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Estimating the determinants of shadow economy in Malaysia

Badariah Haji Din[1]

[1]School of Government, College of Law, Government and International Studies, Universiti Utara Malaysia, 06010, Sintok, Kedah, Malaysia

Correspondence: Badariah Haji Din (email: badariahdin@uum.edu.my)

Abstract

Shadow economy and tax evasion are two inseparable phenomena. The presence of shadow economy reduces the tax base and thereby eventually reduces overall tax revenue. It also creates opportunity for distortions in resource allocation especially in the labour market where firms participating in underground activities are not subject to labour regulations . In developing countries with weak government shortage of funds will force the government to resort to inflationary financing. This study presented new estimates of the Malaysian shadow economy and explored the link between the shadow economy and financial development with the inclusion of control variables such as real income per capita, government consumption and tax burden. The size of the Malaysian shadow economy was calculated for the period 1971-2013 using the modified-cash-deposits-ratio (MCDR) approach recently proposed by Pickhardt and Sardia (2011). Also, using Ordinary Least Squares (OLS), Fully Modified OLS (FMOLS), Dynamic OLS (DOLS) and Canonical Cointegrating regression (CCR) to estimate the long-run model for the Malaysian shadow economy the contention that financial development can mitigate shadow economy was examined. The results showed that there was a non-linear long-run relationship between shadow economy and financial development, an inverted *U*-shape curve, suggesting that at lower (higher) level of financial development commensurate with higher (lower) level of the shadow economy. One policy implication from this finding was the role of the financial sector in reducing shadow economy by improving the accessibility to financing and the credit market.

Keywords: distortions, financial development, modified-cash-deposit-ratio, resource allocation, shadow economy, tax evasion