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The Black Economy in Southeast Asia: Current Issues and Future Challenges

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EXECUTIVE SUMMARY

- Between 1991 and 2015, the level of black economy activity in Southeast Asia equalled 33.4% of regional GDP, higher than for the rest of East Asia and above the global average.
- By 2015, however, the regional average had declined to 28.3% of GDP.
- The level of black economy activity remains highest in Myanmar and Thailand, and lowest in Singapore and Vietnam.
- Whilst black economy activity has declined, several problem areas remain. Tax collection is still weak and poorly enforced in many parts of the region. Corruption is an ongoing issue, as is smuggling (especially of wildlife, timber, jade and gemstones) and illegal transfers of money out of China into Southeast Asia.
- Emerging additional threats include the growth of the methamphetamine drug trade, and the likely prospect that Covid-19 will push many small formal businesses out of the regulated economy as they attempt to survive the current downturn. The financial cost of Covid-19 may also weaken the ability of nations to sufficiently fund enforcement activities in the near future.
- Whilst ministerial and senior government fora already exist to co-ordinate ASEAN work in this area, much remains to be done. This includes a greater adoption of electronic banking and traceable online money transfers; greater usage of biometrics for identity authentication; improvements in tax collection rates in several jurisdictions; a sustained clampdown on smuggling; and regulation of cryptocurrencies to ensure they are not used as a black market tool.

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WHAT IS THE BLACK ECONOMY?

More than 300 endangered tortoises are detected on an inbound flight into Kuala Lumpur. Organised gangs move women into prostitution rings in the Mekong region, and bring timber back with them on their return journey. Military and police officers help Chinese travellers to courier cash in and out of The Philippines without approval.

These are just some of the faces of the black economy in Southeast Asia today.

Trafficking, tax cheating, cash-in-hand unrecorded deals, prostitution, smuggling, illegal drugs: all of the above behaviours – plus a wide range of others – are often referred to as being part of the so-called “black economy.” It is a phrase that many people will have a passing familiarity with, but lack a precise definition of.

The black economy refers to a set of illicit money-making activities that essentially occurs “off the books” – in other words, out of the sight and awareness of regulators, policymakers, administrators, tax collectors and statisticians. It includes both legitimate legal economic activities that should be reported but are not, as well as those which are illegal.

As the OCED (2017) has pointed out, these illicit activities can take a very wide range of forms, such as undeclared cash transactions; trade in illegal products, human organs and wildlife; unreported and/or falsified business earnings; understated or unreported employment (wages and salaries) earnings; employer fraud (wage theft from employees); the use of unregistered and/or phoenix companies; gambling (where proscribed); human trafficking and modern slavery; illegal currency transactions and money laundering; the use of barter or cryptocurrencies to avoid transaction reporting; and a wide variety of violations of tax laws.

This list is not exhaustive. As a number of observers have noted, the practices and forms of the black economy are constantly evolving as laws and regulations change, new economic opportunities emerge, new government policies are enacted, and as different administrators respond in differing ways to the problem (Schneider & Enste 2002). What is illegal at one point in time may subsequently become legal, and vice versa, and black economy participants will adjust their activities accordingly.

The “black economy” phenomenon is often referred to by a wide variety of other terms, including the underground economy, the grey economy, the shadow economy, the black market, the parallel economy, the hidden economy, the non-observed economy, and the informal sector. The phrase “white economy” is sometimes employed to describe its opposite – the legitimate, officially-sanctioned economic behaviour of businesses and individuals.

WHY IT MATTERS

Shadow economic activity creates issues and problems for a number of different members of society. It deprives taxation authorities of revenue that could be spent maintaining the day-to-day work of government, and to improve the services it offers its citizens. A vibrant underground economy also requires the use of additional public funding to detect and

prosecute, diverting resources needed for other community requirements. In some cases, the loss of public revenue may be so great that authorities raise tax rates, which encourages even further leakage from the formal to the informal sector, exacerbating the problem and creating a destructive, self-reinforcing cycle.

Unregulated black trading acts as a source of unfair competition to legitimate businesses. Whilst the former is free to operate without regulatory constraints, *bona fide* firms have to comply with a wide range of licensing, employment, taxation, product safety and other laws. It is a particular problem for small businesses, who typically trade on thin margins and have limited competitive capacity, and at its worse can drive them out of business.

Consumers can also lose out. Because it is unregulated, goods and services traded in the black economy come without the protections and rights that consumers receive from legitimate businesses. Defective goods, personal injuries and losses arising from products that do not meet requisite standards are unlikely to ever be rectified or dealt with.

Likewise, employees in illicit ventures are also at risk. They can be denied full wage and salary benefits, health insurance and other protections provided to those in the formal sector, and may themselves occasionally be liable to prosecution for aiding and abetting lawbreakers.

It is also a practical problem for policymakers and regulators. A vibrant but unrecorded parallel economy can mean that official statistics about employment, taxation, income, consumption, national economic activity and a host of other measures are inaccurate and unreliable.

An active black economy threatens the implicit degree of social willingness in a community to conform to the law. When an underground economy is known to be thriving, it sends a subtle message to other members of society: playing by the rules is not necessary to succeed in life. It invites others to break the law. If not checked, this can encourage more and more people to stop complying and to join the lawbreakers.

At a broader level, the size and scale of black economy activity in an economy is an indicator of how effectively an economy is being regulated and operated. When an economy is working efficiently and is well-governed, the black sector shrinks (although it is never entirely dissipated); when poor policy, regulatory and macro-economic conditions prevail, it grows. Individuals move in and out of the sector with a surprising degree of flexibility, and will usually prefer to stay in the formal sector if the circumstances are right, so a growing underground economy often indicates a poor level of public administration (Schneider & Enste 2002).

Interestingly, not all black economy activity has negative impacts. As several researchers such as de Soto (2002) and Neuwirth (2011) have pointed out, in many developing economies around the world it often provides the only form of work and income generation for many of the poor and dispossessed. This is also the case in many emerging Southeast Asian economies, where it remains a major source of employment (Sam 2005). Schneider and Enste (2002) also note that several researchers have estimated that about two-thirds of income earned in the black economy is immediately spent in the official economy, thus providing a positive stimulus on the formal sector.

THE IMPACT OF CULTURE AND GOVERNANCE

The underground economy can vary significantly from one country to another. Nations differ significantly in their cultural, legal and practical responses to the issue.

In some countries, there can be a broad-based cultural antipathy towards legal compliance, payment of taxes, and following the law. People in such societies often do not expect to have to obey the law, and there is little social stigma towards doing so; there may in fact actually be support for the parallel economic activity. Several cultures have popular sayings that epitomise this behaviour, such as the idiom “only fools pay” in Italy.

Several different analyses of the phenomenon show that black economy activity is greatest in economies with an excessive tax and social security burden; complex employment and labour laws; and high levels of corruption. Conversely, well governed, efficiently and effectively regulated states have a lower level of underground economy activity (Sam 2005). Thus nations like Switzerland and Austria tend to have low levels of shadow economic activity, whilst states such as Zimbabwe record some of the greatest degree (Medina & Schneider 2018).

Just how much do countries vary? That depends on what is measured, and how.

MEASURING THE BLACK ECONOMY

Determining the size of the black economy is complex and fraught with difficulties. Definitive data is very limited. Researchers are essentially attempting to measure an unknown, and numerous assumptions must be made in advance. Information is hard to collect, because the persons involved in these activities actively attempt to avoid detection. And what figures are calculated are often skewed by the interests of the researcher. Tax authorities, for example, are focused on estimating figures such as the tax shortfall (i.e. the difference between the amount of tax they currently collect, and what they should be if all businesses operated in the formal economy), whereas labour market researchers might be more concerned with calculating the number of persons operating in the informal sector.

There are also several different ways in which the black economy can be measured (Bajada & Schneider 2005; OECD 2002)¹. As Medina and Schneider (2018) note in their detailed comparison of these methods, different assumptions and estimations are still made by different researchers. As a result, there is no single definitive, universally-accepted figure on the size of the black economy at a global or national level. All figures, therefore, need to be treated with a degree of caution.

HOW BIG IS THE BLACK ECONOMY IN SOUTHEAST ASIA?

Noting the above methodological limitations, what does the data show for Southeast Asian nations? One of the more detailed and exhaustive longitudinal estimations conducted in recent years has been that prepared by Medina & Schneider (2018), who examined 158 countries using a combination of several different measures, and then compared their results back to the findings of other researchers. Their work provides estimates of the black

economy in each nation as a likely percentage of national GDP, and comes close to other results used by different statistical offices and/or direct surveys. Despite this apparent rigour, they nevertheless caution that it tends to under-calculate the contribution of illegal activity.

Their study includes all Southeast Asian economies, allowing some relatively robust comparisons to be made about the black economy across the region.

The long-term average for Southeast Asia since the early 1990s has been for the region to collectively record quite a high group average. For example, the region's average ratio of black economy activity to GDP between 1991 and 2014 was 33.4%. This figure was much higher than the mean across the broader East Asian community (which included China, Japan, South Korea, Taiwan and Hong Kong SAR) of 21.2%. It was also higher than the global average of 31.9%. By any measure, this was not a particularly good performance.

In recent years, however, local economies have made marked gains, which are reflected in much improved national and regional figures in 2015, the last year for which data have been calculated. This is shown in Table 1 below.

Table 1: Regional Black Economy and Other Recent Economic Indicators

	Estimated size of black economy (% of GDP, 2015)	Tax to GDP ratio (tax revenue as % of GDP, 2017-18)	GDP per capita (current US \$), 2018
Brunei	30.4%	Not available	\$31,628
Cambodia	33.9%	17.1%	\$1,510
Indonesia	21.86%	9.9%	\$3,893
Laos	25.0%	Not available	\$2,542
Malaysia	26.1%	12.0%	\$11,373
Myanmar	51.0%	6.0%	\$1,326
The Philippines	28.0%	14.7%	\$3,102
Singapore	9.2%	13.5%	\$64,581
Thailand	43.1%	15.0%	\$7,273
Vietnam	14.8%	Not available	\$2,566
Regional average	28.3%	Not available	\$12,979

Sources: Medina & Schneider (2018: Table A.1, pp.69-76); World Bank (2019)

The long-term trend suggests that, overall, the level of black economy activity is decreasing throughout Southeast Asia. The 2015 regional collective average of just 28.3% is a considerable drop from the earlier long run mean of 33.4%.

THE BLACK ECONOMY TODAY IN SOUTHEAST ASIA

Different countries in the region are currently dealing with a divergent range of black economy issues. Some issues – such as taxation and corruption – are common to several nations, whilst others are more localised matters.

Indonesia is one nation that has traditionally had a poor rate of taxation collection. To help bring more taxpayers into the formal economy, it introduced a tax amnesty during 2016-17, allowing individuals and firms to enter the regular tax system without penalty for previous non-compliance. This initiative did result in the collection of some additional revenues, but its overall success has been questioned. The country also still lags behind many economies in other measures designed to tackle black economy activity. For example, practical adoption of e-government tools that can help individuals enter and remain within the formal economy is much lower than the regional average, blunting attempts to make it easy for parties to become part of the legitimate regulatory system (Rohman & Meyerhoff 2017). Corruption also remains an issue, and recent legislative changes have seemingly weakened the powers and capacity of the KPK, the country's anti-corruption watchdog.

Malaysia has had to deal with both alleged substantial state-sponsored corruption and weak tax enforcement. The 1MDB scandal, which is currently before the nation's courts, has exposed apparent corruption by some of the nation's leading political figures. At the same time, tax collection is still weak. Last year, then Finance Minister in Malaysia's Pakatan Harapan government, Lim Guan Eng, made a number of public calls for more focus on tax compliance and enforcement. He argued that corruption, active tax evasion, a complex regulatory system, and weak rule of law were all contributing to the problem (Annuar 2020; Channel News Asia 2020). The CEO of the Inland Revenue Board (IRB) announced in response that the IRB would put more resources into collecting money from shadow economy activities and conducting field audits (Aziz 2019), but it remains to be seen if such initiatives will continue under the new government and whether they produce any tangible results.

In Myanmar, two critical current issues are the poor regulation of the gemstones and jade sector, and weak tax regulation. One estimate suggests that up to two-thirds of the nation's precious stone production avoids being taxed, and much is smuggled into China – a serious problem for a country that produces 90% of the world's jade. A number of measures have been undertaken to address these problems, such as membership of the international Extractive Industries Transparency Initiative, but much more remains to be done (Menarndt 2019). Taxation laws and enforcement of the same are also weak, and the rule of law remains weak in parts of the country due to the presence of various armed ethnic groups.

Recent headlines in The Philippines have focused on the effects of large quantities of undeclared Chinese money moving into the country, often working in organised syndicates and assisted by corrupt officials. Much of this appears to be gambling-related funds being illegally moved out of China (Calonzo & Alegado 2020). At the same time, President Duterte's armed crackdown on drugs continues.

Many of Southeast Asia's traditionally porous land borders have a long history of allowing the illegal movement of goods and people between nations. Timber smuggling remains a problem in several parts of the region, such as Indonesia and across the Cambodia-Vietnam border.

Wildlife smuggling is another area of regional concern. Malaysia, for example, has been noted by the United Nations Office on Drugs and Crime as a "destination airport" of choice for illegal wildlife traders, as it provides convenient transit locations and cheaper bribes than Suvarnabhumi Airport in Bangkok (Then, Vanar & Chu 2019). ASEAN's own

Working Group on Wildlife Enforcement has pointed out that Vietnam is also a major transit point, with animals such as the endangered pangolin frequently trafficked through or into the country (UNODC 2019). Illegal wildlife trading may also be responsible for the transmission of diseases across species, and is a suspected originating cause of the Covid-19 virus in China.

A degree of cross-border liaison and co-operation to deal with the black economy is an obvious forum for ASEAN, and has been in existence for more than twenty years. An annual Ministerial Meeting on Transnational Crime was established in 1997, along with an accompanying senior officials meeting which began in 1999. These bodies address a range of issues that broadly fall into the undeclared economy, including arms smuggling, piracy, people smuggling, human trafficking, illegal drug sales, and timber and wildlife trafficking. A number of ongoing working parties have been created to deal with each of these subjects in detail, although it is difficult to gauge what practical outcomes have been achieved.

WHAT NEXT?

The size and shape of the black economy is hard to predict in advance. Shadow traders are notoriously adept at changing their practices as opportunities arise, and shutting down past models when regulators are on their tail. Overall, the future prospects in Southeast Asia are mixed.

Whilst the evolution of the ASEAN Economic Community will inevitably see an accompanying deepening of economic integration throughout the region, this may also increase the capacity for shadow operators to work across borders. Regulators and tax administrators should be able to co-operate more easily under an AEC framework, but to date such joint enforcement has had mixed results.

The current Covid-19 virus is clearly the most pressing issue. Lockdowns and other preventive steps have bought much economic activity in the region to a halt, and many self-employed individuals and micro-businesses will be amongst the hardest hit. Many of those that survive are likely to turn to the informal sector to survive. Regulator priorities have been diverted from traditional enforcement and regulatory compliance work, which may also allow existing black market operations to continue without check. Large outlays by governments to mediate the impact of Covid-19 may also mean that funding for policing activities will suffer. Finally, there is always a danger that over-zealous steps to limit citizen activities and movements, in the name of “flattening the curve” and reducing infections, will create a backlash as time goes by, and create a culture of resistance to the state.

In the longer term, other emergent challenges also loom. The United Nations, for example, has recently noted that Southeast Asia has emerged as the world’s fastest-growing methamphetamine market (UNODC 2019). If this becomes an established illegal market, then it will likely presage more substantial black economy activity in the region.

Some emerging global trends will clearly assist in reducing the underground sector, such as the use of biometric indicators to reduce identity fraud, and the growth of electronic (as opposed to cash) transactions that are easier for authorities to detect. At the same time, other developments may run counter to improvements in compliance. Cryptocurrencies, for

example, can provide easy ways for black economy participants to store financial value and move it without detection. Gig- and sharing-economy activity is popular, and growing, in much of Asia, but is often hard to police, and in many cases income is still not reported to the authorities.

The region still has a way to go in curtailing the black economy within its own borders. Whilst the underground economy can never be totally eliminated from any society, it remains an area in which more work is required if the region is to achieve best-practice standards of government and regulatory enforcement. Without this, the black economy will continue to thrive in Southeast Asia.

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¹ Some methods involve direct approaches such as interviews (with members of the public, with participants in the black economy, or with business managers) or tax audits. Others are more indirect, such as comparing and measuring discrepancies between GDP income and expenditure; between official and actual labour force sizes; between estimated and actual tax receipts; between the actual and theoretically likely demand for currency (cash) at a given level of GDP; the extent to which actual energy inputs match officially-declared levels of business activity in a given region (these can include unusual techniques such as measuring the actual consumption of electricity in a region, or the extent to which lights shine at night); and other measurable outputs (for example, the amount of drug residue found in sewage and wastewater often indicates the level of narcotics used and produced in a community). Finally, there are also some more recent statistical methods which attempt to combine a number of these, in order to increase robustness (Bajada & Schneider 2005; OECD 2002).

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