- **As** operators in the shadow economy do not register to pay tax, this creates an unfair playing field for tax-paying businesses and individuals

- **A** shadow economy of 21% of GDP restrains the government's capability to fund national economic development. The government simply isn't collecting enough revenue to meet a high level of development expenditure and obligated operating expenses

Shadow economy – Why does it matter?

Accelerating the growth of cashless payments can reduce shadow economy activities. Other measures include limiting the amount of cash transactions, and increasing labour inspections in informal workplaces

by
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In most developing countries, recouping "revenue foregone" from a large shadow economy has been a mammoth task for tax administrators as they face challenges to deploy the most appropriate policy and administrative responses to plug tax leakage as well as manage the revenue risks posed.

The shadow economy includes all economic activities and production of goods and services that are hidden from tax authorities for monetary, regulatory, and institutional reasons.

The monetary reasons include avoiding paying taxes and all social security contributions, regulatory reasons include avoiding governmental bureaucracy or the burden of regulatory framework while institutional reasons include corruption law, the quality of political institutions and weak rule of law. In short, businesses operating outside the tax system and registered businesses conceal transactions; taxes are not paid and regulations are not strictly followed.

Defies measurement

It is difficult to measure the size of the shadow economy as those engaged in it try to remain undetected. There is no single infallible methodology for estimating the size and development of this informal economy and the results of different approaches can differ significantly.

According to a recent paper published by Cristina Terra, professor of economics at Essec Business School in France and author of the book *Principles of International Finance and Open Economy Macroeconomics*, the shadow economy in developing countries is estimated to account for about 36% of GDP, in South America it is between 25% and 60% and in Asia 13–50%.

Among members of the Organisation for Economic Cooperation and Development (OECD), the average size of the shadow economy in developed members is smaller at around 13–15% of GDP though for some European countries, it can be as high as 30%.

The International Monetary Fund (IMF), in a research working paper published in January 2018, analysed the results of the shadow economy for 158 countries for the period 1991 to 2015. It found the average size of the shadow economy was 31.9%. Countries with the largest presence of the shadow economy were Zimbabwe with 60.6% and Bolivia with 62.3% of GDP. The lowest ones are Austria with 8.9% and Switzerland with 7.2%.

The Malaysian government is looking into tapping income tax revenue from the shadow economy as, according to Finance Minister Lim Guan Eng, the shadow economy accounts for 21% of GDP and amounts to an estimated RM300.0 bil. Based on the IMF policy paper, the shadow economy in the country has been trending lower from an estimated 37.5% of GDP in 1991 to 31.1% in 2000, 30.2% in 2010 and 26.1% in 2015. The average ratio for the period 1991–2015 was 31.5%, which was higher than Singapore (11.9%), Australia (12.1%), China (14.7%), Hong Kong (14.7%), Vietnam (18.7%), India (23.9%), Indonesia (24.1%) and South Korea (25.7%).

The presence of a large shadow economy deters the development of an inclusive economic development as it deprives potential high tax revenue collection to finance and implement development projects such as healthcare, education and public transportation as well as socio-economic communities.

The shadow economy's adverse economic and social implications are an erosion of tax base, price and competition distortions in the market place, the influx of lower quality goods that poses health hazard to consumers, rampant corruption and the degradation of economic and social institutions, which affect productivity and reduces economic growth. As the informal sector does not register to pay tax, this creates an unfair playing field for registered tax-paying businesses and individuals.

Malaysia has long reckoned that the presence of a large tax gap estimated at 20% (the difference between total taxes owed and taxes paid on time) and the shadow economy of 21% of GDP would restrain the government's budget operation to fund national economic development given a relatively low revenue buoyancy, which had been trending lower from 2.1 in 2011 to 0.5 in 2017, indicating slower tax revenue growth relative to economic growth.

Make tax filing simpler

Although Malaysia's nominal GDP had increased by 7.3% per annum in 2011-2018, tax revenue collection paced slower at 6.0% pa. Tax revenue to GDP ratio had declined progressively from 15.6% in 2012 to 12.0% in 2018 and 11.8% in January-September 2019. Based on available data for regional comparison, Malaysia's tax-to-GDP ratio of 13.0% in 2017 was lower than that of Vietnam (19.0%), Chile (17.4%), Poland (16.8%) and South Korea (15.4%).

This issue of a shadow economy matters because years of budget deficits and a narrow tax base mean the government is simply not collecting enough revenue to meet a high level of development expenditure and obligated operating expenses.

If the informal sectors of the economy and unregistered individuals are captured in the tax net, they will boost tax revenue. With an estimated shadow economy of RM300 bil, a 1% tax collection will translate into RM3.0 bil in additional revenue.

To plug the tax leakages through the shadow economy, the government should reduce the complexity of the tax system, make the tax filing process simpler and adopt a policy to incentivise formal payments for business transactions through banking channels, including electronic payments. It should encourage wide use of e-payments, as e-transactions can prove useful in reducing the informality of businesses. In addition, ICT solutions, including Big Data analytics and Artificial Intelligence (AI), can be used to improve tax enforcement and plug tax evasion by shadow economy transactions.

The government can consider the following initiatives and strategies in strengthening tax administration to tackle the shadow economy:

a) Raise community awareness through education about the importance of taxation policy in supporting socio-economic development, achieving social equity objectives and providing essential public services and infrastructure. The tax agencies must engage the community to identify and reject shadow economy operators through sustained campaigns to raise awareness of the dangers of dealing with them as the presence of these operators puts registered taxpayers at a disadvantage.

b) Reinforcing taxpayers' fiduciary duty through education must be accompanied by better governance of public finance and fiscal discipline. Taxpayers will fulfil the fiduciary duty of paying taxes if they are convinced that the tax money is being utilised for productive economic development.

c) Implement effective identification and registration of taxpayers through the exploring of best practices in identification and registration process and in securing authentication, including the use of biometrics and blockchain technology. In 2019, eligible Malaysian taxpayers of 3.503 million only made up 22.39% of the total workforce of 15.642 million.

d) Tax administration to undertake soft approaches involving other government agencies, including local authorities, to track and influence behaviour of informal sectors to pay taxes. These include devising an effective mechanism to share data, information and sources on the business operation of shadow agents in the economy. Tax administration can collaborate with customers, suppliers and trade bodies to trace the supply chains, involving sub-contractors and traders producing goods and services for the formal sectors.

e) Set up a task force to monitor the activities of the sharing and gig economy. While this sector can yield positive economic effects, it also risks expanding the shadow economy as existing and new activities may go unreported. Hence, the tax administration may have to explore the possible options and solutions to facilitate the growth of online intermediaries, sharing economy and gig agents while fulfilling their tax obligations.

f) Accelerate the growth of cashless payments. Since the passive shadow economy is caused by cash payments, it could be reduced either through actions promoting electronic payments, or through other measures aimed at increasing the share of cash transactions being registered. However, the promotion of electronic payments would not influence the behaviour of the committed shadow economy participants, who would continue to use cash payments in order to benefit from not reporting the transaction. Therefore, this part of the shadow economy has to be addressed with other measures such as limiting the amount of cash transactions, increasing labour inspections at building sites, introducing more restrictive penalty sanctions for counterfeiting of excise products and smuggling. FocusM

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