

# The effectiveness of amnesties in contrasting firms' tax evasion. \*

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## Abstract

In this paper we investigate the effects of temporary amnesties aiming at reducing the underground economy. We consider a tax evading firm operating simultaneously both in the regular and in the underground economy, that is the *moonlighting firm*. The reputation of policy makers in contrasting the underground economy turns out to be strategic for the success of the intervention. We show that the government's credibility in rising enforcement is the crucial issue to determine the size of regular production. Moreover, a trade-off arises between regularity and capital accumulation: a credible enforcement program sharply reduces underground production, but it also causes a fall in capital accumulation, while a simple amnesty moderately rise regularity and also spoors capital accumulation.

Keywords: underground economy, tax evasion, fiscal amnesty, moonlighting.

JEL classification: H26, E26, D21, H25.

## 1 Introduction

The aim of this paper is to assess the effects of the amnesties on the decision of the firms to act in the underground sector.

The general idea is that underground firms choose to be irregular because they are inefficient, so that they tend to squeeze costs by tax evasion. We model amnesties as a temporary production subsidy in order to investigate whether, in presence of tax-evasion, this policy can be an effective tool to reduce the underground economy.<sup>1</sup>

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<sup>1</sup>To keep the model simple a fruitful way to look at the amnesties is to assume that these do not involve the unreported past revenues, but only the tax reduction on current revenues and the relative lump sum payment is equivalent to a tax reduction on production.

We consider a *ghost* firm who decide to partially comply with the amnesty, adopting the technology of the so defined *moonlighting* firm.<sup>2</sup> This technology allows the firm to operate simultaneously in two sectors, the regular and the irregular one, using the same stock of capital and evading taxation in the irregular sector. We find that the role of the policy maker, in particular its reputation in enforcement, is the crucial element to guarantee the success of such policies. However, this produces a policy puzzle generating a "perverse income effect". Enforcement and fiscal amnesties encourages compliance but they shrink activities under the ground reducing wealth. In a context characterized by underground production and low government reputation, which distinguishes, for instance, most areas of the European countries, the announcement of an extra-ordinary amnesty to induce tax compliance may generate lower outcomes than expected.

The structure of the paper is organized as follow. Section 2 provides some stylized facts and defines the motivations of the paper. Section 3 explains the firm maximizing problem and characterizes the long run equilibrium. In section 4 we calibrate and simulate the model; the main results of policy analysis are reported and commented. Finally, section 5 concludes the article.

## 2 Stylized Facts and Motivation of the Paper

Tax amnesties are not unusual in industrialized countries; several European as well as US governments have adopted these programs, because they raise large amount of money that fiscal authorities would otherwise have found difficult or impossible to capture (Leonard and Zeckhauser, 1987; Bordignon, 2002). Moreover, amnesties are a very attractive tool when governments face considerable budget deficits in presence of a sizeable underground wealth. By contrast, depending on the structure of the amnesty program and on the perceived likelihood of repetition, tax amnesties may spoor tax evasion. It is then crucial that amnesties programs are coupled to credible and stricter enforcement regimes, also when amnesties are given to allow the transition to a new fiscal regime.

In Italy there is a long tradition of tax amnesties, always presented as a tool to contrast the underground economy and fiscal evasion. In the last decades, the introduction, by means of the Financial Act, of various forms of amnesties, was always matched to stricter enforcement announcements. In some cases, amnesties were introduced as a necessary and advisable policy to smooth the transition to a new tax system.

The frequent reiteration of amnesties (1982, 1991, 1994, 2002) is certainly a tough stroke to government credibility, which can cause perverse effects, demanding for an attentive evaluation about the typology of policies able to con-

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<sup>2</sup>In tax evasion literature ghost are firms of whom no official record exists. They evade all the production and are completely unknown to fiscal authorities; by contrast, moonlighting firms only partially escape to fiscal obligations (See Cowell, 1990). In this paper we further characterize the moonlighting firm's technology, following the framework adopted in Busato et al. (2005).

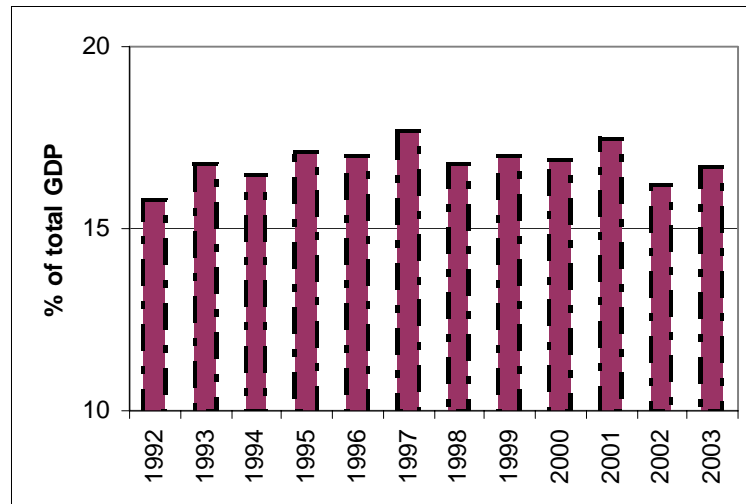


Figure 1: The size of the Italian Underground Economy as a share of total GDP (Istat, 2005)

trast the underground economy. Underground economy is a widespread phenomenon in Italy, as assessed by estimates of the National Statistical Office (ISTAT, 2005) shown in Figure 1. The size of the underground economy in 2003 is about 16% of total GDP, and its dynamic was not affected by the most recent fiscal amnesties (1994 and 2002), which did not sort the expected effect of reducing tax evasion.

A further interesting feature of the underground sector is that the Italian firms which operate in these activities are mostly moonlighters, as suggested by a recent survey by Censis (2005), whose main evidence is shown in Table 1.<sup>3</sup>

Table 1: Irregular firms as a % of the total firms

Irregular Firms	North-West	North-East	Center	South	Italy
2005					
Ghost Firms	5.8	4.9	6.8	16.8	9.7
Moonlighting Firms	29.7	31.3	41.7	59.9	43.4
Total	35.5	36.2	48.5	76.7	53.1

Authors' elaboration based upon Censis (2005).

This empirical evidence may lead to an additional explanation of the weak success of the fiscal amnesties; below, we show that this evidence is coherent with our analysis, which is also able to explain the persistence of a high underground economy size with the frequent introduction of amnesty programs .

<sup>3</sup>The survey realized by Censis (Centre for Social Studies and Policies) is based on a qualitative methodology, that is the interview to privileged witness.

### 3 The Moonlighting Firm

In our model there is a unique homogenous good which can be produced using two different technologies, the regular technology and the underground one; regular production is taxed while underground production is not declared to Internal Revenue Service.<sup>4</sup> Each firm can decide to specialize into regular production (regular firm), underground production (ghost firm) or both:

$$Y_R = AK^a; Y_U = BK^a; Y_M = Y_R + Y_U.$$

where  $a$  represents the elasticity of capital stocks and  $K$  is the total capital stock.<sup>5</sup> The two sectors use identical technologies with the exception of the two scaling factors  $A$  and  $B$ ; we assume that from the perspective of a firm operating in a single sector the two parameters,  $A$  and  $B$  are taken as positive constant, while for a firm operating simultaneously in the two sectors (moonlighting)  $B$  is a function of the total use of capital, the moonlighting effect:

$$B = K^{a\sigma}.$$

The parameter  $\sigma$  represent the entity of the scale economies generated by the simultaneous implementation of the regular and underground technology. Letting  $\mu$  and  $(1 - \mu)$  denote the share of capital allocated to the regular, (underground) sector, we can describe the output of the moonlighting firm as follows:

$$Y = Y_R + Y_U = A(\mu K)^a + B(1 - \mu)^a K^{a(1+\sigma)}. \quad (1)$$

The firm behaves as a partial tax-evader, in fact it complies with fiscal law only for the market production. The institutional side of the model is defined by the triplet  $\{\rho, \tau, s\}$ , where  $\tau$  defines a proportional tax rate to be levied on output,  $s$  represents a surcharge factor ( $s > 1$ ) levied on the tax rate if a firm is detected evading; finally,  $\rho$  is the probability that a firm is detected and convicted of evasion.<sup>6</sup>

Under tax evasion firm's revenues read:

$$\begin{array}{l} \overline{REV_j} \rightarrow \begin{array}{l} \text{Detected} \\ \sim(\rho) \end{array} \quad REV_D = (1 - \tau)Y_M + (1 - \tau s)Y_U \\ \searrow \\ \text{Not Detected} \\ \sim(1-\rho) \quad REV_{ND} = (1 - \tau)Y_M + Y_U \end{array}$$

<sup>4</sup>We are not considering a "pure tax evasion" model but tax evasion associated to participation in the underground economy (see Kesselman, 1997).

<sup>5</sup>Since both sector produce the same commodity, the capital elasticities are assumed to be identical. To simplify the analysis we are considering a single factor technology which employs only capital; this is tantamount to a constant returns of scale technology, with capital and labour inputs: in this case, output as well as capital would be measured per unit of employee.

<sup>6</sup>The tax evasion model with endogenous income is quite standard (Cowell, 1990), Busato and Chiarini (2004).

and the expected revenues are:

$$E(R) = (1 - \tau)Y_M + (1 - \rho\tau s)Y_U.$$

To allow the existence of both productions we assume that the following assumptions hold:<sup>7</sup>

**Remark 1**  $s \geq 1$  and  $\rho s \leq (1 - \rho)$ .

Remark 1 states that the surcharge must be higher than unity, and that the expected surcharge must be lower than the threshold  $(1 - \rho)$ , otherwise the expected return to a unit of evaded production,  $(1 - \rho)\tau - \rho\tau s$ , would be negative, so that the agent would have no convenience to act in the underground sector.

Next, Remark 2 below suggests that the size of external effect in irregular technology should be sufficiently low to not imply increasing returns of scale:

**Remark 2**  $0 < \sigma < \frac{1-a}{a}$ .

The restriction on the size of the external effect  $\sigma$ , and, consequently, the exclusion of any sort of increasing returns of scale, is a necessary assumption to allow the moonlighting firm choosing an optimal size of capital dimension, capturing the positive interaction between regular and irregular production.

### 3.1 Moonlighting and underground-reducing policies

In order to push the firms to go “above the ground”, the government may announce a fiscal amnesty for ghost firms, setting a deadline to comply, and in the meanwhile announcing a rise in enforcement policies. Firms have to decide either *if* to comply, and, if so, the *intensity* of compliance.

We focus the attention on complying firms who decide to engage in moonlighting activities. Such a decision allows the earlier ghost firms to exploit the technological advantage of moonlighting ( $\sigma > 0$ ), and in the meanwhile to get fiscal facilities given by the amnesty. Firms compare the expected fiscal benefits of amnesties (tax\ penalty reduction) with the expected costs (tax compliance).<sup>8</sup>

<sup>7</sup>It is possible to demonstrate that the revenue function is concave.

<sup>8</sup>In a recent research, the CER (CER, 2001, Cer is a research institute in applied economic analysis for European and Italian economic policy) simulated, with a simple model and plausible calibration, the expected effects of the amnesty given in 2001 by law n. 383 to contrast undeclared work. They found that the cost/benefit analysis was very heavy for complying firms, who needed a large growth of their production to keep an acceptable revenue after deciding to go over the ground. In such a situation, the option of moonlighting generates an additional benefit (the moonlighting effect) in the meanwhile reducing expected costs (there is still evasion) so that compliance is certainly more convenient. Nonetheless, a vicious circle occurs: amnesties' success may be risen by moonlighting but moonlighting generates a more persistent underground economy. This vicious circle could be broken by a credible enforcement policy.

When the amnesty program is announced, the agents correct their expectation about the level of enforcement,  $\rho$ , and they evaluate the size of the financial benefit announced on the additional declared revenue. Amnesties usually offer a tax reduction on current additional declared revenues and oblige to a lump sum payment (penalty) on the past evaded revenues. The amount of penalty is sometimes proportional to past declared revenues, even though in some cases it is completely absent. Moreover, some recent laws aiming to contrast irregular jobs, offered fiscal facilities for a extended time.

In order to simplify our analysis, we assume that no penalty on past revenues is announced. Therefore, when firms consider whether to comply with the amnesty, they will take into account the rise in enforcement as well as the tax reduction on the declared revenues. We model the amnesty with the following concave function:<sup>9</sup>

$$g(Y^{reg}) = \alpha (\mu K)^a; \quad 0 < \alpha < 1; \quad g' > 0; \quad g'' < 0.$$

As we will show in the next section, the effect of the amnesty on capital's regular utilization is amplified by the government credibility:

Enforcement Policy:	$\Delta\rho > 0$ credible	→	sharp rise in $\mu$
	$\Delta\rho > 0$ not credible	→	moderate rise in $\mu$

Each instant a firm maximizes the intertemporal cash-flow function, deciding how much resources to allocate to the regular production,  $\mu$ , and how much revenue to invest,  $I$ . The value of the firm is the expected present value of its revenues minus expenditures on capital input. The representative firm maximizes expected cash flow  $\mathcal{V}$  subject to a series constraints (listed below):

$$\max_{\{I, \mu\}} \mathcal{V} = \int_{t=0}^{\infty} e^{-rt} \Pi dt \quad (2)$$

$$s.to : \Pi = (1 - \tau)A(\mu K)^a + (1 - \rho\tau s)(1 - \mu)^a K^{a(1+\sigma)} - I - I^b + \alpha (\mu K)^a$$

$$: \dot{K} = I - \delta K \quad (3)$$

$$: 0 \leq \mu \leq 1$$

$$: \bar{K}_0 > 0 \quad (4)$$

$$: \lim_{t \rightarrow \infty} \phi_0 K = 0 \quad (5)$$

$$: \alpha \in (0, 1); s \geq 1; \rho s \leq (1 - \rho); 0 \leq \tau \leq 1; 0 < \sigma < \frac{1-a}{a}.$$

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<sup>9</sup>Such a policy is similar to a tax credit or a facilitated fiscal regime.

The quantity  $(1 - \tau)A(\mu K)^a + (1 - \rho\tau s)(1 - \mu)^a K^{a(1+\sigma)}$  represents firm's expected revenues, net of expected taxation,  $I$  is the amount of gross investment; capital is subject to physical depreciation at rate  $\delta$ . Investing is a costly process for firms; the assumption here adopted is that the adjustment costs are a convex function of the rate of change of the capital stock:  $C(I) = I^b; b > 1$ . Amnesty allows moonlighting firm to benefit of a fiscal facility whose size is a fixed proportion,  $\alpha$ , of the declared output.

Defining  $\phi_0$ ,  $\phi_1$ , and  $\phi_2$  Lagrange multipliers, the current value Hamiltonian  $\mathcal{H}$  provides the following dynamical system:<sup>10</sup>

$$\begin{aligned}\dot{\phi}_0 &= (r + \delta)\phi_0 - [(1 - \tau)aA + a\alpha](\mu^*)^a K^{a-1} - (1 - \rho\tau s)[1 - \mu^*]^a a(1 + \sigma)K^{a(1+\sigma)} \\ \dot{K} &= I(\phi_0) - \delta K.\end{aligned}\tag{7}$$

The first condition states that the marginal revenue of capital equals its user cost,  $(r + \delta)\phi_0 - \dot{\phi}_0$ ; the second condition implies that  $K$  is increasing when  $\phi_0$  is so higher than the marginal cost of capital,  $I$ , to achieve a level of net investment larger than physical depreciation of capital,  $\delta K$ . Moreover, using first order conditions, we also characterize the short run equilibrium relationship between total capital and its regular use:

$$\mu^* = \mu(K) = \frac{K^{\frac{a\sigma}{a-1}} \left( \frac{(1-\rho\tau s)}{(1-\tau)A+\alpha} \right)^{\frac{1}{a-1}}}{1 + K^{\frac{a\sigma}{a-1}} \left( \frac{(1-\rho\tau s)a}{(1-\tau)A+\alpha} \right)^{\frac{1}{a-1}}} \equiv \frac{CK^d}{1 + CK^d}.\tag{8}$$

The Steady state ( $\dot{\phi}_0 = \dot{K} = 0$ ) is characterized, respectively, by the two equations:

$$\begin{cases} \phi_0 = \frac{1}{(r+\delta)} [(1 - \tau)aA(\mu^*)^a K^{a-1} + a\alpha(\mu^*)^a K^{a-1} + (1 - \rho\tau s)(1 - \mu^*)^a a(1 + \sigma)K^{a(1+\sigma)-1}] \\ I(\phi_0) = \delta K \end{cases}\tag{9}$$

The first equation tells us that in equilibrium (long run) the shadow price of capital is the discounted value of the net-of-tax marginal productivity of capital; the second condition states that the stock of capital is stable when investment is just equal to physical depreciation of capital. Marginal productivity of capital is affected by fiscal policy not only through taxation, but also through the incentives to regular production.

## 4 Parameters Calibration and Policy Simulations

The model depends on five parameters: the capital elasticity  $a$ , which, coherently with standard literature, is set at the value 0.3; the exogenous discount

<sup>10</sup>A complete derivation of the first order conditions is available upon request.

rate,  $r$ , set to the value 0.025; the rate of physical depreciation of capital,  $\delta$ , calibrated to 0.125. The technological parameters  $A$  and  $\sigma$ , are set, respectively to the value 1 and 0.5 to depict the evidence that ghost firms are usually small sized firms.

Next, the tax rate,  $\tau$ , is set to 0.4 to match the average high level of direct taxation in Italy in recent years. The surcharge applied to tax evaders,  $s$ , following the Italian civil law, is set to 1.3 and the probability to be caught when cheating the government,  $\rho$ , is set to a very low value, 0.05, to give an idea of low enforcement, which can be assimilated to the Italian actual conditions. As described above, we are assuming that the fiscal amnesty do not involve penalty on past revenues but is a government tax reduction on current additional declared revenues. We set this parameter,  $\alpha$ , equal to half of the official tax rate, e.g. 20%. Of course, this is very hard to say, but it is useful to investigate the policy implications of the baseline calibration. The amnesty is announced along with a rise in enforcement,  $\rho$ , from 0.05 to 0.3.<sup>11</sup>

Table 2: The calibrated parameters

$\alpha$	$A$	$\tau$	$\sigma$	$r$	$\rho$	$s$	$a$	$\delta$
0.20	1	0.4	0.5	0.025	0.05/0.3	1.3	0.3	0.125

The two steady state relations can be represented in the space  $(K, \phi_0)$ ; the first one describes a negative shaped and convex curve: larger amount of capital reduce its marginal productivity, so that in equilibrium a lower value for the shadow price for capital is commanded (see left panel of **Figure 2**).

In coherence with standard literature on investment function (Summers, 1981), the locus  $\dot{K} = 0$  is displayed as an increasing relationship in the space  $(K, \phi_0)$ : larger amount of capital implies larger amount of physical depreciation, so that investment must increase to keep unchanged the capital stock; given the investment function, it implies an higher shadow price of capital. In the right panel of **Figure 2** it is represented, in the space  $(\mu, K)$ , the relationship between the share of capital stock allocated in the regular sector and the total amount of capital stock defined by Equation 14: for each level of  $K$  identified by the solution of the dynamical system of Eqs 17-18, a unique cash-flow maximizing value of  $\mu$  is identified.<sup>12</sup>

<sup>11</sup>For a detailed calibration analysis of these parameters, see Busato and Chiarini. (2004).

<sup>12</sup>The Jacobian of the system of Eqs. 13 and 14 evaluated at the steady state is:

$$\begin{bmatrix} r + \delta & -\partial^2 \Pi / \partial^2 K \\ \partial I / \partial \phi_0 & -\delta \end{bmatrix}$$

and it has a trace and a determinant given by:

$$TR = r; DET = -\delta(r + \delta) + \partial I / \partial \phi_0 (\partial^2 \Pi / \partial^2 K).$$

Local stability, and in particular saddle path stability, requires that the the trace should be positive, while the determinant should be negative, when evaluated at the steady state. Under our parametrization it implies that the condition  $\partial^2 \Pi / \partial^2 K < 0$ , which is the necessary condition to get a concave objective function, is also a sufficient condition to get saddle path stability.

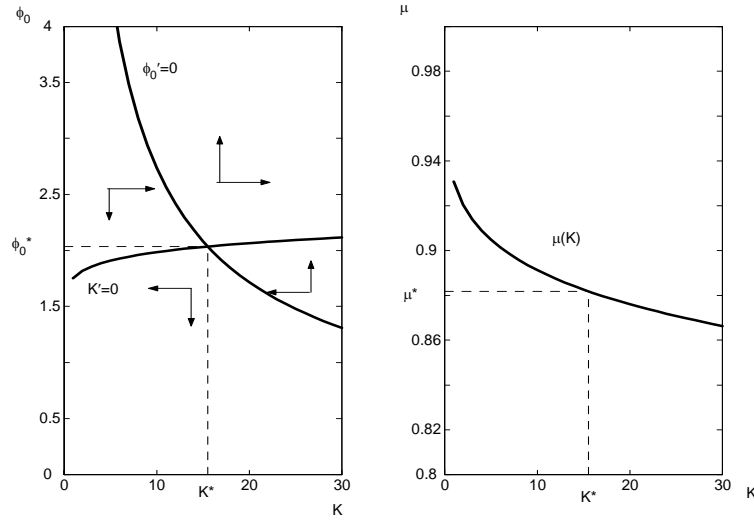


Figure 2: Coherently with q-theory, the locus  $\dot{K} = 0$  is an increasing curve in the space  $(\phi_0, K)$ , while the locus  $\phi_0 = 0$  is negatively sloped.

#### 4.1 The impact of amnesty's credibility

Since firms have rational expectations about fiscal authorities controls  $\rho$ , when government announces an incentive to production associated to a rise in enforcement, e.g.  $\Delta\rho > 0$ , firms will adjust their expectations and will choose how much capital to declare conditional to government reputation. When government is credible, the announced policy aiming at reducing the underground production will induce firms complying with the amnesty to rise the rate of expected fiscal controls,  $\rho$ , while government's low reputation will leave unchanged firm's expectations. These two different attitudes, generates different effects of the announced amnesty, depicted in **Figure 3**.

In the Figure 3 we consider the impact of the depicted policy on a small firm, adopting an unitary productive scale. The two equilibria are both saddle path; when the amnesty is associated to a good government's reputation, it produces a sharper rise in the level of regularity with respect to a not credible enforcement's rise. Nonetheless, a trade -off arises: when agents do not correct their expectations, that is when government's enforcement rise is not credible, the total capital stock is bigger than in case of a stricter enforcement. This aspect leads to challenging policy implications.

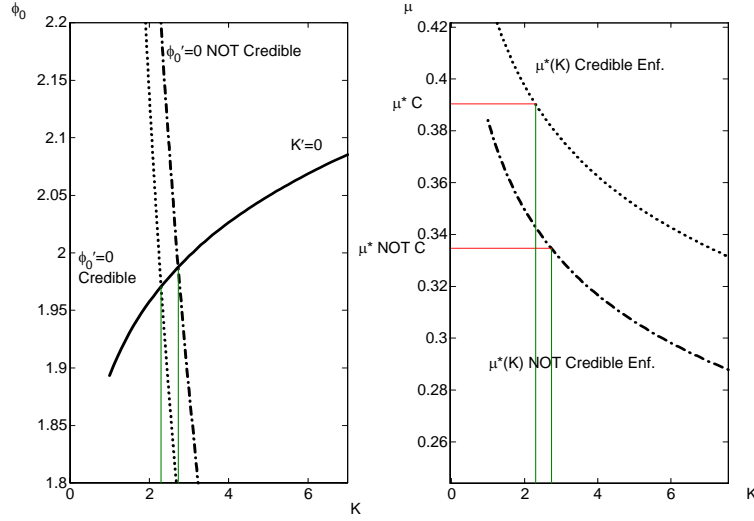


Figure 3: the credible (not credible) policy generates a lower (higher)  $\dot{\phi}_0 = 0$  curve, while the  $\mu(K)$  curve is higher under credible enforcement programs. The long run equilibrium is characterized by an higher capital's regular utilization when the policy is credible.

## 4.2 The trade off between capital accumulation and regularity

So far we have modelled amnesties as a policy realized through fiscal facilities and stricter enforcement, but assuming that government doesn't commit to the announce of a rise in enforcement. Under these assumptions, and considering a ghost firm who chooses to get into moonlighting, the amnesty always induces a rise in regularity, even though the intensity of this change and its impact on the total capital stock need some further explanations. The evidence depicted in Figure 3 indicates that government's credibility increases compliance, while it reduces capital accumulation.

The firm behavior can be traced back to two motivations. The first focuses on the investment decision. The idea is that while the fiscal facility raises the marginal revenue of regular capital, so that it is convenient to invest, the rise in enforcement lowers the expected capital marginal productivity through the irregular side of production (see Eq. 6), so that capital accumulation responds to two different and contrasting shocks. This trade-off explains why when firms do not revise their expectations about enforcement, the total amount of capital is higher. The second motivation of the firm behavior rests on the allocation of capital between the two productions. It can be shown that Eq. 7 implicitly ensures the optimal allocation of capital between the regular and underground production: the marginal effect of a capital reallocation on its net-of-tax produc-

tivity in the two sectors must be equal. As just explained, while the amnesty rises the expected capital marginal productivity in the regular production, a credible enforcement also reduces the irregular productivity, so that firms will find it optimal to enhance the relative capital employed in the regular production when government's reputation is strong.

### 4.3 Policy implications

Three main policy lessons can be suggested by the present analysis.

First, since an amnesty may seem to represent a relaxation of tax enforcement, it should necessarily be linked with a credible system of enforcement.

Second, when small firms account for a large part of the underground economy, amnesties may employ a long time to achieve the goal of reducing the underground production. Actually, as Figure 3 well shows, even in the very favorable situation here considered, the most effective policy only guarantee a share of regularity which is lower than 50%.

Finally, it is important to highlight that the trade-off between capital accumulation and regularity has a consequence also on total welfare. Indeed, the two equilibria shown in Figure 3 generates two different levels of total production, and the most favourable situation occurs when stricter enforcement is not credible. Amnesties to be a policy tool for stamping out evasion necessitates enforcement but a high enforcement is welfare reducing. This is a very critical policy issue, which gives rise to a crucial element for time consistency and call for an attentive evaluation of the policy makers' preferences: government commitment against underground economy can be offset by the knowledge of its recessive implications.

## 5 Conclusions

In this paper we have examined the effect of amnesties on tax evasion and capital accumulation, in presence of small irregular firms.

Starting from a very favorable framework for the amnesty program, e.g. considering firms willing to comply with the amnesty, we have stressed that when underground economy is ruled by moonlighting firms, the role of government credibility turns out to be the strategic issue to ascertain the efficacy of the policy. In fact, government commitment in applying a strict enforcement, largely enhances the fall in underground production; nonetheless, a trade off arises between underground reduction and capital accumulation, since a strict enforcement also reduces the capital accumulation.

Moreover, the paper shows that when underground economy is ruled by small firms, and if they find a specific convenience to stay underground by adopting the moonlighting structure, then the success of the amnesty is short lived. In fact, the share of regularity tend to persist on very low level. This helps in understanding the Italian evidence, which shows a large share of the underground economy in presence of repeated fiscal amnesties.

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