

Shadow Economy and its Impact on Tax Revenues in Mojokerto City

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ABSTRACT

This study aims to empirically study the effects of the allocation, distribution, and stabilization variables on the shadow economy and their impact on tax revenues. This research is descriptive-explorative and explanatory research. The research location is at the PKL Center, Jl. Fort Pancasila City of Mojokerto. The population of 369 with the Slovin tolerance formula of 0.01 was determined as a sample of 79 respondents. Data collection uses a questionnaire; data analysis is assisted by SmartPLS software version 3.3.7. The results show: 1) Allocations have a significant effect on the shadow economy; 2) Distribution has a significant effect on the shadow economy; 3) Stabilization has no effect on the shadow economy; 4) Allocations do not affect tax revenues; 5) Distribution has a significant effect on tax revenues; 6) Stabilization has a significant effect on tax revenues; 7) Shadow economy has a significant effect on tax revenues; 8) Allocations have an indirect effect on tax revenues through the shadow economy; 9) Distribution has an indirect effect on tax revenues through the shadow economy; 10) Stabilization has an indirect effect on tax revenues through the shadow economy.

Keywords: *allocation; distribution; stabilization; shadow; taxes*

ABSTRAK

Penelitian ini bertujuan untuk mempelajari secara empirik pengaruh dari variabel alokasi, distribusi, dan stabilisasi terhadap shadow economy dan dampaknya terhadap penerimaan pajak. Penelitian ini merupakan penelitian deskriptif-eksploratif dan explanatory. Lokasi penelitian di sentra PKL Jl. Benteng Pancasila Kota Mojokerto. Populasi sejumlah 369 dengan rumus Slovin toleransi 0,01 ditetapkan sampel 79 responden. Pengumpulan data menggunakan angket, analisis data dibantu software SmartPLS versi 3.3.7. Hasil menunjukkan: 1) Alokasi berpengaruh signifikan terhadap shadow economy; 2) Distribusi berpengaruh signifikan terhadap shadow economy; 3) Stabilisasi tidak berpengaruh terhadap shadow economy; 4) Alokasi tidak berpengaruh terhadap penerimaan pajak; 5) Distribusi berpengaruh signifikan terhadap penerimaan pajak; 6) Stabilisasi berpengaruh signifikan terhadap penerimaan pajak; 7) Shadow economy berpengaruh signifikan terhadap penerimaan pajak; 8) Alokasi berpengaruh secara tidak langsung terhadap penerimaan pajak melalui shadow economy; 9) Distribusi berpengaruh secara tidak langsung terhadap penerimaan pajak melalui shadow economy; 10) Stabilisasi berpengaruh secara tidak langsung terhadap penerimaan pajak melalui shadow economy.

Kata Kunci: *alokasi; distribusi; stabilisasi; shadow; pajak*

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1. INTRODUCTION

The goal of the state, as stated in its constitution, is to realize social justice (Sudiantara, 2021). A relatively large amount of funding is required (Ayza, 2016). Therefore, state revenue is used as operational financing (Fajarudin, 2019) for the welfare of the people (Furqon et al., 2022). The largest state revenue is tax (Firdausy, 2021), so the role of tax is proportional and positively correlates with the development and progress of a country in terms of the economy (Sutawijaya, 2010).

The fact of tax structure reform is difficult to carry out. It burdens the ability of the tax (Poitras, 2020) itself, especially the hard-to-tax sector (Suharno, 2021) in addition to the lack of commitment and resistance from political forces (Subroto, 2019), the informal sector (agriculture and fisheries) (Rivai, 2019), private individual Usaha Mikro Kecil dan Menengah (UMKM) actors (Murtadho et al., 2022), rich people, related to income and wealth from criminal activity (Poitras, 2020).

Consumption plays an important role and greatly affects the stability of a country's economic activity (Ichvani & Sasana, 2019). The higher the level of consumption, the higher the economic activity and the change in the national income of a country (Mankiw, 2007). However, currently, we are faced with a decline in the portion of realized household consumption to GDP (Saputra et al., 2020). From 2014 to 2018, the average contribution of household consumption to GDP was 56.15 percent (Kusnadi & Utomo, 2022). From 2019 to 2021, the average contribution of household consumption to GDP is 56.2 percent. In detail, in 2019, it was 56.63 percent. In 2020 it rose to 57.65 percent, and in 2021 it fell to 54.42 percent. Entering the first quarter of 2022, the contribution of household consumption to GDP fell to 53.65 percent. The decline continued in the second quarter/2022 to 51.47 percent, until it was even lower in the third quarter/2022 (Pangestu, 2022). The Indonesian economy is currently heavily burdened by the shadow economy; 36.7 million people are involved in it (Schneider, 2012) or are in the range of 8.3 percent to 10 percent of Gross domestic product (GDP). If we use 2018 data as a reference, Indonesia's GDP is recorded at IDR 14,837 trillion, then Indonesia's shadow economy reaches IDR 1,400 trillion (Mohamad, 2020).



Figure 1 Rate of household consumption expenditure to GDP (Y-o-Y)

Source: BPS on www.ekonomi.bisnis.com

The strong influence of direct and indirect taxation on the shadow economy will be further demonstrated by showing empirical results in the case of Austria and the Scandinavian countries. In the Austrian case, whereas as a driving force for shadow economy *activities*, the direct tax burden (including social security payments) has the greatest influence, followed by regulatory intensity and complexity of the taxation system. Indonesia, with large economic characteristics (Andrews et al., 2011) faces this problem severely, where the size of the shadow economy averages 37.4%, and the average tax evasion causes Indonesia to lose revenues of US\$ 11 million per year (Fitria & Wahyudi, 2022). Overall, direct tax reduction is an efficient policy measure for reducing the effects of the shadow economy and stimulating the official economy. This fact leads to the fatal result that almost everyone feels discriminated against by the tax system (Dimuk & Ahmad, 2018).

As of 23 December 2020, tax receipts reached IDR 1,019.56 trillion, equivalent to 85.65 percent of the State Revenue and Expenditure Budget's (APBN) target. The target is lower than the actual tax revenue as of 30 November 2019, amounting to IDR 1,312.4 trillion (Fatimah, 2020). Mojokerto, one of the cities in the East Java region, has also experienced a decline in tax revenues until, as of October 2021 reached 84.24% of the target of IDR 50.34 billion, which was only IDR 42.575 billion (Maarif, 2021). The condition reflects the potential influence of the shadow economy on tax revenues.

APBN is the main tool and instrument in implementing fiscal policy and, at the same time, serves as a guideline for budgeting in the context of implementing development in Indonesia. There are three main functions of fiscal policy: the allocation function, the distribution function, and the stabilization function. In Law Number

17 of 2003 concerning State Finance, it is explained that the allocation function of the APBN implies the state budget must be directed at reducing unemployment and wasting resources, as well as increasing the efficiency and effectiveness of the economy (Aziz, 2013). The distribution function implies that state budget policies must pay attention to a sense of fairness and decency (Rivai, 2019). The stabilization function implies that the government's budget becomes a tool to maintain and strive for a balance of economic fundamentals (Kurniawan, 2022; Sukwiaty et al., 2009). Given the strategic fiscal policy, the APBN, the main tool in implementing the fiscal policy, must be maintained to remain sustainable (Aziz, 2013).

In Mojokerto, such as districts/cities throughout Indonesia, the shadow economy on the allocation function impact on tax revenues. This is in line with research Kodila-Tedika & Mutascu (2014), which reveals that the shadow economy has a significant and negative impact on tax revenues. In other words, when the shadow economy tends to expand, the level of tax revenues decreases. On the other hand, Belev (2003) states that illegal work can be a source of allocation distortion because resources and production factors are not used most efficiently.

Regarding the distribution function in Mojokerto, Araujo & Rodrigues, (2016) argues that the distributional policy of taxation changes, apart from efficiency gains, increases in labor taxes exacerbate income inequality, increasing the shadow economy. Albu, (2007) simulates implicitly assuming the same distribution of the entire population with formal income as in the case of sample A. On the other hand, in sample A, one can find a subsample B which only consists of households earning informal income. Mazhar & Jafri, (2017) research using large data sets from 122 countries over the period 1999 to 2007 found that the well-established negative correlation between political stability and inflation holds if the size of the shadow economy remains modest; it no longer exists at the higher levels of the informal sector measure. The stabilization function implies that the government's budget becomes a tool to maintain and strive for a balance of economic fundamentals (Kurniawan, 2022). Concerning the stabilization function, research by Ilin et al., (2021) states that the shadow economy is a

positive factor because it helps solve several complex socio-economic problems in the country. However, on the other hand, the size of the shadow economy in the country's GDP is very large and threatens national security.

Campodonico et al., (2016) research results stated that If tax consumption is adequate, it will achieve optimal social outcomes without adverse selection. However, if it is necessary to reduce tax consumption, the government will seek a second-best solution which may include adverse selection. The goal is to achieve a sufficient increase in net worth to avoid the adverse effects of selection without imposing excessive profit taxes. The research by Feiock, (1986) states that although service benefits (especially expenditures) tend to be distributed evenly among urban sub-regions, the distribution of tax benefits is regressive. Research results from Kodila-Tedika & Mutascu, (2014) show that the shadow economy significantly and negatively impacts tax revenues. In other words, the tax revenue level decreases when the shadow economy expands.

Several important considerations drive the selection of research locations in Mojokerto for studying tax revenues. Firstly, it allows for analyzing factors that have led to a decline in tax revenues across various districts and cities in Indonesia over the past five years. Secondly, each region has unique characteristics, dynamics, and local policies. By researching Mojokerto, we can uncover specific factors contributing to the decrease in tax revenue, which may need to be present in other regions. This understanding is crucial for providing relevant recommendations to enhance tax policies and practices at the regional level.

Many scientific controversies and political discussions arise because of different or unsatisfactory definitions of the shadow economy.

It is necessary to clarify the term in each context (Schneider & Enste, 2013). "Shadow economy" includes all economic activities that are not recorded in official statistics and therefore are not touched by government regulations and tax obligations (Evers & Korff, 2002). 'Soft' illicit activities ('moonlighting'), and illegal work and social deception, and criminal economic activity (Schneider & Enste, 2013). There are three contrasting explanations for the shadow economy

(Williams, 2014): modernization theory, neoliberal theory, and Political economy theory.

Extensification is achieved through expansion, both tax objects and subjects (Pohan, 2021), while intensification is achieved through increasing compliance with existing tax subjects (Hidayat, 2013). Tax collection is implemented by the state based on several theories, although the problem is reduced to using the state's existing capacity for tax collection (Enevoldsen, 2005). These theories are insurance theory, interest theory, bearing power theory, and the basic theory of purchasing power.

This research addresses several research gaps. Firstly, it fills the gap in the literature by focusing specifically on the shadow economy in Mojokerto, which has yet to receive much attention in previous studies. It aims to provide a comprehensive understanding of the city's shadow economy. Secondly, it contributes to the existing literature by examining the specific impact of the shadow economy on tax revenues in Mojokerto. This detailed analysis will enhance our understanding of how the shadow economy affects local tax revenues in the city. Lastly, it addresses the need for more information on the policies and strategies implemented by Mojokerto to tackle the shadow economy issue. The research presents an opportunity to evaluate the effectiveness and sustainability of existing policies and strategies in addressing the shadow economy in Mojokerto.

This study aims to understand the extent of the shadow economy in Mojokerto, its characteristics, and its negative impact on local tax revenues. In addition, this study will analyze the consequences of the shadow economy on economic welfare by considering factors such as allocation, distribution, stabilization, and the relationship between tax increases, economic growth, business cycles, and employment in the context of the shadow economy.

2. LITERATURE REVIEW

a. Shadow Economy based on three theories

Many scientific controversies and political discussions arise because of different or unsatisfactory definitions of the *shadow economy*. It is necessary to clarify the term in each context (Schneider & Enste, 2013). "*Shadow economy*" includes all economic activities not recorded in official statistics and therefore are not touched by government

regulations and tax obligations (Evers & Korff, 2002). Such as 'soft' illicit activities ('moonlighting'), illegal work and social deception, and criminal economic activities (Schneider & Enste, 2013). There are three contrasting explanations for the shadow economy (Marcelliis *et al.*, 2010; Williams, 2014).

Modernization Theory

Modernization theory states that the shadow economy declines with economic development (Williams, 2014). The public believes the declared economy is constantly developing, and the shadow economy is a remnant of the pre-modern era, which is gradually disappearing as the modern economy becomes more and more dominant (Williams & Nadin, 2011). From this lens, the shadow economy is a traditional pre-modern sector representing traditionalism and underdevelopment, whereas the emerging modern economy expresses signals of 'progress,' and 'development' (Williams, 2014).

Neo-Liberal Theory

The neoliberal theory argues that the shadow economy directly results from high taxes, public sector corruption, and state interference in free markets (Williams, 2014). This theory contrasts with the modernization theory, in which state regulation is the main cause of increased informal employment (Marcelliis *et al.*, 2010). The existence of the informal employment sector is explained by overregulation (Fatnawati, 2013), strong state intervention in the economy through the labor market (Sugiri, 2020), tax policies, and social security contributions (Marcelliis *et al.*, 2010).

Political Economy Theory

The political economy theory explains its pervasiveness as the product of inadequate levels of state intervention in employment and well-being that leave workers unprotected (Williams, 2014). The difficulty is radical and contradicts the perspective of economics and politics. First (the non-Marxian version) places more emphasis on the market. Second, forces where the assumptions and logic of economic work are not easily accommodated, except as "externalities," the phenomenon of coercive forces, since it relies on individually selected axioms, political science

cannot readily accept economic deductive procedures (Nurjaman, 2020).

b. Tax Collection

Concerning the budgetary function, the government always strives to increase state revenues through the extensification and intensifying tax collection (Hidayat, 2013; Supramono & Damayanti, 2010). Extensification is achieved through expansion, both tax objects and subjects (Pohan, 2021), while intensification is achieved through increasing compliance with existing tax subjects (Hidayat, 2013). Tax collection considers four (4) concepts:

Insurance

The tax authorities (tax apparatus) have the right to collect taxes from residents (the state is considered synonymous with insurance companies), and the taxpayer is the insured who is obliged to pay the premium (Nurmantu, 2005) as protection for the person concerned for his safety and property. However, there is no reward if the insured (taxpayer) suffers the risk. Because as a matter of fact, the state has never given compensation money to taxpayers who have been hit by a disaster (Taufik, 2022). Insurance stresses the fairness and legality of tax collection, comparable to insurance agreements. The state protects its citizens by ensuring the safety and security of their lives and property in exchange for taxes. However, equating taxes with insurance premiums is a flawed assumption, as many principles of insurance premiums need to align with those of tax payments (Judisseno, 2004).

Interest

The interest is often equated with retribution because of the costs incurred by the state to fulfill its (operational) obligations to be borne by the people in the form of tax payments (Ervina *et al.*, 2022). The imposition of taxes on the public is based on the magnitude of the public interest in a country (Hidayat, 2013; Supramono & Damayanti, 2010). The intended interest is protecting the community for their lives and assets, which the government should administer. Therefore, it is natural that state expenditure for this protection is borne by the community (Supramono & Damayanti, 2010).

Bearing power

The state's protection costs to citizens must be borne by all those who enjoy it in the form of

taxes (Hidayat, 2013; Supramono & Damayanti, 2010). Based on the principle of justice, the taxes imposed on the community depend on the carrying capacity of each community (Ervina *et al.*, 2022). A person's carrying capacity can be measured based on the amount of income which also considers a person's expenses (Lumentah, 2022).

Service

Society is considered to have an absolute obligation to serve the state (Hidayat, 2013). To prove their devotion, people must realize that taxes are an obligation (Windari *et al.*, 2022). In this case, the state has the absolute right to collect taxes from the public (Ervina *et al.*, 2022). The service theory is also known as the absolute tax liability theory (Irmayani *et al.*, 2022).

The Basic Theory of Purchasing Power

This theory assumes that taxes are collected and used to attract people's purchasing power (Febrian *et al.*, 2022). Taxes collected by the state can reduce the income people use for consumption. A reduction will follow every tax increase in disposable income, ultimately reducing public consumption (Simanjuntak & Mukhlis, 2012).

The hypothesis is proposed based on the description above as follows:

A broader economic consideration includes positive and negative economic effects, and an important objective for economic policy is to increase appropriations (Schneider & Enste, 2013). The relationship between allocation and the shadow economy is complex and multifaceted. Theoretical and empirical evidence suggest that inefficient allocation of resources by the government and high tax rates can lead to an increase in the shadow economy. In contrast, policies that reduce the potential benefits and increase the risks of shadow economy activity can help to reduce the size of the shadow economy.

H₁ Allocations have a significant effect on the shadow economy.

Economic policy must compromise in formulating a balance of economic interests of a particular distribution, which will then be integrated into the constitution (Schneider & Enste, 2013). The most important interventions in the market-determined distribution of income are

tax policies and social spending by the state (transfer payments) for the needy (public assistance, housing support, and similar items) (IRMA, 2018), including education policy, industrial policy, and subsidies, as well as various statutory exemptions, tax laws. This fact leads to the fatal result that almost everyone feels discriminated against by the system (Schneider & Enste, 2013). The relationship between distribution and the shadow economy is complex and multifaceted. Theoretical and empirical evidence suggest that unequal distribution of income and wealth, as well as low wages and high unemployment, can lead to an increase in the size of the shadow economy. Policies that address these underlying issues, such as increasing access to formal sector jobs and reducing income inequality, may help reduce the shadow economy's size.

H₂ Distribution has a significant effect on the shadow economy.

Stabilization policies seek to reduce cyclical fluctuations or structural shifts by applying monetary or fiscal instruments. Global state control, however, proved impractical for various reasons (e.g., time lags, information deficits). Therefore, rational economic politicians must limit themselves to establishing a reliable framework (clear goals on inflation, limited instruments on the labor market, and consistent and solid financial policies). It ensures safe planning for economic agents (Schneider & Enste, 2013). The relationship between stabilization and the shadow economy is complex and multifaceted. Theoretical and empirical evidence suggests that high levels of macroeconomic instability and unfair tax policies can increase the shadow economy's size. Policies that promote macroeconomic stability and ensure a fair and simple tax system may help reduce the shadow economy's size.

H₃ Stabilization has a significant effect on the shadow economy

Distortions arise because a company in shadow economy *activity* can offer its goods at low prices due to tax evasion (Blora Institute, 2005). Honest businesses are pushed out of the market. As a result, they are outraged at the thought of handing these products over to the

public and are forced to give up on saving their business. Secondly, the motivation to supply illegal labor increases, which puts pressure on public finances (Schneider & Enste, 2013).

The relationship between tax allocation and revenue is complex and multifaceted. Theoretical and empirical evidence suggests that tax allocation can affect the behavior of taxpayers and the overall revenue generated by the tax system. Policies that ensure a fair and efficient tax allocation and a broad tax base may help increase revenue collection.

H₄ Allocations have a significant effect on tax revenues.

Government investment depends on the size of regional tax and retribution revenues and the economic potential and wealth of the region's natural resources (Syayuti, 2022). Through government budget policies, the government can carry out the function of income distribution and create an equal distribution of income, for example, through transfers of government spending, so the income gap and socio-economic gap are not too wide, which can have implications for other fields (Ritonga, 2021). The relationship between distribution and tax receipts is complex and multifaceted. Theoretical and empirical evidence suggests that a fair and progressive tax system and high levels of tax morale can help increase tax receipts. Policies that promote income equality, tax fairness, and taxpayer compliance increase tax receipts and fund public goods and services.

H₅ Distribution has a significant effect on tax revenues

Taxes have a stability function that plays an important role in the balance of a country's economy (Mahpudin et al., 2021). Taxes give the government funds to carry out policies related to price stability so that inflation and deflation can be controlled (Hasibuan & Purba, 2022). It can be done by regulating money circulation in society, collecting taxes, and using effective and efficient taxes (Aris, 2021). The relationship between stabilization and tax revenue is complex and multifaceted. Theoretical and empirical evidence suggests that economic fluctuations and stabilization policies can influence tax revenue, as can the responsiveness of taxpayers to changes in tax rates. Policies that balance the need for

stabilization with tax revenue promote economic growth and fund public goods and services.

H₆ Stabilization has a significant effect on tax revenues.

The shadow economy is real economic activity, undetected by the tax authorities. During a crisis, people will try to survive. Those in the formal sector have turned to the informal sector for cash-based activities that do not have financial reporting or even the digital economy that is currently booming (Kartini, 2021). The relationship between the shadow economy and tax revenue is complex and multifaceted. Theoretical and empirical evidence suggests that reducing the size of the shadow economy, promoting tax fairness and legitimacy, and increasing taxpayer compliance may help to increase tax revenue. Policies that aim to promote economic growth, reduce corruption, and improve the tax system's efficiency may also help increase tax revenue and reduce the size of the shadow economy.

H₇ Shadow economy has a significant effect on tax revenues.

The shadow economy influences the factor inputs of production in many ways (Nursabrina & Saepudin, 2019), which have positive and negative consequences due to the symbiotic relationship between parties (Arief, 1993). The basic reference model is important for evaluation. The first two negative effects must be seen in the context of welfare economics. Ideally, the allocation there is undistorted (Schneider & Enste, 2013). In other words, inflation can positively or negatively affect the shadow economy (Yusuf, 2019).

The intensification of competition from *shadow economy activities* has a positive impact on allocations, thereby positively impacting employment, investment, and economic growth (Kuada, 2015). Unofficial economic supply leads to other unhealthy competition that blocks the positive stimulus of competition leading to high costs and prices and inefficient factor inputs (Schneider & Enste, 2013).

H₈ Allocations have an indirect effect on tax revenues through the shadow economy.

H₉ Distribution has an indirect effect on tax revenues through the shadow economy.

H₁₀ Stabilization has an indirect effect on tax revenues through the shadow economy.

3. RESEARCH METHOD

This research is a descriptive-explanatory research to provide an accurate and valid representation of the variables relevant to the research question and aims to collect information about variables and explain causal relationships between variables (explanatory) (Grinnell & Unrau, 2008).

The location of this research was conducted at the street vendors Center Jl. Fort Pancasila City of Mojokerto. The population is 369 MSME actors consisting of 127 "X" Joko Sambang traders and 242 "X" Alon Alon traders from Mojokerto City. Selection of research locations at the center of street vendors Jl. Fort Pancasila City of Mojokerto is based on several considerations. First, this location has an important meaning in the research context because it is the center of the activities of non-formal workers and small entrepreneurs. Second, this location is considered quite good as a representation of street vendors in Mojokerto City. Third, a location that is easily accessible and accessible to researchers, thus enabling efficient data collection. Lastly, this location has a clear link to the research objective.

Determination of the sample size of a population of 369 uses the Slovin formula with a tolerance level (e) of 0.01 (10%), namely $n = N / (1 + Ne^2)$ so that $n = 369 / (1 + 369 * (0,01)^2)$ determined by 79 respondents.

Data collection using a questionnaire with measurements:

- a. The indicators for measuring allocations use the following five items allocation of human resources (Ichsan *et al.*, 2019); funding allocation (efficiency) (Tanjung, 2022); technical allocation (Masbar *et al.*, 2020); asset allocation (Darmawan, 2022); and risk allocation (Widagdo & Lestari, 2018).
- b. The distribution measurement indicator uses the following five items income distribution (Suhendra *et al.*, 2021); welfare distribution (Low & Gleeson, 2019); development distribution; distribution of the basic vision of education; and social economic distribution (Iskandar, 2021).

- c. The stabilization measurement indicators use the following five items: a decrease in the inflation rate (Wardhani, 2017); licensing support; MSME/PKL capital support (Hakim, 2022); poverty reduction (Natakusuma, 2020); and political stabilization (Siswo, 2014).
- d. Indicators for measuring increased tax revenues use the following items: tax reform (Pandiangan, 2008); increasing tax power (tax effort); effectiveness of tax collection; efficient use of taxes; elasticity of laws and regulations regarding taxes (Nurcholis, 2007).

Data analysis was assisted by SmartPLS software version 3.3.7 (Yamin & Kurniawan, 2016). Hypothesis testing is done by comparing the values of *T-Statistics* and *P-Values* and is declared accepted if the *P-Values* < 0.05 (Yamin & Kurniawan, 2016). Several steps were carried out at the stage of measuring variables and determining questions in the questionnaire. First, identify the variables. Then, each variable is broken down into appropriate indicators by considering their validity and reliability. Validity refers to the extent to which an indicator accurately measures the variable in question, while reliability refers to the consistency of measurement over time.

4. RESULT

The results of the convergent validity test obtained the outer loading value of the variable research indicator is > 0.7 with a *p-value* < 0.05 . the cross-loading value, this is stated to meet convergent validity. The results of the discriminant validity test with a cross-loading state showed that the indicators used in this study already have good discriminant validity in compiling the variables. In addition to observing the cross-loading value, discriminant validity is also known through the required average variant extracted (AVE) value for each indicator, and the result is > 0.5 , so this model is good. In the Composite Reliability test, the result is > 0.6 , so it is declared to have fulfilled the composite reliability in the sense that all variables have a high level of reliability. In the Cronbach alpha test, each research variable obtained a value of > 0.7 , meaning that each research variable met the requirements for the Cronbach alpha value. The following are the results of Cronbach's Alpha, Composite Reliability, and Average Variance Extracted (AVE) tests:

Table 1
Cronbach's alpha test results, composite reliability and average variance extracted (AVE)

	Cronbach's Alpha	Composite Reliability	AVE
Allocation	0.889	0.919	0.696
distribution	0.969	0.976	0.889
stabilization	0.896	0.922	0.704
Shadow Ec.	0.978	0.983	0.920
Pen. Tax	0.919	0.938	0.754

Source: processed research results

The results of Cronbach's alpha measurements found that the dimensions of the allocation variable obtained Cronbach's alpha of 0.889, distribution of 0.969, stabilization of 0.896, shadow economy of 0.978, and tax revenues of 0.919. which means showing reliability above 0.70., declared accepted. Composite Reliability measurement results found that the dimensions of the allocation variable obtained Cronbach's alpha of 0.919, distribution of 0.889, stabilization of 0.922, shadow economy of 0.983, and tax revenues of 0.938. which means it shows reliability above 0.70., declared accepted., and the measurement results of average variance extracted found that the dimensions of the allocation variable obtained Cronbach's alpha of 0.696, distribution of 0.889, stabilization of 0.704, shadow economy 0.92, tax revenue 0.754. which means showing reliability above 0.50., declared accepted.

The results of the path coefficient test obtained the greatest influence indicated by the stabilizing effect on tax revenue of 0.456. The influence of distribution on the shadow economy of 0.271, then the effect of allocation on the shadow economy of 0.247, then the influence of the shadow economy on tax revenues of 0.229, then the effect of distribution on revenue tax of 0.204 then the effect of stabilization on the shadow economy of 0.086 and the smallest effect is shown by the effect of allocation on tax revenues of 0.017.

Table 2
Path coefficient test results

	Shadow Ec.	Pen. Tax
Allocation	0.247	0.017
distribution	0.271	0.204
stabilization	0.086	0.456
Shadow Ec.		0.229

Source: processed research results

The goodness of fit assessment is known from the Q-Square value. The Q-Square value has the same meaning as the coefficient of determination (R-Square) in the regression analysis, where the higher the Q-Square, the better or more fit the model can be with the data.

Table 3
Goodness of fit test results

Variable	R-Square value
Shadow economy	0.273
Tax revenue	0.241

Source: processed research results

The results of calculating the Q-Square value are as follows:

$$\begin{aligned}
 \text{Q-Square} &= 1 - [(1 - R^2_1) \times (1 - R^2_2)] \\
 &= 1 - [(1 - 0.273) \times (1 - 0.241)] \\
 &= 1 - (0.727 \times 0.759) \\
 &= 1 - 0.552 \\
 &= 0.448
 \end{aligned}$$

A Q-Square value of 0.448 is obtained based on the calculation results above. The value shows that the model can explain the amount of data diversity is 44.8%. While the remaining 55.2% is explained by other factors outside this model.

Table 4
T-Statistics and P-Values Test Results

	Influence	T-Stat	P-Value	Results
H1	Allocation -> Shadow Ec.	0.475	0.041	be accepted
H2	distribution -> Shadow Ec.	0.693	0.001	be accepted
H3	stabilization -> Shadow Ec.	0.931	0.052	rejected
H4	Allocation -> Pen. Tax	0.453	0.051	rejected
H5	distribution -> Pen. Tax	0.238	0.026	be accepted
H6	stabilization -> Pen. Tax	0.585	0.000	be accepted
H7	Shadow Ec. -> Pen. Tax	0.799	0.043	be accepted
H8	Allocation -> Shadow Ec. -> Pen. Tax	0.193	0.033	be accepted
H9	distribution -> Shadow Ec. -> Pen. Tax	0.127	0.006	be accepted
H10	stabilization -> Shadow Ec. -> Pen. Tax	0.066	0.009	be accepted

Source: processed research results

5. DISCUSSION

a. Allocations have a significant effect on the shadow economy

The analysis results show that the allocation has a significant effect ($0.041 < 0.05$) on the shadow economy. These results indicate that allocations can be used as a parameter to measure the shadow economy. The result follows the Modernization theory states that the shadow economy declines with economic development (Williams, 2014). Based on Political economy theory may be true that most professional economists in non-communist countries adhere to non-socialist political ideologies and this ideological preference is reflected in recommended economic policies (Lindbeck & Samuelson, 1977).

As part of the development process, allocations must follow incoming funds and be directly proportional to outgoing funds (Supena, 2002). Increasing allocations in shadow economy *activities* are possible if, for example, input factors are used more effectively and are not wasted (Schneider & Enste, 2013). Alternatively, higher welfare can also be obtained if people are free from poverty, ignorance, and fear (Sukmasari, 2020), with the

life expectancy indicator measuring health, the literacy rate indicator, and the purchasing power indicator measuring living standards (Dewi et al., 2017).

The results of this study support the research Kodila-Tedika & Mutascu (2014), which states that when the shadow economy tends to expand, the level of tax revenue decreases. The results of this research have great urgency in Mojokerto. They can contribute to better understanding and action regarding the shadow economy and provide a foundation for macro policy implementation at the national level.

b. Distribution has a significant effect on the shadow economy

The results of the analysis show that distribution has a significant effect ($0.001 < 0.05$) on the shadow economy. These results indicate that distribution can be used as a parameter to measure the shadow economy. Blankart et al., (2007) mention that 2/3 of the income from the Austrian shadow economy is immediately spent on goods in the official sector. Thus, the shadow economy has a strong stabilizing effect on the demand for durables and non-durables.

This result follows modernization theory which expresses that the signals of 'progress' and 'development' will reduce the shadow economy but contradict the economic and political perspective (non-Marxian version), which places more emphasis on the market, as well as forces where the assumptions and working logic of the economy are not easily accommodated, except as "externalities" that the future political leaders then lead to significant growth and a respectable second economic size, which is difficult to measure but should, in GNP, be 10 - 40% or even more; it can also vary regionally (Gaertner & Wenig, 1985).

The results of this study support the research Ilin et al., (2021) presented suggests that the shadow economy plays a constructive role by addressing several complex socioeconomic challenges within the country. However, it also highlights the concern that the substantial magnitude of the shadow economy, relative to the country's Gross Domestic Product (GDP), poses a significant risk to national security. In this context, the government needs to adopt a balanced approach. Governments should recognize the shadow economy's benefits in

overcoming socioeconomic problems. However, they should also seek to reduce the size of the shadow economy in GDP and minimize its negative impact on national security.

c. Stabilization has no effect on the shadow economy

The analysis results show that stabilization has no effect ($0.052 > 0.05$) on the shadow economy. These results indicate that stabilization cannot be used as a parameter to measure the shadow economy. Tax reform through large tariff reductions will only sometimes reduce the shadow economy. Such reforms can stabilize the size of the shadow economy and avoid its further increase. Social networks and personal relationships, high profits from irregular activity, and investments in real and human capital prevent people from moving into the official economy (Schneider, 2011). Meanwhile, the lower growth rate in the shadow economy resulting from complementary correlation also harms the official sector (Schneider & Enste, 2013).

These results follow the study by Mazhar & Jafri, (2017), which argues that there is a stable negative relationship between political stability and inflation only holds when the size of the shadow economy remains relatively small; however, this relationship does not hold at levels higher than the size of the informal sector. In the case of a market economy, the supply curve of the shadow economy reflects the level of marginal costs under the official economy because companies in the shadow economy ignore expensive regulations and avoid taxes and social security (Welfens, 2001). Therefore, stability is generally distinguished from staticity. If stability contains a positive assessment, then statistics contains a negative assessment (Soetrisno, 1992).

d. Allocation has no effect on tax revenue

The analysis results show that the allocation does not affect tax revenues ($0.051 > 0.05$). These results indicate that the allocation cannot be used as a parameter to measure tax revenue. Improving allocation as an important goal of economic policy implies optimizing resource inputs (Yulianti, 2014), leading to specific goals such as putting factors of production (jobs, capital, land, and similar items) into productive use to increase consuming power

and productivity (Adyatma & Oktaviani, 2015). In other words, increasing efficiency by achieving the same output with lower factor inputs (Schneider & Enste, 2013) with the aim of the shadow price in the *shadow economy* leads to the equilibrium price that will be formed if there is an efficient allocation (Djokosutono, 1984).

This study's results differ from the Insurance theory and interest theory but follow the Bearing power theory, Service theory, and the basic theory of purchasing power. The results of this study support research conducted by Campodonico et al. (2016), which states: that adequate tax consumption applies social optimality free from adverse selection. However, if tax consumption is to be reduced, the government will adopt the second-best allocation with adverse selection. It can lead to an increase in net worth enough to avoid adverse selection without overtaxing profits.

Increasing state revenue focuses on increasing tax revenue and optimizing non-tax state revenue (PNBP) (Muniarty et al., 2022). Macroeconomic stabilization and economic reform following the overthrow of the Milosevic regime in 2000 are expected to reduce the level of the shadow economy. However, it failed due to: first, the post-2000 period was marked by accelerated transitions, including mass privatization and restructuring, which added to the instability. Second, the claim that inappropriate tax policies, particularly in the labor sector, encourage flight to the informal sector (Krstić et al., 2015).

e. Distribution has a significant effect on tax revenues

The analysis results show that the distribution significantly affects tax revenues ($0.026 < 0.005$). These results indicate that the distribution can be used as a parameter to measure tax revenue. The 'discriminatory' design of the taxation system has led to an escape into the shadow economy in the middle and lower-income classes, as it is currently considered the only possible way to avoid increased taxation. An important consequence here is that the state no longer has control over the amount of income (Schneider & Enste, 2013).

This study's results follow the insurance, bearing power, and service theories but need to follow the interest and basic theories of

purchasing power. This study supports the research of Feiock (1986) states that although service benefits (especially expenditures) tend to be distributed evenly among urban sub-regions, the distribution of tax benefits is regressive.

However, the basic principle of public finance is avoided, namely tax efficiency, an important pillar of tax laws and regulations. In the long term, this threatens the taxation system and, thus, the country's financial base. Illegal workers are 'free riders': as long as public services are not or cannot be financed on an equal basis (e.g., public goods), they can use, for example, public infrastructure (e.g., roads) without paying taxes. It reduces tax yields and decreases public investment and goods supply, negatively impacting the middle and low-income classes (Schneider & Enste, 2013).

Efforts to pursue a tax ratio must begin by pursuing taxpayer compliance in reporting annual tax returns, the realization of which has not been 100% causing taxes not to become an effective instrument for realizing income redistribution and reducing economic inequality (Safitri et al., 2021).

f. Stabilization has a significant effect on tax revenues

The analysis results show that stabilization significantly affects tax revenues ($0.000 < 0.05$). These results indicate that stabilization can be used as a parameter to measure tax revenue. The shadow economy has two conflicting effects. On the one hand, demand is stimulated by lower prices; on the other hand, demand shifts from the office to the informal sector. Therefore, the net effect needs to be clarified in its entirety. In addition, we must consider the relationship of opposites between different products (complementation or substitution of sectors). In principle, consumers' wishes are increasingly fulfilled because the *shadow economy* supply is adjusted to individual desires, and these are satisfied with the quality offered. However, these partial positive effects were offset by openly discussed negative consequences for households (Schneider & Enste, 2013).

The results of this study follow the Insurance theory, bearing power theory, and service theory, but not following the interest theory and the basic theory of purchasing power. The results of this study support Manasse, (1996)

research which states that 'low' tax rates are optimal when stabilization of future government spending is expected so that the debt/GDP ratio rises on an optimal path as stabilization is approached.

g. Shadow economy has a significant effect on tax revenues

The results of the analysis show that the shadow economy has a significant effect ($0.043 < 0.05$) on tax revenues. These results indicate that the shadow economy can be used as a parameter to measure tax revenue. To a certain extent, public discussion is limited almost exclusively to the high tax detriment and the increasing burdens of illegal work, such as rising unemployment. Further consequences, however, are generally overlooked despite their relevant impact on OECD, developing, and transitional countries. For example, it is possible that without shadow economy *activities*, there will be considerable additional problems in providing subsistence levels and achieving higher growth rates (Schneider & Enste, 2013).

One of the causes of the low tax revenue is the limited space for the government to make tax efforts or more efforts in pursuing tax revenues. In addition, economic activities that are not formally recorded (*shadow economy*) make it difficult for the government to carry out tax efforts.

The shift in demand from the official economy to the shadow economy has another effect. Lower prices in the shadow economy stretch consumers' budgets with more income. The same goes for producers because of the revenue saved from taxes and other contributions. Schneider (2013) shows that 2/3 of the income generated in the Austrian shadow economy *is* immediately spent on goods produced in the official sector. Thus, the shadow economy has a strong stabilizing effect on the demand for both durable and non-durable goods.

h. Allocation, distribution, and stabilization have an indirect effect on tax revenues through the shadow economy.

The analysis results show that the allocation has an indirect effect ($0.033 < 0.05$) on tax revenues through the shadow economy. The analysis results show that distribution has an indirect effect ($0.006 < 0.05$) on tax revenues through the shadow economy. The results of the

analysis show that stabilization has an indirect effect ($0.009 < 0.05$) on tax revenues through the shadow economy. Shadow economy activities are always combined with a huge waste of resources. Then, hiding and gathering information is very expensive for illegal workers, and, on the other hand, the state also increases costs related to control, investigation, and prosecution. This waste can be clarified when considering the optimal taxation system, which is widely accepted by the public and does not distort allocation decisions much. When combined, these transaction costs are generally offset by additional added value, so the result is always higher welfare, although resources are not being used to support growth (Schneider & Enste, 2013).

The fact that necessary public investments (e.g., infrastructure) cannot be made due to financial shortages resulting from tax evasion results in official negative economic growth. Public goods cannot be supplied in the desired quantity, and the economy's aggregate supply falls. When the financial situation worsened, shadow economy *activities* were viewed negatively. However, this can only be proven empirically with very limited assumptions (Schneider & Enste, 2013).

From an allocation perspective, the informal sector is a cheaper alternative for small businesses in urban environments, particularly in transitional and developing countries. Sustained growth can be guaranteed if property rights are regulated in this sector. In the long term, pressure from shadow economy *activities* can help change legal regulations and social and economic institutions. In particular, market reform is inevitable if the state budget situation is very apprehensive. External pressure for such reforms from the International Monetary Fund could support this development (Schneider & Enste, 2013).

In addition to these vertical effects, horizontal distribution effects vary according to different structures (e.g., the field of skilled artisans, industries). Illegal labor is supplied by low- and middle-income groups (particularly by unemployed men and educated people, such as students), whereas the demand demographics are much more heterogeneous.⁴⁰ If the additional probability of demanding illegal work is integrated into the analysis, the redistribution direction of shadow economy activities is

ambiguous. Higher-income groups also demand illegal labor, mostly for car repairs or renovation work around their homes (Schneider & Enste, 2013).

However, extensive redistribution system reforms must work towards the 'equality of system efficiency' demanded by the public. Only then does a discussion of the combination of unintended transfer payments, illicit jobs, and unintended redistribution effects become redundant. Society disapproves of the concept of a social market economy with state-wide regulation and redistribution. In the long run, no institution can tolerate the fact that more and more people feel discriminated against, and, in the end, normal behavior is seen as the exception. In addition to this discussion of social policies, the effect on the economy as a whole plays an important role (Schneider & Enste, 2013).

Regardless of the desired redistribution, economists can hint at how objectives can be met with as little distortion of market outcomes as possible; that is, which action changes allocations the least and thus causes the least economic cost (Schneider & Enste, 2013). A further consequence of the distorted data from illicit activities is that the stabilization policy does not correspond to the actual situation, further exaggerating the cycle.

Opinions diverge when assessing this distributional impact and issues like growth, business cycles, and employment (the stabilization effect). However, actual research supports a more favorable, theoretically predicted stabilizing impact to some extent (Schneider & Enste, 2013).

6. CONCLUSION AND RECOMMENDATION

Conclusions

- a. Allocations have a significant effect on the shadow economy. This study's results follow Modernization theory, and the results support previous research where these ideological preferences are reflected in recommended economic policies.
- b. Distribution has a significant effect on the shadow economy. This result is consistent with modernization theory, which indicates that signs of "progress" and "development" tend to reduce the shadow economy, but this is contrary to the economic and political perspectives. and the results of this study

support previous research that consistently negative relationship between political stability and inflation only occurs when the shadow economy is relatively small; however, the relationship does not apply at the higher levels of the informal sector.

- c. Stabilization does not affect the shadow economy. This finding aligns with the principles of neoliberal theory, which states that the shadow economy arises because of high taxes, corruption in the public sector, and government intervention in free markets. The finding also supports previous research showing that the shadow economy can address complex social problems in a country's economy. However, the significant size of the shadow economy in a country's GDP can threaten national security.
- d. Allocation does not affect tax revenue. The results of this study are not following insurance theory and interest theory but follow bearing power theory, service theory, and the basic theory of purchasing power. The results of this study support previous research that adequate taxes achieve optimal social outcomes without adverse selection. However, if taxes are to be reduced, the government will seek a second-best solution which may include adverse selection. The goal is to increase net worth to avoid adverse selection effects without imposing excessive profits taxes.
- e. Distribution has a significant effect on tax revenues. This study's results follow the insurance, bearing power, and service theories but need to follow the interest and basic theories of purchasing power. This study supports previous research, which states that although service benefits (especially expenditures) tend to be distributed evenly among urban sub-regions, the distribution of tax benefits is regressive.
- f. Stabilization has a significant effect on tax revenues. The results of this study are consistent with the insurance theory, carrying capacity theory, and services theory but inconsistent with the interest theory and purchasing power theory. This research also supports previous research, which states that low tax rates are optimal when government spending is expected to stabilize in the future.
- g. Shadow economy has a significant effect on tax revenues. These results support previous

research, which stated that when the shadow economy tends to expand, the level of tax revenue decreases.

- h. Allocation, distribution, and stabilization indirectly affect tax revenues through the shadow economy.
- i. Allocations indirectly affect tax revenues through the shadow economy.
- j. Distribution has an indirect effect on tax revenues through the shadow economy.
- k. Stabilization has an indirect effect on tax revenues through the shadow economy.

Recommendations

Stabilization variables that do not affect the shadow economy and allocation variables that do not affect tax revenue have not answered the objectives of this study, considering that this research is limited to the effects of allocation, distribution, stabilization of the shadow economy and their impact on increasing tax revenues, therefore theoretical recommendation suggested for further researchers it is necessary to review these variables by developing more specific ones. A practical recommendation for the Government is to increase allocations, compromise on preparing economic balances, dampen cyclical monetary fluctuations, and make budget policies to carry out the function of distribution and equal income distribution.

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