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PREMIER TAX EVENT OF THE YEAR  
**NATIONAL TAX CONFERENCE**  
**2020**

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**VIA LIVE STREAMING**

Speaker:

**Dr Richard Record**  
*Lead Economist for Malaysia*  
*World Bank*

# TOPIC 3: TAXING THE SHADOW ECONOMY

# Outline of the Presentation

1. Malaysia's revenue challenge
2. What is the shadow economy?
3. How large is the shadow economy?
4. Lessons from other countries in taxing the shadow economy
5. How to measure success?
6. Some policy options for Malaysia



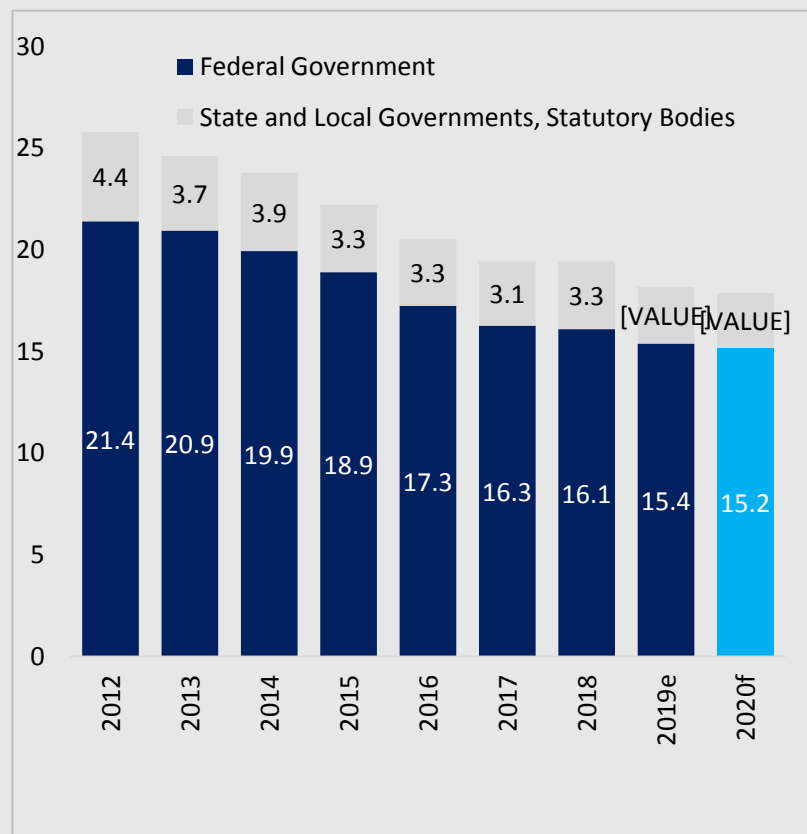


# Malaysia's Revenue Challenge

# Revenue collection has been on a downward trend, lagging comparators (even before the COVID-19 pandemic)

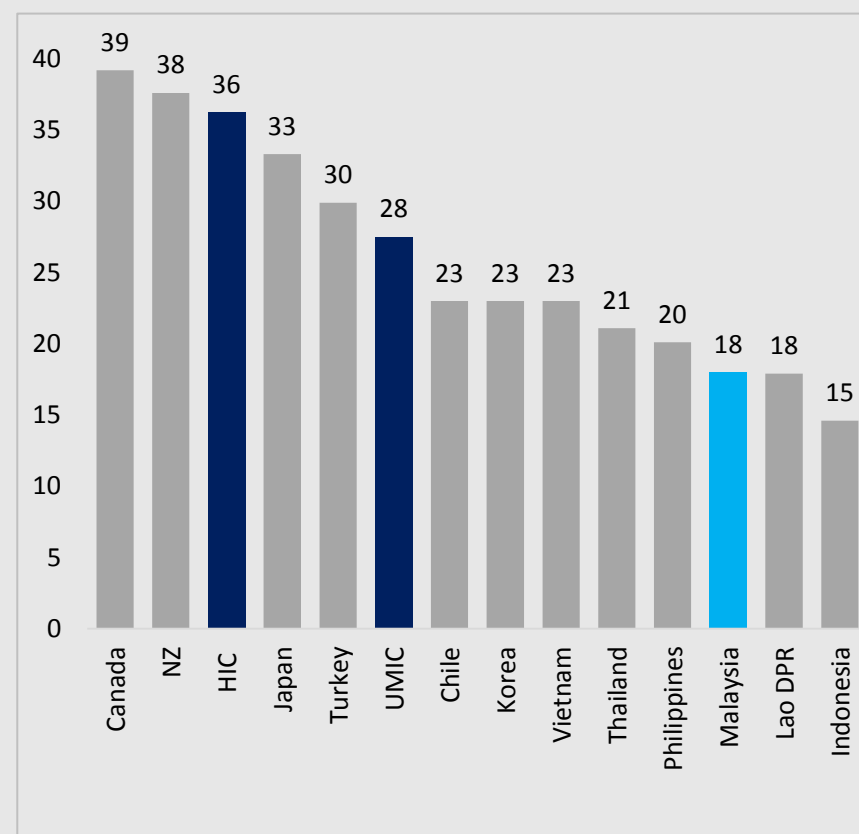
Malaysia's revenue collection has been on a steady decline since 2012...

General Government Revenue, 2019f, Percentage of GDP



...and is well below the average of comparator countries

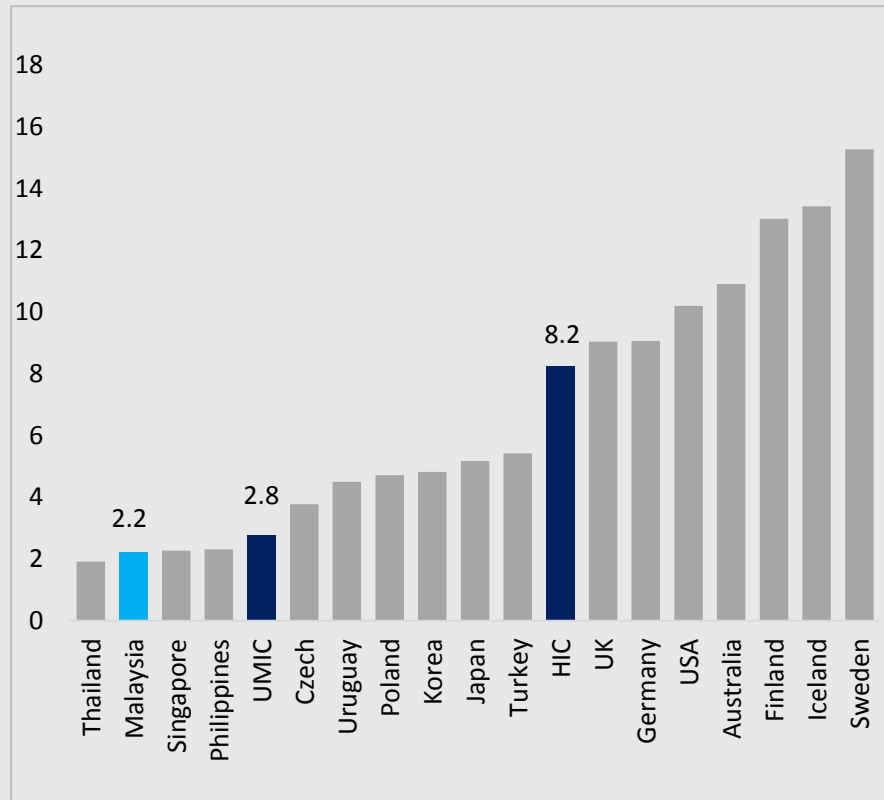
General Government Revenue, Percentage of GDP



# Collection of personal income tax and consumption tax falls especially short of benchmark comparators

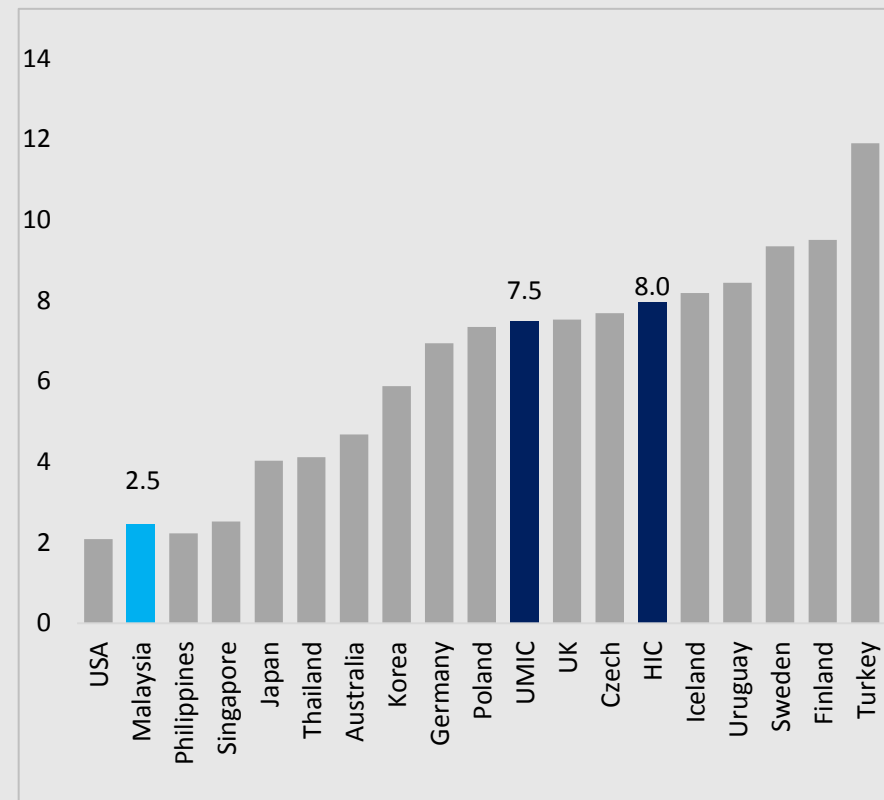
Malaysia's personal income tax revenue collection trails comparators...

Personal income tax, Percentage of GDP, Avg. 2012-2017



...as does consumption tax collection as a share of GDP

Goods and services tax, Percentage of GDP, Avg. 2012-2017

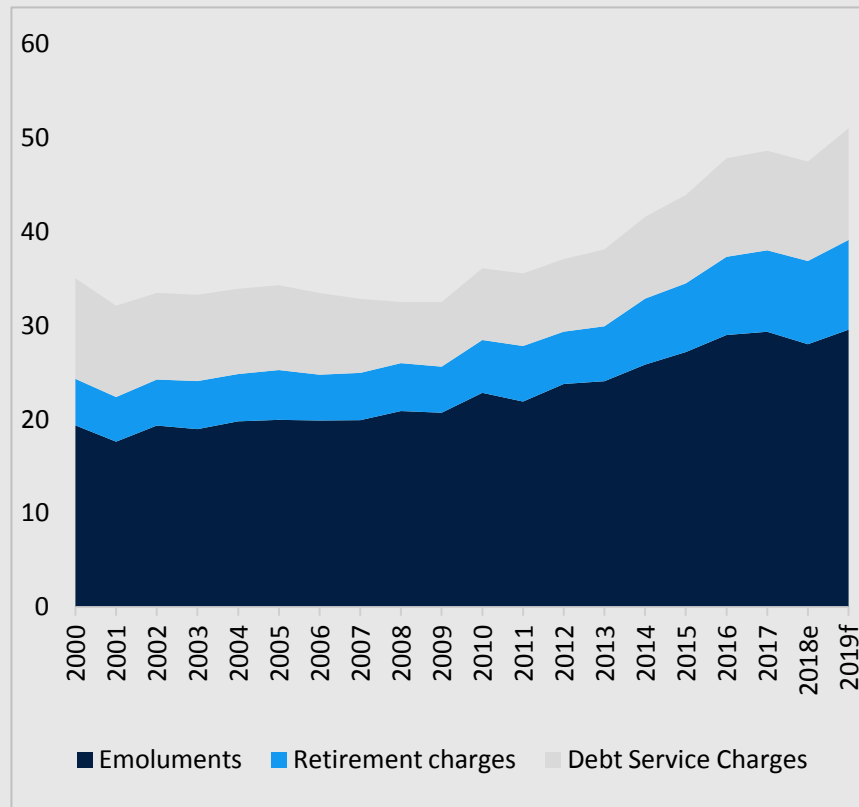




# High public debt and the wage bill costs crowd out government spending in other areas, leaving little room to absorb shocks

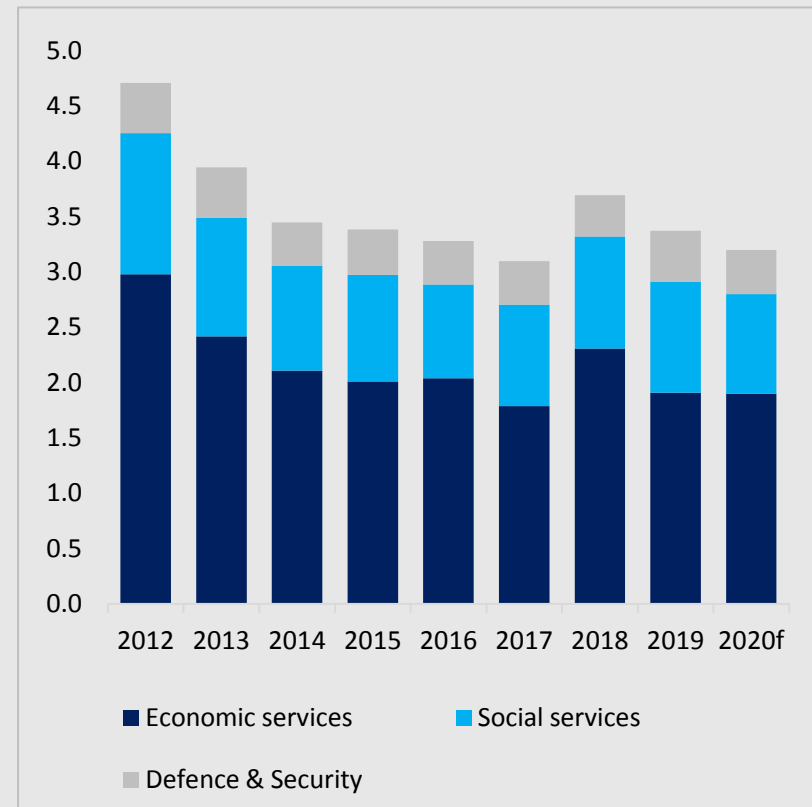
Rising locked-in expenditures represent a major portion of overall spending...

Share of expenditure items, Percentage of GDP



...putting a constraint to development and social spending

Development expenditure, Percentage of GDP





# What is the Shadow Economy?



# What do we Mean by the Shadow Economy?

## THE SHADOW ECONOMY

### CONSIST OF FOUR COMPONENTS:

1. Unreported income arising from legal activities
2. Unreported income arising from illegal activities
3. Production of goods for own use
4. A “statistical underground” reflecting shortcomings in statistical techniques and information sources

### CAN ARISE FROM:

1. Omissions in reporting (deliberate, careless or out of ignorance)
2. Overclaimed deductions
3. Unreported transactions in non-cash form

***The OECD’s Forum on Tax Administration uses the following definition: “Economic activities, whether legal or illegal, which are required by law to be fully reported to the tax administration but which are not reported and which therefore go untaxed unlike activities which are so reported.”***

# Why the Shadow Economy Matters

- It costs society lost revenue.
- It undermines trust in the tax system -“tax morale”.
- It drives up other costs (regulation, costs of fraud).
- It distorts competition.
- It puts consumers at risk.
- It is associated with other crimes: people trafficking, worker exploitation, money laundering and organised crime.



# How large is the Shadow Economy?



# Various methods for estimating the size of the shadow economy



## DIRECT APPROACHES

### Sample survey

Estimates size of the shadow economy from survey data.

### Tax audit

Estimates size of the shadow economy from audit measurements of undeclared taxable income.



## INDIRECT APPROACHES

### National accounting statistics

Estimates size of the 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 the shadow economy on basis of 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 the 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.

### Physical inputs (electricity consumption)

Estimates growth of the 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

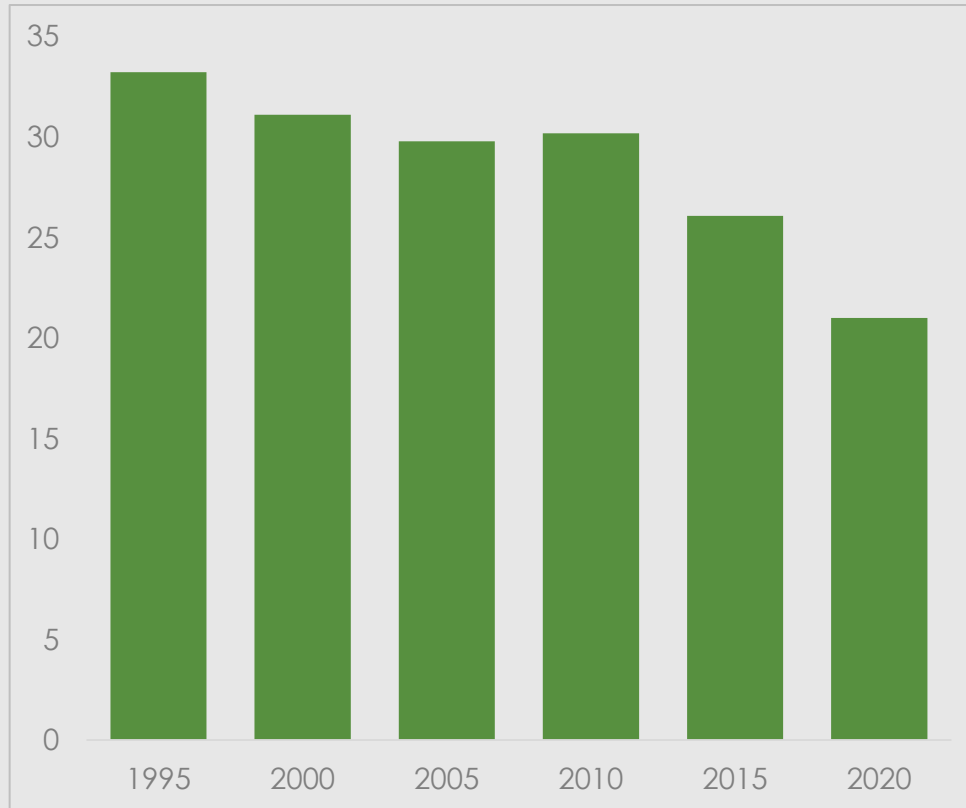
Estimates the size of the shadow economy as a function of observed variables that are assumed to influence the shadow economy—for example, the burden of taxation, the burden of government regulation—and of variables where shadow economic activities leave traces, like cash, official working time, unemployment, etc. Advantageous method because it considers multiple causes and effects simultaneously.

Source: Schneider, F., and Enste, D. (2002). *Hiding in the Shadows: The Growth of the Underground Economy*. International Monetary Fund, IMF Economic Issues No. 30, Washington, D.C.

# Malaysia's shadow economy has been shrinking in size in recent years

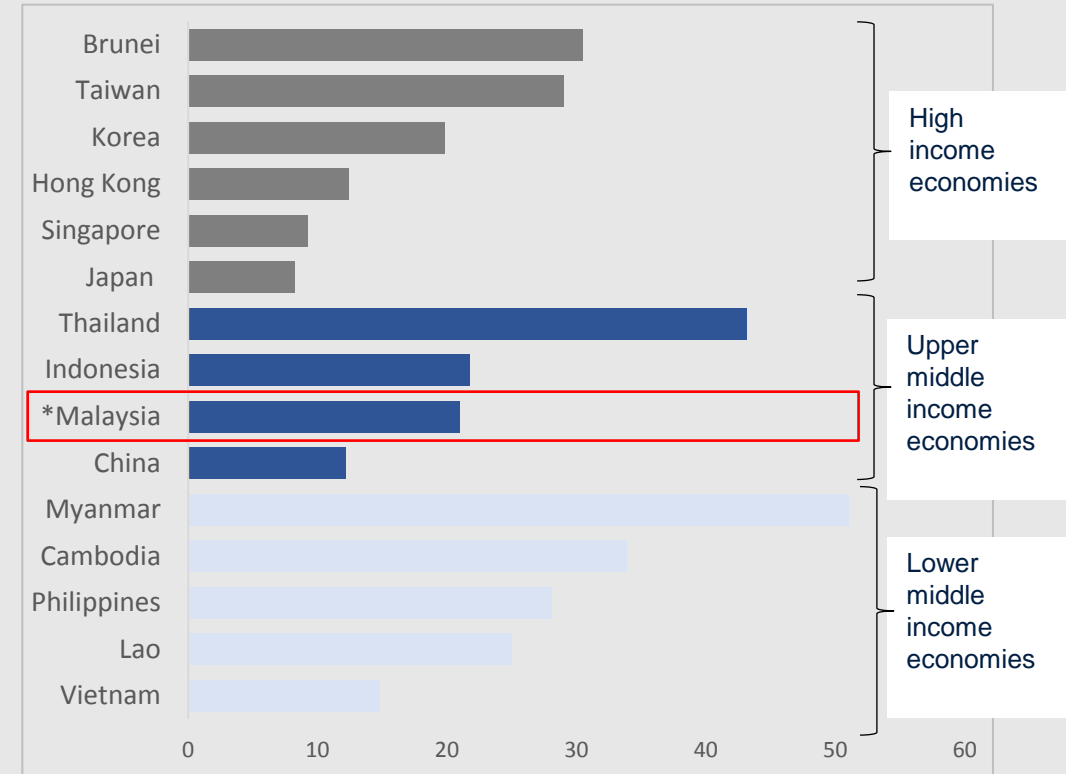
Estimates of the size of Malaysia's shadow economy have fallen in recent years...

Shadow economy as a percentage of GDP, Malaysia, 1991-2020



...and it is about average in size relative to comparators

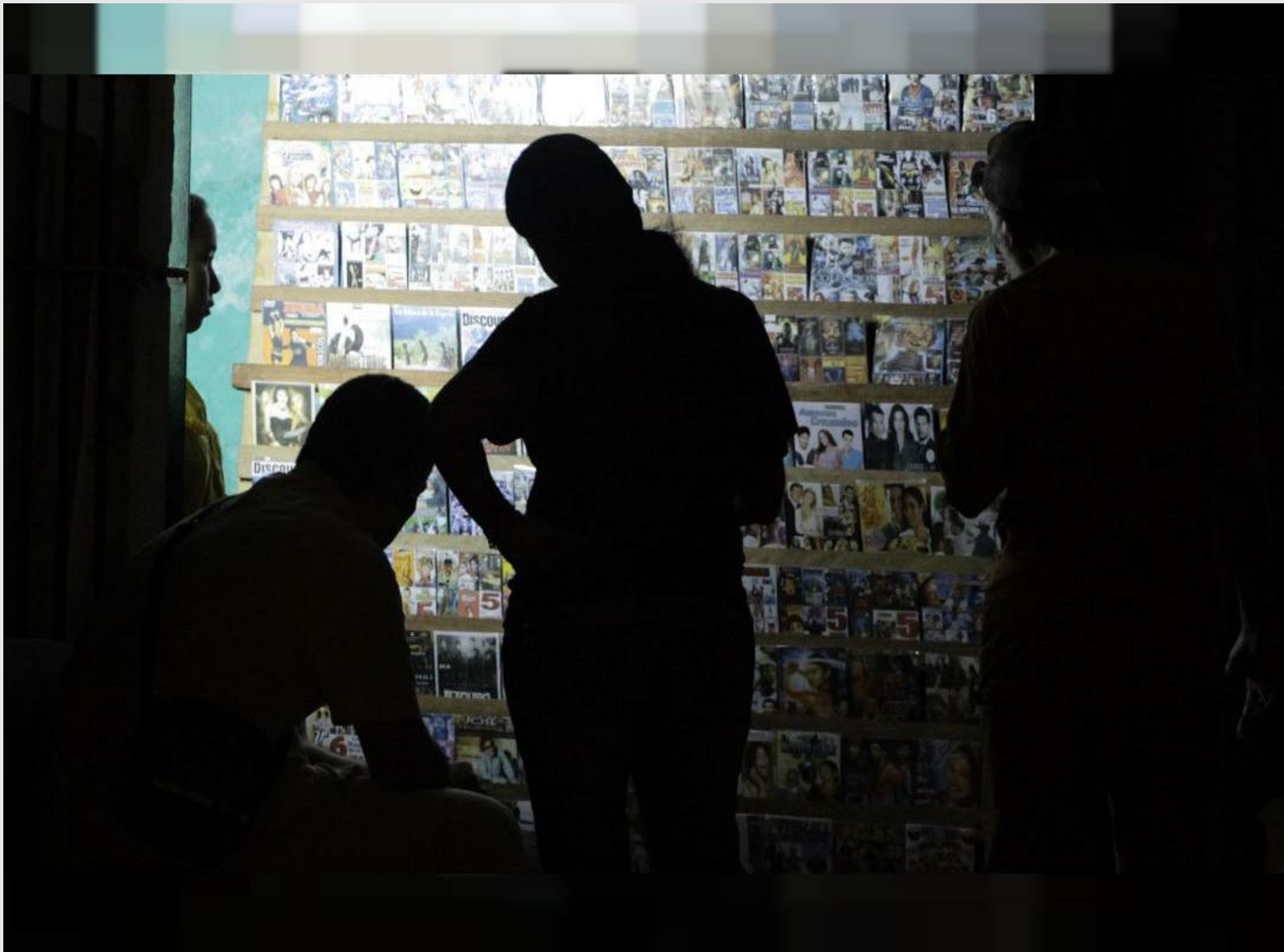
Shadow economy as a percentage of GDP, Malaysia and selected comparators, 2015



Note: Data for Malaysia is as at 2020

Source:

1. Medina, L., and Schneider, F. (2018). *Shadow Economies Around the World: What Did We Learn Over the Last 20 Years?*. International Monetary Fund, IMF Working Papers WP/18/17, Washington, D.C.
2. 'Malaysia's shadow economy 21% of GDP, Guan Eng says', *The Star*, 13 January 2020, Accessed 10 August 2020, <https://www.thestar.com.my/business/2020/01/13/malaysia039s-shadow-economy-21-of-gdp-guan-eng-says>.



# Lessons from Other Countries in Taxing the Shadow Economy



# Tackling the Shadow Economy is Challenging

- **Difficult to detect:**
  - large number of participants.
  - informality of the economic activities.
  - deliberate steps taken to conceal transactions.
- **Difficult and time-consuming task to quantify unreported income:**
  - inadequate books and records.
- **Large number of participants** with relatively **small amounts of tax** involved:
  - need to weigh the costs of collection against the amounts that can be collected.
  - give appropriate consideration to equity issues.

# Evolving Strategies for Tackling the Shadow Economy

- **Traditional tools relied on enforcement:** audits of registered businesses and physical searches for unregistered businesses.
- **Modern strategies are multi-faceted:** more investment in prevention, taxpayer education to tackle common sources of error, simpler processes and reinforcing of social norms.
- **Adapting to a changing business environment:**
  - A shift away from cash (a trend that is being accelerated by COVID-19).
  - Widespread access to sophisticated technology: capabilities that were once only available to large business now affordable for even the smallest business.
  - More business is online (also accelerated by COVID-19).

# Tools for Enhancing Compliance



Cash registers connected to the tax administration.



Mandatory electronic invoicing.



Third party information.



Pre-filling tax returns.



Caps on cash transactions.



Distributed ledgers (blockchain).

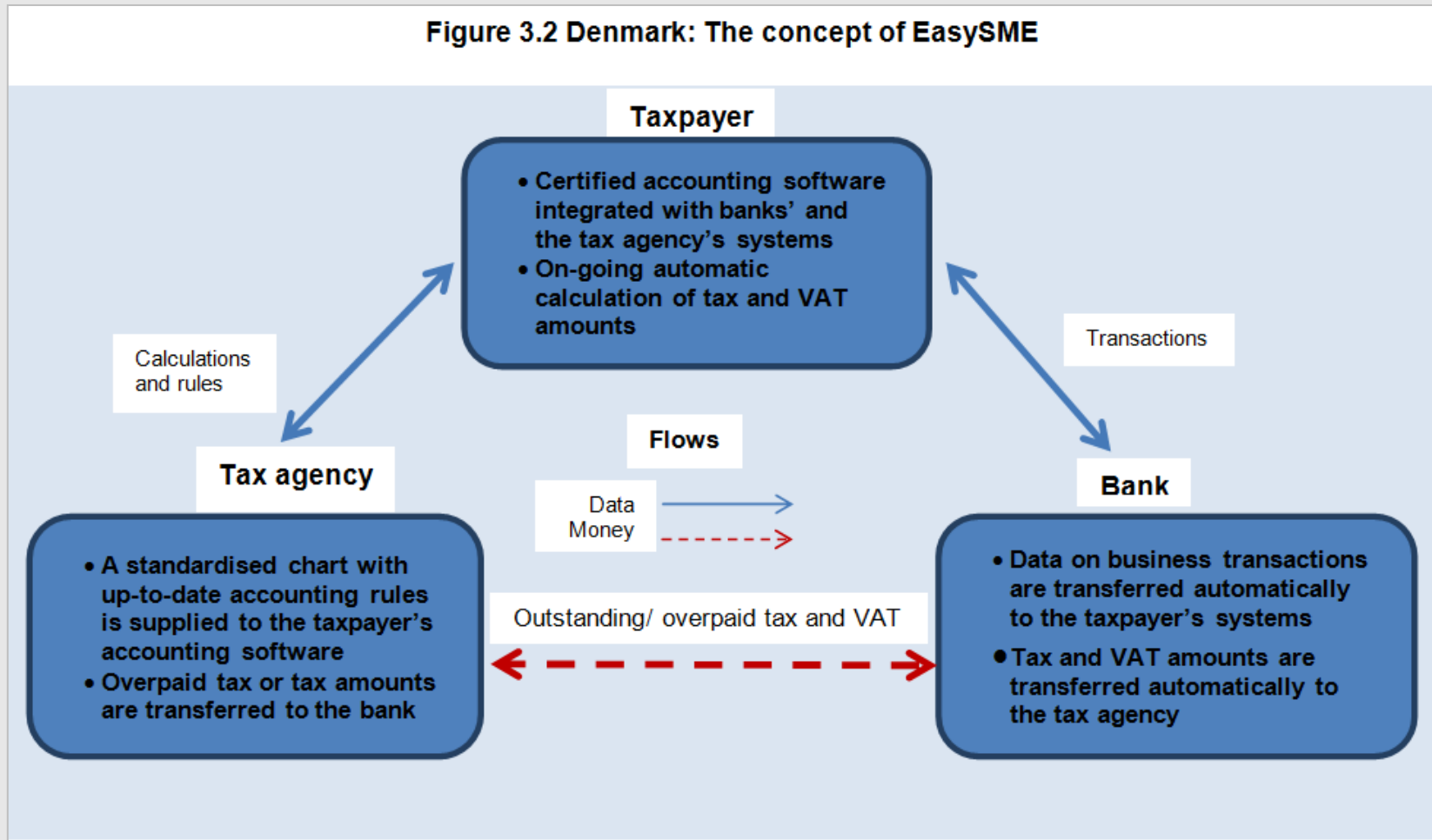


# From Paper to Digital

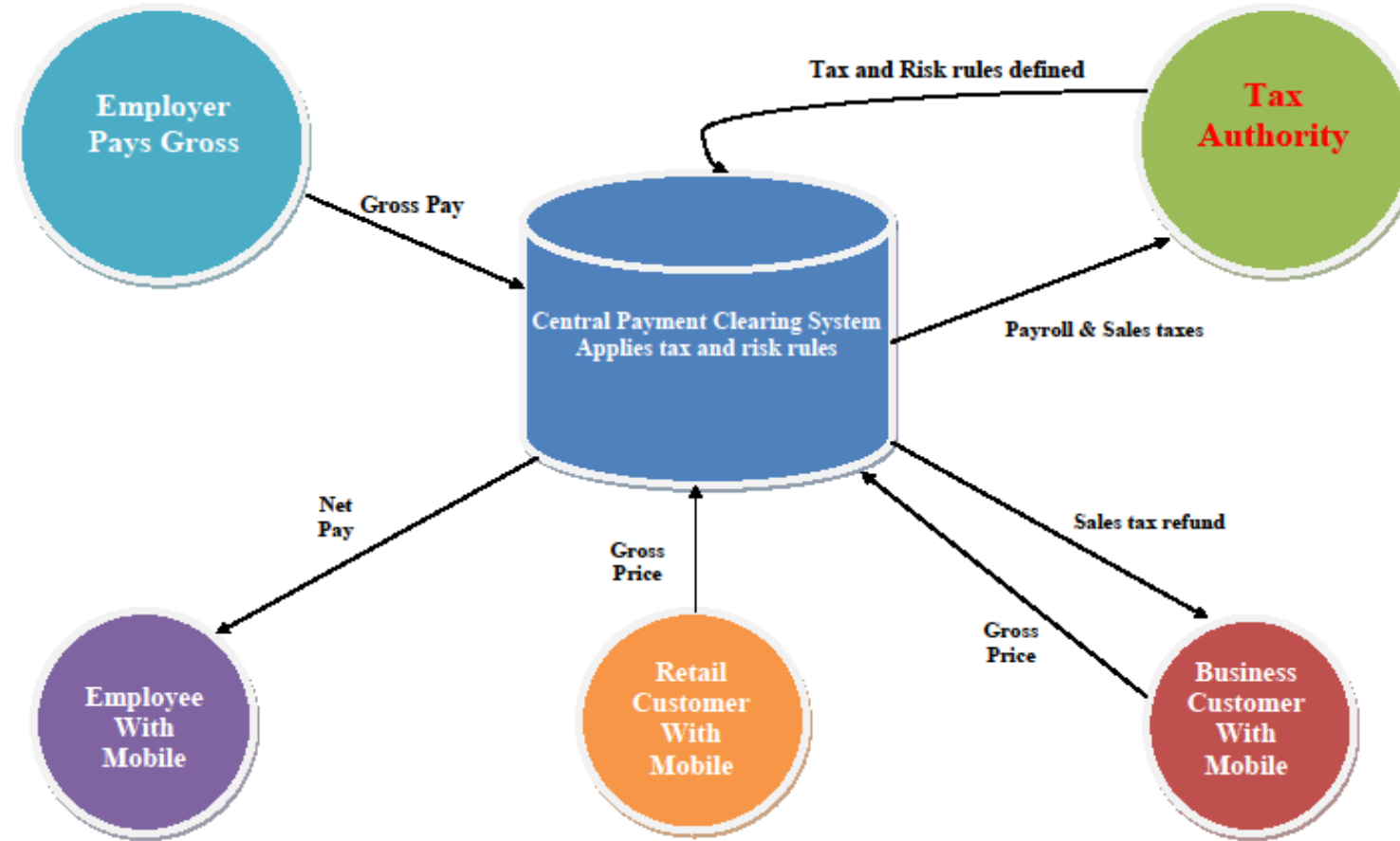


# Denmark's Efforts to Automate Tax Compliance

Figure 3.2 Denmark: The concept of EasySME

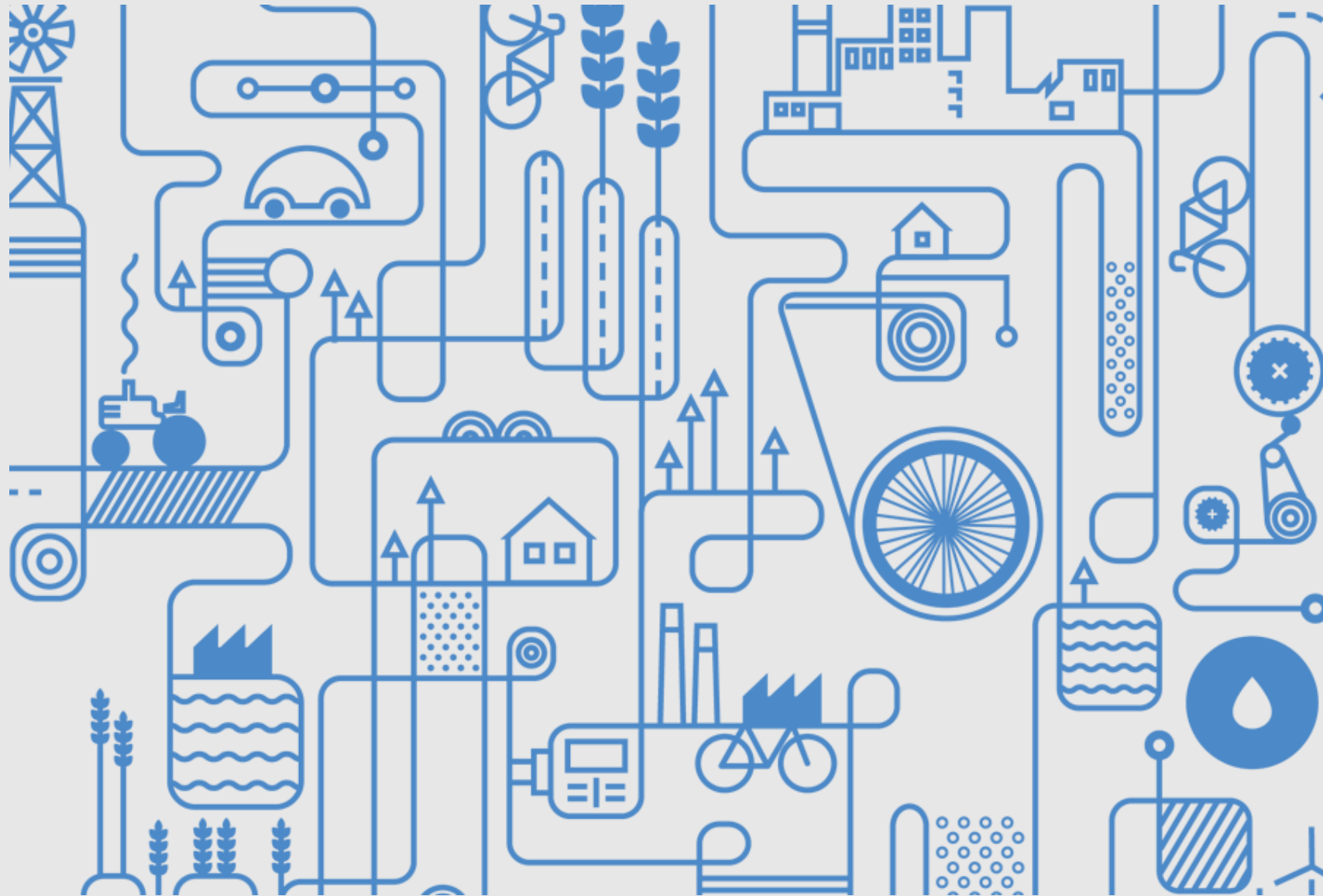


# Splitting Payments



1





# How to Measure Success?

# Need to Focus on Overall Performance of the Tax System

- Tax system exists to deliver correct tax at right time=value=outcome
- Voluntary compliance delivers better outcomes: sustained increase in tax revenues and closing of the tax gap
- Audit yield is a good measure of downstream activities ( i.e. responding to non compliance) but:
  - Not helpful for upstream activities that prevent or deter noncompliance
  - As voluntary compliance improves audit yield may even decrease
- Tax administrations increasingly use a basket of indicators to track overall performance. These include regular measures of the “tax gap” using the techniques discussed earlier

# Possible Metrics for SME Tax Outcomes

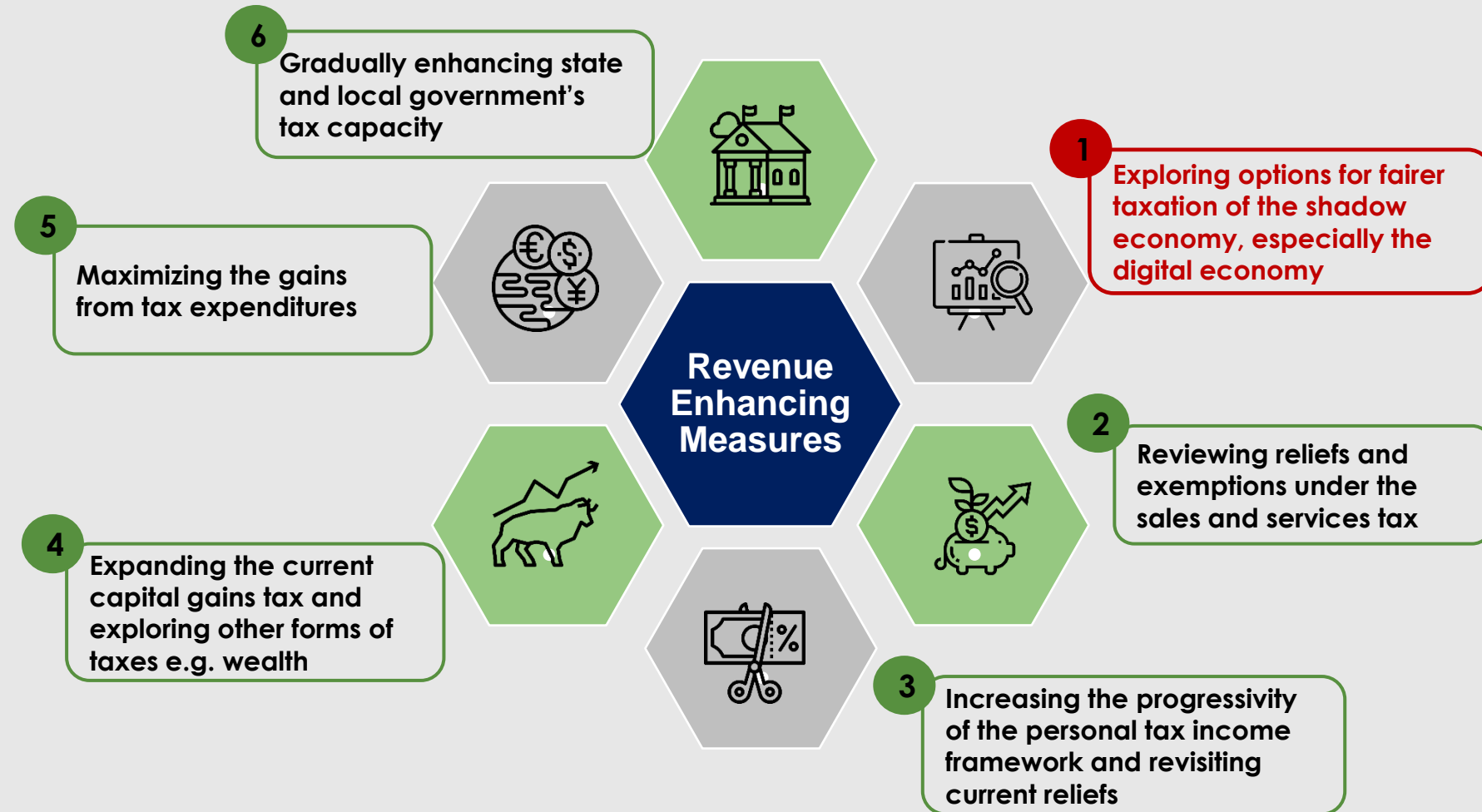
- **Simple measures of compliance rates:** timely filing and payment
- **System based measures:** numbers of SME taxpayers using certified systems and/or intermediaries validated by systems audits
- **Comparisons with economic indicators:** some administrations compare receipts against economic indices, but with some concerns around independence of data.
- **Tax/business ratios:** real time compare with industry benchmarks. How does that vary between low risk and high risk segments (those not using certified systems and/or intermediaries)?
- **Qualitative measures:** “stakeholder confidence” - focusing on the extent to which the tax administration is trusted to deliver fair compliance outcomes.
- **Efficiency measures:** reductions in costs for tax administration and for taxpayers, who should be able to focus on their business



# Some Policy Options for Malaysia



# Malaysia Needs to Collect More and Spend Better, and Taxation of the Shadow Economy can Play a Role Here



# Thank You



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