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Shadow Economy in Malaysia: An Introduction
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Introduction

A shadow economy denotes commercial transactions considered illegal, either because of the illicit nature of the commodities or services exchanged or because the transactions do not adhere to state reporting mandates (The Star, 2023). It consists of unregistered and unlicensed enterprises that circumvent taxation by executing cash transactions to escape income reporting, resulting in tax collection deficiencies (The Sun, 2024). A shadow economy exists in every country, irrespective of its economic classification as developing, transitional, or developed (Sanusi et al., 2021).

Tax evasion, a significant element of the shadow economy, is a deliberate, unlawful conduct aimed at reducing or entirely avoiding tax obligations by taxpayers. The existence of a shadow economy diminishes the tax base, thereby leading to a reduction in total tax collection. Tax evasion denotes the forfeited tax revenue resulting from clandestine economic operations, with the determinants of tax evasion also affecting the shadow economy (Alfano et al., 2024). In Malaysia, tax evasion is characterised in section 114 of the Income Tax Act (ITA) 1967 as an act of deception and is therefore unlawful.

Malaysia has encountered significant shadow economic activities. A substantial shadow economy indicates more tax avoidance. The LDHN indicates that shadow economy activities significantly affect the country's tax gap, frequently linked to unregistered and unlicensed enterprises that fail to submit tax declarations. In the year 2022, the Malay Mail stated that the nation forfeited over RM70 billion each year in tax revenue due to shadow economy activities. Moreover, Malaysia's shadow economy constituted 21% of the gross domestic product (GDP), amounting to an estimated RM330 billion, according to Deputy Finance Minister 1, Datuk Seri Ahmad Maslan (The Star, 2023).

Shadow Economy

Smith (1985) characterises the shadow economy as economic activity and transactions that circumvent governmental restrictions and fail to adhere to tax laws. The shadow economy, a crucial component of the unobservable economy, exists outside the confines of legal regulation while still engaging in the lawful production of goods and services (Bashlakova & Bashlakov, 2020). Hoinaru et al. (2020) suggested that the shadow economy pertains to economic operations concealed from governmental oversight rather than illicit actions.

Table 1 A taxonomy of types of underground economic activities

Type of activity	Monetary transactions		Non-monetary transactions	
Illegal activities	Trade with stolen goods; drug dealing and manufacturing; prostitution; gambling; smuggling; fraud; etc.		Barter of drugs, stolen goods, smuggling, etc. Produce 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 neighbour help

Source: Mirus and Roger (1997, p.5) with additional remarks (Schneider & Enste, 2000)

Table 1 offers concise definitions of monetary and non-monetary transactions, together with the legal and illegal status of activities (Mirus & Roger, 1997). Tan et al. (2016) defined the shadow economy as any legal economic activity involving monetary transactions that evade tax obligations.

This paper review employs the enhanced and contemporary definition proposed by Medina and Schneider (2018). The shadow economy includes any economic activities that are hidden from official authorities for financial, legislative, and institutional reasons. Monetary variables encompass tax evasion and the circumvention of social security contributions; regulatory factors pertain to the avoidance of state bureaucracy or the encumbrance of legal frameworks, whereas institutional factors entail bribery practices, the efficacy of political institutions, and inadequate rule of law. The shadow economy, for this study, primarily encompasses legal economic and productive activity that would augment national GDP if documented.

Tax Evasion

The Malaysian tax system has experienced significant modifications to enhance global competitiveness and mitigate tax leakages (Sanusi, Abdullah, Chin, Rastam, & Rozzani, 2021). However, in numerous nations, taxes are widely recognised for their deficiencies. Consequently, numerous entities will use the advantages to evade taxation, thereby elevating the tax evasion rate among the populace. A significant number of individuals do not adhere to tax obligations (Ghani, Hamid, Sanusi, & Shamsuddin, 2020).

Tax evasion transpires when taxpayers deliberately neglect to file tax returns, misrepresent income, exaggerate costs, or remit less than the owed tax amount (Rashid, 2020). Furthermore, Rashid (2020) characterised tax evasion as an unlawful act that contravenes existing statutes and diverges from societal norms to diminish an individual's tax obligation. Tax income is the paramount source of funding for a nation's economic development; yet tax evasion significantly complicates the tax authority's ability to achieve comprehensive and efficient tax collection from taxpayers (Rashid, 2020).

Tax evasion is a worldwide issue encountered by nearly all nations. Tax evasion is widespread in both rich and developing nations and is frequently considered a contemporary financial crime. Tax evasion has been a contentious problem among politicians for decades, necessitating effective measures to address this growing economic danger. The taxpayers' noncompliance with applicable tax law rules signifies tax evasion, a practice that is becoming progressively challenging to monitor due to the innovative and evolving strategies employed in evasion.

Shadow Economy versus Tax Evasion

The shadow economy and tax avoidance are intrinsically linked phenomena. The existence of a shadow economy diminishes the tax base, thereby leading to a reduction in total tax collection. The shadow

economy, defined by unreported and unregulated economic activities, is inherently associated with tax evasion, as individuals and businesses intentionally falsify their revenue to avoid tax obligations. Furthermore, the shadow economy encompasses the production of legally permissible goods and services that are intentionally exchanged privately to evade tax obligations (Sanusi et al., 2021).

Numerous studies have examined tax evasion and the shadow economy, primarily concentrating on the factors and implications of their magnitude (Dell'Anno, 2022). A study by Ishak and Farzanegan (2020) examined the impact of the shadow economy on tax revenue and recorded its adverse influence on tax income in both developed and developing nations. The shadow economy is directly associated with heightened tax evasion and escalating governmental laws (Sanusi et al., 2021). Hoinaru et al. (2020) asserted that the shadow economy serves as a sanctuary for those attempting to evade tax responsibilities, thereby promoting a culture of tax evasion.

Furthermore, the mechanics of the shadow economy might affect tax morale—the inherent drive of individuals to fulfil their tax obligations. This trend is exacerbated in nations with fragile institutional frameworks, where corruption and poor governance foster the expansion of the shadow economy and the incidence of tax evasion (Stasinopoulos et al., 2022).

Conclusion

The shadow economy and tax evasion are significant challenges in Malaysia, affecting economic growth, governance, and public funding. These two are closely interconnected, with each affecting the other. A strong shadow economy can enable tax evasion, and elevated tax evasion can further promote the growth of the shadow economy. Both posed substantial issues for global economies. Comprehending the drivers and ramifications of these phenomena is essential for formulating effective methods to combat tax evasion and alleviate its detrimental impacts on economic growth and social equality.

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