

Critical Factors of Underground Economy and Tax Evasion: Evidence from Pakistan

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Abstract

Underground Economy and Tax evasion remains the hot cake for economists because of its direct relationship with the country's GDP and social development. This paper aims to investigate the main critical factors of underground economy and tax evasion contributing towards the regressing economic landscape of Pakistan. The presence of Underground Economy is a reflection of the citizens of the country. As it conceals their income generation sources to avoid tax payments; this is either because they are not worth revealing or more primarily earned from illegal businesses that are banned in Pakistan including Smuggling, Trafficking, Drugs and other similar unlawful activities. Tanzi (1983) equation for measuring the underground economy is used to highlight the contributing factors of underground economy. These factors are analysed prudently to dig out the critical factors for the Underground Economy of Pakistan from the existing literature. The findings of the study explains that corruption and concealment of income to avoid tax payments to state are the main factors; consequently followed by unaware labour force, de-regularized fiscal policies and weak tax collection system are the constituents of Underground Economy in Pakistan. The paper concludes with recommendations to policy makers to combat the nuisance of underground economy and tax evasion, and to put the economy of Pakistan on the track towards progress.

Key Words: Underground Economy, Tax Evasion, Pakistan, Critical Factors, Tanzi Equation

1. Introduction

Underground economy is a consistently prevailing loophole with in the economy of countries throughout the world. Alternatively known as a shadow economy, hidden economy, unofficial economy or black economy all the same cast impediments in the economic development of the country by undermining the scare resources available within the territory (Keith, Bose, & Capasso., 2012). The overall economic scenario is being disturbed due to these drawbacks. Underground economy means the transactions of goods and services which are not under the government's notice; therefore they are beyond the reach of tax collectors and regulators (Friedrich, 2013). This non-payment of tax is mainly known as tax evasion (Karl-Erik & Bengt, 1999). Tax

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evasion, Smuggling, Trafficking or any other unlawful activity in one system or another affects the GDP of the country and so is the case in Pakistan.

This paper aims to investigate the main effects that occur due to underground economy. The primary objectives of this study are to conduct a critical analysis of current economic situation of Pakistan based on existing literature. What are the Critical Factors of underground economy and tax evasion? How Underground Economy and Tax Evasion are affecting the overall economy of Pakistan.

This study is significant as it highlights the main factors of underground economy and methods adopted by non- tax payers for tax evasion in Pakistan with a structural approach. It set implications for government and tax officials to formulate regulations to contain the major causes of underground economy in the country. The study is structured as introduction, followed by review of existing literature, research methodology, discussion on highlighted factors, conclusion, and recommendations for policy makers and directions for future researchers.

2. Literature Review:

The underground economy refers to illegal activities that include drug trafficking, human trafficking, money laundering, tax evasion, Forced labour, smuggling of animals, Organs trade, Smuggling of precious metals any similar illegal activities (Friedrich, 2013). The underground economy plays a major role in a country's economic development. Transactions in the underground economy are illegal, either because of the good or service traded is illegal in a country or the requirements required to provide those services or good by the government are not fulfilled (Benno, Torgleracd, & Friedrich., 2009). In many cases, products and services are considered as illegal because of the duties charged on those goods are not paid. The underground economy is also known as shadow economy, black market and informal economy (Schneider, 2008).

The shadow economy includes the earning that has not been reported to the authorities so that no one can investigate from where the money has come and from which source. The individual that is involved in shadow economy takes the money "under the table" in cash and does not report the authorities so that the person have a chance to avoid income tax and duties associated to such activities. Other elements that make up the shadow economy are unreported work and income of illegal migrant workers, unreported tip income and the sale of stolen goods (Friedrich, 2013) (Pozdnyakova, Lobova, Ragulina, & Popova, 2019), (Goel, Saunoris, & Schneider, 2019).

Tax evasion refers to the unpaid customs and duties that are applied on several products and services. Tax evasion also refers to the declaration of less sources and income earned or given in order to avoid high taxes that are imposed by the governments according to their rules and regulations (Keith, Bose, & Capasso., 2012). Tax evasion is the illegal evasion of taxes by the individuals, corporations and trusts. It is an activity associated with the informal economy.

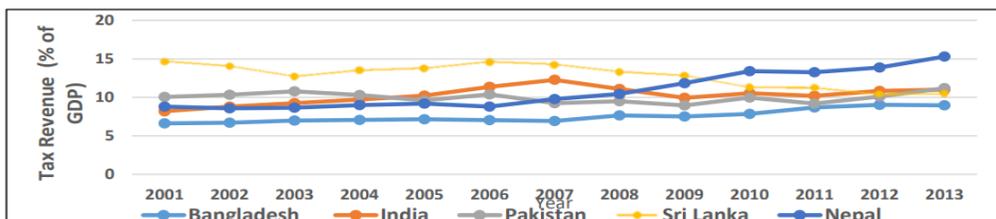
Around the globe the underground economy and tax evasion has played a major role in developed, developing and under developed countries. The underground economy and tax evasion has a big role and effect towards any country's GPD (Johnson & Kaufmann, 2013). GDP works as a centre of gravity for measuring the economic

performance of a country and can be calculated using the total of four components: personal spending, business spending, government's spending and net exports (Frey, HanneLore, & Weck-Hanneman, 2004).

An overview of the controversies of different studies and their respective results concerning the range of tax evasion and avoidance is provided by Fuest/Riedel. Cobham (2005) calculates a sum of US\$285 billion per year which developing countries lose because of tax evasion in the domestic informal economy. Estimates on tax revenue lost due to corporate income shifting vary between US\$35 billion and US\$160 billion per year. Tax evasion by wealthy individuals is estimated to cause additional revenue losses in developing countries ranging from US\$15 billion to US\$124 billion annually. The underground economy primarily includes the economic expansion of individual and their businesses. The primary concern in relation to the underground economy's impact on GDP is the rendering of a nation's GDP less-than-accurate figure. This can adversely affect government policies that are at least partially based on GDP numbers. According to estimates the American underground economy was approximately 8percent of GDP, or \$1 trillion, in 2009. By 2013, largely due to the financial crisis and the resulting contraction of the formal economy, the amount had reached \$2 trillion. The OECD average underground economy has increased to 20percent from 1999 to 2010 which shows a drastically increasing underground Economy (Johnson & Kaufmann, 2013).

In Pakistan the underground economy and tax evasion has played a big role. In a developing country like Pakistan, the most important source of Governments revenue is Tax collection. The revenue earned by the Federal Government by means of Tax is reallocated for Federal government and Provincial government's expenditure. But when Tax evasion occurs it effects the economic growth of the country in terms of less distribution of revenue (Murshed & Saadat, 2018). Time series data from FY 2001 – 2013 in Figure. 1 indicates tax revenue an average trend of 12percent of total GDP of the country. This trend is compared with other south East Asian countries indicating an eight percent in Bangladesh, 11 percent in Sri- Lanka, 12 percent in India and 15 percent in Nepal.

Figure 1: South – Asian Countries Tax Revenue percent of GDP



Source: World Development Indicator 2017

A minor contribution to tax revenue indicates a parallel existence of underground economy. Hence it is imperative to conduct research to identify and cope major features of underground economy and impediments for tax revenue (Murshed & Saadat, 2018).

3. Research Methodology

3.1 Purpose

The purpose of this research work is to explore the critical factors of underground economy and tax evasion that impact on the current economic situation of Pakistan.

3.2 Sample

Research is based on secondary data collected from recent existing literature. Secondary sources include, research journals, world development reports and economic surveys. Detailed analysis is conducted and literature of underground economy and tax evasion in context to Pakistan is extracted and presented in one single paper.

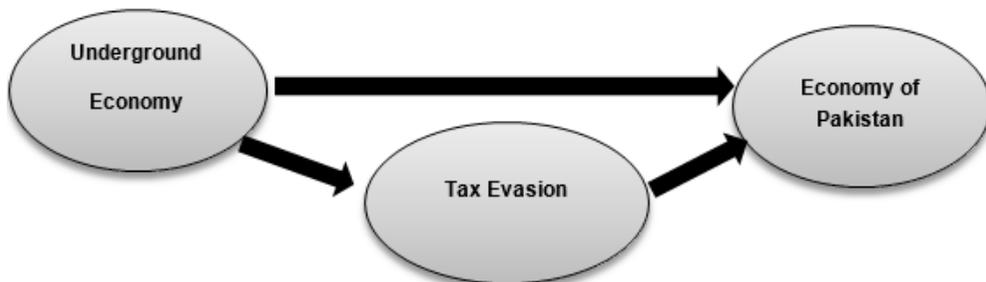
3.3 Nature

The nature of this research work is descriptive and qualitative. The literature gathered from the existing work is analyzed and written in a comprehended way.

3.4 Theoretical Framework

Theoretical framework of the study is presented in figure 2 as follows,

Figure. 2: Theoretical Framework



Source: Author Compilation

4. Hypotheses

1. Underground economy has a positive relationship with economy of Pakistan.
2. Tax evasion has a positive relationship with economy of Pakistan.
3. Tax evasion mediates the relationship between underground economy and economy of Pakistan.

Here the paper aims to discuss the impact of two variables of the study, the Independent variable of Underground Economy, the mediating variable of Tax Evasion on the dependant variable of Pakistan's economy. Current economy of Pakistan is a dependant variable as both of these factors have a huge impact on it. The research paper conducts a critical analysis on the variables of this study and concludes how these variables impacts the economic scenario of the country, specifically to Pakistan. Theoretical framework shows the clear positive relation of dependant and independent variables that how the country's economy is effected from Tax evasion and

underground economy. Basically when these two independent variables are practiced in a country the GDP of country become stagnant or started decreasing due to which the overall economic situation become vulnerable. That's why above mentioned framework explain a strong impact of independent variables on the economy of the country.

5. Discussion

On the basis of existing literature, this section discusses the critical factors of underground economy and Tax evasion that directly impacts on Pakistan's economy. The underground economy can be measured by the Tanzi model for the estimation of underground economy (Tanzi, 1983.)The equation for this is described as follows,

$$(CC/M_2)_t = \beta_1 + \beta_2 (T/Y)_{t-1} + \beta_3 (BS) + \beta_4 (INT)_{t-1} + \beta_5 (Y_g) + \beta_6 (CC/M_2)_{t-1} + \epsilon$$

Table 2: Variables of Tanzi Equation (1983) explained

Variables	Definitions	Sources
CC	Currency in circulation that is held by the State Bank of Pakistan.	State Bank of Pakistan (2002).
M ₂	Money supply	State Bank of Pakistan (2002).
T	Total taxes	Government of Pakistan (2002).
INT	Interest rate	State Bank of Pakistan (2002).
Y	Gross Domestic Product	Government of Pakistan (2002).
BS	Banking services	State Bank of Pakistan (2002).
Y _g	Growth rates	Government of Pakistan (2002).

Source: Author Compilation

The main factors contributing towards the underground economy in the light of tanzi equation constructs are discussed below with the primary focus on the case of Pakistan.

5.1 Corruption

Corruption is defined as a fraudulent activity and a dishonest conduct by the influential people in power. This phenomenon conventionally occurs involving bribery [19]. The prime critical factor for underground economy identified from literature is Corruption. This element has its roots embedded deep down in both the public and private sector. The major players involved have their network of personnel's in these sectors, which facilitate them in hiding and overruling the foot prints of their financial records attained illegally. This corrupt array of spider web conceals the humongous income earned by people illegally hence avoiding tax payments (ENIOR, 2006). The baseline for social development in the country is done by tax payer's money. When citizens of the country conceal their income and declare much less of what they earn, then the same is paid in terms of tax. The country generates low statistics of taxation amount which ultimately leads to underground economy.

5.2 Illegal transactions

Transactions that are pertaining towards illegal trade or fake invoicing are termed as illegal transactions (Awan & Hannan., 2014). More elaborately, transactions that do

not match with the financial records of government are called illegal transactions. Or such financial records that are not listed in the government records are considered as illegal transactions.

Similar is the case observed in Pakistan. The income earned due to illegal transactions is not listed in the books of the government and hence contributing towards the under-ground economy. In 2018 there are many reports issued by FIA and NAB which gives the clear account of illegal transactions.

5.3 Money laundering

Money laundering is also another factor that contributes equally in tax evasion. It is also one of a critical factor of underground economy. In this process the illegal transactions are the main method to make or store the wealth. Panama case in year 2017 overshadowed money laundering network and renowned politicians in Pakistan (Cheema, 2018). Digital currency is a main tool for money laundering. This practice has been increased in recent years due to the invention of different digital currencies such as bit coins. Digital currency is banned now in Pakistan but the people involved in this have strong tiers outside the country to facilitate them in that matter. According to dawn news this practice also costs Pakistan more than \$10bn a year. (2017)

5.4 Misrepresentation

In Pakistan businessmen and political personalities with strong financial backgrounds often misrepresent their assets. According to recent Panama reports there are number of such people who are involved in this practice. Most of them are not paying tax while they had a wide range of unofficial assets (Cheema, 2018). In recent years there were many individuals who are arrested by NAB Pakistan in the case of hiding their actual assets and not paying Tax (Gangl, Kirchler, Lorenz, & Torgler, 2017).

5.5 Decentralized clandestine markets

The term decentralized market is basically used for such markets or business which do not have any physical office. The medium of the business is in the form of online websites. Clandestine means anything that is planned to be done secretly. Therefore, such online businesses which are not accessible by the government institutions are also the main reason for tax evasion and underground economy. Now a days online business is one of the growing market in Pakistan as majority of literate persons are trying to make money through online means. Such sorts of small private online business are also having a major contribution towards a shallow economy of country (Akram, Ilyas, & Alam, 2017).

5.6 Unaware labour force

Only 0.6 per cent of the population pays taxes in Pakistan, as against 4.7 per cent in India, 58 per cent in France and 80 per cent in Canada (Khan M. Z., 2012). In Pakistan labour force is using footpaths and roadsides for selling their products. They are unaware of tax and other policies. Due to this they did not pay tax and government doesn't pay attention to educate them about tax policies (Cheema, 2018).

5.7 Country's fiscal policy

Role of fiscal policies plays major role in tax evasion. People who pay tax regularly are yet not satisfied with the fiscal policies. They are of the point of view that tax is not utilised properly. This discourages people and they did not pay taxes. Fiscal policy of the country is implementing high taxes on the people. But most of the times it happens that people who pay taxes are still deprived of their basic needs due to the negligence of government officials. Secondly country's fiscal policy is lacking the strict punishments for the non-tax payers. If it should be modified with strict punishment definitely there will be a visible increase in the tax revenue. In addition to it there is a weak check and balance on the implementations of the policies. Pakistan is already having a reliable fiscal policies but there is lack of implementation (Gangl, Kirchler, Lorenz, & Torgler, 2017), (Cheema, 2018), (Murshed & Saadat, 2018).

5.8 Weak monitoring system

Another critical factor of tax evasion and underground economy is lack of check and balance. The institutions which are responsible to check these activities are not capable enough. A streamlined process is required to check these practices. Moreover authorities of these organisations should focus on the productive work of their employees. They should take strict actions against dishonest employees. Government institutes and officials are showing their least interest in taking actions against the non-tax payers because many of them are having self-centred approach they will only extract their own benefit from the revenue generated from tax. So there is a need of check and balance on both sides either it is civilians or government officials. Both sides are just taking their own benefits and damaging the country's economy (Pozdnyakova, Lobova, Ragulina, & Popova, 2019), (Murshed & Saadat, 2018).

In retrospection of the above discussion the hypotheses of the study are confirmed that underground economy has a positive relationship with economy of Pakistan, Tax evasion has a direct relationship with economy of Pakistan. Tax evasion as a major contributor of underground economy mediates the relationship between underground economy and economy of Pakistan. As this paper is a qualitative paper where the relationships are established on the basis of existing literature rather empirical analysis.

6. Conclusion

Tax evasion and underground economy are adversely affecting the economic situation of Pakistan. Due to these two loopholes GDP of our country is drastically declining. People do not pay tax and government is unable to generate the targeted revenue. This not only affect the GDP but due to these factors our government is unable to fulfil the negative balance of payment. Lack of revenue is the most prominent hindrance in the way of country's progress. Declining of the economy is the main impact of tax evasion and underground economy in Pakistan which overall effects the country's situation domestically and globally.

In order to improve the economic situation of country it is proposed to create check and balances.

- Government should take certain steps to control these activities that include, frequent tax auditing and penalties for tax averters.

- Government should act as an investigation body which will check the activities of governmental institutions that are responsible for tax collection.
- Government should make reliable fiscal policies to attain the trust of subjects.
- Tax collected by the people should be utilised in a transparent manner in order to gain the satisfaction of public.
- A streamlined process should be introduced for tax paying so that illegal activities could be banned.

It is recommended for future researchers to investigate the success stories and the successful models applied by the governments for controlling the underground economy and tax evasions. These models can be proposed as prototypes to overcome this nuisance and placing the economy of Pakistan on the path of successive progress.

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