社会经济研究中心

SOCIO-ECONOMIC RESEARCH CENTRE

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THE MALAYSIAN TAX CONFERENCE 2021

Hiding in the Shadows

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Outline

The Nature of the Shadow Economy

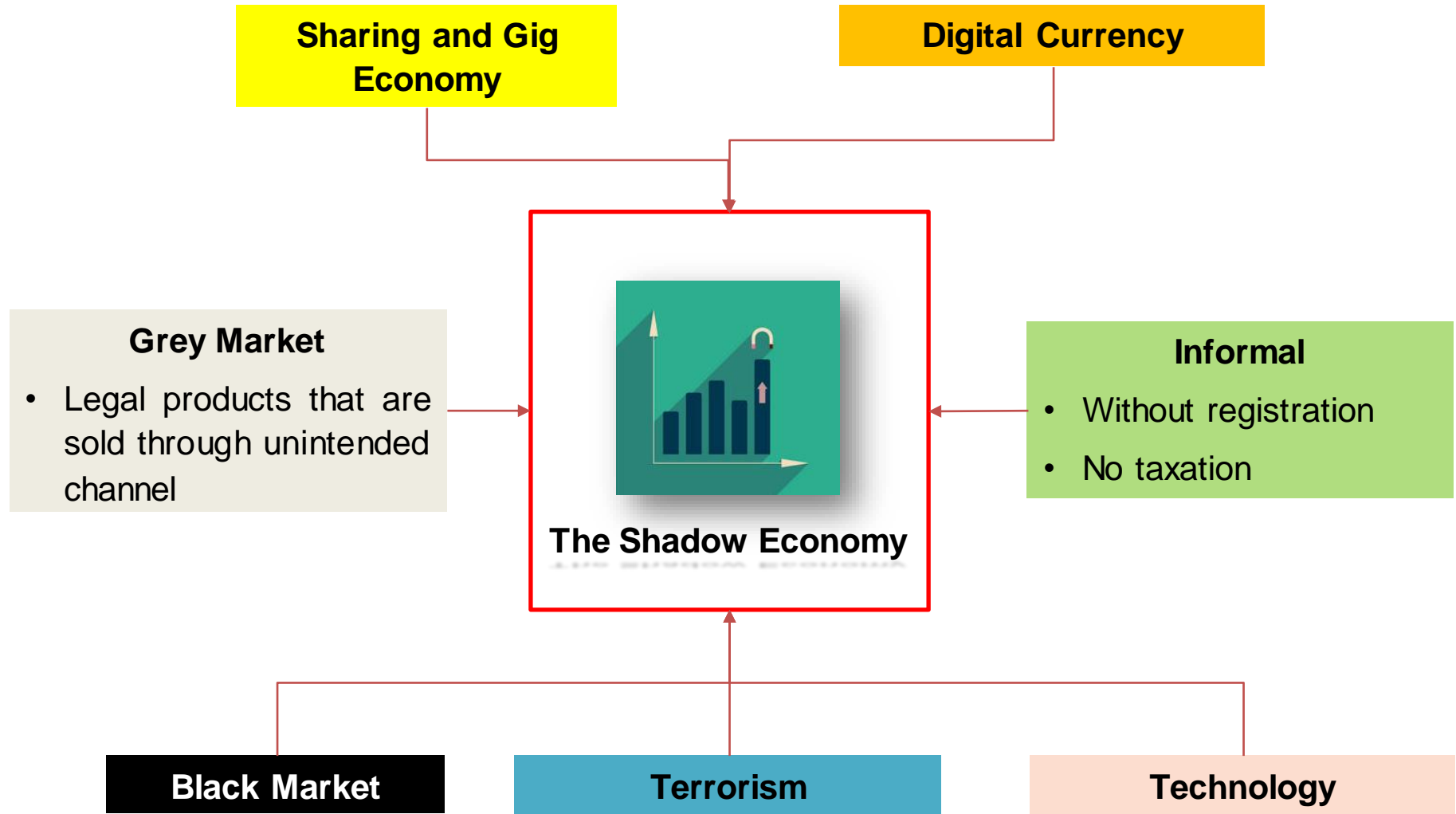**Shadow Economy in Malaysia – Why Does It Matter?**

Initiatives and Strategies to Tackle the Shadow Economy

- **"Globalisation, enhanced international co-operation, developments in technology and criminals** increasingly entering the legal business market

- Presenting opportunities and challenges to tax administrations as things move into and out of the shadows, **changing the nature, scale and type of some shadow economy activities**." - *OECD*

The Nature of the Shadow Economy

Sharing and Gig Economy

Digital Currency

Grey Market

- Legal products that are sold through unintended channel

The Shadow Economy

Informal

- Without registration
- No taxation

Black Market

Terrorism

Technology

The Nature of the Shadow Economy (cont.)

- **Underground, informal, hidden, grey, black or parallel economy**.

- **Difficult to measure the size of shadow economy;** agents in shadow economy **remain undetected**.

- **No ideal method exists** to estimate the size of the shadow economy. Results can differ significantly between different approaches.

Types of Underground Economic Activities

Type of Activity	Monetary Transactions	Non-monetary Transactions		
ILLEGAL ACTIVITIES	Trade in stolen goods; drug dealing and manufacturing; prostitution; gambling; smuggling; fraud	Barter of drugs, stolen, or smuggled goods, Producing or growing drugs for own use. Theft for own use.		
	Tax Evasion	**Tax Avoidance**	**Tax Evasion**	**Tax Avoidance**
LEGAL ACTIVITIES	Unreported income from self-employment. Wages, salaries, and assets from unreported work related to legal services and goods	Employee discounts, fringe benefits	Barter of legal services and goods.	All do-it-yourself work and neighbor help.

Source: IMF

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The Nature of the Shadow Economy (cont.)

Examples of Shadow Economic Activity

Activity	Examples
Non-registered businesses	**Businesses that do not register with the tax administration** for either income tax or value added tax (VAT). They may still register with other agencies or service providers.
Under-reporting of business income	Ranges from **businesses or sole traders which skim off some cash sales** to those which **engage in large scale fraud**.
Unreported sources of income	Businesses or individuals receiving **sources of income not known** to the tax administration from investments, property etc.
Inflation of costs	Those who **inflate tax deductible expenses**, for example using **false receipts or invoices or collusion with others**.
Identity fraud	Use of **fake identities** to **avoid tax liabilities or to claim refu**nds due to others. Also commonly used to continue to claim benefits while working.
Phoenix companies	Companies that are created with the **intention of becoming insolvent before paying tax and other bills** (with the business being transferred but not the debts). Similarly, companies may strip assets and disappear prior to paying tax due.
Moonlighters	People registered with the tax administration for some employment but not for all, for example someone with **a part-time job paid by cash on top of regular employment**.

Source: OECD

The Nature of the Shadow Economy

Examples of Shadow Economic Activity (cont.)

Activity	Examples
Ghosts	Those **unknown** to the tax administration, **never having registered for tax**. Examples may be some informal market traders, day or seasonal labourers, those providing domestic services and those carrying out serious crimes.
Cross-border fraud	Those who carry out **activities across border** with the aim of exploiting gaps and being able to hide out of reach of another tax administration.
Employer fraud	**Not registering workers with the tax administration or requiring such registration as a condition of employment**; not complying with requirements to withhold tax or social security liabilities; employing illegal workers – for example those without a permit or underage; not carrying out identity checks; paying less than required minimum wages etc.
Money laundering	Bringing money from **illegal activity into a legal business** in order to make its origin appear legal.
VAT fraud	**Claiming refunds or deductions for VAT that has not been paid by the supplier**, including through organised cross-border fraud.
Distance selling	**Evading the payment of VAT** by selling into one country from another online without registration.
Illicit trafficking	**Smuggling of goods on which duty has not be paid** or which are fake for sale informally or through established businesses.

Source: OECD

Industry Sectors or Taxpayer Groups of Most Concern

The industry sectors most commonly reported by tax administrations/revenue bodies.

Industry sector	Bodies reporting (%)	Nature of activities included in this sector
Personal Services (B2C transactions)	22.1	House cleaning, hairdressing, beauty, dry cleaning, catering, pest control, computer maintenance, security, health, pet care, matchmaking, etc.
Hospitality	16.4	Restaurants, cafés, pubs, takeaways, hotels
Retail	15.6	Store based, flea/public markets, etc.
Construction	15.6	Building, home renovations, home repairs
Car sales & service	5.7	
Transport	3.3	
Taxi	3.3	
Agriculture, Fishing, Aquaculture	2.4	
Other	15.6	Tourism, real estate (incl. rental), recycling, internet based, freelancers, professionals, entertainers, etc.

Source: OECD

Measuring the Shadow Economy

Ways of Measuring the Shadow Economy: Different Methods

Method	Main Features
DIRECT APPROACHES	
Sample survey	• Estimates size of shadow economy from **survey data.**
Tax audit	• Estimates size of shadow economy from **audit measurements of undeclared taxable income**.
INDIRECT APPROACHES	
National accounting statistics	• Estimates size of shadow economy on basis of the **discrepancy between income and expenditure statistics in national accounting or in individual data**.
Labor force statistics	• Estimates growth in shadow economy on basis of **a decline in labor participation in the official economy**, assuming the labor force has a constant participation rate overall.
Transactions	• Uses data on the overall **volume of monetary transactions** in the economy to calculate total nominal (unofficial plus official) GDP, then estimates size of shadow economy by subtracting official GDP from total nominal GDP.
Currency demand	• Estimates size of shadow economy from the **demand for cash**, assuming shadow transactions are undertaken in cash and that an increase in the shadow economy will raise demand for cash.

Source: IMF

Measuring the Shadow Economy

Ways of Measuring the Shadow Economy: Different Methods (cont.)

Method	Main Features
INDIRECT APPROACHES	
Physical inputs (electricity consumption)	• Estimates growth of shadow economy from **electricity consumption**, assuming that electricity consumption is the single best physical indicator of overall economic activity. • Subtracts the growth rate of official GDP from the growth rate of total electricity consumption and attributes the difference to the growth of the shadow economy.
MODELS	
Latent variable approach	• Estimates the size of the shadow economy as **a function of observed variables that are assumed to influence the shadow economy**—for example, **the burden of taxation, the burden of government regulation—and of variables where shadow economic activities leave traces, like cash, official working time, unemployment**, etc. • Advantageous of this method because it considers multiple causes and effects simultaneously.

Source: IMF

- Estimates of the size of shadow economy vary **from under 1% of GDP** in some countries to **over 20%** in others.

- The **main drivers** of the shadow economy

  - **Opportunity and risk of detection**
  - **Benefits**
  - **Deterrence**
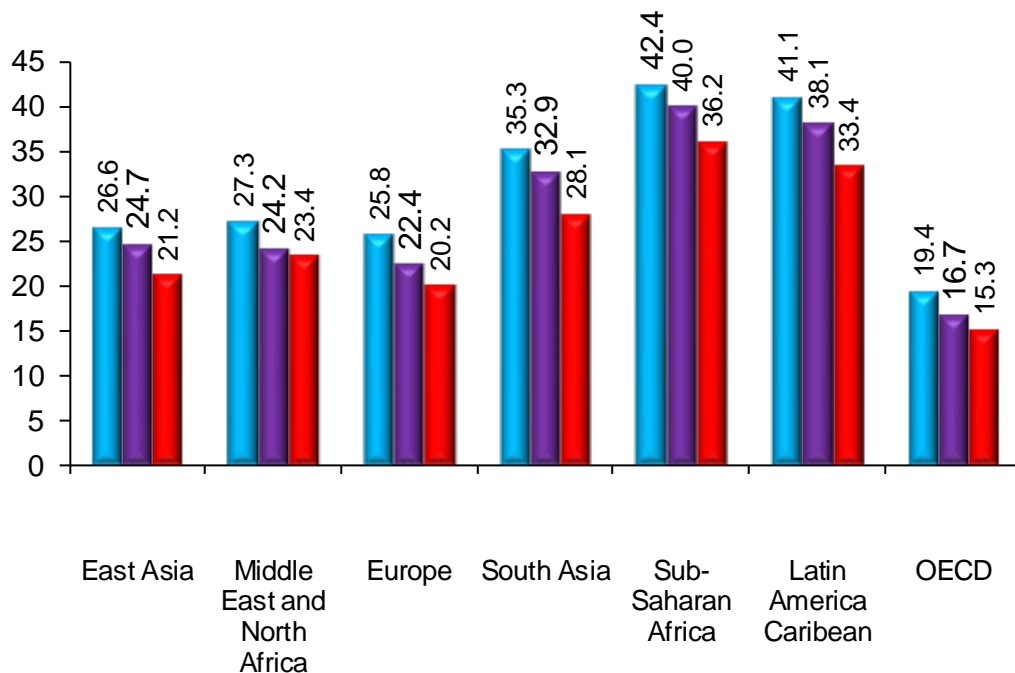 - **Difficulty of complying**
  - **Tax morale**

Size of Shadow Economies

- A study by IMF covering 158 countries has shown that the **mean value** of the size of the shadow economy of 158 countries is **31.9% of GDP** and **median 32.3% of GDP.**

- The size of the shadow economy **had declined over time between 1991 and 2015**.

- **High income countries have the LOWEST shadow economy** vs. low income countries

Shadow Economy by Region (Average, %of GDP)

■ 1991-99 ■ 2000-09 ■ 2010-15

Region	1991-99	2000-09	2010-15
East Asia	26.6	24.7	21.2
Middle East and North Africa	27.3	24.2	23.4
Europe	25.8	22.4	20.2
South Asia	35.3	32.9	28.1
Sub-Saharan Africa	42.4	40.0	36.2
Latin America Caribean	41.1	38.1	33.4
OECD	19.4	16.7	15.3

Shadow Economy by Income Level (Average, %of GDP)

■ 1991-99 ■ 2000-09 ■ 2010-15

Income Level	1991-99	2000-09	2010-15
SSA	42.4	40.0	36.2
EM	34.9	31.8	27.6
AE	18.9	16.5	15.0
LIC	43.8	42.2	38.8
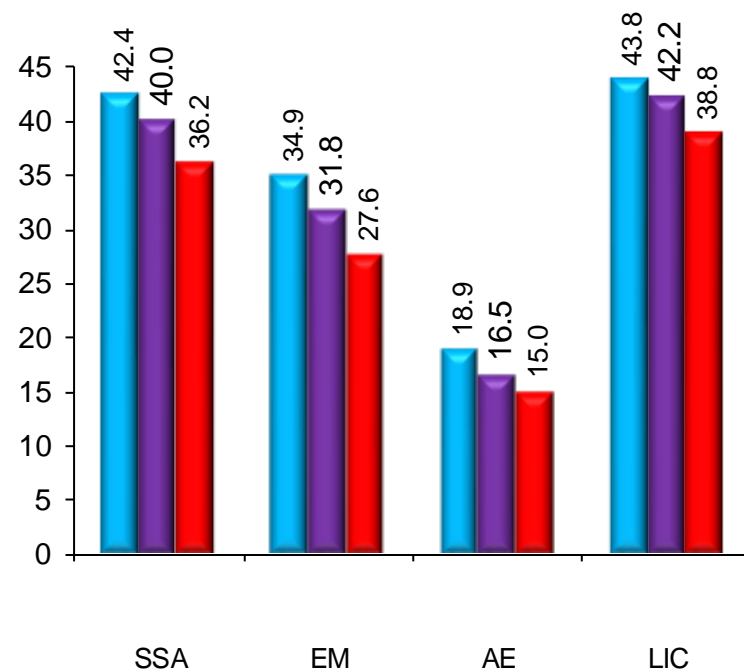
Source: IMF

Note: Sub-Saharan Africa (SSA); Emerging Market economy (EM); Advanced Economy (AE); Low-Income Country (LIC)

Why Are Shadow Economies Growing?

Taxation System

- Countries with relatively low tax rates, fewer laws and regulations as well as a well-established rule of law tend to have smaller shadow economies.

Increasing Burden of Tax and Social Security Payments

Add to cost of labour

Incentive for employers and employees to participate in the shadow economy

- License requirements;
- Labour market regulations;
- Trade barriers;
- Restrictions on foreign workers

Weak Governance

Ineffective and discretionary application of the tax system and regulations

Provides fertile ground for shadow activities

- Conditions for corruption to flourish
- Studies found that more corruption resulted in a larger shadow economy.

Regulations and Compliance Costs

Raise the cost of labour to firms

- Studies show that among 84 developing, transition and advanced economies, **a one point increase in a regulation index (ranging from 1 to 5) is associated with a 10% increase in the shadow economy**.

Shadow Economy Can Magnify Economic and Social Impacts

Growth of shadow economy can set off a DESTRUCTIVE cycle

1

Undermine Trust in Tax System

Deprives potential high tax revenues

Less money for socio-economic development projects

2

Erode Tax Base or Reduce Tax Compliance

Worsens budget constraints

Raising tax rates

Further flight into the shadow economy

3

Price and Competition Distortions
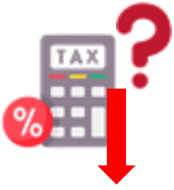
Influx of lower quality goods; creates unfair playing field

4

Rampant Corruptions and Degradation of Economic and Social Institutions

Affect productivity and lower economic growth
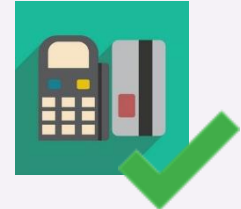
Shadow Economy - Implications for Action

- **Reductions in tax rates?** Though it will not substantially shrink the shadow economy, but may be able to stabilize it.

- **Moving away from direct taxes to indirect taxes**

- **Frequent tax audits and heavier penalties for tax evasion**

- **Legalise certain shadow economy activities**

- **Regulatory reforms to make them transparent and ease of compliance** reduce the incentives for corruption > encourage more legal business

- **Good governance and strict enforcement of regulations**, rather than having unreasonable regulations

- Shadow economy in Malaysia – why does it matter?

- The Malaysian government is looking into tapping income tax revenue from the shadow economy

Shadow Economy in Malaysia estimated 21% of GDP in 2019

- **Malaysia's shadow economy is estimated to account for 21% of GDP**, equivalent to **an estimated RM300.0 billion** based on 2019's GDP nominal value of RM1.5 trillion.

- Based on the IMF policy paper, **Malaysia's estimated size of shadow economy has been trending lower** from **37.5% of GDP in 1991** to 31.1% in 2000, 30.2% in 2010 and **26.1% in 2015**.

Size and Development of the shadow Economy

Source: IMF

Socio-Economic Research Centre
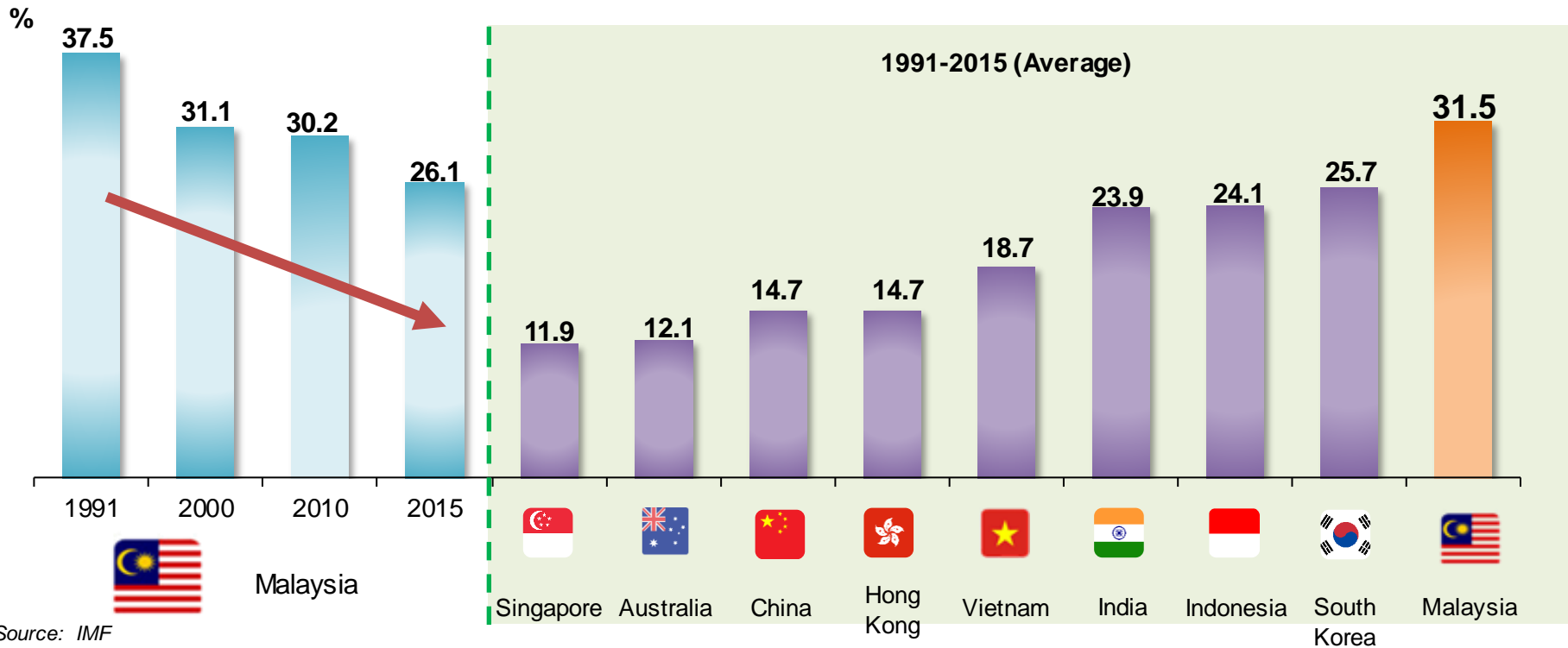
Malaysia Faces Budget Constraints due to Narrow Tax Base

- A large **tax gap estimated 20% of GDP**. It measures the difference between total taxes owed and taxes paid on time.

- **Shadow economy estimated 21% of GDP**.

- Relatively **low revenue buoyancy**, which had been trending lower from **2.1 in 2011 to 0.9 in 2019**.
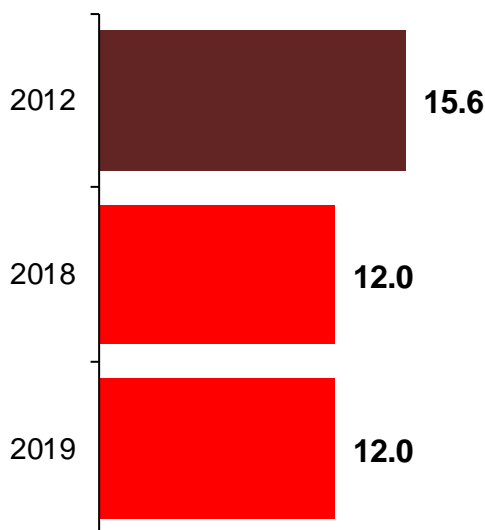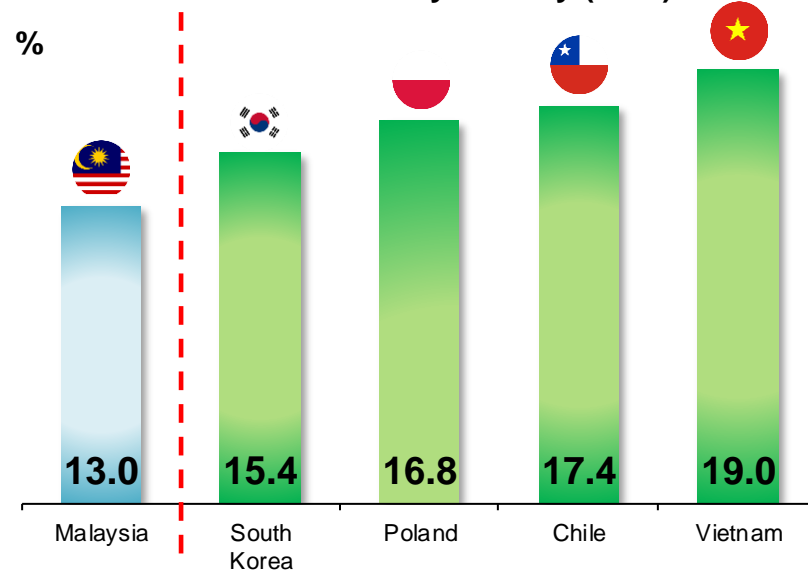
Malaysia

Nominal GDP (2011-2019)

GDP

6.5% pa ⬆

Tax Revenue Collection (2011-2019)

3.7% pa ⬇

Tax revenue-GDP ratio

2012	15.6
2018	12.0
2019	12.0

Tax -GDP ratio by country (2017)

%

Malaysia	South Korea	Poland	Chile	Vietnam
13.0	15.4	16.8	17.4	19.0

Source: IMF, BNM

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The Appalling State of Malaysia's Tax System

The state of taxes in Malaysia is truly shocking

- As at end-2017, **62.4% of 1.25 million companies** were registered with the Inland Revenue Board, of which **7.8% were subjected to tax.**

- For **personal income tax**, **only 16.5% or less than 2.5 million people** are subjected to taxes.

- It is understood that the Inland Revenue Board has **only about 9,000 people with more than RM1 million annual income in its register**. That number sounds shocking, given the number of luxury cars sold every year.

- Between **US$22.9 billion (RM94.2 billion) and US$33.7 billion (RM138.7 billion) was illegally siphoned out of Malaysia from 2006 until 2015**, according to the latest 10-year report by US think tank Global Financial Integrity (GFI).

- Malaysia needs to **broaden its tax base** or **risk overburdening the small pool of taxpaying individuals and businesses that contribute 45% of its revenue**.

- Plug the **tax leakages** via the shadow economy:

- **Reduce the complexity of the tax system**, make a simpler tax filing process.

- **Adopting policy to incentivize formal payments for business transactions** (via banking channels, electronic payments, and encourage wide use of e-payment and e-transactions).

- **Using ICT solutions, including Big data analytic and Artificial Intelligence** to improve tax enforcement and plug tax evasion shadow economy transactions.

Proposed Initiatives to Tackle the Shadow Economy

- **Effective management of the shadow economy requires actions at all levels – government, cities, local communities and individuals**
- **The following initiatives and strategies in strengthening tax administrations to tackle the shadow economy as follows:**

- **Raise community awareness through education**.
- **Realise the importance of taxation policy** in supporting socio-economic development, **achieving social equity objectives** and **providing essential public services and infrastructure**.

- **Reinforcing taxpayers' fiduciary duty** through education.
- **Better governance of public finance and fiscal discipline**.

Proposed Initiatives to Tackle the Shadow Economy (cont.)

- **Implement effective identification and registration of taxpayers** through **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.

- Tax administration to undertake **soft approaches** involving other government agencies, including local authorities, to **track and influence behaviour of the 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.

Proposed Initiatives to Tackle the Shadow Economy (cont.)

- **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.

- To **explore the possible options and solutions to facilitate the growth of online intermediaries, sharing economy and gig agents while fulfilling their tax obligations.**

- **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.

- **Whole of government approaches.** Actors in the shadow economy will often be involved in social security fraud, failure to comply with regulations (including health and safety) and, in some cases, serious crime.

- **Tax administrations are increasingly working with other agencies/departments/financial institutions on tackling these issues** to help improve overall effectiveness.

- **Sharing of intelligence:** Tax administrations have much to share on the developing risks in the shadow economy, including **on cross-border aspects, mutual administrative assistance, international co-operation between tax authorities as well as on effective countermeasures.**

Conclusion

- The shadow economy is constantly changing and adapting.

- Globalisation, international cooperation, the growth of internet economy and digital technology have not only changed the ways of working and business models but also caused new shadow economy activities to emerge and some existing ones to expand in scale or scope.

- While the emergence of sharing and gig economies can have strong positive impacts on the economy, new business models raise the elements of price differential (due to regulatory arbitrage) and differential tax treatment, potentially reducing the tax base.

- The driving forces of the shadow economy include an increased burden of taxation, labor market regulations, the quality of public goods and services, and the state of the "official" economy.

- Effective management of the shadow economy requires actions at all levels – government, cities, local communities and individuals.

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