

ANALYSIS OF UNDECLARED WORK: THE LITHUANIAN CASE

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Abstract. Undeclared work is a structural part of the shadow economy. In literature, undeclared work is generally analysed by macro methods to estimate disparities between costs incurred from declared work and income derived from work. On the basis of such studies, the undeclared work structure (groups of economic operators, phenomena of undeclared work) cannot be estimated. The article presents an analysis of estimation methods applicable to the undeclared work and income derived from such work as well as practical application aspects particular to those methods. The author proposes to investigate the phenomena of undeclared work and measure the effects they have on the national consolidated budget, i.e. the amount of tax losses (the tax gap). The article provides the principal methodical layout and the method for quantification of the dimension of undeclared work. The article also offers the results of undeclared work, the dimension of the income derived from such work, and the tax gap in Lithuania.

Keywords: undeclared work, income derived from undeclared work, tax evasion, tax gap, personal income tax, social insurance contribution.

1. Introduction

In times of rapid economic change, economic and social development trends of a country are typically assessed by recording the change in the key macroeconomic indicators (i.e. gross domestic product (GDP), inflation, unemployment rate, final consumption expenditure, and etc.). However, such estimations present the country's economic reality in a somewhat more or less distorted manner. Potential significant changes in the shadow economy are one of the most important drivers behind the need for a more detailed assessment (Gruževskis, Gražulis 2008).

In this article, the concept of the “shadow economy” contains economic activities undertaken in spite of legislative requirements and restrictions even though such activities are subject to rigorous regulation and control (Krumplytė 2008, 2009a, 2009b, 2009c). Consequently, the economic performance of self-employed – which is not included into national accounts as per GDP estimation methodology applied by statistical bodies – falls outside the scope of the research object chosen by the author.

Undeclared work is one of the most prevalent phenomena of shadow economy. The scale of undeclared work in different countries may vary depending on a number of reasons, such as particularities of the labour market system, labour taxation, and other aspects (Schneider, Klinglmaier 2004; Williams 2009). Considering these circumstances, it is appropriate to deliver a study on undeclared work aimed at identification of undeclared work phenomena. To assess the

amount of lost tax revenue payable to the national consolidated budget (the tax gap), the article addresses the undeclared work in the light of tax noncompliance.

The aim of the research: to design methodological principles for detail assessment of undeclared work and apply them empirically using Lithuania as an example.

Objectives:

1. reveal the concept of undeclared work in the context of tax noncompliance;
2. analyse the methods used for evaluation of undeclared work and ascertain their strengths and weaknesses;
3. design methodological principals for detailed assessment of undeclared work;
4. perform an empirical investigation on the tax gap resulting as a consequence of undeclared work phenomena during 2006–2008 and supply the results.

Research methods: analysis, synthesis, expert evaluation, modelling, and summary.

2. The concept of undeclared work in the context of tax noncompliance

Scientific sources provide different definitions for the concept of “undeclared work”; besides, different terminology is used for its' description (i.e. informal employment, part-time employment, concealed unemployment or illegal work), which — somewhat unreasonably — are often used interchangeably as synonyms. In the narrow sense, undeclared work is perceived as work without a labour contract between an employee

and an employer or in breach of its terms and conditions (Pocius, Okunevičiūtė - Neverauskienė 2007).

Generally, there are two types of undeclared work, i.e. *full* and *part-time*. Full undeclared work (some sources use the term “informal employment”) is defined as employment of individuals in enterprises devoid of a labour contract in order to avoid labour-related income taxes and social insurance contributions. Part-time undeclared work (or part time informal employment) is defined as exclusion of a portion of income derived from work from official accounting to reduce payable taxes and social insurance contributions. In case of the part-time undeclared work, a labour contract is drafted, although only a portion of wages is formally reflected in accounting records (Williams 2008; Pocius 2006).

The concept “informal employment” is more frequently used in the applied research, wherein it is defined as the number of people working in the informal labour market. It is defined as illegal purchase and sale of labour force devoid of a labour contract and ignoring other laws that regulate labour relations. In this case, the research object does not cover the self-employed involved in unregistered self-employment.

In the broad sense of the meaning, undeclared work is defined as the undertaken commercial, economic, financial or vocational activity in breach of legislation (i.e. concealing income derived from work under absence of an established enterprise or acquired licence, or failure to officially register or document a number of employees) (European Commission 2004).

Considering the concept of the “shadow economy” and the planned research direction (to assess the undeclared work in the light of tax noncompliance), this article defines the undeclared work as an economic activity (comprising labour relations in enterprises as well as self-employed), which is carried out in violation of legislative requirements with the purpose of tax avoidance.

The aforementioned undeclared work phenomena can also be grouped according to the status of the economic operator, distinguishing between such phenomena characteristic to natural persons and legal entities. In cases where an activity in violation of legislation involves both a legal entity and a natural person (in a form of an employee), the legal entity is regarded to be the prime offender as the activity in violation of legislation is undertaken exclusively subsequent to the decision of the chief executive officer (in spite of the fact which person (the employer or the

employee) proposes participation in the shadow economy) (Krumplytė 2009c).

This article does not address violations unrelated to tax avoidance and tax evasion. For example, an employee dismissal prior to maturity of the labour contract, irregular payment of wages, and other similar cases are outside the scope of the research. All these phenomena are characterized as labour law violations, which result in infringement of employee interests, however, they do not have an impact on the lost tax revenue that should have been collected to the national consolidated budget.

Despite the diversity of the undeclared work phenomena, all of them share one common goal – tax avoidance (tax reduction or noncompliance by reduction or complete elimination of the amount on which the tax is charged, utilizing artificially designed business schemes or series of transactions) and tax evasion (tax noncompliance by concealing an economic activity) (Toder 2007; Krumplytė 2009b). The scope of undeclared work is not reflected in the official statistics or rather distorts it (in cases where there is a counterfeit increase in labour costs). Therefore, considering the changes in the officially registered unemployment rate, the reality of unemployment as an economic and social issue may be distorted.

3. Analysis of the scientific potential of undeclared work assessment

Quantification of undeclared work – and herewith the shadow economy – is somewhat complex due to the specifics of the research object: the investigation targets something that is concealed; there is reluctance to disclose information in order to remain in “the shadow” and avoid taxes and sanctions for noncompliance.

The basis for the potential of the current methodological assessment of the shadow economy (as well as the undeclared work) comprises of indirect macro methods. The purpose of these methods is to relate and compare data on a particular phenomenon (e.g. the number of employed people in the country) retrieved from different sources. The mismatch of data received during the analysis is regarded to be the shadow economy.

The scientific and applied literature usually addresses indirect methods for evaluation of shadow economy (some of them are used for evaluation of undeclared work): 1) discrepancy methods, 2) labour input methods, 3) degree of participation method, 4) Tanzi (monetary) method, 5) global indicators methods: electricity consumption; 6) latent variable methods

(Schneider, Klinglmair 2004; Schneider, Enste 2002).

Next, a brief review is provided on two methods (the national income and expenditure discrepancy method, and the formal and actual labour force discrepancy method), which are generally utilized for the assessment of the degree of undeclared work.

The national income and expenditure discrepancy method is based on the assessment of the difference between the national revenues and expenditure. In the national accounts, the GNP estimated on the basis of the income method should be equal to the GNP assessed on the basis of the cost method. Since costs are not declared, the statistical services provide preliminary estimations of the GDP on the basis of the cost method. The difference between expenditure and income could be perceived as an indicator of the shadow economy, although a portion of it might arise due to estimation errors.

The purpose of the formal and actual labour force discrepancy is comparison of data retrieved from different data sources (the official labour statistics and labour force analyses) (Williams 2009; Williams, Round 2008; Schneider, Klinglmair 2004; Schneider, Enste 2002; Pocius 2006). In case the official statistics indicate a decline of the employment rate (i.e. the number of employed decreases or the number of part-time workers increases), it is considered to be a symptom of an employment rise in the informal market. The weakness of this method lies in its' fundamental assumption maintaining that the total labour force employment rate is fixed, thus the formal employment rate decline – provided other conditions remain unchanged – may be perceived as an indicator of an increase in undeclared work. However, differences between the formal and the actual employment rates may arise due to a variety of reasons (Schneider, Enste 2002; Schneider, Klinglmair 2004; Pfau-Effinger 2009). Moreover, this method disregards a certain percentage of the population engaged in a part-time employment at the same time working illegally (this is regarded to as “additional earnings”). Due to the above-named shortcomings, the undeclared work estimation results obtained using this method are preliminary and may not be used for assessment of the dimension and trends of the shadow economy.

It should be noted that in some cases, direct methods (market research, expert evaluation) are utilized to retrieve data for the application of indirect methods. Yet another possible direct assessment method is the review (audit) of the randomly selected representative sample of

economic operators. Despite the costly utilization of this method (in terms of manpower of controlling authorities), other deficiencies should be considered as well, i.e. a possible risk of non-detection of shadow economy phenomena if carefully concealed. Thus, in all cases, the results of analysis of the dimension of shadow economy (and the undeclared work) contain certain errors arising mostly due to the specifics of the research object rather than limitation of the methods.

As there are no especially reliable primary sources of data on the dimension of undeclared work (which are most likely nonexistent), the quantification is based on collection, interrelation and analysis of data retrieved from a variety of sources (Di Porto 2009).

To sum up, the existing undeclared work evaluation methods allow for estimation of the possible dimension and trends of undeclared work as summation of certain phenomena; although they cannot be used to quantify the amount of the tax loss (the tax gap). This is due to the fact that undeclared work is not a homogeneous occurrence, thus requires an elaborate assessment by phenomenon. Labour-related income gained by different groups of economic operators or self-employed natural persons are taxed differently.

On the other hand – in terms of utility of research results and practical application – estimation of the dimension of undeclared work (as summation of certain phenomena) and monitoring of trends is of little help. Such results demonstrate the magnitude of undeclared work as an economic iniquity. They can be compared with equivalent indicators for previous periods of time or indicators of other countries. However, such identification of undeclared work remains an end in itself; as such, research results do not disclose the undeclared work structure and the dynamics of the structural components. This limits the possibilities to identify the caused for change in the dimension of undeclared work.

4. Methodological principals for detailed assessment of undeclared work

Following the analysis of the peculiarities of the scientific potential of undeclared work evaluation and taking into account the objective of the study – to provide a detailed assessment of the dimension of undeclared work and quantify the tax gap – the principal layout of undeclared work evaluation is offered below (Fig.1).

According to principal layout of undeclared work evaluation, *the first stage* involves identification and classification of undeclared

work phenomena. As undeclared work is an integral part of the back economy, it is therefore appropriate to design the classification of the shadow economy phenomena, singling out the group of undeclared work phenomena as a hierarchic level. Methodological recommendations for implementation of this stage and the Lithuanian classification of the shadow economy phenomena are provided in another research of the author (Krumplytė 2009c).

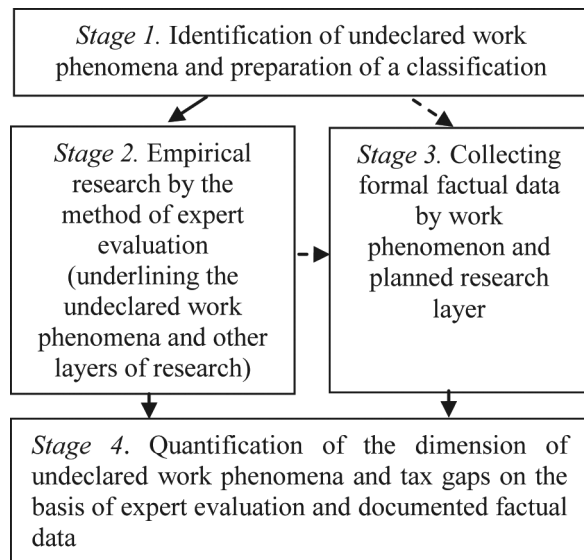


Fig. 1. The principal layout of detailed evaluation of undeclared work (designed by the author)

In the *second stage*, the empirical research by the method of expert evaluation is carried out. The objective of the research is to obtain indicators of the **distribution of undeclared work phenomena** and the **extent of officially undeclared income** to be used in the following calculations.

The indicator pertaining to the *distribution of the phenomenon* depicts a portion of active economic operators partaking in the shadow economy.

The indicator pertaining to the *extent of officially undeclared income* demonstrates the portion of formally undeclared income within a certain type of total income per capita.

Expert valuation in accordance with the research objectives may be detailed not only by phenomena of undeclared work, but also by other research aspects (such as size of businesses, sector of economic activity, territory, etc.). Research layers provide a greater number of indicators pertaining to distribution and dimension of undeclared work phenomena.

The *third stage* involves collection of formal factual data by work phenomenon and planned research layer identified in the second stage.

Databases of the state authorities that compile information on the number of workers and wages subject to different aspects (i.e. size of businesses, sector of economic activity, etc.) are used as the data source.

In the *fourth stage*, quantification of the dimension of undeclared work phenomena and tax gaps on the basis of expert evaluation and documented factual data is carried out.

The tax gap resulting from undeclared work is calculated as the summation of tax gaps arising from individual undeclared work phenomena:

$$TG_{UW} = \sum_{i=1}^n TG_i, \quad (1)$$

where:

TG_{UW} – a tax gap resulting from the totality of undeclared work phenomena;

TG_i – a tax gap resulting from a certain individual undeclared work phenomenon i ;

n – the number of undeclared work phenomena.

The tax gap of a certain undeclared work phenomenon (TG_i) is calculated as follows:

$$TG_i = K_i \times T_i, \quad (2)$$

where:

K_i – the number of economic operators implementing the phenomenon i ;

T_i – the amount of noncompliance of one economic operator due to the phenomenon i .

Indicator K_i is calculated as a product of factual number of economic operators and the indicator of distribution of undeclared work phenomenon i (obtained during the expert evaluation). Depending on an undeclared work phenomenon, the factual number of economic operators provides either the number of self-employed natural persons or the number of legal entities (enterprises). In case tax gap calculations are detailed depending on the size of a business, the factual number of economic operators and indicator K_i are adjusted respectively.

Indicator T_i is calculated by taking into account the tax regime applicable to income derived from a certain phenomenon. Usually, it is calculated in the following way:

$$T_i = \sum_{j=1}^k P_i \times t_{ij}, \quad (3)$$

where:

P_i – undeclared income of an economic operator implementing phenomenon i ;

t_{ij} – rate of a certain tax applicable to undeclared income (in relational value);

k – the number of types of taxes applicable to undeclared income. This indicator depends on the

tax regime applicable to each undeclared work phenomenon under analysis. In case of Lithuania, indicator k may comprise of the personal income tax, state social insurance contributions, compulsory health insurance contributions, and contributions to the Guarantee Fund.

In certain cases, the amount on which the tax is charged — pertaining to different types of taxes of the same undeclared work phenomenon — may differ (e.g. calculating the personal income tax gap, non-taxable amount of income may be deducted from one employee's undeclared wages; while other taxes would be worked out on the basis of the total amount of undeclared earnings).

Indicator P_i is worked out by recalculating factual average documented income of one economic operator applying the indicator of the dimension of undeclared work phenomenon i (obtained during the expert evaluation).

$$P_i = P_{i(\text{total})} - P_{i(\text{decl})}, \quad (4)$$

$$P_{i(\text{total})} = P_{i(\text{decl})} / (1 - m_i), \quad (5)$$

where:

$P_{i(\text{total})}$ – factual (declared and concealed) income derived by one economic operator from phenomenon i ;

$P_{i(\text{decl})}$ – factual average declared income of one economic operator derived from phenomenon i ;

m_i – the dimension of phenomenon i (a comparative indicator).

It should be noted that calculation of a tax gap resulting from certain undeclared work phenomena may slightly differ, given the nature of the phenomenon and the tax regime applicable to a certain type of income.

5. Assessment results pertaining to the Lithuanian tax gap resulting from undeclared work

Evaluation of undeclared work phenomena indicated by foreign experience – which was conducted in the course of the empirical research – and taking into account the specificities of the Lithuanian labour market and labour income tax peculiarities, the undeclared work phenomena were classified by the legal status of economic operators, distinguishing between such phenomena characteristic to natural persons and legal entities. Classification of undeclared work phenomena is an integral part of the classification of the shadow economy phenomena (Krumplytė 2009c).

In case of Lithuania, expert evaluation was carried out. It took place during August–September 2009, in the form of an anonymous survey. The survey involved experts – employees of the State

Tax Inspectorate under the Ministry of Finance of the Republic of Lithuania (the central and territorial offices) with experience in conducting tax-payer reviews and tax investigations (involving on-site visitations and control of regular activity). 702 experts (93 % of potential experts) took part in the survey.

The majority of experts (73 %) had no less than 5 years of experience in the area of taxpayer control.

The author-conducted calculation results – made in accordance with the methodological principles for detail assessment of undeclared work – pertaining to Lithuanian tax gaps for 2006–2008 resulting from undeclared work phenomena are presented in Figure 2.

The results demonstrated that during the period, the maximum tax gap (considering undeclared work phenomena) resulted from non-documentation of wages (envelope wages) (LTL 470 million in 2008) and “rearrangement” of a portion of wages using property lease agreements and business trip allowances to avoid taxes (363.6 million LTL in 2008).

On the basis of the calculations, the national consolidated budget (i.e. the state and municipal budgets, the State Social Insurance Fund and Guarantee Fund) might have suffered a tax loss amounting to LTL 3448.25 million resulting from undeclared work phenomena that occurred during the period of 2006–2008. According to the study, in comparison to 2007, in 2008, the tax gap resulting from undeclared work phenomena might have increased by LTL 74.36 million or 6.2 %; and over the period of two years (2006–2008) it might have grown by approximately LTL 270.68 million or 27.2 %.

During the years, the change in the summation of the tax gap resulting from a certain undeclared work phenomenon might have arisen from not only the increase in distribution and dimension of the undeclared work phenomenon, but also due to changes in the tax system (e.g. changes in tax rates).

The analysis of estimated tax gap amounts by size of enterprises (criterion being the number of employees in an enterprise) revealed the largest amount of a tax gap (which resulted from undeclared work phenomena) found in medium-size enterprises (with 20–249 employees) for the period 2006–2008 (Table 1). In this group of enterprises, the tax gap amount was 48.8 % (or LTL 1419.3 million) of the total tax gap amount, considering all undeclared work phenomena characteristic to legal entities. (In total, the tax gap of legal entities resulting from undeclared work phenomena during

2006-2008 might have amounted to approx. LTL 2908.9 million.).

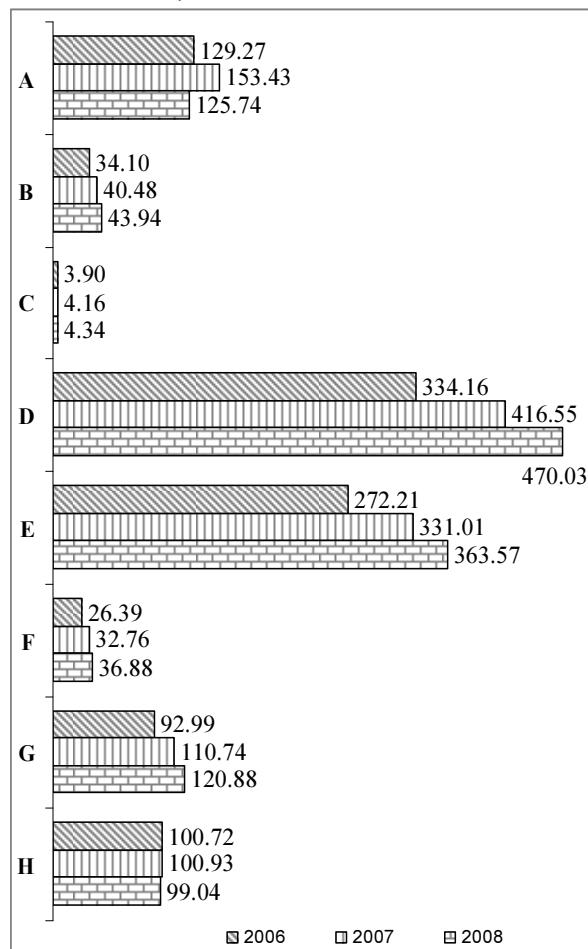


Fig. 2. Calculation results pertaining to Lithuanian tax gaps for 2006-2008 resulting from undeclared work phenomena, in millions of LTL (calculations by the author)

Undeclared work phenomena characteristic to natural persons:

A – participation in self-employment (registering the self-employment and/or obtaining a business licence) devoid of income tax returns

B – participation in self-employment devoid of registration of economic activity (including cases when such activity is engaged in after official work hours, i.e. when employees engage in unregistered self-employed activity)

C – informal work undertaken in farms (without an official labour contract)

Undeclared work phenomena characteristic to legal entities:

D – non-documentation of wages (envelope wages), including the concealed wages obtained while working in the same enterprise during a formal leave

E – “rearrangement” of a portion of wages using property lease agreements and business trip allowances and etc.

F – incorrect accounting of working time (part-time employment, inaccurate documentation of work during nights, overtime, and public holidays as well as week-ends)

G – “rearrangement” of income derived from labour relations in the form of author contract to reduce payable taxes

H – informal work (formally undeclared labour relations or work in an enterprise without a labour contract)

Table 1. Calculation results pertaining to Lithuanian tax gap amounts by size of enterprises (criterion being the number of employees in an enterprise) for the period 2006-2008 resulting from undeclared work phenomena, in millions of LTL

The number of employees in an enterprise:	Tax gap amounts by undeclared work phenomena:					
	D	E	F	G	H	Total
with no more than 9 employees	87.88	40.02	6.16	37.72	68.57	240.35
with 10–19 employees	184.74	103.61	13.66	29.87	41.29	373.16
with 20–249 employees	631.68	457.73	47.21	146.03	136.61	1419.26
with 250–499 employees	119.80	117.82	10.26	40.32	21.62	309.82
with 500 employees or more	196.63	247.62	18.75	70.69	32.59	566.28
In all enterprises:	1220.74	966.80	96.03	324.62	300.68	2908.88
D – non-documentation of wages (envelope wages), including the concealed wages obtained while working in the same enterprise during a formal leave.						
E – “rearrangement” of a portion of wages using property lease agreements and business trip allowances and etc.						
F – incorrect accounting of working time (part-time employment, inaccurate documentation of work during nights, overtime, and public holidays as well as week-ends).						
G – “rearrangement” of income derived from labour relations in the form of author contract to reduce payable taxes.						
H – informal work (formally undeclared labour relations or work in an enterprise without a labour contract).						

In micro companies (with no more than 9 employees) the tax gap was approx. 8.3 % (or LTL 240.4 million) of the total tax gap amount; while in small enterprises (with 10-19 employees) this figure amounted to 12.8 % (or LTL 373.2 million) and in large enterprises (with 250-499 employees) – to 10.7 % (or LTL 309.8 million).

Distribution of the tax gap was determined by a variety of factors, i.e. the number of a certain-size enterprises and the total number of employees therein; and uneven distribution of undeclared work phenomena and undeclared income in enterprises of different sizes. According to experts, the distribution and dimension of the majority of undeclared work phenomena for the period 2006-2008 was much greater in micro and medium enterprises, while the largest companies had much smaller indicators. Estimation results support the above: the tax gap resulting from undeclared work phenomena in the largest enterprises of Lithuania (with 500 employees or more) totaled LTL 566.3 million or 19.5 % of the total tax gap amount resulting from such phenomena in enterprises of the entire country.

To sum up, high level of accuracy is not (and cannot be) characteristic to the quantification of undeclared work (as well as the entire shadow economy) (due to specific of the research object and limitations of calculation methods). This is the reason results in this area of research should be interpreted with extreme caution and responsibility.

6. Conclusions

Results of undeclared work (as well as the entire shadow economy) are not included into the formally accounted GDP as well as the formally registered unemployment rate.

Generally, macro methods are used to analyse undeclared work as the summation of phenomena. This article provides detailed analysis of undeclared work. The object of the research is the multifaceted summation of undeclared work phenomena that involves a variety of labour relation aspects in businesses and peculiarities of self-employment.

Quantification of the undeclared work (which was based on the results of expert evaluation as well as calculations based on the official statistics) revealed that the national consolidated budget might have suffered a tax loss amounting to LTL 3448.25 million resulting from undeclared work that occurred during the period of 2006-2008.

The detailed analysis of undeclared work – which focuses on certain phenomena (tax evasion and tax avoidance methods) and estimation of the

amount of taxes lost due to each phenomenon (tax gap) – is especially important both from the scientific and practical points of view. Results of such research contribute to a better understanding of undeclared work in its full capacity. Detailed results of the empirical research may be utilized for strategic decision-making in order to achieve a streamlined choice of measures for reduction of undeclared work and increase of expedience of preventive programmes.

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