

Fiscal Evasion and Shadow Economy: Albanian Case

Jonida Balliu

Bachelor of Banking-Finance

"Epoka" University

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Abstract

Shadow economy includes economic activities and the income obtained due to avoidance of taxes. Fiscal evasion is one of three main parts of shadow economy. It is a problem present almost in every country in the world. It is very largely people's desire to evade taxes that creates most of the shadow economy. First of all, this thesis focuses on the factors which affect informal economy and different forms in which it is seen. Second part of this study is about fiscal evasion and shadow economy in Albania. It is analyzed the factors which have helped in developing of informal economy in my country, by using evidences from different sources. in Albania section, it is also included a sub-section which focuses on the different ways that needs to be followed in order to fight against fiscal evasion. Shadow economy and fiscal evasion, cannot be completely eliminated, but all the countries should fight in order to reduce fiscal evasion, thus reducing the size of informal economy.

Introduction

Shadow economy is a major problem found in every country of the world, with different levels. In developing countries it gives a significant help to a more rapid economic growth. The shadow economy is greater in the Southern European countries than in other OECD countries (Hart, 1994). There exist different definitions about the shadow economy. According to Kelly, shadow economy refers to those economic activities that are not reported or not taxed (Schneider & Friedrich, 2007). One of the definitions which is widely used and accepted by most of the people around the world is that shadow economy gives a relationship between unofficial (unreported) income and the measured income which is reported to tax authorities. According to this definition shadow economy includes all those activities which are unrecorded and provide a value for the economy of a country that should be present in the gross national product (GNP).

Shadow economy can be divided into three main parts:

Tax Evasion (Legally performed economic activities, but tax are not paid)

Black Economy (Legal activities are illegally performed)

Criminal Activities (Illegal activities)

Fiscal evasion is the use of illegal tactics to avoid financial liabilities. There are different ways to engage in fiscal evasion. The most common one is hiding or not declaring the incomes, thus resulting in reduction or avoidance of taxes. This allows people to keep more money for their purposes. Other ways to engage in fiscal evasion are reporting more expenses than really incurred, falsifying the accounts and not obeying the rules found on the article of the "Income-Tax Act". Such unethical practices often create problems for the tax evaders. Tax evaders are punished with different penalties like fines, prison or even the persecution of their belongings. There should be made a clear distinction between tax avoidance and tax evasion. Tax avoidance means performing the economic activities in a way that reduces taxes. Tax avoidance is legal, while tax evasion is illegal and as mentioned above it is punished. In order to prove the legality of tax avoidance the case is usually sent to a court. As it is illegal those engaged in this activity have several reasons to seek to conceal what they are doing. The formal economic theory of tax evasion can be dated at 1972, with the publication of the article "Income Tax Evasion", a theoretical analysis made by Allingham and Sandmo. (Allingham & Sandmo, 1972).

According to Yitzhaki (1974) an increase in the tax rate increases the amount of reported income, and he also found in his research that the fine which will be paid by the tax evader will be proportional to the amount of evaded taxes. This model of Yitzhaki was not realistic, because all other researches were finding that when tax rate increases the amount of evaded taxes will be increased, too (Yitzhaki, 1974). Yitzhaki (1987) reworded this theory by arguing that the probability of being caught is positively related to the amount of unreported taxes. He concluded that an increase in tax rates increases tax evasion. Many other authors – like Gordon (1989); Klepper, Nagin, and Spurr (1991); Lee (2001); and Panades (2001) have conducted their searches in order to explain the contradiction between findings from the studies and theories.

The presence of an underground sector is simply a reflection of individual's incentives to hide their economic activities, either because these activities would be less rewarding if practiced in the formal sector, or else because the activities are illegal to begin with. Understanding what factors might influence such incentives is an important subject of my thesis. By its nature, the shadow economy is difficult to study empirically. Whilst different approaches yield different estimates, the general conclusion is that the extent of informal economy is substantial. (SCHNEIDER & ENSTE, 2002). The underground economy in Egypt, Thailand, and Nigeria, during 1998-1999 was estimated to be 69, 70, and 77 percent of official GDP, respectively. Amongst the developed countries, Greece and Italy have the largest shadow economies, estimated to be in the region of 27-29 percent of GDP during 1989-1999. The key factors that influence the underground economy have been related to aspects of public policy and public administration. Included among these are the burdens of taxation and social security contributions, the complexity of the tax system, the extent of bureaucracy and regulations. Functioning of financial markets has an important role to play in determining informal behavior. The recent studies about this are; First by Dabla-Norris and Feltenstein (2005) reports a significant negative correlation between measures of financial development and the size of shadow economy (Norris & Feltenstein, 2005). The second study is by Straub (2005) that provides evidence of a significant positive effect of credit market efficiency on the degree of business formality.

Evidences of shadow economy in Albania were first seen in the years of transition to the market economy. This transition found Albanian economy with a significant level of lack of capital stock, and Albanians were seeking to change this situation as soon as possible. The collapse of pyramid schemes in 1996-1997 left a big gap between the real economy growth rate and institutional one.

Evolution of Tax Structure

Scholars of the historical evolution of tax structure like Hinrichs (1966) and Musgrave (1969) have stressed the importance of tax administration issues. They note that modern tax structure development has generally been characterized by a shift from excise, customs, and property taxes to corporate income and progressive individual income taxes. This shift has been made possible by the expansion of the market sector and relative decline of the rural sector, the concentration in larger establishments, and the growing literacy of the population. Changes in the technology of tax administration, including globalization financial innovation may shift from progressive income taxes toward tax system that rely more on broad-based consumption taxes such as value-added tax (VAT) and flatter rate structures for income taxation. Alt's (1983) treatment of the evolution of tax structure stresses the role of administrative costs. He argues that it has become easy to collect taxes from organized business rather than from households. Consideration of evasion, avoidance, and administration is essential to the positive and normative analysis of taxation. It is tax policy in action that determines how much the taxpayer must pay, and the effects of the payment. Knowledge of the statute is only a start in knowing a tax system. The interpretations placed on language by administrators and courts, the simplicity and understandability of tax reforms, and the competence of audit influence the amount of revenue collected and the economic effects of the tax.

Evasion, Avoidance, and Real Substitution Response

The distinguishing characteristic of evasion is illegality. Evasion is concerned with concealing or misrepresenting the nature of transaction, when avoidance takes place the facts of the transaction are admitted but they have been arranged in such a way that the resulting tax treatment differs from that intended by the relevant legislation (Fagbemi, Uadile, & Noah, 2010). At times we will refer to real substitution responses, as those responses which come about because the tax law changes the relative price of different activities, and that induce taxpayers to respond by choosing a different consumption basket. Substitution responses are efforts to reduce one's tax liability without altering one's consumption basket, which we will refer to as avoidance. This definition covers a broad range of behaviors.

One example is to pay a tax professional to alert one to the tax deductibility of activities already undertaken.

Another example is to change a legal form of a given behavior, such as reorganizing a business from A corporation to a B corporation.

A third example is tax arbitrage, when economically equivalent, but differentially taxed.

Literature Review

The concept of the informal economy was first introduced during an empirical study conducted regarding urban labor markets in Ghana (Hart, 1973) by ILO since then it has frequently been used by ILO in other studies and by World Bank reports in studies regarding poverty in developing countries (Sethuram 1981, Mazumdar 1981). Term of "informal economy" was firstly used as a way of describing dualistic economic structure found in developing countries. There have been used different terms to refer to informal economy. It has been called irregular economy (Ferman, 1973), black economy (Dilnot and Morris, 1981), shadow economy (Frey, Weck and Pommerehne, 1982; Cassel & Cichy, 1986).

At ILC held in 2002, the term of "informal economy" refer to economic activities which are not legal and not recognized from the law, it also refers to revenues collected from unpaid or lucrative work. Schneider's definition of informal economy (2012) : "the shadow economy includes all market-based legal production of goods and services that are hidden from public authorities in order to avoid payment of income taxes (VAT or other taxes), to not pay social security, to avoid dealing with some bureaucratic procedures, such as completing statistical questionnaires or other administrative forms" .

The relation between corruption and shadow economy has been studied by many authors. They see these two elements as either complements or substitutes of each other. Both Johnson and Hidricks see corruption and shadow economy as complements of each other. According to Hidricks this happens in the cases where the tax payer agrees or corrupts the responsible person in of tax authorities to under report tax liabilities.

This relationship differs from countries with high income level and those with a low income level. in high income countries corruption is low. Corruption can be seen in case it is desired to benefit from an activity that makes the work easier, e.g. winning a contract from a public authority, getting a license.

In low income countries, we expect different situation. in these countries companies are almost fully engaged in informal activity. These can be restaurants, bars and even bigger production companies. The public goods provided by the official sector are in many developing countries less efficient as compared to high income countries.

Schneider in 2007 has stated that the informal economy is low in countries where the income level is high, while in countries with a lower income level informal economy is higher due to a larger percentage of corruption. in the first one there exists a substitution effect between these two indicators, while in the second case these indicators are complement of each other.

Fiscal evasion was firstly studied by Allingham and Sandmo in 1972 (Allingham & Sandmo, 1972). in their "portfolio" model the individual behaves in a way that takes the highest satisfaction from evading taxes, makes a balance of benefits of this action and the probability of being caught and then punished, and after this confrontation decides to pay the taxes fully or partially because is afraid of being detected. in their study they observed that the factors that affect tax evasion directly or indirectly affect the shadow economy as well, even though there is no congruence between fiscal evasion and shadow economy.

The model of tax evasion by Sandmo, Allingham and Yitzhaki assumes that tax payers decide how much to evade according to their income level, tax rate, probability of detection and penalty rate (Sandmo, 2005). According to an audit of TCMP (Taxpayer Compliance Measurement Program), in USA 1998, was found that the amount of unreported income from workers, working in someone else company, is lower than unreported income from self-employed ones. Another issue that arises from the analysis of fiscal evasion is the level of non-compliance income class. (Fiorio & D'Amuri, 2005)

Tax evasion and trust in the institution are inversely related, the higher the trust in the institution the lower amount of taxes evaded. (Gërkhani, 2004).

In the process of paying taxes free-rider effect can be found. A tax payer will be more willing to pay the taxes¹⁾ if it is believed that others will do the same, 2) if it is believed that government will keep its promises. As the trust in government institution and in other citizens' fall, tax evasion increases. The willingness to pay drops to zero or only the amount they believe can be detected and punished is being paid.

An increase in taxes increases the level of underground economy, thus increasing fiscal evasion. The influence of tax growth in informal economy has been emphasized by a number of empirical studies made by Schneider (1994) and Johnson (1998). This strong influence of tax growth in underground economy has been proven with the Austrian and Scandinavian cases. From studies that have been made it is found that when tax rate is increased the willingness to pay the taxes is decreased. (Clotfelter, 1983)

Perception of audit rates is another factor that affects the compliance of taxes, indirectly the level of shadow economy. Individuals appear to underestimate the probability of audits to be conducted. If a taxpayer believes that probability if an audit to happen is high, then the level of evasion will be decreased, due to fear of being caught .When audit rates increase

by 10% the amount of reported income increase by 1% or even 2% (Witte and Woodbury, 1985; Dubin, Graetz, and Wilde, 1990). Fiscal evasion is sometimes ethical (Nasadyuk & McGee, 2007). A study regarding this hypothesis was made in Ukraine by Irina Nasadyuk and Robert W. McGee. They conducted a survey and found that the view that tax evasion is somewhat ethical is prevalent for 17 out of 18 statements. Several psychological studies have concluded that tax evasion is found as ethical depending on the circumstances. According to Robert Pennock tax evasion is seen as ethical in case the country where this evasion takes place is in an unfair war. Empirical studies conducted in Argentina, Bosnia & Herzegovina, China, Germany, Guatemala, Poland, where the respondents were asked about the ethics of fiscal evasion, reached a common conclusion that tax evasion is justified depending in the circumstances. As study of Mexican migrant workers found that when people are somewhat rewarded for paying taxes, the probability of tax evasion to incur is lower.

Methodology and Data

This thesis is an analysis of fiscal evasion and shadow economy in Albania for 2000-2010. Data for this analysis are taken from Bank of Albania, World Bank, IMF, INSTAT and other national and international organizations.

As the scope of the project is very broad, there have been used different methods to better analyze the problem. One of them is the survey research. This method is important if we want to test the hypothesis stated below.

Hypothesis

Tax growth increases tax evasion.

Tax evasion will be higher when government is perceived to be corrupt.

Tax evasion is sometimes ethical

According to Spector (1981) and Denscombe (2003), by conducting a survey we can collect information from a large number of people and use this information to establish statistical significance. Since the study is about tax evasion population of the study was comprised of tax payers, business owners, sample was randomly selected. It is used the surveys made by different national and international organization, regarding informal economy in Albania.

For the aim of comparison of shadow economy and fiscal evasion in different countries it's used data from statistical institutions and international organization like: IMF (International Monetary Fund), World Bank, EBRD (European Bank for Reconstruction & Development).

In order to measure the fiscal evasion, direct and indirect methods were used. These include: Auditing by tax authorities, which yield an estimate of the person real income, thus allowing them to better understand the level of fiscal evasion. An indirect way of measuring fiscal evasion is making a comparison of one's reported income and their expenditures, in budget surveys or in national income accounts. The data for measuring fiscal evasion were taken from other studies made before, but in the case of Albania the data were obtained from INSTAT, IMF etc

Albanian Case

The size of informal economy is a serious problem in Albania. It is seen as one of the main factors which prevent economical and political development of the country, as well as integration of Albania in European Union.

In the beginning of 1990's Albania left Communism system. This system had destroyed country's economy. in this period informal economy grew too much, due to lack of state structures and law. Informal sector helps economy grow in the short run, but is very dangerous in the long run. That is what happened to Albania.

Factors of informal economy in Albania

I am going to analyze the main factors which have affected the growth of informal economy in Albania.

Labor Market

Non-Declaration of Income

Corruption

Taxation System

Cash Economy

Labor Market

Informal works as a labor market category. The Dual Labor Market Theory (Doeringer & Piore 1971; Sant-Paul 1997) provides one approach to understanding the place of informal work within the labor market. It divides the labor market into four categories: primary, secondary, informal, and illegal. The authors argue that that these categories reflect the class, racial, and gender stratification in our society. The primary sector is regular, where wage jobs are taxed and regulated. The secondary sector is composed of jobs that have less security than primary work and are not well regulated, where I can mention lower wage jobs in the service sector. The Dual Labor Market Theory argues that the informal sector is composed of people who are not able to access primary or secondary work. Informal work includes people who operate their own small business in cash only or unregulated arrangement. The forth category is illegal work and that includes all criminal activity that is revenue generating.

Diagram 1: Labor Market Categories

Primary Sector	Secondary Sector	Informal Sector	Illegal sector
High wage	Low wage	Self-employment	Criminal
High security	Low security	Casual labor	Unregulated
Well regulated	Poorly regulated	Unregulated	

Source: Cross & Johnson, 2000

One problem with this typology is that it assumes discrete categories based on class, race or gender. Other research has found that many people who have easy access to the primary sector make the choice to engage in the informal economy, either as their primary source of income or as a means to generate supplemental income.

Labor market in Albania has undergone significant changes after 1990's. After 1990 a large group of people migrated to the western countries. Development of private sector goes uniformly with the development of informal economy. The working age population (15 and over) makes up approximately 88% of total population (INSTAT: Albanian Institute of Statistics, 2013).

In 2004 OECD conducted a research in Albania regarding the level of informal economy. They found out from their analysis that informal production in small enterprise sector was dominant over formal production. in the sectors of manufacturing, trade, transportation, construction, retailing and other service sectors the level of the informality is about 40% larger than the formal production. in other sectors such as public administration the scope for informal production is much more limited.

From the analysis made by OECD was measured that over the half (51%) of value-added generated from the above sectors is informal.

Unemployment

in the end of 2011 unemployment rate was 13.1 %, by the end of 2012 it has reduced to 12.8%. The highest percentage of unemployment is comprised of youth unemployment. According to INSTAT data, 64% of head of families are jobless. This is a critical point, as unemployment means less income per family, becoming a burden for the state. Because of this situation people engage in illegal activities, resulting in an increase of the size of informal economy. When applying for a job, most of organizations do not take their decisions on the basis of meritocracy; instead they use "references" from their friends or relatives. Even after 20 years of transition, unemployment remains one of the main factors of informal economy.

Table1: Unemployment Rate

Year	2009	2010	2011	2012
Nr. of unemployed people	143340	143040	142950	141755
Unemployment rate	13.6	13.8	13.1	12.8

Source: INSTAT

Illegal employment is seen more in the following economic sectors:

Construction Sector

Small and medium size manufacture sector

Service Sector

Transportation

Trade

Private Fishing activity

Non declaration of income

Non-declaration of income is a wide spread phenomenon in Albania. Finding data about this topic is very difficult, as it is an informal activity.

Table2. Level of informal economy

Year	1999	2000	2001	2002	2003	1st half 2004
Checked Entities	2421	33616	28988	40850	34117	1669
Number of employees found	9176	104119	101966	117943	115216	16943
Illegal employees found	3372	28060	22384	22564	18236	3798
% of Illegality	36.7%	26.9%	21.9%	19.2%	20.1%	22.4%
% Informal Economy		32.2%	27.5%	28%	18.3%	9.5%

Source: Trade-unions Research Institute Albania (2004)

From the above table we can see that the phenomenon of non-declaration of income is wide spread in Albania. Non-declaration or under-declaration of income is positively related with the level of informal economy.

For example, in the 1st half of 2006 of 1669 checked entities the number of illegal employees was 3798 or 22.4 %.

There exists an under-declaration of wages and salaries in Albania. Companies usually under-declare wage levels, thus under-paying social securities. Employees working in these kinds of organization claim that it is better for them an immediate direct cash payment and neglect the future benefits of paying social securities.

Table3: Number of the registered economic activities and the number of declared employees

from 2000 to the 1st half of 2008.

Year	2000	2001	2002	2003	2004	2005	2006	2007	1st half 2008
Registered in SLI	20564	26039	32132	40454	30408	30418	32541	33248	30232
Declared employees	74511	92257	81121	75984	79897	82457	85467	86750	43177

Source: INSTAT

From an inspection made on the construction sector over years, illegality is found to be about 20-25%, while informality at about 7-9%. in SM manufacturing sector, it is found to be at a rate of 10%- 15%.

Corruption

Corruption is one of the biggest issues that Albanian government has to deal with. It is seen in different forms, like: giving gifts public officials, abusing with tenders, faulty privatization etc. Corruption is also related with organized crime. Because of corruption Albania's progress development has been hindered.

Table4. Estimates of corruption level in Albania

	% of firms expected to give gifts to public official to "get thing done"	% of firms expected to give gifts in meeting with tax officials	% of firms expected to give gifts to secure government contracts	% of firms expected to give gifts to get an operating license	% of firms expected to give gifts to get an import license
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Albania(2007)	57.7	22.4	30.5	10.9	21.8
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Source: INSTAT 2007

The need for a better treatment explains why the public officials mostly paid are the doctors. According to different surveys that have been undertaken the 71 % of the citizens that pay bribes pay to the doctors, where 47% to the nurses and 14 % to the police officers. There are some reasons that push the citizens to make payments such as need to speed up a procedure, to receive a better treatment or to avoid a fine. From ten Albanian citizens eight interact at some point during the year with the public administration.

This type of corruption is seen more in rural areas than in suburban ones. Women are those who pay most of the bribes. These bribes are mostly paid on cash. in most of the cases 30% of bribes are paid by citizens themselves, 15% are given as a result of a request made by a third party for the public official. However, Albania has made a significant progress in the controlling of corruption.

Taxation system

Another very important factor affecting informal economy in a country is the taxation system. After 1997 Albania has undergone significant reforms in the taxation system. in Albania women tend to evade taxes less than men do (Gerxhani & Kuiper, 2004). According to the results a survey, in Tirana 80% of the interviewed people do not pay any state taxes, only

a few pay the social security payments in their formal employment. The payment of only one-third of this amount was provided by informal sector activities.

Level of tax evasion compared to a decade ago has been improved. Nowadays, tax evasion levels comprise mainly of non-payment of taxes and duties, but also of unpaid insurance. (Mema & Preci, 2003). There is a tax of only 10 percent on duties from income in my country. Despite this low tax rate there is still a high level of informality in Albania.

A major problem seen in the taxation system is the failure to declare the financial system. Companies manipulate their asset values in balance sheet.

According to a study conducted by ACER (Albanian Center for Economic Research) in 1999 in Albania, which was made to find the level of tax evasion in domestic and foreign companies operating in Albania, found that out of 87 respondents: (ACER: Albanian Center for Economic Research, 1999)

- 75% of companies admitted that tax evasion is a widely used practice.
- 73% of companies admitted that they do not report their real profit level.

Another problem that shows malfunction of taxation system is the failure to collect incomes.

The fault for this malfunction fall both on the tax-payers and tax authorities. Tax-payers have lost the faith on tax authorities, as a result of the briberies paid to them. They consider it unfair for them to pay the taxes, while others by giving some gifts to public officials avoid paying taxes. What is important for well functioning of tax system is a well-qualified staff. An informal sector 30% above of GDP implies negative consequences for collection of tax revenues.

Cash economy

Albania is a cash economy. Credit cards are rarely used in Albania. They are usually accepted at major hotels in Tirana, large shopping centers, and at some international airline offices. Checks also are rarely used, but they can be changed at banks, but only in large cities. The use of cash helps increase the level of informal economy in the country. The mentality of the people has also helped in favoring cash economy. People think that by using cash, their money is safer, than using credit cards when making a transaction. One of the problems that arise from the use of cash in every transaction is money laundering. People prefer to use cash in their transactions because they want to avoid the frustrating long procedures and controls by authorities. This way the origin of the money cannot be proved. Banking infrastructure is another factor that has favored the use of cash. Most of the banks are concentrated in the larger cities.

How to fight fiscal evasion

I believe that there are several ways to combat fiscal evasion in Albania. First of all the quality of audits need to be increased. This can be done through an improvement in tax audit methodologies and existing topics, creating a unique database with the results of inspections made on businesses and individuals. Strengthening of financial control may also help in the reduction in the size of informal economy. We should develop business management tools for a more precise control or a database including taxpayer's taxpaying habits.

Fiscal evasion can be reduced also by the improvement of enforcement procedures.

In order to control tax evasion government should:

Build business- friendly policies

Abolish repressive practices against business and fiscal arbitrariness

Increase cooperation between different state agencies

Increase the capacity and professionalism of customs and tax administration

Dr. Preci argues that in order to improve the control of fiscal evasion in the labor market it is required the education of both employees and employers; strengthening the legal and financial penalties for individuals and companies who manipulate company balance sheets.

Conclusions

This paper has explored a number of issues regarding shadow economy and fiscal evasion. Although in different levels and ways, shadow economy is present in every country. Tax evasion is an important and significant phenomenon that affects both developed and developing economies. Size of the informal economy and fiscal evasion associated with it should be clearly understood, in order to forecast the appropriate policies to deal with these issues. As it is mentioned above size of underground economy changes from country to country, even in developed countries like US or UK it comprises 10 percent of the measured economy. In less developed or developing countries, it goes up to 30-40 percent.

In this paper also is analyzed the relationship between corruption and the shadow economy. It is stated that informal economy and corruption are substitutes in countries with high income level. In countries which have a low income level, corruption and informal economy are complements of each other.

I have also studied the relationship between tax rate, tax growth and the level of tax evasion. Generally countries with low tax rate, tend to have less fiscal evasion. However, Albania is an exception, since it has a low tax rate, but fiscal evasion is still a major problem. As the tax rate increases, the probability of evading taxes increases, too.

In the study about fiscal evasion I concluded, based on some researches, that fiscal evasion is somewhat ethical. It is seen as ethical in different situations like the case when human rights are abused, etc.

Fiscal evasion and size of informal economy is expected to increase if government is perceived as corrupted. Tax payers lack trust on governmental institution, so they evade taxes or pay only the amount they believe they can be caught.

An important part of the thesis was the relation between the income level and the compliance of taxes. There exists a positive relationship between these two factors. As income falls the under-reported income level also falls.

As a conclusion, I would say that shadow economy and fiscal evasion, cannot be completely eliminated, but all the countries should fight in order to reduce fiscal evasion, thus reducing the size of informal economy.

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