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Shadow Economy Disruption: Real-Time Tax Technology, Digital Payment Density, and Corporate Tax Compliance

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Abstract:
Tax administrators, and most other people in developing countries, grapple with this issue every day. A large shadow economy undermines tax collections; reducing the shadow economy is associated with higher tax collections. Even when controlling for per capita income, a 1 percent smaller shadow-economy-to-GDP ratio is associated with a 0.125 percent higher tax-to-GDP ratio[1].

Complex tax laws, weak tax enforcement, and lack of incentives to make payments through formal banking channels are among the factors affecting the size of the shadow economy. Greater tax complexity imposes heavier compliance burdens on taxpayers, disincentivizes tax compliance, and encourages taxpayers to move into the shadows. Receipt-free cash transactions for goods and services increase the risk of tax evasion.

Keywords: Shadow economy, disruption, tax-technology, digital payment, compliance

INTRODUCTION

Governance-related factors, such as the quality of regulation and control of corruption, are also associated with a smaller shadow economy. Poor, burdensome regulation acts much like a complex tax system, discouraging compliance with formal economic systems and pushing activities into the dark. Corruption leads to lower tax morale and poor trust in government, which in turn leads to larger shadow economies.

Taxpayer trust in government is a fundamental driver of tax morale. Increased trust in tax systems can accrue by improving public benefits from taxation—as taxes and the public goods and services they finance are perceived as fair, equitable, and accountable (the “direct pathway”).[1,2,3]

Moreover, forthcoming World Bank research argues that where fairness, equity, reciprocity, and accountability feature prominently in tax reform, taxpayers are empowered to make more successful demands of governments for improved outcomes (the “empowerment pathway”).

Finally, pursuing these same goals can strengthen the state-building role of taxation—more competence and greater political ability of governments to deliver benefits to taxpayers. In other words, tax is a lot more than just tax.
The technological readiness of an economy also has a significant bearing on the shadow economy and taxation. Technology can shine a light into the shadows. In the digital world, Information and Communication Technology (ICT) platforms and modern technology that enforces tax compliance increasingly drive tax administration.

Today's ICT systems allow tax administrators to access data on taxpayers' financial transactions with banks and other institutions on a regular and automated basis. These data can be analyzed via algorithms to generate taxpayer risk profiles and to aid in risk management. Electronic invoicing systems allow reconciliations that test sales and profits to ensure they do not go underreported or unreported.

In Tajikistan, for example, where the Tax Administration Reform Project is financing a number of reforms, including establishing e-invoicing systems, the total number of individual (small) taxpayers has doubled to 273,000 in 2018 from 137,000 in 2012; the VAT productivity has increased from 37 percent to 40 percent; and, adjustment per auditor has increased from 184 million somoni to 712 million somoni over 5 years.

Altogether, potential taxes get forced out of the shadow economy and into systems of tax compliance, allowing services to be delivered. The higher an economy's technological readiness, the better and more effective such compliance measures can be.[4,5,6]

Some advice

In this context, we would like to offer a couple of pieces of advice:

Use ICT-based technological solutions to stop underreporting or non-reporting of sales, or inflating expenses, through false invoices.
Make formal payments for business transactions through banking channels—including electronic payments and "plastic money"—more attractive than using cash. (This is sometimes called "incentivizing.")
There are other effective ways to improve tax enforcement: mandating limits on cash use; taxing cash withdrawals and deposits; mandating issuance of tax invoices, including e-invoices; requiring that point-of-sale systems be installed; applying withholding taxes; accessing third-party data; and matching data with tax declarations.

Measures to incentivize the use of formal payments range from taxpayer education and moral persuasion to invoice lotteries and actual tax rebates (for insisting on receipts and using formal payment methods [2]).

In Tanzania a taxpayer education campaign coupled with tax infrastructure improvements resulted in a total of 376,666 taxpayers registered with a newly introduced mobile tax payment for property taxes. In

Punjab, Pakistan, a receipt lottery system has had a positive impact on revenues and the World Bank project is supporting tax audit improvements to further the gains.

Moreover, a successful strategy to tax cash-economy businesses and transactions requires a holistic approach to compliance. Traditional monitoring and enforcement tools—such as enabling tax administrators to access taxpayer data and match information from various public and private sources—play a key role.

As for our tax commissioner and the cash-or-receipted bike purchase, what do you think he did? He thought about the dilemma, paid the higher price, got a receipt—and unleashed a mighty fury on the shadow economy, from which we are still learning.

DISCUSSION

The shadow economy causes tax authorities worldwide to lose a lot of revenue. According to the IMF, it accounts for about one-third of the global economy. Cash transactions are a big part of the problem because they don't leave a paper trail, which allows businesses and consumers to dodge reporting sales and taxes.

Many consumers are tempted to buy goods and services without receiving a receipt to avoid paying value-added tax (VAT) or sales tax. For example, when paying cash for services like plumbing or carpentry, consumers don't realize that VAT should be included in the service fee. Because consumers don't claim VAT or report these expenses for income tax, they have no reason to ask for receipts. This benefits both consumers and businesses but makes it hard for authorities to detect and address unreported transactions. [7,8,9]

The World Bank defines the shadow economy as a combination of activities that are legal but intentionally kept hidden from the government for several reasons, such as:

To avoid payment of all kinds of taxes.

To skip paying into social security.

To dodge following certain rules like minimum wage laws.

To bypass administrative procedures like filling out forms.

In this post, we specifically look at the part of the shadow economy where businesses conceal their earnings to avoid paying income or value-added taxes. However, this category overlaps with other reasons for hiding income, like dodging social security payments or ignoring legal standards. Therefore, when policies target this type of tax evasion, they also unintentionally address these other issues.

For example, small unregistered businesses avoid paying taxes altogether and also skirt around rules like minimum wage laws and social security contributions. So, if policies are put in place to bring these

businesses into the formal economy and make them pay taxes, it will also tackle other forms of noncompliance.

RESULTS

With rapidly changing conditions in business, digitalization has moved from operational processes and customer support services to finance management and taxation. Digital taxation is being adopted by governments around the world to increase transparency, minimize tax evasion, and make the process easier for citizens. In India, firms have adjusted themselves to new technologies, automation, and AI-based tax processes, making the compliance process much easier than it used to be. With changing regulations, understanding company taxation in India has become very important for businesses of all sizes.

Evolution of Digital Tax Compliance

Digital tax compliance can be defined as the use of technology for managing the process of taxation from calculation of taxes, record keeping, filing of returns to statutory obligations. It has been seen that instead of manual paperwork, businesses utilize accounting software and other cloud-based services for fulfilling their statutory obligations.[10,11,12]

Introduction of GST, e-Invoice, Online Return Filing, and digital payments has transformed tax compliance in India.

Importance of Digital Compliance

Organizations gain from having digital tax compliance systems because:

They reduce errors in tax calculations caused by human mistakes.
The systems make financial reporting more transparent.
The process of filing taxes is made easier.
Filing is done more quickly.
There is less likelihood of penalties being incurred for failure to file on time.

Technologies Transforming Corporate Taxation

There are several types of technology being used by modern businesses to simplify tax compliance processes.

Artificial Intelligence (AI)

AI-based tools can automatically categorize payments, detect any discrepancies, and compute taxes. Such systems also allow businesses to spot inconsistencies prior to filing their taxes.

Cloud Computing Technology in Accounting

Accounting software that is based on cloud computing offers access to financial data anytime from anywhere. This technology syncs payments, expenditures, and taxes in real-time.

Data Analytics
Using data analytics enables organizations to quickly analyze financial data. It also allows businesses to find opportunities for saving money on taxes.

Advantages of Digital Tax Compliance
There are various benefits when companies embrace digital tax technology.

Increased Accuracy
Through automation, there are few errors when inputting data manually, resulting in accuracy in the statements prepared.[13,14,15]

Time Saving
The use of digital tax technology saves time in the preparation of statements and computation of tax amounts.

Efficient Document Control
The use of digital records makes it easy to find and manage invoices and other documents in case of an audit.

Decision Making
The financial insights acquired from the software allow for good decision making by business managers.

Challenges that Organizations Face in the Digital Tax System
While digital taxation brings many advantages, organizations should also anticipate challenges.

Security Issues
Sensitive data should be secured using proper cybersecurity and safe cloud systems.

Training Employees
The finance department should receive consistent training on the ever-evolving tax system and other digital solutions.

Software Updates
As tax regulations evolve, businesses should regularly update their tax software to remain compliant with the latest requirements for company taxation in India.

Best Practices to Ensure Effective Digital Tax Management [16,17,18]
Firms will be able to improve their tax management through adopting the following practices.

Investing in Efficient Tax Software
Select software that incorporates accounting, invoicing, GST compliance, and other activities within software.

Perform Periodic Internal Audits
Such actions will assist in detecting mistakes prior to the tax assessment.

Keep All Financial Records in Order
Document each financial transaction effectively.

Consult Professional Advisors
Professionals will be able to guide firms in dealing with regulations as well as in creating optimal compliance solutions regarding company taxation in India.

Technology has changed the nature of corporate taxation, making it quick, clear, and extremely efficient. Automation, artificial intelligence, cloud computing, and data analytics have brought about changes in the way companies deal with their tax-related issues. Companies that adopt tax compliance in a digital way will not only lower the risk of operations but will also enhance their financial acumen and regulatory readiness.

CONCLUSIONS

Shadow economy creates a significant barrier to economic progress in developing economies, whereas financial inclusion plays a crucial role in boosting economic performance. This study examines the impact of the shadow economy on economic growth and explores how financial inclusion moderates this relationship. We use two key dimensions of financial inclusion, including financial market development and financial institution development. We apply system GMM and difference GMM techniques on a dataset of 120 selected developing economies worldwide, from 2002 to 2020. [19] The estimation results reveal that a sizeable shadow economy significantly hampers economic growth, while higher levels of financial inclusion improve it. Additionally, financial inclusion, particularly through the development of financial markets and institutions, moderates the adverse effects of the shadow economy on economic growth, suggesting a significant substitutability between the shadow economy and financial inclusion. This indicates that increasing financial inclusion reduces the size of the shadow economy and mitigates its harmful effects on economic growth. These results remain robust when using an alternative measure of the shadow economy. Based on the findings, we recommend governments promote financial inclusion initiatives, such as expanding banking services, advancing mobile banking, and increasing financial literacy.[20]

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