

Title:**Characteristics and Estimates of the Size of Underground Economy in Malaysia****Abstract**

The GDP is the official economy of a country but may not be the country's actual economy. The gap between GDP and the actual economy has led to the conceptualisation of a second economy. The underground economy (UE) is a portion of the second economy. UE is defined here as the income of legal activities (irregular economy) and illicit activities (illegal economy) that evade taxes. The characteristics and size of UE is estimated based on enforcement data of tax and commercial criminal of 1980-2009 using ratio and regression techniques. The objectives of this UE study are; to explore its proxy indicators; estimate its size and growth; identify its characteristics; examine its economic association (CPI, GDP per-capita, cash in circulation, electricity consumption and economic crises) and evaluate government interaction to curb UE activities (tax system and federal expenditure).

Over the 1980-2009 period, the UE has increased up to 5.46 folds amounting to MYR849 billion. The size of UE fluctuates between 8.92% and 26.94% of GDP, hovers around 20% most of the time. The opposite UE growth direction of GDP denotes their complementary association. About 60% to 80% of UE composed of irregular economy and 20% to 40% of illegal economy. In bad time the irregular economy is at its minimum level while the illegal economy is at its maximum level. In terms of participants, institutional UE is larger

(88.37%) than individual UE (21.63%), but participation tendency of UE are equal, about 50% income earned is concealed. UE skews more than the official economy within and across specific economic sectors and common at the upper income level. The left skew income distribution partly contributed to an unfair “tax burden” and “private gains”, which could have worsen income disparity of the population.

In “real economy”, UE is most elastic to CPI (3.14%) followed by GDP per capita (0.74%), cash in circulation (0.97%) and electricity consumption (1.29%). UE had affected a sizeable national budget, for 2000s decade, its impact on direct taxes and indirect taxes amounting to 13.85% and 24.96% of federal revenue respectively. Government remedial efforts through; tax reforms has changed tax non compliant mix; and increased federal expenditure has suppressed UE growth and size relative to GDP, but inadequate to reduce its size in absolute term.