.1 | | |
| | | | | |

Source: International Financial Statistics, IMF; Banca d'Italia; ISTAT. M_1 = Currency + Demand Deposits; M_2 = M_1 + Time Deposits; Y = Gross Domestic Product. M_1 and M_2 data are averages of stocks as of end of quarter for 1958-1966; data for 1967-1978 are monthly averages. All figures are based on the "old" GDP series.

97.1

50.6 '

1978

flow of new legislation is such that it gives an unprecedented meaning to Jonathan Swift's famous remark, "If books and laws continue to increase as they have done for fifty years past, I am in concern for future ages, how any man will be learned, or any man a lawyer."

What follows is an account of the so-called "underground" economy in Italy, which I consider a masterpiece of my countrymen's ingenuity, a second Italian economic miracle which has saved the country from bankruptcy, and an example for the other "free" countries to follow.

Clues in the Money Supply

In the second half of 1978 the Italian economy presented a puzzle to economic observers. The money supply had been consistently growing at the rate of 20-25 percent per year for almost three years. This was true for both the M₁ (currency plus demand deposits) and the M₂ (currency, demand deposits, and time deposits) aggregates. The rate of growth of M₁ had reached the 20 percent mark in the first quarter of 1976 and remained in the 20-25 percent range since that time. The rate of growth of M₂ had been in the same range since the third quarter of 1975. The government deficit - the main source of money creation - had risen from 14,707 billion lire in 1976 (10.4 percent of national income) to 22,531 billion in 1977 (13.2 percent) and was expected to be in the neighborhood of 35,000 billion for fiscal 1978 (reaching an all-time high of 17.2 percent of national income). And yet, the trade surplus was expected to be a record \$3.5 billion, and even more puzzling was the fact that, despite the high rate of monetary growth, the rate of inflation was going down, putting an unfair strain on the nerves of those of us who had unwisely predicted an acceleration of the inflationary process.³

The short-term puzzle was coupled with a long-run paradox relating to the money/income ratio, which is one way to measure the amount of money people wish to hold.⁴ This ratio has been high in Italy (as compared with other industrialized countries) and it has shown the tendency to increase rather quickly over time (see Table 1). It is a known fact of monetary

^{3.} The deceleration of inflation in the second half of 1978 was shortlived. From the beginning of 1979 on, inflation resumed speed. Indeed, the behavior of the inflation rate in Italy in the 1970s conforms — with a

theory that the demand for money increases more than in proportion with income, so that an increase in the money/income ratio is to be expected.⁵ What normally happens is that when income increases, people tend to increase the fraction of their income they wish to hold in the form of money. However, while income increases tend to increase the amount of money people want to hold, inflation tends to have the opposite effect. People tend to economize on their use of cash balances as they experience an erosion in their value due to inflation. Therefore, one would have expected Italy's money/income ratio to decrease, or at least remain constant, and it was hard to reconcile the rapid increase in demand⁻for money with the inflationary history of the country. Furthermore, the absolute

Money (M_1) **Consumer Price Index** 1970 - 1978 = 1001972 - 1980 = 1001970 47.3 51.11972 1971 56.3 56.61973 1972 66.0 67.4 1974 1973 82.0 78.9 1975 1974 89.7 92.1 1976 1975 101.8 109.0 1977 1976 121.0 123.4 1978 1977 149.4 146.0 1979 1978 186.0 175.1 1980*

two-year lag - to the quantity theory of money in its most simplistic, mechanical form (see table).

Source: Banca d' Italia; ISTAT M_1 = currency & demand deposits. end of year figures. * = estimate

4. As known, this is one way to measure the demand for money: "... the real quantity of money can be expressed in terms of the number of weeks of aggregate transactions of the community, or aggregate net output of the community, to which it is equal." Milton Friedman, "A Theoretical Framework for Monetary Analysis," in R. J. Gordon, ed., *Milton Friedman's Monetary Framework* (Chicago: The University of Chicago Press, 1974), p. 2.

5. "A 1 percent increase in real income per capita has therefore, on the average, been associated with a 1.8 percent increase in real cash balances per capita and hence with a 0.8 percent *decrease* in income

value of the money/income ratio seemed unusually high when compared with that of other countries.⁶

If we look at Table 2 we see the average M_1 /income ratio in the past four quinquennia in Italy compared with the same ratio in the U.S., Great Britain, France, and West Germany. As the table shows, the time pattern of the ratio in Italy differs from that of the other countries in that it increases steadily over the whole period. Even more significant is the fact that the ratio is substantially higher in Italy than in the other countries, and the difference tends to grow over time.

Similar conclusions can be arrived at by looking at the $M_2/$ income ratio (Table 3). Even here the ratio is substantially higher in Italy than in the other countries and the gap grows over time.

Explaining the Statistical Anomalies

There are several possible explanations for the paradox, and they are not mutually incompatible. The first is the one mentioned above: an increase in the demand for money due to an increase in income. (This is usually referred to as the "secular decline in income velocity." Income velocity is the ratio of income to the quantity of money – that is, the inverse of the money/income ratio – so that to say that the money/income ratio has increased is equivalent to saying that the income velocity has declined. This process, which is well known in monetary theory, is a long-term one; hence it is referred to as

velocity." Milton Friedman, "The Demand for Money: Some Theoretical and Empirical Results," in the Optimum Quantity of Money and Other Essays (Chicago: Aldine Publishing Company, 1969), p. 113. See also, "Judged by the long-period evidence, money is in this respect a 'luxury' like durable consumer goods, rather than a 'necessity' like bread. A one percent increase in real per capita income has on the average been associated with an increase in real per capita money holdings of about one and twothirds percent." Milton Friedman, "The Demand for Money," in Dollars and Deficits (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1968), p. 199.

6. The high money/income ratio led many of us to fear that, should people decide to decumulate cash balances, this might result in an autonomous inflationary potential. See Giannino Parravicini, "Il mercato monetario e finanziario e la spesa pubblica," Bancaria, nn. 5-6, 1977, and Antonio Martino, "Finanza inflazionistica e tasso d'interesse," Rivista di politica economica, vols. 8-9, 1977, reprinted in Rivista di politica economica, Selected Papers, No. 11, 1977, as "Inflationary Finance and 'the' Interest Rate."

| т | Α | R | T | E. | 2 |
|---|---|---|---|----|---|

| 1958-62 | 1963-67 | 1968-72 | 1973-77 |
|---------|--|--|---|
| 31.6 | 36.4 | 47.2 | 52.4 |
| 28.7 | 24.8 | 22.3 | 19.2 |
| 24.9 | 21.3 | 18.6 | 16.1 |
| 30.3 | 33.9 | 29.1 | 27.2 |
| 15.8 | 15.3 | 14.8 | 14.9 |
| | 1958-62 31.6 28.7 24.9 30.3 15.8 | 1958-621963-6731.636.428.724.824.921.330.333.915.815.3 | 1958-621963-671968-7231.636.447.228.724.822.324.921.318.630.333.929.115.815.314.8 |

TABLE 3

M₂ / Y (%)

| | 1958-62 | 1963-67 | 1968-72 | 1973-77 |
|---------------|---------|---------|---------|---------|
| Italy | 64.4 | 73.6 | 85.8 | 95.7 |
| U.S.A. | 43.0 | 43.7 | 44.4 | 45.9 |
| Great Britain | 39.2 | 34.8 | 33.5 | 37.6 |
| France | 33.5 | 39.7 | 42.4 | 48.6 |
| Germany | 34.7 | 40.6 | 46.9 | 57.8 |

a "secular" process.) This is true of the M₉ figures for all the five countries considered, although to a differing extent. However, while the secular decline explains why the ratio is increasing, it does not explain why it is so much higher in Italy than in the other countries, nor why it increases at such a rapid rate.

A second possible factor might be an increase in the precautionary demand for money due to the general climate of uncertainty. However, this might explain why the ratio is high but not why it is rising, and it is doubtful that it has played a role for such a long period of time.

A third explanation is given by the lack of alternatives open to small savers. This undoubtedly has played a significant role in Italy. Indeed, time deposits might be the only option available to small savers because the stock market is negligible, and they might lack the kind of sophisticated financial knowledge required to look for other alternatives (such as taking the money out of the country - which, by the way, is illegal).⁷ However, it is hard to believe that this factor alone can explain the growth of the ratio in times of high inflation. For if it is true that both demand deposits and time deposits pay interest, it is also true that nominal interest rates on all kinds of deposits have consistently been lower than the rate of inflation, so that real interest rates have been negative. Why didn't the small savers try to avoid the inflation tax by increasing their spending (especially on consumer durables)? After all, this would have been a perfectly legal (albeit, therefore, less attractive) way of avoiding a tax.

A fourth possibility might be some sort of "money illusion." People might have interpreted the high rates of inflation of the past few years as exceptional, and come to the conclusion that negative real rates of interest were going to be temporary. This might have been true in the early stages of the inflationary

7. ". . . the Italian financial system differs institutionally from most of the others examined . . . in that Italian banks pay interest on demand as well as on time deposits Checking accounts thus serve as a store of value to a greater extent than elsewhere . . ." J. M. Boughton, "Demand for Money in Major OECD Countries," OECD Economic Outlook Occasional Studies, OECD, December 1978, p. 39. Another factor that plays a role in making checking accounts an attractive store of value is their secrecy. They can be inspected only in the case of a criminal investigation, thus providing a good hiding place for tax evaders.

process, but, after many years of double-digit inflation and negative real rates, any "money illusion" must have been eroded.⁸

All of the above, and undoubtedly other factors as well, might have played a role at one time or another. However, even taken together, it is hard to believe that they can account for the fact that the average Italian holds almost one year's income in cash and keeps on adding to his money holdings even though these continue to deteriorate in real terms because of inflation. The "true" explanation might be a completely different one.

A possible explanation for the peculiarity of the Italian monetary figures and trends — an explanation that complements those mentioned above — might be provided by the so-called underground sector of the Italian economy. Should there be such a sector, its existence might explain the behavior of the money/income ratio better than any other hypothesis.

Indeed, if there is such a sector, firms operating in it might not have access to the "legal" credit market. They might, therefore, be forced to hold large amounts of money both in the form of deposits and in cash.⁹ This might make the money/

| 8. | Real interest rates | on gover | mment bonds have thu | s been estimated | :t |
|----|---------------------|----------|----------------------|------------------|----|
| | 1972 | -0.64 | 1976 | -12.35 | |
| | 1973 | -5.76 | 1977 | 0.28 | |
| | 1974 | 17.44 | 1978 | 1.94 | |
| | 1975 | -0.42 | | | |

Where real rate = nominal rate - rate of inflation of the following year. See Rainer Masera, Disavanzo pubblico e vincolo del bilancio (Milano: Edizioni di Comunita', 1979), p. 72. Nominal rates on deposits are generally lower than on government bonds. Therefore, real rates on deposits have been even more negative than the ones above.

9. The secrecy of deposits (see footnote 7) makes them even more suitable to this task. This is why the ratio of currency to demand deposits, which has been used as an indicator of the size of the underground economy in other countries, would not be as meaningful in Italy. For, given the secrecy of deposits, illegal activities and tax evasion do not necessarily imply the use of currency but can be settled through checks. For a study of the ratio of currency to demand deposits (the "currency ratio") as an indicator of the size of the underground economy in the US, see Vito Tanzi, "Underground Economy, Income Tax Evasion, and the Demand for Currency in the United States, 1929-1976," I.M.F. unpublished paper, 1979. See also, about the "cash" economy in England, Tax Avoision, The Institute of Economic Affairs, Readings 22, 1979.

income ratio higher than otherwise. The growth of the underground sector relative to the whole economic system could, on the other hand, explain why the money/income ratio has been increasing.

Still more important, if income produced by the underground economy is not recorded in income statistics, the "true" money/income ratio is lower than the recorded one. This might explain why the ratio is so much higher in Italy than elsewhere, and why it keeps on growing.

Needless to say, this theory is conjectural. Just as the few superficial remarks above about the demand for money do not amount to a statistical analysis, to say that the existence of the underground sector might explain things does not *prove* anything in any meaningful sense.

However, if this conjecture is valid, and if the existence of the underground economy is the only factor behind the difference between the ratio in Italy and that in the other countries, then statistically recorded income might fall short of "true" income by a very large fraction. It would not be surprising if official income statistics were, say, 30 percent below the mark.

The hypothesis above is based on the implicit assumption that monetary statistics are more reliable than income statistics. If something is wrong with the recorded ratio, then the ac-

It could be argued that, since demand deposits can serve the same purpose as currency because of their secrecy, the ratio of M_1 to M_2 (the latter being made up of currency, demand deposits, and time deposits) could be used in place of the currency ratio. Now, the M_1/M_2 ratio in Italy has shown the same time pattern generally attributed to the ratio of currency to demand deposits – that is, it has been *falling* with economic development. However, there is a notable exception: in the quinquennium 1968-1972 the ratio had been *increasing*, reaching a peak in 1973, and then resuming its downward trend. It might be that the exceptional behavior of the ratio during that time is somewhat connected to the underground economy (it was a period of labor unrest on a larger than usual scale, and of particularly foolish legislation). However, any hypothesis would require extensive statistical analysis.

 $\begin{array}{c|c} \underline{M_1 \ / \ M_2 \ (\%)} \\ \hline 1953 \ 68.20 \\ 1958 \ 57.98 \\ 1963 \ 57.04 \\ 1968 \ 56.75 \\ 1973 \ 66.57 \\ 1978 \ 53.15 \end{array}$

ceptance of the hypothesis means putting the blame on the denominator (GNP) rather than on the numerator (M_2) .

This assumption was confirmed by the reaction of the government statistical office (ISTAT: Central Institute of Statistics) to the money/income hypothesis. As a result of such a reaction, ISTAT unintentionally confirmed the unreliability of income statistics and the existence of a substantial "underground" economy. In November 1978 a brief summary of the hypothesis was published in a major national newspaper.¹⁰ It was suggested that, as a "simplistic arithmetical exercise," paradoxically supposing that the "true" ratio had remained stable over time, the underground economy's contribution to national income in 1977 might have been "in the neighborhood of 40 percent," so that 28 percent of GNP was not recorded in the official income statistics. The article appeared at a time when many people were talking about the underground economy, and, maybe because of that enthusiasm, the "simplistic arithmetical exercise" was taken as a serious estimate.¹¹

So in February 1979, ISTAT set up a Committee to study the reliability of income data and the problem of the underground economy (Commissione per la formazione e gli impieghi del reddito). On the occasion of its first meeting, in February 1979, ISTAT senior statisticians strongly criticized the money/ income hypothesis on two grounds. First, they argued, monetary statistics were not necessarily more reliable than income data. Second, an income of 30,000-60,000 billion lire could not conceivably pass unrecorded. The explanation given for the unusually high Italian M2/income ratio was the one mentioned

10. Antonio Martino, "L'economia clandestina ci ha salvato dal baratro," Il Giornale nuovo, November 19, 1978.

11. Shortly after the appearance of the article, the authoritative Italian economic weekly *Il Mondo* published a survey of opinions on the size of the underground economy ("Il tesoro sommerso," *Il Mondo*, December 13, 1978), in which it quoted me as saying that income produced by the underground economy actually was in the neighborhood of 40 percent. In the same survey, several economists, industrialists, and government officials — using different methodologies — suggested widely different estimates of the size of the underground economy, ranging from 15 percent to 35 percent of national income. My "estimate," therefore, turned out to be the most extreme. ISTAT senior statisticians were also quoted in the same survey. For them, an error of 5 percent don't know what they are talking about."

TABLE 4

Gross National Product, Market Prices (Billions of lire)

| | Old figure | Revised figure | Percent difference |
|------|------------|----------------|--------------------|
| 1975 | 115,072 | 125,378 | + 9.0 |
| 1976 | 143,849 | 156,657 | + 8.9 |
| 1977 | 172,988 | 189,978 | + 9.8 |
| 1978 | 201,000 | 220,743 | + 9.8 |
| | | | |

Source: F. Reviglio, Il significato economico della rivalutazione dei conti nazionali, unpublished paper, ISPE, June 1979.

above: the lack of alternatives open to small savers and the high nominal rates on deposits. Finally, it was suggested that the statistical error in the official income figures was unlikely to exceed 700 billion lire, or 0.35 percent! The arguments given by ISTAT in defense of official income statistics were very plausible.¹² However, it was hard to believe that the error was only on the order of one-third of one percent!

This skepticism was confirmed (and faith in the reliability of ISTAT figures shaken) when in the following month, March 1979, after increasing criticism of official figures, ISTAT decided to revise its GNP time series from 1975 onwards. Income figures were revised upward by almost 10 percent!

A nice byproduct of the decision was the possibility it offered to ridicule believers in "fine tuning." Arguments going on at that time about the desirable size of the target rate of growth – the alternative positions differing by less than 1 percent – were made to look absurd by the official admission that income figures had been 10 percent underestimated.¹³

12. Indeed, so much so that I decided not to publish a somewhat longer version of the money/income hypothesis that I had already completed. It was then published the following month. See Antonio Martino, "Metamorfosi della ricchezza sommersa," Alleanza, March 1979, pp. 22-24.

13. Antonio Martino, "Quando scienza economica significa fumo negli occhi," Il Giornale nuovo, April 22, 1979.

97

Moreover, the decision encouraged further speculation about the size of the underground economy,¹⁴ and lent credibility to the money/income hypothesis.¹⁵

Another Italian Economic Miracle?

The fact that six million persons are quietly working in defiance of the law amounts not only to a huge social rebellion but also to a new kind of conflict, one very different from the self-destructive kind in Britain. Faced with an untenable situation, huge numbers of Italians have decided to ignore rather than try to change the system.

C. Matthews

"Underground' Workers Keep Italian Economy Running" International Herald Tribune, Feb. 5, 1979

The existence of a substantial underground economy helps explain a few puzzles relating to the labor market. The "activity rate" - the ratio of the labor force to total population - has been declining rapidly and is presently at a level that is generally considered exceptionally low. According to ISTAT figures, in 1978 there were 21,730,000 Italians in the labor force out of a population of 55,806,000, or 38.9 percent. If one excludes the 1,571,000 unemployed, the activity rate falls to 36.1 percent.¹⁶ ISTAT stresses that the decline of the activity rate is a historical process: in 1861 it was roughly 60 percent, and by the beginning of the century it had dropped to 50 percent. However, some economic observers believe that the decline in the activity rate cannot be interpreted as a "normal" continuation of a historical trend. They claim that the ratio of the labor force to total population has dropped from 44 percent at the end of the 1950s to less than 34 percent in 1976 and that such a decline is much sharper than in any other industrialized country.¹⁷

14. For example, see "Tirata a galla puo' esplodere," Il Mondo, April 20, 1979; Luigi Frey, "Dal lavoro nero alla misurazione del reddito 'sommerso'," Notiziario Ceres di economia del lavoro, May 16, 1979; "E dall' economia sommersa emerge una sorpresa," Il Mondo, June 29, 1979.

15. Barbara Ellis, "Italy's prosperous anarchy," Forbes, April 2, 1979.

16. See I conti degli Italiani (Rome: ISTAT, 1979), p. 5.

17. Bruno Contini, Lo sviluppo di un' economia parallela (Milano: Edizioni di Communita', 1979), p. 15.

According to ISTAT, several factors account for the decline in the activity rate. First, there are demographic changes which have increased the percentage of total population made up of people older than 65 and younger than 14. Then, there have been migratory movements which have in the past contributed to the decline in the rate. Third, and more important, there has been an increase in the number of students who stay in school beyond compulsory education, and an increase in the number of years they remain in school. Another factor is the decline of agricultural employment, which might have meant that some members of the family (especially women and children) have left the labor force. More specifically related to our point is the last factor: the "improvement" in social security benefits and their extension to still other groups in society has led many people to drop out of the "official" labor force, either by early retirement or by qualifying for a pension for the "invalid" (i.e. disabled) citizen. The number of these has swollen in recent years to an incredible 5,437,528, almost 10 percent of total population, in 1979. Of the 12,603,678 people who draw a pension from INPS (the Italian equivalent of Social Security), 43 percent are "disabled citizens."¹⁸ Some of these people are not included in the labor force even though they often work (as in the recent case of a professional photographer who was drawing a pension for the blind), and the same is true for those on old-age pension.

A host of studies has pointed out in recent years the inadequacy of official figures of the activity rate. First, some observers have estimated that about one half of the officially unemployed hold "unofficial" jobs (while drawing unemployment benefits).¹⁹ Second, roughly 1,400,000 youngsters between the age of 14 and 29 hold "precarious" jobs while being officially considered students, and, therefore, outside the labor force. Third, about 1,250,000 people above 50 years of age, while drawing a pension for old age, "unofficially" work. Fourth, almost 600,000 women between 30 and 49 years of age, while being classified as housewives and excluded from the

18. See "Siamo un popolo di invalidi, almeno per l'INPS," Il Giornale nuovo, March 29, 1980.

19. After this paper was written, on June 12 of this year, the Ministry of Labor made the results of a survey known: in Naples 57 percent of those listed as unemployed held a stable job.

labor force, hold occasional and precarious jobs. Finally, 235,000 minors between 10 and 15 years of age, although excluded by definition from the labor force, do work. This last figure, according to other sources, should be increased to $430,000.^{20}$

Another factor that plays a role in supporting the idea of an underground economy in the labor market is the presence of foreign workers. These for the most part hold jobs that Italians consider menial or unpleasant, for example, servants or miners. Significantly enough, some of them come from the communist world. Thus, the old communist leader Giorgio Amendola recently cited the example of Polish miners employed in Sardegna (a region with a high rate of unemployment) as evidence that unemployment statistics are misleading.²¹ Estimates of the number of foreign workers employed in Italy widely differ, for many of them enter the country illegally. However, their number should not be less than 500,000 and might well be close to 750,000.²²

Considering these various factors, it is estimated that the underground economy employs around 6 million persons.^{2 3}

To this so-called "non-institutional" labor force, one must add moonlighters. This phenomenon takes place on a grand scale in Italy and involves all categories. My favorite "Friedman's law" is thus undoubtedly confirmed. Professor Friedman has argued that university professors all over the world tend to have the same income; what varies from country to country is the number of jobs they must hold in order to make that income. Not all income from moonlighting is recorded, and it obviously adds to the underground economy. Moonlighting apparently involves 1,300,000 people.²⁴ However, estimates are highly unreliable, because of the illegal element often present.

20. Luigi Frey, op. cit.

21. Giorgio Amendola, "Interrogativi sul 'caso' Fiat," Rinascita, n. 43, November 9, 1979, pp. 13-15.

22. Giuseppe Alvaro, "La valutazione dell'economia sommersa: principali problemi statistici ed economici," I.S.P.E. unpublished paper, 1979.

23. The estimate of 6 million underground workers is due to Luigi Frey, Tendenze dell'occupazione (Rome: Ceres, 1978). Such estimate is supported by a number of studies that show that the activity rate is in many cases 20 percent higher than the official one. See Bruno Contini, op. cit., and the bibliography.

24. Giuseppe Alvaro, op. cit.

Examples of moonlighting could fill a whole book. The Rome Post Office, which employs 1,500 people to distribute the mail in the city, handles the same amount of correspondence handled by "Romana Recapiti," a private delivery agency, which employs 300. Needless to say, "Romana Recapiti" is faster and more reliable than the Post Office. But the interesting thing is that most of the 300 people working for "Romana Recapiti" are moonlighting employees of the Post Office. Not surprisingly, the rate of absenteeism at the Post Office is in the neighborhood of 50 percent.

Indeed, absenteeism and moonlighting go hand in hand and represent a typical feature of contemporary Italy. It has been acutely observed that Italians are socialist in the morning and capitalist in the afternoon. What this means is that many bureaucrats work for the government in the morning and moonlight in the afternoon. They hold the government job because it entitles them to retirement schemes, health insurance, fringe benefits, and, of course, a salary, with very little (or no) work. Then, in the afternoon, they moonlight for some capitalist "underground" organization, where they make money and show their talents and efficiency, "unprotected" by labor unions or social benefits. This is particularly true of the bureaucracy of government ministries that has succeeded in maintaining the 8 am to 2 pm working hours first introduced at the time of World War II. Needless to say, almost no one reports to work at 8 am and most leave before 2 pm. Thus, ministries have been defined as buildings where those who are a bit late to work meet on the stairs those who leave work a bit early.

Absenteeism is typical of the "official" economy and is present in all sectors: public, semi-public, and private. It is the inevitable consequence of the legislation that has been introduced to "protect workers' rights." When I was teaching in Naples, I was approached by someone who wanted to work as a research assistant. When I told him that no position was available and that, therefore, I could not pay him, he replied that he was willing to work for free since he already had a job. "How are you going to find the time to do research?" I asked him. He answered that he had plenty of time, because he was "exonerated from work" being a union leader.

A wonderful example of the effects of legislation on absenteeism and its effects on production is provided by the case of Alfasud, the semi-public automobile factory of the Alfa Romeo

company. "When things are going well at the Alfasud car plant, only about one in five of its workers do not show up. Under such optimum conditions, car production may reach 520 units a day in a plant built to produce 1,000 . . . Last year it lost some \$100m. Since it belongs to the state . . . there is of course no talk of closing it down." The high rate of absenteeism at Alfasud should be blamed on ". . . an anomalous system of penalties for absence. A worker who arrives half an hour late to the factory is docked part of his salary, whereas if he reports sick he is not penalized. But sick leave is only legitimate if it lasts for a minimum of three days. So a worker who misses a train connection is better off financially if he turns round and spends the next three days at home rather than going on and arriving late. The company is penalized doubly: first by the absence of the manpower, and second because the first three days of illness are not covered by the workers' social insurance, but are borne by the company itself."²⁵ What the author of the article fails to mention is that the connection between absenteeism and the underground economy is confirmed, in the case of Alfasud, by the sharp increase in the rate of absenteeism at harvest time. Many of Alfasud employees "went to the assembly line . . . directly from farming"; they have retained their farms and take care of them by not reporting to work.

Absenteeism is, of course, much higher in the public than in the private sector. Newspapers have recently come out with the story of a street sweeper in Palermo who has totalled 1,278 days of absence in five years,²⁶ and that of an employee of the public transportation company in the same city who totalled 700 days of absence in 27 months.²⁷ Both of them claimed that they could not work because of "hypochondriasis" – a nervous disturbance because of which they were convinced of being sick. It is far from clear that they will lose the legal case brought against them by their employers. Absenteeism is also present in the private sector, although to a smaller extent. And yet, Fiat claims that in 1979 it lost the production of 300,000 cars

^{25. &}quot;Alfasud, Italy's well-intended industrial disaster," The Economist, March 10, 1979, p. 81.

^{26. &}quot;Controcorrente," Il Giornale nuovo, January 6, 1980.

^{27. &}quot;Assente 700 giorni in 27 mesi di lavoro," Il Giornale nuovo, February 5, 1980.

because of absenteeism and strikes (both due to foolish legislation and connected to the underground economy).²⁸

Political Effects on the Labor Market

Absenteeism is not the only factor making labor costs in the "official" economy artificially high. Another element is social security contributions. In 1975, direct pay as a percentage of total labor costs in industry was 50 percent in Italy, as compared to 76 percent in the United Kingdom, 63 percent in West Germany, 58 percent in France, Holland, and Belgium. On the other hand, social security contributions were highest in Italy: 28 percent versus 12 percent in the United Kingdom, 18 percent in West Germany, 23 percent in Holland and Belgium, and 24 percent in France.²⁹ In some cases, social security contributions amount to more than 55 percent of total labor costs. The incentive this provides to both workers and employers to try to evade the social security tax by creating "underground" jobs needs no comment.

Another factor that plays a large negative role in the "official" economy is labor mobility. As one industrialist remarked: "Hire someone in your factory and it's like you're married. You can't fire him."³⁰ Besides the fact that in the "official" economy employers cannot make mistakes in the sense that it is almost impossible to fire someone, labor mobility is also greatly reduced in the sense that labor unions oppose overtime work,³¹ and even resist mobility within the same factory.

Finally, one must mention the high rate of increase in nominal wages that the unions succeed in obtaining in the "official" economy thanks to their monopoly power. The average annual increase in hourly earnings in manufacturing from 1965 to 1977 has been higher in Italy than in any other EEC country: 15.2 percent, as compared to 12.2 percent in France, 12.1 percent in Belgium, 12 percent in the United

28. The effects of absenteeism and strikes on productivity are illustrated by the fact that Alfa Romeo currently produces 7.2 cars per worker per year, and Fiat 11, as compared to Opel's 29 and Toyota's 43. Fiat claims that it can never use more than 65 percent of its productive capacity.

29. Primo Rapporto CSC sull' Industria Italiana (Rome: Confederazione Generale dell'Industria Italiana, 1978), p. 28.

30. See Barbara Ellis, op. cit.

31. For a fascinating story, see "No overtime please – we're Italian," The Economist, July 8, 1978.

Kingdom, 10.9 percent in Holland, and 8.4 percent in West Germany.³²

On top of all of this, strikes, which are typical of the "official" economy (and absent in the underground economy), occur at a rate that has earned Italy the nickname of "strikeland."^{3 3} In the face of absenteeism, high social security costs, reduced or non-existent labor mobility, labor union pressures, rapidly rising nominal wages, and strikes on a large scale, it should not be surprising that firms in the "official" economy are not doing very well. A good example is given by Iri, the giant state holding, Europe's largest industrial employer, which has succeeded in accumulating debts for an incredible amount: 30,000 billion lire (some \$34 billion).³⁴

Mention must also be made of tax evasion and its relation to the underground economy. It is generally believed that Italians do not pay taxes, or that they pay less than the people in other European countries. The statement is wrong: the ratio of total public sector spending to gross national product which is the only correct measure of the cost of government has risen from 49.2 percent in 1976 to 55.8 percent in 1979.³⁵ However, it might conceivably be true that there is some correlation between the underground economy and tax evasion, and that if all income produced in the country were correctly recorded, those percentages would be much smaller. It is an undeniable fact that Italians do not object to tax evasion on

32. The Economist, February 25, 1978.

33. Number of working days lost through industrial stoppages, per 1000 employees, per year. 1963-1978 average.

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|----------------|---------|
| Luxembourg | 0.0 |
| Holland | 36.2 |
| West Germany | 47.3 |
| Denmark | 206.3 |
| Belgium | 274.8 |
| France | 284.0 |
| United Kingdom | 499.8 |
| Ireland | 924.7 |
| Italy | 1,412.9 |
| | |

34. "Il 'buco' dell'Iri e' di 24 mila miliardi," *Il Giornale nuovo*, February 6, 1980; "Superano i 30 mila miliardi i debiti Iri," *Il Giornale nuovo*, March 20, 1980.

35. Franco Reviglio, *op. cit.* The percentages above refer to the old GNP figures. They are reduced by some 5 percentage points if one refers to the new GNP figures.

moral grounds (except, of course, when it is someone else who evades). For instance, my dentist told me that he was not going to take care of one of his patients anymore, "because," he said indignantly, "she asked me to give her a receipt for her payment." The receipt, incidentally, is legally compulsory, and it is a criminal offense not to issue it. However, many people simply ignore the law; plumbers, doctors, lawyers, and other professionals seldom bother to issue the compulsory receipt. Obviously, their income goes unrecorded, and it adds to the size of the underground economy.³⁶ It is a sad byproduct of the discussions about the underground economy that the government is now engaged in an all-out war against tax evasion.³⁷

I would like to conclude on an optimistic note and venture to predict that the efforts of legislators will keep on being frustrated by the ingenuity of my countrymen. For what has been argued in this paper is that lawlessness can be beneficial. Monetary figures, and a great deal of evidence in other areas, suggest that the underground economy in Italy produces anywhere between one-fourth and one-third of national income. Obviously, activities within the underground economy are often carried on by violating the law – income tax evasion, evasion of social security contributions, violation of labor laws, and outright fraud (as in the case of pensions).³⁸ However, if citizens

36. The fact that professionals evade taxes is implicitly acknowledged by our tax laws. Income tax rates are higher for professionals than for people on fixed income, with the justification being that "professionals evade taxes."

37. One of the first measures introduced is that it is now compulsory for restaurants and hotels to give their customers a receipt, and even customers are fined if they leave the restaurant or the hotel without such a receipt. Several other measures are now being introduced.

(The compulsory receipt for restaurants and hotels was introduced at the time this paper was written. The only effect it seems to have produced so far is that at the end of the meal the waiter will ask you if you want a legal receipt — usually in a threatening tone of voice. If you insist on the legal receipt, he will make it clear that he will have to charge 15 percent more!)

38. Of course, some of the activities in the underground economy not mentioned in this paper are of the "traditional" criminal type, such as prostitution, gambling, drug traffic, contraband, kidnapping (a growth industry at the moment), extortion, etc. Here the social benefits of violating the law are doubtful or absent. But it can be argued that their existence is part of the social cost of an excessive amount of bad legislation. respected the law, most, if not all, of these activities would simply not exist, and the social cost of law abidance would be enormous. These activities are undeniably beneficial to society. However, they also entail a social cost, for when people start violating the law they end up violating all laws, good and bad. In order to find a solution, we should remember the words of Frederic Bastiat: "No society can exist unless the laws are respected to a certain degree. The safest, way to make laws respected is to make them respectable. When law and morality contradict each other, the citizen has the cruel alternative of either losing his moral sense or losing his respect for the law."³⁹ Until the quality of legislation is improved and its quantity restricted, the best Italians can hope for is affluence from lawlessness.

39. Frederic Bastiat, *The Law* (1850) (Irvington-on-Hudson, New York: The Foundation for Economic Education, Inc., 1974), p. 12.

Gold Prospects

HENRY HAZLITT

A gratifying number of economists have recently come out in favor of restoring a gold standard, but less than a handful have ventured to propose a specific blueprint for achieving that goal. Outstanding among these has been Arthur B. Laffer. His plan is complicated in its details, but essentially it is a proposal to return to a fractional gold standard—some might say a fractional gold-exchange standard—and to take certain precautions to assure its maintenance.

Before I examine what I think is wrong with his specific suggestion, let me make clear that I fully agree with him on the desirability—in fact the necessity—of returning to a gold standard.

The gold standard was not some artificial contrivance. Historically, men may almost be said to have begun with one. For reasons too numerous to spell out here, individuals have always valued gold for its own sake—and also have known that nearly everyone else valued it. It undoubtedly served as a medium of exchange—as a money—before governments started stamping coins of uniform weight and fineness. When paper money developed, it circulated and took its value from the fact that it was convertible on demand into a specific weight of gold. As long as the promise of convertibility was trusted, the paper money had exactly the value of the gold into which it was convertible.

The moment that convertibility ceased, because of the overissuance of notes—of promises—or for any other reason, the paper units began to lose their value. Because everyone felt the need for a medium of exchange, it was found that the now inconvertible paper continued to circulate—at a discount. It was also found that the size of the discount bore a close relation to the amount by which the issuance of the paper money was increased.

This gave birth to the belief that the previous convertibility-ondemand into gold had been unnecessary, and that all a government really had to do was to stamp a certain number of scraps of paper with a name and a figure and declare them to be a money, worth so-and-so much in terms of gold (though not convertible into it) or in terms of other money. Thus, the argument continued, the value of this paper-money unit could be precisely con-