

Governing through non-enforcement: Regulatory forbearance as industrial policy in advanced economies

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Abstract

Political economy scholarship generally assumes that governments are interested in enforcing economic regulations. Cases of non-enforcement are predominantly studied in the context of developing countries and are chiefly associated with states' deficient institutional capacity. This article casts doubts on these assumptions by showing how governments in advanced democracies manipulate the regulatory regime and generate selective non-enforcement of economic regulations to shape markets at their discretion. We argue that regulatory forbearance becomes an attractive form of industrial policy when governments are prevented from intervening discretionally in markets due to legal obstacles, which they cannot overcome; or when the productive structure of the country makes alternative forms of intervention unviable. Drawing on the study of tax non-enforcement in two most-different cases of strong and weak state capacity such as Germany and Italy, the article theorizes three techniques through which governments manipulate regulatory regimes: legal and organizational sabotage and shirking. By shedding light on the economic logic of forbearance, the article points at non-enforcement as an overlooked mode of regulatory governance and suggests the need to inquire further into governments' strategic agency behind regulatory regimes.

Keywords: regulatory regimes, non-enforcement, taxation, industrial policy, economic regulation.

1. Introduction

The changing nature of states' economic governance is at the core of the political economy scholarship. Early works on states' economic governance focused on the *developmental state's* interventions to foster industrialization (Gerschenkron 1962). Subsequent studies investigated how the *activist Keynesian state* managed aggregated demand (Marglin & Schor 1992) and shaped the supply side of the economy through industrial policy (Shonfield 1965; Zysman 1984; Katzenstein 1985; Hall 1986; Federico & Foreman-Peck 1999). The deepening of European integration and the rise of neoliberalism in the 1980s have brought about the *regulatory state* where pro-competition rule-making has replaced discretionary fiscal spending (Majone 1994, 1997).

Thus, scholars have started to ponder on whether states have “retreated” from the rising global economy (Strange 1996) or whether they retain the capacity for economic governance. A growing body of industrial policy research has shown that governments continue to shape markets through “market-supporting” interventions (Levy 2006) and carry on aiding selected domestic producers or sectors by making strategic use of economic re-regulation (Thatcher 2014; Bulfone 2020a). Overall, while the literature has acknowledged the resilience of states' economic activism, governments' strategic actions to alter the composition and functioning of the economy through regulatory non-enforcement have gone unnoticed.

In this article, we shed light on regulatory forbearance as a subtle mode of regulatory governance through which governments shape the supply side of the economy. By combining recent scholarship on law enforcement (Van Rooij *et al.* 2013; Amengual 2016; Milmanda & Garay 2019; Holland 2016, 2017; Gordon & Hafer 2013;

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Declaration of conflict of interest: The authors declare no conflict of interest.

Accepted for publication 18 December 2020.

Ronconi 2012; Dewey *et al.* 2021; Dewey 2018) with political economy literature on industrial policy and states' economic activism, we highlight aspects of what can be thought of as a *non-enforcing state*. We contend that forbearance, put into practice through the strategic manipulation of the regulatory regime, can become a form of industrial policy. Although previous work on non-enforcement has predominantly focused on developing countries and chiefly associated non-enforcement with weak states' institutional capacity or corruption (Migdal 1988; Brinks *et al.* 2019), we argue instead that governments exploit the selective non-enforcement of economic regulations as a strategic means to govern the economy. By tinkering with enforcement mechanisms—that is, applying “political leniency” (Holland 2016: p. 233) or pursuing the “reduction in the stringency” and effectiveness of enforcement mechanisms (Gordon & Hafer 2013: p. 209)—governments confer selected advantages to targeted socio-economic groups who benefit vis-à-vis other law-abiding market actors. Through fewer disbursements to the state, these groups of non-compliers enjoy a combination of higher profits and the capacity to pass on part of such savings onto their final prices, capturing market shares from compliant competitors. Regulatory forbearance, therefore, can be thought of as functionally equivalent to direct subsidies used as old instruments of industrial policy in an age where the EU competition policy and state aid regulations significantly constrain governments' discretionary interventions in markets (Jabko 2006; Clift & Woll 2012; Bulfone 2020b).

Drawing on two most different cases of advanced democracies such as Germany and Italy, we analyze forbearance in the realm of tax enforcement, with implications that have the potential to travel to all those domains where economic regulation imposes substantial costs to producers. In fact, the higher the costs of compliance, the higher the incentive to defect will be for the rule-taking producers. For governments, forbearance becomes an attractive policy choice when they want to aid sizeable producer groups or economic sectors but lack the legal competence to do so lawfully; or when the productive structure of the country is such that regulatory forbearance can be deployed more effectively than alternative lawful industrial policies. We theorize a set of three techniques through which governments pursue forbearance. In fact, while corruption and state capture are often taken for granted in developing countries, monitoring and enforcing regulations in advanced democracies is often the competence of independent state agencies shielded from political interference. Therefore, as we document in the case studies, governments resort to alternative means such as legal sabotage, organizational sabotage, and shirking to generate selective non-enforcement.

The contribution to the existing literature is twofold. Firstly, this article expands our current understanding of forbearance (Gordon & Hafer 2013; Holland 2016, 2017). To our knowledge, no attention has been paid to the economic or developmental dimension—as opposed to short-term electoral motivations—of regulatory forbearance. Moreover, forbearance has been so far analyzed only in developing countries where state capture seems to be the rule (Holland 2016, 2017). We fill these gaps by dissecting the mechanisms through which rule makers generate non-enforcement in order to affect economic outcomes in advanced economies. Secondly, this article contributes to ongoing debates on the political economy of regulatory governance (Guidi *et al.* 2020), highlighting the importance of the enforcement side of regulatory governance and rule makers' strategic agency behind regulatory regimes.

The argument draws on different primary and secondary sources of information, including interviews with two high-ranked politicians who held key positions in office in the two countries. However, since the phenomenon in question consists of bypassing the legal setting, this article cannot but run against limitations when trying to collect empirical material on the subject. Given the vested interests of the actors involved, we acknowledge upfront the difficulty of pinning down situations of regulatory forbearance. Nevertheless, we regard this article's insights as a starting point for future research on the study of regulatory non-enforcement.

This article unfolds as follows. The first five sections present a review of the literature and unpack the economic logic of forbearance and governments' incentives to employ it as a form of industrial policy. Section six provides the logic of case selection and section seven a stylized account of the two cases. Finally, conclusions wrap up the findings and discuss implications for future research on regulatory governance.

2. Non-enforcement in the literature

This article combines insights from the literature on non-enforcement with the literature on industrial policy and state-centered political economy. Work on non-enforcement has been usually associated with the expansion of

illegal economies and white-collar crime (Reuter 1984; Andreas 1998; Paoli *et al.* 2009; Snyder & Duran-Martinez 2009; Pontell *et al.* 2014; Dewey 2017; Bergman 2018). Non-enforcement has also been identified as a mechanism for dealing with crime-related phenomena and the management of complex social constellations (Buxton 2006; Houborg *et al.* 2014; de la Feria 2020; Schmoll 2020). Commonly focused on street-level bureaucrats, this body of research builds on the assumption—very much present in studies on law enforcement in general—that governments are willing to enforce the law, even if they fail to do so. Accordingly, failing to enforce the law is explained on the basis of deficient states' institutional structures. Here, explanations of non-enforcement generally allude to weak institutional capacity of tax bureaucracies (Sun 2015, p. 71), usually caused by the lack of resources or rampant corruption (Migdal 1988; Brinks *et al.* 2019).

We contend that the weak state explanation cannot be generalized. Firstly, cases exist in which states considered “strong” do not enforce the law in certain spheres as well as cases in which supposedly “weak” states are capable of effective law enforcement. Lack of state capacity refers to structural impediments, which are treated by the literature as more or less constant over time. Yet, swings in compliance suggest that the will to enforce the law may be responsive to changes in the government's political attitude. In fact, the state capacity explanation tends to ignore the self-interested motivations of those political actors controlling the state (Acemoglu 2005).

Secondly, and relatedly, explanations for non-enforcement based on state capacity tend to treat the latter as given “exogenously” and “frozen” over time. However, once we allow for the self-interested motivations of the rule makers, we must consider that state weakness may be endogenous to politics (Besley & Persson 2013), that is, to the willingness of rule makers not to enforce the law by proactively undermining state capacity. In other words, as political sovereigns, governments dispose of the legal capacity to both strengthen and reduce state capabilities. Indeed, state capacity is not frozen in time: a plethora of examples exist in which supposedly weak states—ranging from, for example, Bangladesh to Paraguay and Rwanda—successfully upgraded their state capacity to extract tax revenues, thanks to sustained political commitment and administrative reforms (OECD 2015).

Taking heed of these criticisms, current studies analyze the lack of enforcement as a result of purposeful political agency. Thus, politicians' strategic law non-enforcement has been used as a response to increasing competitive pressures produced by trade opening (Ronconi 2012) or even as a tool to extract resources from specific economic activities (Ceccagno 2017; Dewey 2018; Dewey 2020). This perspective has gained momentum with Holland's (2016, 2017) work on forbearance. In her view, politicians capture enforcement agencies and use regulatory non-enforcement to redistribute benefits with the expectation of being rewarded by voters during elections.¹ Although we find these arguments compelling, we extend Holland's electoral explanation in two ways. First, we highlight the economic logic of forbearance put to use for industrial policy motives rather than purely electoral ones. Second, while Holland studies forbearance in developing countries—where non-enforcement occurs because of state capture—we cast light on the techniques through which forbearance can be pursued in mature democracies where semi-autonomous enforcement agencies are shielded from direct political interference.

3. The economic logic of forbearance

Our analysis follows the Organisation for Economic Co-operation and Development (OECD)'s conceptualization of industrial policy as “any type of intervention or government policy that attempts to improve the business environment or to alter the structure of economic activity toward sectors, technologies or tasks that are expected to offer better prospects for economic growth or societal welfare than would occur in the absence of such intervention” (Warwick 2013, p. 16). Two types of industrial policies are generally distinguished (Foreman-Peck 2006). *Vertical* policies selectively alter the structure of the economy by redistributing resources among sectors, industries, or firms (e.g. through targeted tax incentives or exemptions, subsidized credit, direct subsidies). Vertical policies to “pick winners” are a form of state support for industries or businesses deemed to have great potential. Policies to “help losers” provide aid to industries and businesses in trouble, interfering with the process of creative destruction. *Horizontal* policies, instead, apply to the economy as a whole and secure the framework conditions necessary to foster business activity or improve the ecology of the economy.

The distinction between industrial policy and other types of public policy interventions is not always clear-cut.² From an industrial policy standpoint what matters is that, through these policies, the state seeks to influence the supply side of the economy (Thatcher 2014, p. 10) by lowering producers' input costs in the process of output

production (Foreman-Peck 2006, p. 39). Regulatory forbearance can be understood as a market-distorting instrument of industrial policy, which applies horizontally—that is, by undermining the *erga omnes* applicability of the regulatory regime—but whose economic effects are produced in a way similar to vertical industrial policies³—i.e. by favoring specific producer groups or sectors and creating winners and losers. Forbearance falls within this category because non-enforcement fosters selective non-compliance with costly regulations which, under normal conditions of full enforcement, would instead be borne equally by the same producers in the economy.

Compliance with economic regulations imposes costs by requiring specific expenditures by company owners to make their businesses conform to the provisions mandated by legislation. Besides tax regulations, other examples of costly economic regulations are labor, health, and safety standards as well as environmental regulations (Rothstein & Demeritt 2019; Rothstein *et al.* 2019).⁴ The higher the costs imposed by economic regulation, the higher the incentive for producers to defect will be. Defection occurs through partial compliance or, at worst, fraudulent behavior. Non-compliance then yields an unfair competitive advantage vis-à-vis other rule-abiding producers which, through forbearance, political rule makers tolerate or may even incentivize.

This article focuses on tax regulations because it represents one of the major costs which economic agents incur during production. Tax policy serves multiple purposes in society (e.g. redistribution and stabilization). But governments have made extensive use of tax policy's allocative function (Musgrave 1959) as an instrument of industrial policy—for example, to attract capitals in a global economy (Reurink & Bernardo 2020) or to grant fiscal subsidies (Thatcher 2014)—and foster distinctive models of capitalism (Shonfield 1965; Haffert 2019). If, with governments' connivance, tax regulations are enforced only for some producer groups, regions or sectors but not for others, the latter *de facto* enjoy a tolerated exemption vis-à-vis other actors subjected to effective enforcement. Non-enforcement becomes selective because the possibility to avoid regulation—tax evasion in our case—is not an equally viable option for all economic actors or sectors in the economic system. It is well known for instance that tax evasion is hardly an option for audited larger corporations while smaller firms or the self-employed, often subjected to simplified accounting, enjoy a greater capacity to evade taxes, especially within some identifiable segments of the service sector (e.g. retail, construction, hospitality).⁵

Selective tax non-enforcement jeopardizes compliance and reduces the effective tax rates by facilitating tax evasion (Genschel & Schwarz 2011, p. 352). Tax evasion by some distorts market competition and undermines the principle of “horizontal tax equity” according to which taxpayers in similar circumstances should bear similar tax burdens (de la Feria 2020, p. 11). Less tax disbursements to the state lower the relative input costs, which the non-compliant producers face vis-à-vis the compliant ones. Thanks to relative lower production costs, the non-compliant economic actors can make higher profits—which can be reinvested to further increase one's own competitiveness—or can pass part of the savings onto lower prices capturing market shares from those law-abiding competitors (Santiago 2010).

Therefore, forbearance works as a functional equivalent to a fiscal subsidy, which can be targeted at both “helping the losers” and “picking winners.” In the former sense, as we show in the Italian case, forbearance slows the process of creative destruction by granting less productive and less innovative undertakings a greater chance to survive than the one they would have in a regime of effective regulatory enforcement (Bobbio 2016). In the latter sense, as we show in the German case, forbearance can be used as a tool for attracting profitable and innovative businesses within one's jurisdiction by promising a lax approach to the enforcement of costly regulations (Genschel & Schwarz 2011, p. 352). In both cases, forbearance tampers with the self-regulating mechanism of markets and alters the structure of the economy.

4. Governments' incentives to pursue economic forbearance

We expect governments to have incentives to deploy forbearance especially under two circumstances:

- 1 When they want to aid sizeable producer groups or sectors in the economy but lack the legal competence to do so lawfully.
- 2 When the productive structure of the country is such that regulatory forbearance can be deployed more effectively than alternative lawful industrial policies.

Institutionalist scholarship in political science argues convincingly that governments' policy choices are significantly shaped by the incentives and constraints posed by the institutional setting (Steinmo *et al.* 1992; Hall 2010).

An established body of literature also indicates that the state's institutional and legal characteristics go a long way in explaining public policymaking (Katzenstein 1978; Evans *et al.* 1985; Hall 1986). Behind our first expectation lies the insight that every policy presupposes the government's legal capacity to enact it within a given policy system (Scharpf 1997). However, when governments are confronted with significant legal obstacles to policy action, regulatory forbearance provides them with a convenient path to circumvent these constraints without the need for legal and institutional change. Leaving the policy system unaltered *de jure*, forbearance makes it more flexible *de facto*, enabling policy choices hitherto unviable.

For instance, Germany's subnational governments are responsible for fiscal expenditures but lack the legal capacity to alter tax policy, which is a federal competence. Thus, Länder governments seeking to alter tax policy (e.g. to make it more business-friendly) cannot do so selectively due to the high consensus needed in the upper chamber to alter the German fiscal constitution (Scharpf 1988; Di Carlo 2019). Alternatively, it could be the case that supranational regulatory regimes prohibit given policy choices altogether. Within today's systems of multi-level governance, policy choices must conform with regulatory regimes in place at different levels of the polity (Scharpf 1997). This is particularly the case for industrial policymaking in Europe. Since the 1970s, the strengthening of EU competition policy and state aid regulations have increasingly curtailed governments' capacity to intervene discretionally in the economy (Jabko 2006; Clift & Woll 2012; Bulfone 2020b). Thus, national or subnational governments have incentives to deploy forbearance because they have only limited or no direct power over higher-level regulations, which they cannot readily change.

But the government can also be expected to select industrial policies most attuned to the productive structure to which these must apply. The literature in political economy has long suggested that policy choices can be driven by an economy's structural characteristics and the mode of economic coordination among firms and suppliers (Hall & Soskice 2003). Thus, the productive structure of the country should equally provide incentives and constraints, which shape the selection of alternative types of industrial policy. We do not intend to imply that these structural features fully determine governments' choices but only suggest that governments cannot be indifferent to the initial characteristics of the economy when selecting the most effective industrial policies among a set of alternatives.⁶ By the country's productive structure, we mean the constellation of available input factors (e.g. capital, skills, raw materials), the dominant mode of production in the economy, the nature of the prevalent economic activities and the characteristics of the socio-economic groups which underpin them.

Assuming a government interested in seeking re-election but also fostering economic and social development, regulatory forbearance will be more effective at aiding selected producer groups or sectors if, compared to alternatives, it can achieve greater economic and social gains at the minor political and economic costs within the shortest possible time horizon.⁷ This clearly depends on the characteristics of the productive structure and on the regulatory domain to which forbearance is to be applied. For the case of tax non-enforcement, regulatory forbearance becomes an attractive policy in a productive system where (a) a large number of producers is in a position to benefit from tax non-enforcement; (b) non-enforcement produces tangible economic aid in the short term;⁸ (c) given the characteristics of the productive system, alternative industrial policies are either unviable or will only yield uncertain future rewards.

5. Forbearance through the strategic manipulation of regulatory regimes

Governments in advanced democracies are neither in charge of regulatory enforcement nor can easily capture enforcement agencies. Therefore, we need a better understanding of the techniques through which governments pursue forbearance.

A regulatory regime is an infrastructure utilized by regulators to achieve regulatory goals (May 2007). We introduce an analytical distinction to differentiate, within the regime, between the roles of *rule makers*, *rule enforcers*, and *rule takers*.⁹ Rule makers are those political actors which design regulatory regimes and derive their authority to pass legislation from their political—temporary—control of the polity. Rule enforcers are state agencies or ministerial departments to which the legal competence to carry out regulatory enforcement is assigned. Rule takers are all those individual or collective actors who are compelled to abide by the law by virtue of their participation in economic activities.

Rule makers and rule enforcers may have conflicting interests. This is because rule makers are political actors in government who perform a plethora of wider socio-economic objectives while enforcement agencies have a narrow mandate to ensure law enforcement. Governments may conceivably have an interest in undermining the effectiveness of the tax regulatory regime if non-enforcement becomes a strategic means to shape economic outcomes. Non-enforcement produces economic advantage by bending the *erga omnes* applicability of regulation to provide targeted support to specific sectors, firms, regions, or clusters of producers.

Holland (2016, 2017) has shown that governments may neutralize enforcement to gain electoral advantages. But governments are not only *responsive* to electoral groups. They are also *responsible* for ensuring economic growth and citizens' protection from the vagaries of capitalism (Scharpf 1999; Mair 2009). Through industrial policy, governments may legitimately aspire to promote the development of a particular sector, to create or preserve employment, to improve or alter the distribution of income, or even to address regional backwardness (Warwick 2013, p. 17).

To the contrary, enforcement agencies' legal mandate is precisely that of ensuring the *erga omnes* applicability of regulations. In many regulatory domains of advanced democracies, enforcement competencies are assigned to state institutions which are separated and semi-independent from parliaments and governments (e.g. environmental protection agencies or labor inspectorates in the respective regulatory domains). Among developed democracies, this is part of a more general trend of increasingly delegating powers to non-majoritarian institutions (Thatcher & Stone Sweet 2002). In the realm of taxation, "national revenue bodies" do enjoy substantial autonomy in the exercise of law enforcement which shields them from political interference (OECD 2009). Therefore, governments cannot just simply capture state agencies, if only because they would run the risk of being publicly named and shamed, with ensuing reputational losses. This article's key insight is that they must resort to more subtle ways to manipulate the effectiveness of regulatory regimes and weaken enforcement. We distinguish among three complementary techniques which governments can employ conjointly or interchangeably.

Manipulation through legal sabotage can take place at two distinguishable points in time. *Ex ante*, rule makers can purposefully design inconsistent, inappropriate, or unclear legislation, which creates opportunities for rule takers to exploit loopholes in order to escape enforcement. Alternatively, rule makers can purposefully design weak sanctions in order *not* to credibly discourage defective behavior by rule takers. By favoring non-compliance by rule takers, *ex ante* legal sabotage is meant to reduce the capacity of rule enforcers to comply with their legal mandate to enforce tax regulation even before enforcement takes place. Contrarily, *ex post*, rule makers can purposefully abrogate or reverse legislative measures which, after their introduction, have proven to be effective in increasing compliance, thus aiding rule enforcers to effectively enforce the law. This constitutes a legislative reversal to re-establish the *status quo ante*.

Manipulation through organizational sabotage occurs when rule makers purposefully sabotage the capacity of independent enforcement agencies. This is the process through which governments can reduce state capacity from within. State weakness is thus engineered endogenously. There are different ways in which rule makers can engineer and maintain deficient bureaucratic capacity. Enforcement agencies can be kept purposefully understaffed by governments that either obstruct the competitive exams required to access the public administration or constrain their budgets. In more extreme cases, agencies' legal independence can be diminished or revoked to compel enforcement agencies to comply with the government's political objectives.

Manipulation through shirking is a form of *state inertia* producing effects similar to the logic of institutional change through drift (Streeck & Thelen 2005). But this is a strategic type of state inertia. It arises anytime rule makers purposefully avoid or delay the adoption of legislative measures needed to recalibrate the regulatory regime in the face of clearly understood deficiencies which incentivize or permit non-compliance by rule takers. This is a form of shirking because, by reproducing ineffective institutional regimes, governments evade their political mandate to ensure the rule of law and the representation of the public interest in the polity.

6. Logic of case selection

Germany and Italy have been selected according to a "most different systems" design (Gerring 2006, pp. 139–142). Both cases exhibit very different state capacities where, however, notable instances of forbearance of tax regulations are observed. Controlling for the state's institutional capacity is pertinent in light of the main alternative explanation for non-enforcement found in the literature. In this sense, if state capacity were the crucial

Table 1 Indicators of state capacity and quality of democratic institutions in Germany and Italy

	Italy	Germany
Corruption (Corruption Perceptions Index, 2018)	High Score: 52/Ranked: 53rd	Low Score: 80/Ranked: 11th
Adherence to rule of law (Rule of World Justice Project's Rule of Law Index, 2019)	Low Score: 0.65/Ranked: 28th	High Score: 0.84/Ranked: 6th
Regulatory enforcement (World Justice Project's regulatory enforcement index, 2019)	Low Score: 0.59/Ranked: 33rd	High Score: 0.85/Ranked: 7th
Quality of national institutions (WEF Global Competitiveness Index: Institutions pillar, 2018)	Medium low Score: 56.4/Ranked: 56th	Medium high Score: 73.5/Ranked: 16th
Adherence to rule of law (SGI†, 2018)	Medium low Score: 7.3/Ranked: 21st	High Score: 9.0/Ranked: 5th
Quality of democracy (SGI, 2018)	Medium low Score: 7.3/Ranked: 20th	High Score: 8.7/Ranked: 5th
Government effectiveness (Scores from World Bank Governance Indicators, 2017)	Low Score: 0.50	High Score: 1.72
State structure‡	Unitary (regionalized)	Federal
Administrative tradition‡	Rule-of-law legalism (Napoleonic) w/extensive clientelism and party patronage	Rule-of-law legalism (Rechtsstaat)
Tax administration	Centralized	Decentralized
Economic forbearance	Present	Present

†SGI indicates Sustainable Governance Indicators from *Bertelsmann Stiftung*/World Economic Forum. ‡Information compiled from Pollitt and Bouckaert (2017, p. 63). *Source*: authors' elaboration based on data from the reports from the indicated institutions and years. [Correction added on 18 January 2021, after first online publication: The indicators of the rows 'Administrative tradition' and 'Tax administration' under columns 'Italy' and 'Germany' have been interchanged.]

explanatory variable, we would *not* observe regulatory forbearance within states with strong enforcement capacity and adherence to the rule of law.

Table 1 provides a set of indicators that aptly capture these cases' differences and show that the quality of governance, adherence to the rule of law, and state capacity in Germany are much higher than Italy.

Italy clearly epitomizes a state with weak bureaucratic capacity, pervasive corruption, and persistent clientelistic ties between politicians and socio-economic groups (Ranci 1987). Instead, Germany represents a polity with medium-high bureaucratic capacity, strict adherence to the rule of law, and low corruption (Thijs *et al.* 2018, p. 55).

7. Forbearance in action

7.1. Germany: Forbearance as "Standortfaktor"

In line with expectation 1 mentioned earlier, the German case shows that governments have incentives to tolerate and stimulate tax non-enforcement when they lack the legal capacity to intervene discretionally in the economy and cannot alter the policy system through institutional and legal reforms.

The beneficiaries from a selective enforcement of tax regulations in Germany are the businesses located in a given Federal state which pursues regulatory non-enforcement. Most importantly, as shown by the data mentioned later, it is small and medium-sized enterprises (SMEs) who benefit from lax tax enforcement. The losers are the economic actors resident in the Federal states which do enforce the law. In this way, within the same national economic market, some actors in Federal states with weak enforcement enjoy a competitive advantage vis-à-vis those where enforcement is done effectively. This is how non-enforcement becomes a "Standortfaktor"

(a factor for relocation) within Germany. Forbearance becomes a way for local governments to selectively confer a competitive advantage and attract businesses in the competition for business relocation across states.

To understand how the manipulation of the tax regulatory regime interacts with the structural constraints of the German state, one needs to appreciate the peculiarities of the German polity. Germany's fiscal federalism consists of joint tax revenues that are distributed across national and subnational levels. Although tax legislation in Germany is centralized, subnational governments have only little or no capacity to set taxes. However, Federal states are independently responsible for tax collection and enforcement. Additionally, the constitution regulates the transfer of revenues from various taxes within state levels. The latter is known as a fiscal equalization system, an institutional mechanism through which financially strong states transfer revenues to financially weaker states. Although such redistributive mechanism plays a crucial role in financing subnational governments, the combination of centralized tax policy and decentralized enforcement has been historically problematic. The incentives to defect that it provides have in fact been a recurring critique (Troost 2016).

According to a recent example, once fiscal equalization has taken place among states, the Länder can retain only a fraction of the taxes collected. In this regard, the German Economic Institute (Hentze 2015) asserts: "If, for example, Schleswig-Holstein collects an additional 100 euros in wage tax, 57,50 euros will go to the state and its municipalities. However, due to additional receipts (generated in the context of the equalization system), Schleswig-Holstein loses transfers worth 48 euros. What remains for the state are just 9 euros." Thus, states have little incentives to step up their enforcement efforts while the joint decision-making system and the architecture of Germany's federalism make a change of the rules of the game extremely difficult.

The manipulation of the regulatory regime occurs within this entrenched institutional framework. Generally, governments compete in fiscal matters in four different ways (Genschel & Schwarz 2011, p. 351): by reducing the statutory tax rate, narrowing the tax base, improving national secrecy legislation, or relaxing tax enforcement. The first three choices are not an option to governments of the German states. Although in some cases, Germany's subnational governments have become famous for not collecting taxes altogether—for example, the German rural village Norderfriedrichskoog did not levy business taxes to attract DAX companies (Zeit Online 2008)—extant literature consistently points to the non-enforcement of tax regulations as the preferred mechanism used by the German states to chase national investments and improve local attractiveness (Lenk & Schneider 1998; Cremer & Gahvari 2000; Stöwhase & Traxler 2005; Genschel & Schwarz 2011; Troost 2016).

As we make clear below, the attribution of the intention to not enforce the law to political actors, a difficult task when it comes to unearth the causes of non-enforcement, is based on several factors. First, the German state exhibits overall bureaucratic capacity, which could be put to use to enhance the effectiveness of the tax administration. Second, there is clear knowledge about the fiscal losses generated by understaffed tax administrations and also about the financial gains that more auditors and tax investigators would bring (Troost 2016). Third, state oversight agencies as well as unions and other civil society organizations have been calling for greater attention to this phenomenon at least since 1998 (Lenk & Schneider 1998). Fourth, state oversight agencies at the federal and state levels have denounced repeatedly the lack of auditors and tax investigators especially in richer states as well as pointing at regional governments' behavior as driven by tax competition motives (Engels 2006; Blasberg *et al.* 2014; Schäfers 2018).

7.1.1. Manipulation through organizational sabotage

The German case presents a rather insulated bureaucracy that does not directly execute politicians' desires. This means that, to understand how governments manipulate the regulatory regime through organizational sabotage, we need to observe how governments tinker with institutions in charge of enforcing tax laws. German tax enforcement institutions are manipulated through the understaffing of specific segments of the subnational tax administration, specifically the staff of auditors and tax investigators. This manipulation has been acknowledged in a 2006 report entitled "Problems with the enforcement of tax laws." Written by the president of the German Oversight Agency, the report stated that "some federal states give the impression that it is not worthwhile hiring more auditors because of the Federal states' fiscal equalization system" (Engels 2006, p. 78). Although this is a problem largely acknowledged at the federal level, understaffing has several consequences, the most relevant of which is the sabotage on the effectiveness of state enforcement efforts and, consequently, the spread of tax non-compliance.

Understaffing can be estimated in Germany through what is known in the public administration at large as “calculations of staff requirements” (*Personalbedarfsberechnungen*) (Weingarten 1993; Kammradt 2019). These sector-specific analyses of personnel requirements are made by a specialized team made of representatives of all federal states and the federal government. Although the proposals made by the mentioned teams are not binding, they have enormous relevance for political authorities, which use them as reference point for the distribution of positions, the calculation of facilities needed and the management of future workloads in the tax administrations. State oversight agencies at national and subnational levels take into great consideration the results of these calculations during their regular evaluations of the public administration. Overall, what these calculations reveal is a situation of permanently understaffed sections of the tax administrations, especially those sensible for the collection of taxes, and with particular intensity in rich federal states, that is, those affected negatively by the fiscal equalization system. Furthermore, these calculations make clear the political nature of the problem. The large discrepancy between the number of the staff required and the actual number of employees appointed as auditors or tax investigators is a chronic problem in rich states, pointing to deliberate political decisions. More specifically, this gap draws attention to the budgeting process at the subnational level as a space in which political authorities discretionally determine spending levels for different departments of the public administration and where “the finance minister has a non-negligible influence on the budget during the entire following budget year” (Thomasius 2013, p. 76).

Although not unique, a paradigmatic example of understaffing as a governmental strategy aimed at non-enforcing tax laws to promote economic activity is Bavaria’s tax administration. As shown in Table 2, calculations indicate not only that tax enforcement needs more auditors and tax investigators but also that the actual staff has been reduced over the years. Although referring to political decisions regarding the budget, the Bavarian oversight agency states have denounced that, clearly, “if fewer staff is available, either the intensity or the number of audits is reduced” (Bayerischer Oberster Rechnungshof 2016).

Additional evidence shows that, between 2006 and 2011, throughout Germany there has been a clear decline in the number of employees in the tax administrations while, at the same time, economic activity increased steadily (Fig. 1). Overall, the number of auditors has decreased across the country while the complexity of economic activities and the number of companies have increased remarkably (Meinzer 2015).

Within this general context, Bavaria and Baden-Württemberg lead the way. As Meinzer (2015, p. 157) points out, since 1998, the Bavarian state oversight agency (*Oberste Rechnungshof*) has warned about the need for a greater number of skilled staff in the tax enforcement agency, a situation that has not improved according to the 2014 and 2016 reports for both auditors and tax investigators. In the latest report in which the problem is addressed, the Bavarian state oversight agency asserts that “in view of the still tense staff situation, the tax investigators’ staff should be deployed primarily within Bavaria to improve the quality of processing” (Bayerischer Oberster Rechnungshof 2016, p. 152). Likewise, the report highlights how understaffing has become a problematic issue, creating difficulties in processing information about taxpayers and preventing synergies between auditors and tax investigators.

As shown in Figure 2, in federal states such as Bavaria and Baden-Württemberg, tax auditors and tax inspectors are responsible for the oversight of a much larger portion of economic activity and thus auditing volumes than any other German states. The left panel shows that a tax auditor in the two richest states is responsible for auditing services covering double the size of economic activity than that of Saxony-Anhalt. A tax investigator, instead, must monitor economic activity twice as large as that of Schleswig-Holstein. Both figures indicate

Table 2 Actual and required number of employees in Bavaria’s tax administration (2006–2011)

	2006	2007	2008	2009	2010	2011
Auditing						
Actual staff	1,873.9	1,929.4	1,879.6	1,861.5	1,825.7	1,791.3
Staff required	2,114.0	2,126.8	2,127.5	2,127.5	2,127.5	2,200.0
Tax investigation						
Actual staff	3,434	3,390	3,348	3,430	3,396	3,359
Staff required	3,750	3,750	3,750	3,793	4,000	4,200

Source: Authors’ elaboration from data from Bayerischer Oberster Rechnungshof (2012, p. 57).

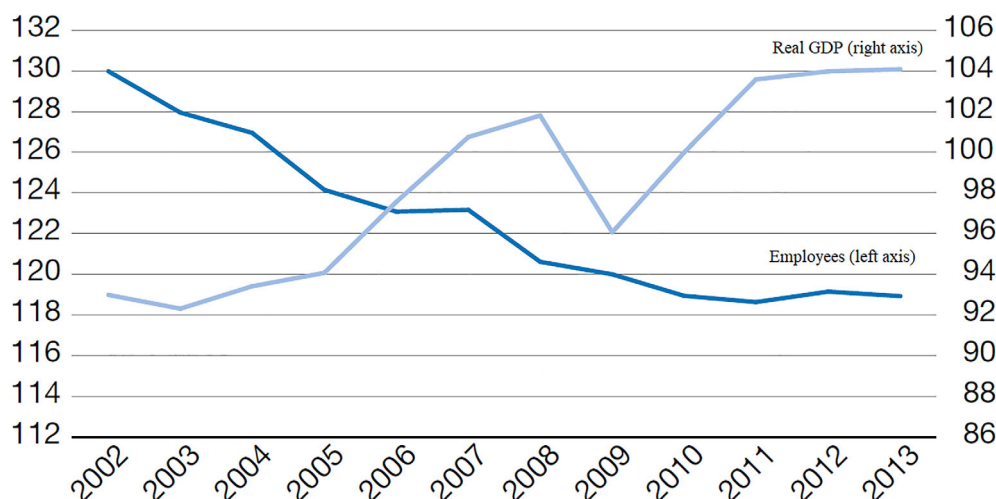


Figure 1 Real GDP growth (2010 = 100) and personnel (in thousands) employed in Germany’s tax administrations (2002–2013). *Source:* Authors’ elaboration from Meinzer (2015, p. 15).

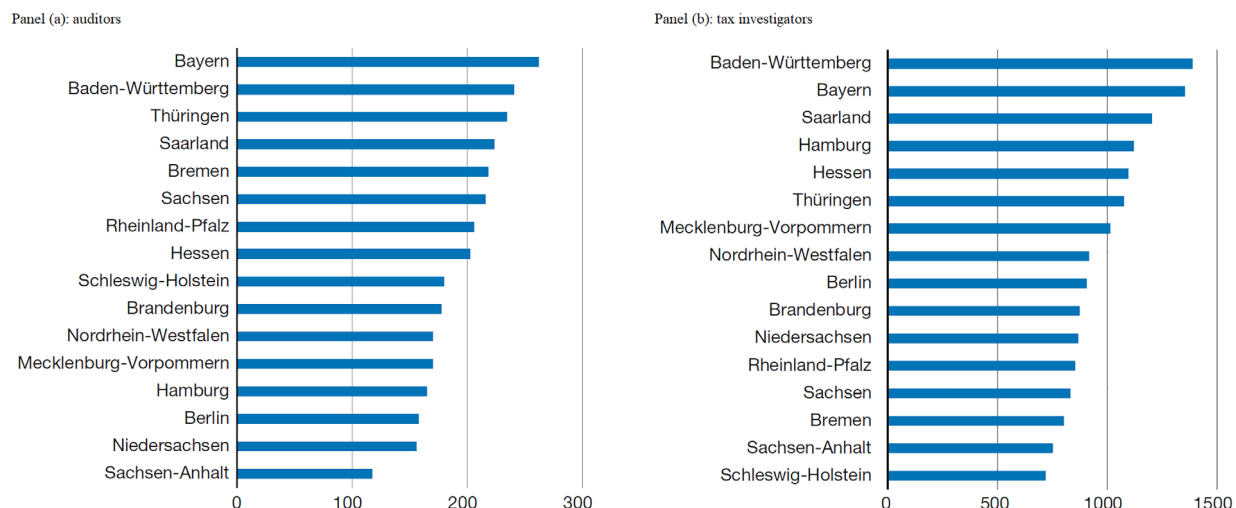


Figure 2 German states’ GDP (in €bn) divided by the number of local tax auditors (panel a) and tax investigators (panel b) (2008–2014). *Source:* Authors’ elaboration from Meinzer (2015, p. 157).

understaffed tax administrations with workloads excessively above the national average, which are hard to explain only in terms of economies of scale (Meinzer 2015).

The evidence provided thus suggests that non-compliance with tax regulations is the result of a strategy aimed at weakening the enforcement of tax laws through organizational sabotage. In fact, as aptly recalled by a previous member of the *Bundestag*’s Financial Committee, opportunities for non-compliance are widespread since “understaffing creates less control simply because the auditors are not there” (Interview 2020). Indeed, this is reflected in the actual lack of inspections. According to Meinzer’s (2015) estimates, while large companies are audited frequently, the likelihood for SMEs to be audited is much lower. Only in three federal states—Berlin, Saarland, and Saxony-Anhalt—a medium-sized company can expect an audit every 10 years while small companies every 30 (Meinzer 2015, p. 158). As shown in Table 3, Bavaria underperforms vis-à-vis the recommended frequency of controls. Small undertakings in Bavaria were likely to be audited approximately every 37 years by 2010 as opposed to the recommended 20 years. Meanwhile, in Bavaria, a medium-sized company is likely to be audited every 16 years on average as opposed to the recommended 10 years. As described by a former Bavarian state auditor, “in a large company, an auditor comes by on average every four to five years, in a medium-sized

company only every 22 years, in small companies every 40 years. A small business such as a bar only has to expect an inspection every hundred years” (Blasberg *et al.* 2014).

In all, given the hurdles typical of this type of research centered on “less official” state actions (Auyero & Jensen 2015, p. 361), a characterization of those economic segments benefiting from an absence of tax enforcement is only partially possible. Yet, the German case reveals that beneficiaries of forbearance are, above all, the German *Mittelstand* companies and smaller undertakings.

7.1.2. Manipulation through shirking

The manipulation of the regulatory regime through shirking originates in the very institutional design of the German tax system where tax legislation is a federal competence; tax administration is the competence of each federal state; and tax revenues are distributed through a national fiscal equalization system. As several studies show and oversight agencies at national and subnational levels suggest (Lenk & Schneider 1998; Meinzer 2015; Troost 2016), this institutional constellation disincentives the empowerment of tax enforcement agencies. Indeed, as mentioned at the beginning of this section, after a certain level of tax collection, the costs involved in effectively enforcing tax laws are greater than the collection ultimately retained by the federal state. As a consequence, the system establishes greater incentives for fiscal competition than for the enforcement of fiscal regulations.

More importantly, however, the entrenched nature of the German fiscal and political system forbids the capacity to alter states’ statutory tax rates discretionally and prevents the possibility of overcoming veto points to effect a constitutional change required to centralize the tax administration. Although there have been several proposals to reform the tax system, and efficiency gains justify the centralization of the tax administration (Senger 2009), the systematic opposition of the rich states to centralization suggests that inertia has become an economic strategy in itself. When describing attempts at reforming the tax system, a previous member of the *Bundestag*’s Financial Committee recalls:

It is a problem recognized at the federal level. For example, a group of experts, subsumed to the Finance Commission, met several times years ago and tried to involve different actors asking if they see a need for reform. It was contacted the Head of the National Administration, the Head of the National Fiscal Administration, the State Secretary of the Ministry of Finance and also people from the federal states tax administration offices. All were invited to talk. The Bavarians refused to participate from the very beginning. (Interview 2020)

In sum, while the structure of the tax system creates disincentives for state governments to step up their enforcement efforts, states which tolerate and incentivize tax non-compliance also oppose reforms of the system which would enhance the efficiency of the regulatory regime, with widespread benefits across the country. Centralizing the tax administration would imply losing the competence for tax enforcement and, concomitantly, the possibility to continue conferring competitive advantages to “pick the winners” in the quest for business attraction vis-à-vis other states.

Table 3 Recommended and actual frequency of tax audits in Bavaria (2005–2010) (values in years)

Recommended frequency	Actual frequency of tax audits					
	2005	2006	2007	2008	2009	2010
For large undertakings = 4 years	3.8	4.7	4.5	4	4.5	5
For middle-size undertakings = 8.4 to 10.5 years	14.6	15.9	14.9	14.4	15.1	16.6
For small undertakings = 14.4 to 20 years	29.7	28.8	29.3	28.6	29.9	37.1

There is no law regulating the frequency of tax audits but, according to an ex-president of the German Oversight Agency (Engels 2006, p. 72), a standard requirement made by Conference of the Ministers of Finance in 1997 indicates the frequency referred to (also confirmed in Interview 2020). *Source:* Authors’ elaboration from data from Bayerischer Oberster Rechnungshof (2012), annual report.

7.2. Italy: Forbearance as “economic subsistence”

In line with expectation 2 mentioned earlier, the Italian case indicates that governments have strong incentives to tolerate and stimulate tax non-enforcement when the productive structure of the country is such that forbearance can be deployed more effectively than alternative lawful industrial policies.

Tax evasion is and has always been a mass phenomenon in Italy. It has been widely documented that it is SMEs and the self-employed professionals who evade the most (Marino and Zizza 2012; MEF 2018, p. 16) and that tax evasion is most densely concentrated in the backward Southern regions, especially within wholesale and retail trade, handicraft, and services more generally (Bordignon & Zanardi 1997, p. 192). Corporate taxes are evaded the most in the wholesale and retail trade sector and construction and systematically more in the Southern part of the country among SMEs established as limited liability companies (Visco 2017, p. 74). Thus, forbearance knowingly aids the self-employed professionals and SMEs (often family-owned) concentrated in segments of the service sector and geographically located in the Southern regions (Santoro 2010, pp. 35–38). Yet, despite knowledge of the phenomenon and the availability of new technologies to tackle tax evasion effectively, the problem has not been solved due to governments’ political unwillingness (Visco 2017). Tax evasion has been “tolerated, at times stimulated and covered and certainly constricted with very weak efforts”¹⁰ (Grosso 1980, p. 6).

The literature has rightly acknowledged that enforcing tax regulations to crack down on tax evasion would have hurt the economic interests of the petty bourgeoisie who supported the Christian Democrats in power during Italy’s First Republic and the center-right neoliberal parties during the Second Republic (Pizzorno 1974; Amable *et al.* 2011; Barta 2018). In this sense, we agree that it was a political exchange. Governments never truly considered fighting tax evasion a “natural and ordinary objective in Italy” (Tutino 2009, p. 218; Castronovo 2013 pp. 314–315). Yet, the economic logic of forbearance in Italy has been overlooked.

SME’s owners and self-employed are certainly important electoral groups in Italy (Afonso & Bulfone 2019). Yet, one should not forget that they also constitute the backbone of Italy’s productive system, generating economic growth and employment. A quarter of the working population is self-employed in Italy, with an especially high concentration in wholesale and retail trade (OECD 2018). Self-employment is widespread in the South (and the North-East), and the reported incomes of the Southern self-employed is half of that of the Northerners (Coletto 2009). SMEs account for 80% of total employment and 95% of these SMEs are micro-firms with less than 10 employees characterized by much lower productivity than the larger Italian SMEs and even their OECD’s competitors (OECD 2014, p. 20).

Here, we posit that there was an industrial policy logic behind the decision to tolerate and stimulate tax non-enforcement in post-WWII Italy given the remarkable deficiencies of the Southern productive structure and the difficulty of implementing alternative forms of industrial policy. We surmise that the electoral logic was complemented by forbearance’s economic logic. Forbearance does not only avoid a political backlash against the government, it especially guarantees the survival of a large number of less efficient and less innovative economic undertakings, which would otherwise be wiped out under conditions of effective enforcement (Bobbio 2016)—with disastrous repercussions on economic growth, employment, and social order. In fact, it would be unrealistic to believe that governments could ignore the imperatives provided by such a deficient productive structure. To the contrary, in the words of a former deputy Finance Minister, tax evasion knowingly grants the “economic subsistence” (“evasione di sopravvivenza”) of large parts of the Italian productive system (Corriere 2013)—a need publicly acknowledged even by the head of Italy’s tax enforcement agency (Indini 2013).

Thus, policy makers are aware of the enormous socio-economic repercussions which revoking forbearance would have, especially on the Southern productive system. In Italy’s South, the pursuit of alternative lawful forms of industrial policies other than forbearance has always been complicated by the absence of a full-fledged industrial sector and the predominance of self-employment, SMEs, and micro-enterprises concentrated in service activities; the lack of skilled labor, private capital owners, and readily available raw materials; the presence of widespread illegality, high poverty rates, and the large use of informal labor in black markets. Forbearance has had a developmental function akin to vertical industrial policies aimed at “helping the losers.” However, over the course of time, tax non-enforcement has become an institutionalized feature of the productive system which, now, makes it hard to revoke forbearance. Restoring the rule of law today is further complicated by two factors. Various rounds of EU enlargement have directed the EU’s structural funds to other backward countries, reducing substantially the amount of EU subsidies devoted to Southern Italy’s development (Felice 2013). Secondly, the

EU regulatory and fiscal constraints rule out virtually any alternative form of vertical industrial policies to help the South – while horizontal policies will only have long-term uncertain effects.

Far from being mutually exclusive, the political and economic logics of forbearance complement each other in the Italian case. This is the reason why tax non-enforcement is so difficult to revoke in Italy today notwithstanding the lip-service paid to fighting tax evasion by governments of different complexion.

7.2.1. Manipulation through shirking

The shortcomings of Italy's tax regime had been already acknowledged by political authorities in the 1940s.¹¹ After WWII, the Christian Democrats in power inherited a tax system which suffered from widespread tax exemptions, a remarkable degree of tax evasion, an inefficient financial administration, and legal impunity for tax evaders (Cosciani 1950). The burden of high tax rates fell on a relatively small number of taxpayers and the need for reforming the tax administration ranked high among the priorities of Italy's Constitutional Assembly (Cosciani 1948, p. 713; Manestra 2010, pp. 33–35). In 1947, the Finance Ministry set up a special Commission to implement reforms aimed at eliminating tax evasion and distribute the tax burden more equally among socioeconomic groups. Other commissions and various proposals followed (Marongiu 2017, Ch. 3). Yet, for the next two decades, no substantial reform of the tax system was implemented. In fact, an effective inspective bureaucracy was never set up, leading prominent observers to question the very credibility of the regulatory regime (Cosciani 1963, pp. 463–464). The reorganization of the tax administration was not pursued, its financial resources remained scarce and tax administrators' wages relatively meagre (Manestra 2010, p. 38). Deficient administrative capacity resulted in the first place from governments' shirking. Until the 1970s, the lack of an organic reform of the regulatory regime resulted from a political choice by the Christian Democratic parliamentary majority (Botarelli 2004, p. 23). The government remained inert and delayed the reforms to avoid damaging the socio-economic groups, which would have been hurt by tax enforcement (Cosciani 1967).

Economically, enforcing tax regulations effectively would have meant causing immediate irreparable damage to the productive structure of Southern Italy without a readily available alternative; without a developed welfare state needed to compensate the losers of this transition to legality; and, most importantly, in a climate of social revolts and anti-republican separatist tendencies. In the North, the presence of an intact industrial sector generated export-led economic growth and jobs after the war (Ciocca 2020, p. 234). But in the South, various parliamentary inquiries painted a picture of chronic mass poverty, obsolete methods of production and social organization, high unemployment levels, and widespread illegality—which the government could not ignore (Castro-novo 2013). There, the predominant economic activities were concentrated in agriculture and services, characterized by precarious and occasional employment, extremely low productivity, and black markets (Daneo 1975, pp. 44–45). Both industry and risk capital were absent. Furthermore, social unrest and the presence of an alphabet and unskilled labor force hampered private investment and industrialization (Carey & Carey 1955). With meagre public budgets, few were the resources which the state could directly deploy in the South to foster growth (Ciocca 2020, p. 234). Other interventions were aimed first and foremost at providing physical infrastructures which the backward regions lacked.¹² Tolerating tax evasion was the most effective way the government could aid those Southern economic producers to prevent the further deterioration of their living conditions and social disorder. A former Finance Minister and long-time member of the Italian Parliament (Interview 2018) describes governments' approach to tax enforcement as follows:

The central element (of governments' vision) has to do with the nature of this country's economy. First of all, it is a weak economy. It has always been like this since its unification. Secondly, our capitalism lacks large capitalists. So, the idea has been – supported also by the trade unions – that if companies didn't pay much of their taxes, this would be alright so that the unions could pretend higher salaries with more employment... during the 1980s many large companies closed and there was a restructuring process within the country in which many new SMEs were created, often by previous workers of the large companies. This created a decentralized productive system where these companies, which were considered the result of workers' engagement and hard work, enjoyed the tolerance of the governments, even from the left... in Italy, the cultural and administrative components behind tax non-compliance feed into each other. The fact is that if people were really under pressure from the tax administration, also the culture would then gradually change. But the general company owners' reaction is: "if I had to pay taxes seriously, instead of 2.500€ per month, I would just take home 1.000 or perhaps 1.500€"

due to taxes and social contributions". Tax compliance would then worsen these people's living standards. Many companies would instead close altogether. This is a great preoccupation for politicians.

7.2.2. Manipulation through legal sabotage

The reform of the tax system was eventually carried out in the early 1970s. It aspired to rationalize the system by reorganizing the multitude of minor taxes into four main taxes to create a simpler and more transparent regime. In the transformation, the system changed from one being heavily reliant on indirect taxation to one centered on the taxation of personal incomes. The income tax (IRPEF) acquired a prominent share of the tax revenues (Pedone 1984). For such a tax system to work effectively, two necessary conditions must be present: individual income declarations must be readily accessible for verification by the tax administrators;¹³ the capacity of the tax administration must be expanded simultaneously on a par with the substantial increase in the number of income declarations to be verified. Hence, the new system would work effectively only under the premise that good accounting practices be present and the tax administration be endowed with adequate resources.

While bigger firms dispose of internal accounting departments, for the Italian smaller firms (often family-run) and the self-employed, accounting practices are more informal and less transparent. This makes their accounting practices less reliable and often difficult to verify for the tax authorities. Given the characteristic of the Italian productive structure, where the vast majority of economic enterprises are SMEs, micro-firms and self-employed professionals, the effectiveness of a similar tax system was meant to be jeopardized from the very beginning. In fact, since the post-war period, a differentiated legal system had been created for which SMEs were granted the possibility to resort to simplified bookkeeping as a form of "compensation" for the inefficiencies deriving from Italy's inadequate public administration (Barca 2010). This dual legal system of fiscal and accounting practices has long been a prominent feature of the dual Italian industrial system (Arrighetti & Seravalli 2010) making the analytical establishment of the taxable base opaque and difficult to scrutinize in the first place (Pedone 1984, p. 391). Pedone (2016) argued that the design of the reform was inconsistent given the peculiar structure of the Italian productive system, populated by myriads of SMEs and informal undertakings, and this very inconsistency has undermined the incisiveness of the reform.

Furthermore, the weak and inadequate fiscal administration, as it was, would not meet the requirements of the new regime. In the previous system, around 4.8 million income declarations were submitted. The introduction of the IRPEF tax meant that, overnight, the fiscal administration found itself confronted with 22.75 million potential contributors (Di Gialluca 2012, p. 56). The reform *de facto* institutionalized an inadequate system of tax inspections: in 1981 only 1.5% of eligible taxpayers would be inspected (Di Gialluca 2012, p. 57).

Next to these measures of *ex ante* legislative sabotage, more recent examples indicate actions of *ex post* legislative sabotage. Legislative reversals on the limits of cash usage constitute one of the most prominent instances. While reducing cash circulation is generally known to be one among the most effective measures to reduce the size of the underground economy and counteract evasion (Santoro 2012), various governments have shown inconsistent attitudes. Governments' lack of commitment to seriously tackle tax evasion has been highlighted by the National Court of Auditors which denounced inconsistent legislative reversals on the limits of cash usage which reportedly undermined the government's anti-evasion approach (Corte 2013, p. 1). During the 1990s, for instance, the center-left government led by Romano Prodi reduced cash usage down to €1,000. The center-right government led by Silvio Berlusconi increased it to €12,500 euros in 2008. The technocratic government led by Mario Monti decreased it to €1,000 in 2012, until the center-left government led by Matteo Renzi increased it to €3,000 in 2016 (Parente 2018). Simultaneously, the Renzi government has also softened sanctions for fiscal frauds and introduced the possibility to pay fines in instalments (Livadiotti 2015).

Tax amnesties have also been recurrent practices through which governments have undermined the very credibility of the regulatory regime through *ex post* legislative measures. Throughout Italy's fiscal history, there have been more than 80 tax amnesties during which governments pardoned evaders, lifting or reducing outstanding criminal charges. This recurrent practice is known to have fostered a culture of tax evasion and widespread impunity (MEF 2014, pp. 102–104).

7.2.3. Manipulation through organizational sabotage

Italy's tax administration (*Agenzia delle Entrate*) has suffered severely from constant staff reductions over the last decade. Despite an anti-evasion rhetoric, the tax agency has, since its creation in the early 2000s, often reported severe shortages in personnel and reductions in funding.¹⁴ Especially after the financial crisis, the number of employees in Italy's tax administrations has decreased by more than 10% (Fig. 3), leading the trade unions confederations to file multiple formal complaints to the government, asking to invest in human resources to address the tax administrations' severe shortages (Parente 2019).

In conjunction with a decreasing number of employees, the number of tax inspections among small undertakings and the self-employed professionals has halved during the last decade (Table 4). That is to say, tax inspections have declined steadily exactly for these groups of producers known to be at the greatest risk of evading.

Additionally, after the creation of the new enforcement Agency, in 2002, the available funding has been reduced throughout the mid-2000s, leading the agency's head to warn publicly against the diminished deterrence

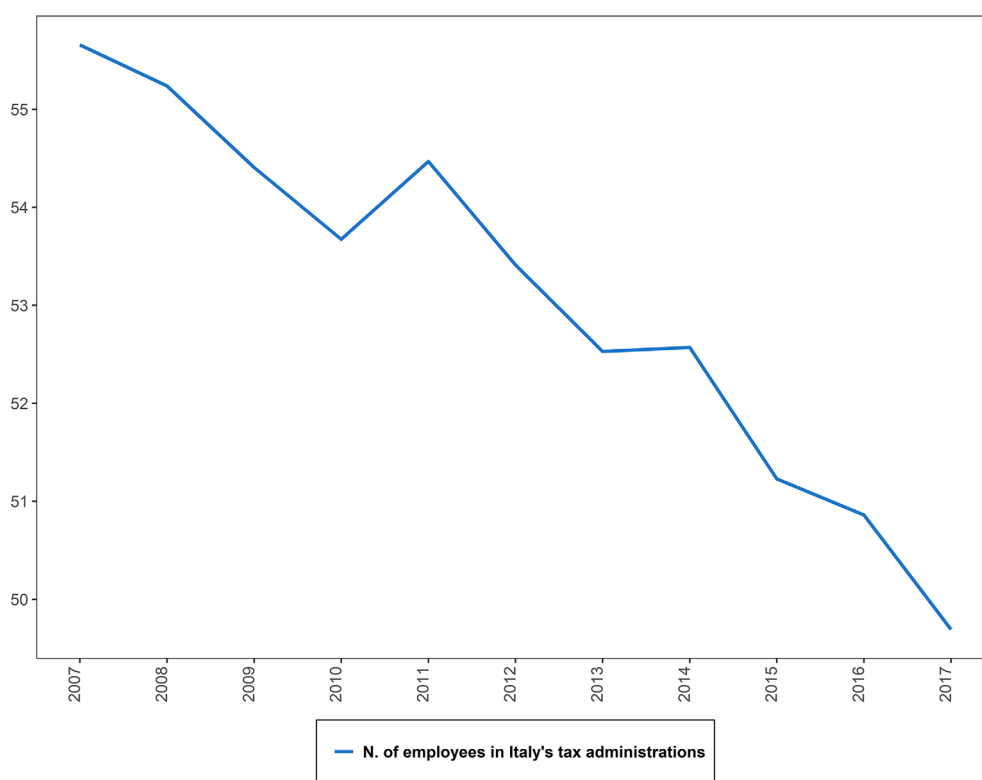


Figure 3 Number of employees in Italy's tax administration (2007–2017) (in thousands). *Source:* Authors' elaboration based on data from Italy's Ministry of Economy and Finance, Ragioneria Generale dello Stato.

Table 4 Yearly number of tax inspections conducted by the Italian tax enforcement agency according to the size of the business undertakings (2009–2018)

Type of taxpayers	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Large undertakings	1.667	2.609	2.763	3.011	2.981	3.112	2.734	2.367	2.264	2.224
Medium-sized undertakings	7.248	15.524	16.08	15.211	14.363	14.211	13.262	11.12	10.776	9.986
Small undertakings and self-employed professionals	244.470	219.878	178.263	173.387	167.392	160.007	140.972	104.162	144.877	140.238

Source: Authors' elaboration from Agenzia delle Entrate's annual financial reports.

capacity caused by meagre budgets (Agenzia delle Entrate 2005). In 2016, the Renzi-led government cut by 30% the Agency's fund for anti-evasion interventions and again reduced its overall budget (Fiore 2015). In all, when scrutinizing the Italian tax administration, the OECD concludes that "several reforms and spending cuts have tarnished the agencies' autonomy in the key area of financial autonomy" (OECD 2016, p. 37).

8. Concluding discussion

Despite the rise of the regulatory state which constraints governments' political discretion in economic policymaking, debates on states' economic activism have highlighted new forms of market-supporting interventions (Levy 2006) as well as of strategic economic re-regulation (Thatcher 2014; Bulfone 2020a). Recent contributions have also made a plea for a more political economy-centered approach to the study of regulatory governance (Guidi *et al.* 2020). However, unlike other research fields in which phenomena such as state inaction, non-enforcement, or state tolerance are gaining momentum (Gordon & Hafer 2013; Houborg *et al.* 2014; Huisman 2019; Beqiraj *et al.* 2020; Berger 2020; Beyers & Nicholls 2020; Sabrow 2020), regulatory non-enforcement has received little attention in the study of public policymaking and political economy more generally.

By bringing together the literature on state-centered political economy and industrial policy with sociological and political studies on law non-enforcement, our aim was to shed light on the *non-enforcing state*, that is, governments' strategic use of forbearance as a mode of regulatory governance. This article argued that forbearance, put into practice through three techniques that generate selective non-enforcement of economic regulations, can be used as a form of industrial policy to shape markets and aid selected groups of suppliers or sectors in the economy. We argue that forbearance becomes an attractive policy choice when governments want to aid sizeable producer groups or economic sectors but lack the legal competence to do so lawfully; or when the productive structure of the country is such that regulatory forbearance can be deployed more effectively than alternative lawful industrial policies.

The study of non-enforcement as a form of industrial policy bears wider insights for ongoing debates on the political economy of regulatory governance and law enforcement. Indeed, regulation produces the intended outcomes only when complied with or effectively enforced. The general assumption in the literature is that governments share an interest with regulatory agencies to enforce the law. The regulatory state is thus responsible for ensuring a level playing field in which economic actors must compete. Cases of non-enforcement are then explained by weak state capacity. This article's findings challenge both claims and point, instead, to governments' interest in the strategic non-enforcement of the law when they can confer competitive advantages and target specific socio-economic groups who benefit vis-à-vis other law-abiding market actors. Thus, our case studies indicate that regulatory non-enforcement cannot always be explained fully by weak state institutions. To the contrary, we posit that states' weakness may at times be endogenous to politicians' will to neutralize enforcement. The German and Italian cases suggest that rule makers can tinker with the functioning of regulatory regimes to sabotage enforcement with the aim of shaping markets in an attempt to circumvent the constraints imposed by the rise of the regulatory state.

The article has focused on the case of tax regulations due to the substantial costs which taxation imposes on the production process. Yet, the general logic of the argument can be expected to travel to those other regulatory domains which substantially affect the process of economic production by increasing input costs. Among these, laws in the realm of labor, health, and safety standards as well as environmental regulations are other regulatory domains in which forbearance by governments yields substantial competitive advantages to the non-compliant producers. Governments can then resort to legal or organizational sabotage and shirking as techniques to manipulate the functioning of regulatory regimes. Yet, we concur that these are techniques more likely to be adopted within the context of developed democracies where independent regulatory agencies are hard to capture by politicians, contrary to developing countries where state capture of regulatory agencies is widespread.

Given the increasing constraints on governments' discretionary capacity to intervene in markets in the age of regulation, this article suggests that non-enforcement is likely to increase in importance as a subtle mode of governance through which governments can circumvent structural impediments in public policymaking. Future studies could investigate in greater details governments' strategic agency behind non-enforcement. Given the difficulty of collecting evidence on illegal behavior, this could be attempted through ethnographic fieldwork or

archival analyses of declassified documents uncovering governments' decision-making motives. Such detailed analyses, however, were beyond the purpose of this article.

Acknowledgments

For their comments and suggestions, we are indebted to Jens Beckert, Fabio Bulfone, Josef Hien, Alisha Holland, Martin Höpner, Arjan Reurink, Lucas Ronconi, Timo Seidl, Wolfgang Streeck, Cornelia Woll and three anonymous reviewers. An early draft of this article was presented in one of the meetings of the economic sociology research group at the Max Planck Institute for the Study of Societies (MPIfG) and at the workshop on the "Political Economy of Law Enforcement" held at the MPIfG in November 2019. We are grateful to all the participants in these meetings for their helpful insights. [Correction added on 13 January 2021, after first online publication: Acknowledgments section has been added.]

Endnotes

- ¹ Casaburi and Troiano (2016) document an alternative view whereby politicians make electoral gains when they commit to enforce the law effectively.
- ² Governments' support for education and training could be classified as a form of social policy as well as an industrial policy designed to increase an economy's skills supply while lowering producers' cost for skills-formation (Durazzi 2019). Similarly, a direct subsidy or targeted tax exemptions to groups of suppliers could legitimately be analyzed as redistributive fiscal policy as well as vertical forms of industrial policies.
- ³ Horizontal policies that produce vertical effects are well known in the industrial policy literature (e.g. the Irish fiscal strategies targeted to favor export-oriented FDI) (Cohen 2006, p. 88; Regan & Brazys 2018).
- ⁴ To mention but a recent example of costly health and safety regulations, the e-commerce giant Amazon reports that it will spend \$4 billion in foregone profits to keep up with changes in the health and labor standards required to keep its operations ongoing during the recent COVID-19 global pandemic (Financial Times 2020).
- ⁵ To the contrary, larger corporations usually have a greater capacity to engage in more sophisticated practices of tax avoidance across international jurisdictions.
- ⁶ Our interest here is on the effectiveness of a given industrial policy in granting aid to selected producer groups, regions or sectors. Therefore, our aim differs from the study of economic efficiency as understood by welfare economics.
- ⁷ The literature in political science indicates that, under general circumstances, governments tend to prioritize policies which yield the greatest political and economic returns in the short term while avoiding policies with uncertain future rewards (Jacobs 2011).
- ⁸ Similarly: where non-enforcement is already widespread and revoking forbearance produces tangible short-term economic and social damage without an alternative, which will generate certain future benefits.
- ⁹ On the distinction between rule makers and rule takers in regulatory regimes, see also Streeck and Thelen (2005).
- ¹⁰ Authors' translation from Italian. For analyses on the many acknowledged deficiencies of the post-war tax regulatory regime see Andriani & Violante, 1979.
- ¹¹ Hien (2018) argued that the roots of Italy's problem with tax evasion are to be found in the deep-seated conflict between the Church and the State and how the former has proactively tried to undermine the latter's capacity to tax. We acknowledge this original argument which, however, focuses on the legitimizing role of the Church on Italians' tax non-compliance behavior. Our article focuses on non-enforcement from the perspective of the government.
- ¹² The Fund for the South (*Cassa per il Mezzogiorno*) was mandated to build public infrastructures (e.g. roads, aqueducts, and water reclamation) until the late 1950s. It was only then that it could intervene for the industrialization of the South. However, the capital-intensive plants that were built could not absorb the large numbers of unskilled laborers across the South (Carey & Carey 1955).
- ¹³ The myriads of self-employed professionals and general partnership companies across Italy are taxed via the IRPEF income tax levied on the individuals' profits. However, these "minor taxpayers" were allowed to use simplified bookkeeping procedures, which made the determination of their actual revenues and expenditures hard to establish (Pedone 1984, p. 391). Limited liability companies are instead taxed via the business tax (IRPEG then replaced with IRES in 2004).
- ¹⁴ See the yearly reports of the Italian tax agency *Agenzia Delle Entrate*, publicly available online.

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