

# THEORETICAL AND PRACTICAL CONSIDERATIONS ON THE IMPACT OF THE UNDERGROUND ECONOMY ON SUSTAINABLE ECONOMIC DEVELOPMENT

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## Abstract:

*The underground economy is a major challenge around the world and is a priority for many governments as it affects both developed and developing economies. The aim of this research is to address the concept of the underground economy and identify the effects of this phenomenon on the economy at the micro and macro level. In order to achieve the research aim, the following specific objectives were set: O1- to provide a current state of knowledge of the underground economy by referring to the relevant literature in the field; O2- to identify the peculiarities of the phenomenon of money laundering as a financial mechanism of the underground economy, O3- to analyse the tax system at international and national level as a determining factor in the development of the underground economy. In order to achieve the proposed aim and objectives, the research methodology used mixed research techniques, specific to qualitative and quantitative research. The results of the study demonstrate that the underground economy presents more risks than opportunities, as tax evasion, social injustice, economic distortions and associated institutional weakness outweigh the possible benefits, all of which can harm the business environment, competitiveness and equitable economic development. We believe that the study is particularly useful for international and national regulators to reconsider and adapt their tax policies to the current needs identified in this study in order to reduce the negative effects of the underground economy on economic development.*

**Key words:** economic instability, gross domestic product, underground economy, tax system

**JEL classification:** M 41, E62, H30

## 1. INTRODUCTION

Tackling the underground economy has been and continues to be a priority for many governments and various international organisations, affecting both developed and developing economies.

The reasons and conditions under which the underground economy develops are mentioned by Štulhofer (2019), namely: economic traditionalism; poverty; opportunism and distrust of institutions. Therefore, these dimensions are negatively correlated with the perception of illegitimacy of the underground economy and therefore, the author states that they have a positive effect on its persistence or expansion. Therefore, in this study we will try to explain the concept of the underground economy, to analyse its link with economic instability, what are the mechanisms used in an informal economy and to represent the size of the underground economy at the micro and macro economic level.

The aim of this research is to address the concept of the underground economy and to identify the effects of this phenomenon on the economy at micro and macro level. At the same time, we will analyse money laundering as a financial mechanism of the underground economy and highlight the tax system as the determining factor in the development of this phenomenon. In order to better understand the phenomenon of the underground economy, we will try to analyse its dimension at national and international level and we will bring some considerations related to the underground economy as a risk or opportunity for the formal economy.

Thus, we believe that identifying the features of the underground economy is an extremely important concern for the state, but also to ensure that its taxpayers comply with the law.

## 2. LITERATURE REVIEW

It is certain that the underground economy exists in all countries of the world, in varying proportions in the gross domestic product (GDP). The concept of the underground economy appears in the literature under various names (more than 20): hidden, concealed, disguised, parallel, appended, dangerous, ghost, invisible, unofficial, dual, cash, informal, secondary, illegal, grey, shadow, unmeasured, counter-economy. In this context, the definition given to this concept by Pierre Pestieau, according to which the underground economy is "all the economic activities that are carried out outside criminal, social or fiscal laws or that escape the national accounts", is important and is considered by specialists as the most comprehensive definition of the underground economy (Braşoveanu, 2010).

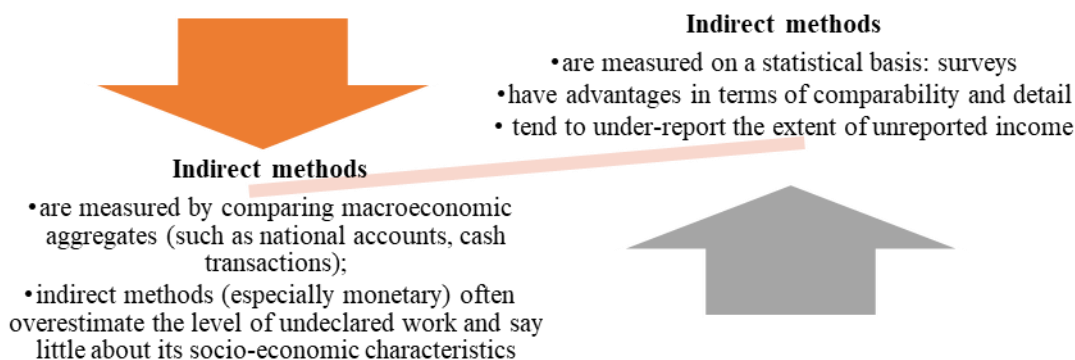
The authors Timofte (Coca) and Socoliuc (2019) show that tax evasion is a mass socio-economic phenomenon, present globally, which negatively affects the economies of states.

The study by Socoliuc and Grosu (2019) demonstrates that tax evasion is a transnational phenomenon with harmful effects on all economies of the world's states and that measures to counter it are an important objective for policy makers around the world.

Also, the study by Koloane and Bodhlyera (2022) focused on estimating the size of the underground economy in South Africa shows that the underground economy is positively influenced by variables such as unemployment rate, tax burden and social benefits provided by the government and is negatively influenced by GDP, self-employment and deposit interest rate.

According to the author Duţulescu (2019) tax evasion, as part of the underground economy, included in the great mass of the set of activities that make up economic crime, arose with the advent of trade, out of the desire to avoid paying a portion of the profits to the authorities. This desire still persists today, the difference being that with the development of human society the techniques used by traders to pay as little as possible to the state budget have also evolved.

For this reason, the definition most often used seeks to relate the underground economy to national income, officially measured, including all productive (i.e. value-added) activities not currently recorded, which should be in the national product. The underground economy can be measured directly, indirectly or statistically. The first two methods are shown in the figure below.



**Figure 1. Methods of measuring the underground economy**

Source: Processing after Wang and Zhang (2022)

The third method is statistical models that use statistical tools to estimate the underground economy as an "unobserved" or "latent" variable; for example the MIMIC method (Erdoğan, 2015).

Feige and Ott (2019) consider underground economies to be characterised by non-compliant economies, behaviour involving evasion, avoidance, abuse and/or corruption, rule-breaking, and accompanying efforts to hide these illegal behaviours from public authorities.

Research undertaken by Nguyen and Tran Pham (2023) highlights that an increase in government spending and fiscal imbalance contributes to the expansion of the underground economy. The authors believe that the effects of government spending on the underground economy will intensify and lead to a higher level of fiscal imbalance.

Tax growth is based on economic growth, although it is influenced by a variety of factors, such as adjustment of tax laws, erosion of the revenue base brought about by the black market, etc. In reality, a number of factors can influence the independence of a tax from GDP. It is clear that a variety of factors contribute to tax growth and that there is no direct correlation between tax growth and GDP.

Thus, we see that the underground economy is commonly associated with tax evasion and violations of other laws, which can lead to increased government intervention and reduced economic freedom (Melega, 2023).

In this respect, the shadow economy is a complex and pervasive reality in modern society, with a significant impact on GDP and fiscal policies. Tax growth is not directly proportional to GDP growth, as there are many factors that influence tax independence from underground economic activities.

In the following, we will try to synthesise the information from the scientific literature on the underground economy in order to determine what are the characteristics of this phenomenon, namely: how the underground economy appears in a formal economy, what are the factors contributing to the development of this phenomenon and what are the effects on the economic system at macro and micro level.


In general, the deep crisis faced by autonomous companies and utilities can undermine the formal economy and provide fertile ground for the growth of the underground economy. In this regard, we believe that it is essential for governments and authorities to address the root causes of the crisis, strengthen legal and financial control measures and rebuild security systems to mitigate the effects of the underground economy on a country's level of development.

The literature shows that the underground economy occurs for several reasons. The first reason is a high tax burden. Another reason is the social security contribution (which leads to the development of the grey or black economy) and the multitude of regulatory procedures, i.e. a high degree of tax bureaucracy.

In addition to the above factors, we add the fact that companies try to mitigate the impact of low revenues in the formal economy in times of recession by operating in the informal economy. All these factors contribute to the increasing scale of this phenomenon (Abu-Lila et al., 2021).

At the same time, the need to comply with legal labour market standards, such as minimum wage linked to working hours, public safety standards, etc., may encourage firms to engage in informal economy activities.

In another vein, the literature has also identified that the informal economy has both a positive and negative impact on the economy, and these effects can be seen in the figure below. In our view, the shadow economy has a negative impact on economic policy formulation. In this context, macroeconomic aggregates such as the unemployment rate or the income level become unreliable as a result of considerable underground economies. Therefore, economic policies based on these findings probably become ineffective.



Advantages	Disadvantages
<p>It functions as a kind of "social release valve" during crises by creating jobs and income opportunities and increasing supply.</p> <p>Lower product prices due to lower production costs, flexibility of time and working conditions.</p> <p>Provides dynamism to the economy and leads to capital accumulation and growth.</p>	<p>Inadequate calculation of public sector volume;</p> <p>Budget deficit due to insufficient taxation</p> <p>Instability of economic balances due to large borrowing or money issuance;</p> <p>Inadequate assessment of creditworthiness of firms due to inadequate financial reporting</p> <p>Over-reported unemployment rates;</p> <p>Over-reported inflation rates;</p> <p>Unfair income distribution;</p> <p>Inefficiencies in the legal system;</p> <p>Unfair competition, etc.</p>

**Figure 2. Advantages and disadvantages of the underground economy**

Source: Processing after Erdinc, 2016

Analysing both the advantages and disadvantages of the underground economy, we see that the balance is destabilised by the disadvantages that damage the economic environment, as mentioned above.

In relation to the above, we are of the opinion that the existence of the underground economy is exacerbated and favoured by the deep crises faced by companies and the population, as well as by the lack of compliance with the law.

### 3. RESEARCH METHODOLOGY

The achievement of the research aims and objectives involved a methodological approach, using research methods specific to the social sciences, such as: a critical analysis of the literature, used with the aim of achieving a current state of knowledge on the studied topic, analysis, synthesis, comparison and problematization were used to describe the impact of the underground economy on the level of development of nations. In this regard, analyses of the phenomenon of money laundering as well as analysis of the tax system, from an international and national perspective, as important exponents of the phenomenon represented by the underground economy, were carried out. Qualitative research techniques were combined with quantitative research techniques in order to describe the phenomenon under study.

Therefore, in the following section, the most important results of the research are presented.

### 4. RESULTS AND DISSCUTIONS

As mentioned in the previous sections, the present research focused on the analysis of the impact of the underground economy on economic development at the macroeconomic level, through the analysis of money laundering and the analysis of the international and national tax system as the main determinant of the level of the underground economy. The following sections will therefore be devoted to clarifying these issues.

#### 4.1. MONEY LAUNDERING - FINANCIAL MECHANISM OF THE UNDERGROUND ECONOMY

As far as the money laundering process in the financial system is concerned, it can be carried out in three stages, using banks, other financial activities and commercial activities. According to Vuia (2021) the basic stages of the money laundering cycle is the one represented in the figure below, as follows:



**Figure 3. Stages of the money laundering cycle**

Source: Processing after Vuia, 2021

1) *Placement particularities.* This stage involves the initial introduction of illicit funds into the financial system. In the underground economy, individuals or organisations may generate income through illegal activities such as tax evasion, smuggling, drug trafficking or fraud. In order to hide the origin of these funds, they are usually introduced into the formal financial system by various means. This may include depositing cash in bank accounts, making small and frequent transactions or using money transfer services.

2) *Deposit Specifics.* Once illicit funds have been placed in the financial system, the next step is to store or hide them. In the context of money laundering, this is done to distance the funds from their illegal source and to make it difficult for law enforcement agencies to trace them. The storage phase may involve transferring funds between different accounts or financial institutions, purchasing assets such as real estate or luxury goods, or investing in legitimate businesses.

3) *Integration particularities.* The final stage of the process involves reintegrating illicit funds into the legitimate economy, giving them the appearance of having been legally obtained. This usually involves the use of various financial and commercial activities. In the case of the underground economy, individuals or businesses may engage in legal transactions or investments to commingle their illicit funds with legitimate income. They may open businesses or acquire assets to legitimise their wealth, making it more difficult to distinguish between legal and illegal sources of income.

Legalising illegally received income means money funds that have been earned through the grey and underground economy. Currently, activities in the underground economy include the sale of drugs, weapons, the creation of shell companies (rarely used), financial fraud, illegal gambling etc. to the grey sector of the economy which includes tax evasion through the payment of wages and more. In the authors Ilyn and Anfinogenova's 2019 opinion, money laundering mainly takes four main forms, shown in the figure below:

material	procedural	economic	legal
<ul style="list-style-type: none"> <li>•The material includes various types of transactions related to the sale or acquisition of property, i.e. the transfer of funds other than cash and other property from the underground economy to the legal sector of the economy.</li> </ul>	<ul style="list-style-type: none"> <li>•The procedural form of money laundering allows you to determine the original source of the property or money funds, as well as their past and present owners who wanted to escape criminal and administrative prosecution</li> </ul>	<ul style="list-style-type: none"> <li>•Economic form is the intentional misrepresentation or misrecording of business transactions within the entity, resulting in the misrepresentation of consolidated reporting forms and then the falsification of income. Economic form also includes illegal transactions that do not involve the payment of taxes to the state and other taxes.</li> </ul>	<ul style="list-style-type: none"> <li>•The legal form includes the actual misrepresentation of the origin of the property for this legalisation.</li> </ul>

**Figure 4. Main forms of money laundering**

Source: Processing after Ilyn și Anfinogenova, 2019

In general, all operations that fall under the scope of the underground economy involve hiding financial profits made by various methods.

The underground economy encompasses a wider range of informal or illicit economic activities that are conducted outside the scope of government regulation and supervision, and money laundering is widespread and well known.

For example, in Romania, after the emergence of privately owned companies until around 2005, avoiding paying taxes or fraudulently obtaining tax refunds from the state budget involved the use of a special firm called a shell company. The rule was that both profits and tax liabilities were channelled from the official economy to the underground economy.

These companies, which did not work from their declared headquarters, officially carried out very large value transactions and paid no taxes, were involved in complex branches, through which payment documents circulated in such a way that the companies worked "in the open." were apparently exempt from tax burdens. Tax liabilities remained with the shell companies, which could not be subject to any tax controls or executions (Gruia et al., 2019).

## **4.2. THE TAX SYSTEM - A DETERMINING FACTOR IN THE DEVELOPMENT OF THE UNDERGROUND ECONOMY**

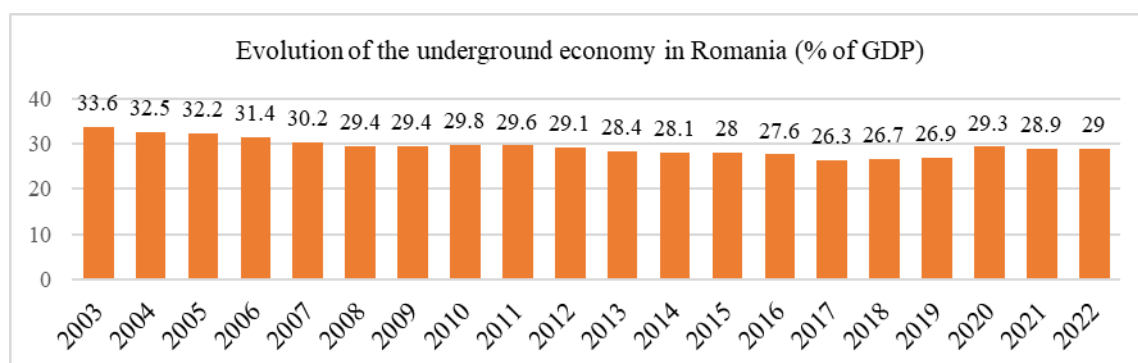
As we all know, the tax system covers public needs and, on the other hand, stimulates taxpayers' interests in entrepreneurial activity. Even so, the impact of tax burden on economic activity and financial strength of the state remains the most pressing problem of economy and economic policy (Musayev and Musayeva, 2018). This influence is observed due to the variation of indicators of GDP, exports, public expenditure, etc. In the following, we will present in a value-based way what influence tax policy has on the underground economy at the national and international level.

### **4.2.1.SIZE OF THE UNDERGROUND ECONOMY IN ROMANIA**

The decline and slowdown in the growth rate of the formal economy are negative consequences of a high level of the underground or informal economy. For a country like Romania, the percentage held by this underground economy is worrying, and the negative effects of high percentages are visible in the level of GDP and in the level of tax revenues (Popovici et al., 2019).



In line with this statement, a study conducted by the Department for Economic, Scientific and Quality of Life Policies at the request of a European Parliament committee shows that Romania's underground economy is estimated to account for 29% of official GDP in 2022.



**Figure 5. Evolution of the underground economy in Romania (% of GDP)**

Source: Processing after Schneider și Asslani, 2022

According to the chart in Figure 5, we can see how the underground economy has evolved as a percentage of GDP over the period 2003-2022. Thus, we observe a relatively constant evolution of the underground economy which leads to the conclusion that there is a weak effectiveness of fiscal policies and measures taken to combat this problem, the trend of the underground economy being relatively constant around 30%.

There were slight fluctuations in the percentage of GDP allocated to the shadow economy during the period under review, but these were generally minor. In some cases, there was a slight increase in the percentage of GDP in some years, such as in 2020, when it increased to 29.3%. However, overall, the downward trend persists.

In this regard, the author Șargu, 2022, believes that the disappearance of this phenomenon in the near future are not obvious and that this phenomenon will continue. Therefore, we agree that immediate measures are needed to reduce this phenomenon, as a condition without which sustainable and accelerated economic growth of the economies of the world's countries cannot be achieved, with implications for the increase in the quality of life for their citizens.

#### 4.2.2. SIZE OF THE INTERNATIONAL UNDERGROUND ECONOMY

Governments use taxation as a key fiscal tool in raising funds to pay for expenditure incurred in the national interest, irrespective of any one-off benefits received. However, tax authorities often find it difficult to establish a person's income when those activities are hidden and undeclared.

In the table below, we present data showing the estimated percentage of the underground economy in each country at EU level, i.e. the undeclared or unknown part of the economy, which includes illegal or unregulated activities.

**Table 1. Evolution of the underground economy in the European Union**

Country/An	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Austria	8.2	7.9	7.6	7.5	7.8	8.2	7.8	7.1	6.7	6.1	7.2	6.9	6.6
Belgium	17.4	17.1	16.8	16.4	16.1	16.2	16.1	15.6	15.4	15.1	16.2	16	16
Bulgaria	32.6	32.3	31.9	31.2	31	30.6	30.2	29.6	30.8	30.1	32.9	32.4	33.1
Croatia	29.8	29.5	29	28.4	28	27.7	27.1	26.5	27.4	26.4	29.6	29	29.7
Czech Republic	16.7	16.4	16	15.5	15.3	15.1	14.9	14.1	13.6	13.1	14.2	13.9	13.5
Denmark	14	13.8	13.4	13	12.8	12	11.6	10.9	9.3	8.9	9.8	9.6	9.7
Estonia	29.3	28.6	28.2	27.6	27.1	26.2	25.4	24.6	23.2	22.1	23.6	23.1	22.7
Finland	14	13.7	13.3	13	12.9	12.4	12	11.5	11	10.6	11.4	10.9	10.8
France	11.3	11	10.8	9.9	10.8	12.3	12.6	12.8	12.5	12.4	13.6	13.1	14.2

Germany	13.5	12.7	12.5	12.1	11.6	11.2	10.8	10.4	9.7	8.5	10.4	10	8.8
Greece	25.4	24.3	24	23.6	23.3	22.4	22	21.5	20.8	19.2	20.9	20.3	20.9
Hungary	23.3	22.8	22.5	22.1	21.6	21.9	22.2	22.4	22.7	23.2	26	25	25.4
Ireland	13	12.8	12.7	12.2	11.8	11.3	10.8	10.4	9.7	8.9	9.9	9.4	10.1
Italy	21.8	21.2	21.6	21.1	20.8	20.6	20.2	19.8	19.5	18.7	20.4	20.2	20.3
Latvia	27.3	26.5	26.1	25.5	24.7	23.6	22.9	21.3	20.2	19.8	20.9	20.2	19.9
Lithuania	29.7	29	28.5	28	27.1	25.8	24.9	23.8	23	21.9	23.1	22.9	22.4
Luxembourg	8.4	8.2	8.2	8	8.1	8.3	8.4	8.2	7.9	7.4	8.6	8.4	8.3
Malta	26	25.8	25.3	24.3	24	24.3	24	23.6	23.2	22	23.5	23.1	23.4
Netherlands	10	9.8	9.5	9.1	9.2	9	8.8	8.4	7.5	7	8.1	7.8	8.2
Poland	25.4	25	24.4	23.8	23.5	23.3	23	22.2	21.7	20.7	22.5	22	21.9
Portugal	19.2	19.4	19.4	19	18.7	17.6	17.2	16.6	16.1	15.4	17	16.5	15.7
Slovenia	24.3	24.1	23.6	23.1	23.5	23.3	23.1	22.4	22.2	21.5	23.1	22.5	22.1
Spain	19.4	19.2	19.2	18.6	18.5	18.2	17.9	17.2	16.6	15.4	17.4	16.9	15.8
Slovakia	16.4	16	15.5	15	14.6	14.1	13.7	13	12.8	12.2	14	13.7	13.1

Source: Processing after Schneider and Asslani, 2022

At a first glance, from the table above, it can be seen that the underground economy has been declining in most European countries in recent years. This trend may be the result of efforts to regulate and combat tax evasion, as well as improvements in the legal framework and law enforcement.

In the alternative, we can infer that there is significant variation in the size of the underground economy in some countries such as Bulgaria, Croatia, Greece, Lithuania and Malta, which have relatively high shares of the underground economy compared to other European countries.

We also see fluctuations in the size of the underground economy in some countries over the period 2020-2022. In this respect, the COVID-19 pandemic and the war in Ukraine have had a significant impact on European economies, generating disruptions in economic activities as well as an increase in the underground economy in some areas.

In this respect, economic theory reveals that when a tax system does not lead to the collection of sufficient resources due to tax evasion, new tax instruments will most likely be introduced to lead to higher revenues for the state budget. This means introducing higher taxes on reported income, while unreported income continues to be omitted from taxation.

Villela, 2002 considers that this phenomenon of tax avoidance affects tax incidence because, in his view, it is easier to evade taxes on some income than on others.

The study by Timofte and Socoliuc (2019) shows that there is a positive correlation between tax evasion and the complexity of the tax system as well as the bureaucracy of the tax system. The authors cited above also demonstrate that a complex and bureaucratic tax system leads to higher rates of tax evasion, which is also confirmed by previous results obtained through scientific research related to this area.

#### 4.3. CONSIDERATIONS ON THE UNDERGROUND ECONOMY PHENOMENON FROM THE PERSPECTIVE OF RISK AND OPPORTUNITY ANALYSIS

In our view, financial development can promote economic performance, i.e. a reduction in the size of the underground economy. Under this aspect there is a broad consensus in the literature, authors (Blackburn et al., 2012) point out that financial development is beneficial for economic growth, as it allows borrowers and lenders to boost both the volume and productivity of investment.

An expanded informal economy limits the capacity of the state, which can hinder institutional development, in turn discouraging the expansion of the formal sector and limiting the benefits of the formal economy to a relatively small number of participants, discouraging potential economic growth and broader economic opportunities (Adil et al., 2012).

Therefore, we find that a higher return on investment in the underground economy sector means a higher opportunity cost of investment in the formal sector.



Large underground economies pose a challenge for fiscal policies: governments with large informal or underground economies may increase tax rates to offset revenues, thereby promoting further expansion of the underground sector.

This could further undermine the government's institutional capacity. Poorly developed states are particularly vulnerable to slipping into this vicious spiral. In addition, large informal economies make official statistics inaccurate and inadequate, complicating policy-making. The benefits of a formal economy, such as protection of property rights and access to credit markets, are not universally available in this "bad" equilibrium, which can hamper economic growth and limit economic opportunities for many taxpayers.

We want to emphasise that the shadow economy is a phenomenon with a high risk of tax evasion and fraud. According to author Schneider (2012), the underground economy is the entire market that is based on the legal production of goods and services and the avoidance of paying taxes, duties, social insurance or compliance with labour market rules, such as minimum wage, maximum hours worked, safety standards and regulations (Ursache and Hlaciuc, 2016).

We are of the opinion that the underground economy is more of a risk than an opportunity, as tax evasion, social injustice, economic distortions and weakening of the institutional capacity of statutory bodies outweigh the possible benefits associated with it. All this negatively affects the business environment, competitiveness and the fair and sustainable economic development of state economies.

Last but not least, the underground economy is commonly associated with tax evasion and violations of other laws. This can lead to increased government intervention and reduced economic freedom. We also believe that the underground economy has a significant negative impact on GDP and fiscal policies and that it is imperative that national and international governments continuously adjust their fiscal policies in order to limit as much as possible the negative effects of the underground economy.

We are of the opinion that only through a joint effort of all decision-makers, with powers in this regard, can the shadow economy be reduced to an acceptable minimum with noticeable effects on the level of sustainable development of all countries in the world.

## 5. CONCLUSIONS

We believe that the underground economy is a complex and pervasive reality in modern society and that it has a significant negative impact on GDP and fiscal policies.

We believe that an increase in taxes is not directly proportional to the increase in GDP, as there are many factors that affect fiscal independence from shadow economic activity. At the same time, the existence of the underground economy is facilitated by the deep crises faced by companies and citizens, as well as by the non-compliance with legal regulations.

The results of the present study confirm that when the tax system does not generate enough revenue due to evasion, new fiscal instruments may be introduced to meet the revenue demand. We believe this can be achieved through higher taxes on declared income while unreported income continues to avoid taxation. Therefore, under the aspect, it is necessary, first of all, to identify the incomes considered "hidden" from their taxation and taxation, followed by an analysis of the fiscal efficiency of the tax increase or the introduction of new taxes and fees, because an increase in taxation may inevitably lead to an even higher degree of tax evasion.

Research shows that the underground economy presents more risks than opportunities, as tax evasion, social injustice, economic distortions and associated institutional weakness outweigh the possible benefits. As a result, all these aspects negatively influence the business environment, competitiveness and fair and sustainable economic development of the economies of the world's states.

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