

Everything about Informal Economy.

Reducing Corruption by Developing Cashless Payments

Analytical commentary

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Increasing cashless payments

Cash is the instrument due to which corruption exists. Cash anonymity, impossibility to identify its source, and non-traceability of cash transactions are the reasons why beneficiaries of corruption depend directly on the presence and circulation of cash. If there were no cash available, it would be much more difficult to get involved in corruption transactions, because of the possibility to reconstruct every transaction, including its beneficiaries, revealing thus their interests. Decreasing the high share of cash in financial flows can help eradicate corruption at least partially.

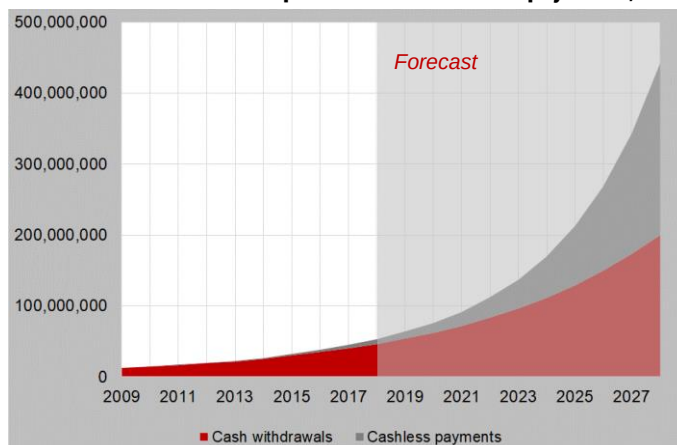
Cashless payments witnessed an explosive increase in the last decade, which resulted in an increasing global economy, lower levels of informal economy and diminishing of corruption. According to a report of the European Central Bank, in 2016, the number of cashless transactions in the European Union increased by 8.5% compared to the previous year and the number of issued banking cards reached the level of 1.6 per inhabitant¹. For comparison purposes, the number of issued banking cards in Moldova, at the end of 2017, was about 1.7 million – about 0.5 cards per inhabitant, which is three times less than the EU average. During 2017, the cardholders made 40 million transactions on the territory of Moldova, recording a 25% increase compared to 2016. It is worth mentioning that most of the card transactions continue to be withdrawals of cash at ATMs. Although the share of cash withdrawals to cashless payments is 60:40, the value of cash withdrawal operations considerably exceeds the value of cashless payments, the proportion being 90:10 (Figure 1). On average, a cash withdrawal transaction at the ATM amounts to about MDL 1,650, whereas in a cashless transaction only MDL 300 is spent. At the same time, the number of cashless transactions increased from 1.45 per card in 2010 to 9.3 transactions per card in 2017. Note that the number of cash withdrawals decreased from 18.8 to 14 transactions per card². These trends show that people are increasingly using banking cards for daily operations, even though of small value.

Figure 1 reveals that if the trends from the last 10 years continue, value of cashless transactions will exceed the value of withdrawal operations only by 2028. This aspect does not take into account cash transactions that are not part of the banking circuit; if such data is taken into account, the share of cashless transactions would be much lower than 10%.

¹ <https://www.ecb.europa.eu/press/pdf/pis/pis2016.pdf?be9989f6bd72483ebe27d8dfae1f0362>

² Figures are small, most likely due of the large number of inactive banking cards. Salary projects are the main reason people get new banking cards. Only a few people close their old accounts when they change their job and the banking cards are still active.

Figure 1: Value of cash withdrawal operations and cashless payments, thousand MDL

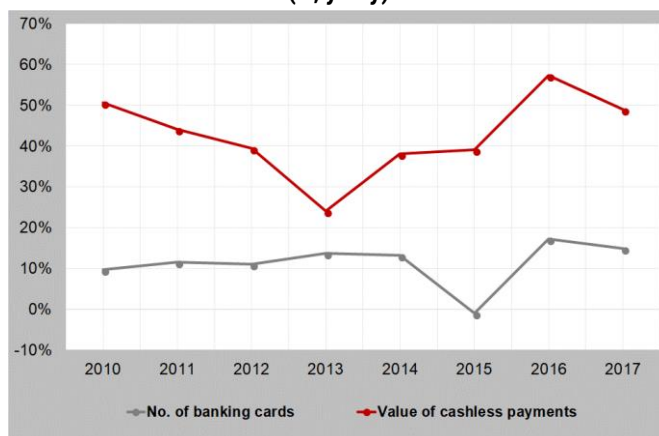


Source: NBM data and author calculations

Importance of cashless payments

Strengthening the cashless payments system is essential for achieving several major goals. First, the widespread use of payments with banking cards is beneficial for the economic development. According to a recent study conducted by Moody's Analytics in 70 countries, a 1% increase in the use of banking cards has a positive impact on the state's economy, resulting in a GDP increase of about 0.04%³. Although the contribution appears to be insignificant, it is sizable taking into account the fast spread of digital payments in developing countries. For example, in Moldova over the last 8 years, the number of banking cards put in circulation has increased by an average of 10% annually and the value of cashless transactions – by 43% annually (Figure 2). Only in 2015, the increase in the number of banking cards put in circulation had a negative value – when Banca de Economii, Banca Sociala and Unibank were liquidated.

Figure 2. Increase in the number of banking cards and the value of cashless operations (% , y-o-y)



Source: NBM data and author calculations

By its nature, cashless payments are highly transparent, a fact which contributes to diminishing the informal economy. Due to the trace left by each electronic transaction, it becomes more difficult not to declare the income and avoid paying taxes. The anonymity of cash and the impossibility to identify its source of origin are the elements that make it more likely to be used both by criminals and transgressors. A recent PwC study conducted with the support of

³ <https://usa.visa.com/dam/VCOM/download/visa-everywhere/global-impact/impact-of-electronic-payments-on-economic-growth.pdf>

the Good Governance Fund revealed that the informal economy accounts for about 43.4% of Moldova's GDP⁴, much higher than in Romania for example, where the level was estimated at 30.1% of the GDP. The high share of remittances from abroad is one factor that amplifies this problem in Moldova. The money received from abroad rarely enters the banking circuit and is rather spent through cash transactions. This factor is exacerbated by the large share of retail trade and entrepreneurial activity on the basis of patents. The shadow economy is extremely complex and combating it requires a multilateral approach, including by reducing the tax pressure on business entities, relaxing labor legislation, tightening sanctions and controls conducted by the authorities, and last but not least – a strategic vision to formalise the economy. Cashless payments should not be seen as an essential tool to fight against the shadow economy; yet their popularisation can play a supporting role in combating the informal economy.

Using electronic payments and diminishing the contact with people can reduce the level and risk of corruption. Any extra interaction between business entities and state representatives in order to pay customs duties or for other government services, which results in an exchange of cash, increases the risk of abuse by demanding bribes. It is important to mention the Government Electronic Payment Service [MPay](#) – an informational instrument that can be used to pay for various public services, such as: road fines, real estate or income taxes, civil status services and so on. One of the objectives of this platform is to provide the possibility to pay online for all the public services. Although the initiative is praiseworthy, it does not seem to be part of a well-rounded view of the authorities concerning the digitisation of the economy. First, there are still public services that cannot be paid through the platform. In some cases, even the number of banks through which the transactions can be done for a fee is limited. Second, we must note that the term of validity of the entrepreneurial patent is repeatedly extended. As regards the subject addressed by this note, the biggest issue is not the form of organisation based on patent, but rather the failure to record the revenue obtained by patent holders, which limits the state's possibility to assess the reliability of taxes or payments made by them.

Recommendations

Currently, the society is not fully aware of the importance and benefits of cashless payments. That is why citizens do not request alternative payment methods, and payment providers are reluctant to invest time and capital to develop the necessary infrastructure. To increase the share of cashless payments it is necessary to put in place a holistic approach that will include policies to stimulate businesses and consumers to favour cashless payments, develop a legal framework to support the development of the infrastructure of cashless payments and inform citizens about the benefits of using it. In particular, we can highlight some strategic recommendations, namely:

1. **Boost the activity of the National Payment Council.** Promoting cashless payments and reducing the amount of cash in circulation was one of the strategic objectives included by the NBM in its 2013-2017 Strategic Plan⁵. This objective was to be achieved also by setting up a National Payment Council – an event that took place on 16 September 2013⁶. Unfortunately, the activity of that council was not visible enough during the implementation of the Strategic Plan. One of the Council's functions is to identify the legal loopholes that hinder the daily activity and daily operations of the participants in the market of payment services, as well as the interests of the final customers⁷. The role of this professional forum is crucial in achieving the objective of promoting cashless payments, thus, its visibility needs to be increased considerably.
2. **Extend the possibility to pay for all public services through cashless payments (through electronic platforms or bank subsidiaries), free of fees and commissions.** The development of the M-pay system proves the

⁴ <https://monitorul.fisc.md/editorial/pwc-nivelul-economiei-informale-in-moldova-atinge-434.html>

⁵ https://www.bnm.md/files/Planul%20Strategic%20al%20BNM%20pentru%20anii%202013-2017_1.pdf

⁶ <https://www.bnm.md/ro/content/consiliul-national-de-plati>

⁷ Article 4: https://www.bnm.md/files/Statut_CNP_VF_1.pdf

potential of implementing a favorable framework to promote the cashless payments, so it is imperative to extend the possibility to pay for any public service by electronic means. Additionally, so far, a fee is charged for the payment of certain public services through banks. This fee is charged in order to cover the operating costs of banks and of payment processing companies. When private transactions are paid with a banking card, the transaction costs are covered by the business entities, whereas in case of public services, the Government lets the citizens to bear the costs. In addition, in some cases, the possibilities of paying for services are limited to a particular bank or a small number of means of payment. Because banks are among the main beneficiaries of cashless payments, the burden of fees could be supported by banks while they should also be obliged to accept payments for public services.

3. **Promote the vision and the infrastructure of cashless payments for services provided by local public authorities.** In order to have a major impact, the vision of promoting cashless payments should be extended to services subordinated to local public authorities, which citizens use every day. A good example would be the digitalisation of payments for transport services. In some countries, the digitalisation of payments for transport services resulted in an increase in receipts of about 140% due to the elimination of people in receiving payments⁸.
4. **Assess the possibility of granting a tax reduction to consumers who use electronic payments.** A similar initiative registered a huge success in South Korea, after the late 1990s when the possibility to request an income tax exemption for cashless transactions was introduced. Thus, South Korea became one of the states with a very small share of cash transactions. Other countries provide a reduction of VAT by 1-2 percentage points for each transaction made with a banking card. Although in the short run, this may result in lower collections to the budget, such an initiative should not be permanent. Once the behaviour of citizens changes, the elimination of tax exemption does not mean that people will go back to cash payments. Additionally, as corruption and informal economy shrink, the tax base could increase and as a result, this could fully cover the budget losses caused by that exemption.
5. **Extend the network of payment terminals (POS), and reduce the list of entrepreneurial activities that can be carried out on the basis of patents.** The repeated extension of the validity term of the entrepreneurial patent proves that the issue is complex and that it is necessary to identify a more revolutionary solution. A very large network of payment terminals and the elimination of the possibility to provide trade services on the basis of patents could be an important starting point. At present, the Law on Entrepreneurial Activity and Enterprises provides for the installation of POS terminals for business entities that have an annual turnover of more than MDL 2 million⁹ with few exceptions. An analysis conducted by Ernst and Young audit and consultancy company regarding the payment system in the Central and Eastern European countries highlights that even if governments finance 100% of the costs for expanding the network of POS terminals, in the long run, the impact will still be positive: revenues from the larger tax base will compensate the investment in extending the network of terminals¹⁰.
6. **Create a regulatory sandbox for financial and technological solutions (FinTech).** On 8 March 2018, the European Commission decided to develop a blueprint with best practices on regulatory sandboxes. 'A regulatory sandbox is a framework set up by regulators that allows FinTech startups and other innovators to conduct live experiments in a controlled environment, under a regulator's supervision.'¹¹The United Kingdom was the first to pilot such a concept in order to encourage innovation in payments and other financial services, and this idea gained popularity in various countries of the world. Under the supervision of the authorities (central banks or financial market supervisory commissions), participants can test products by obtaining a

⁸ <http://www.cgap.org/blog/public-private-partnership-digitize-bus-fares-rwanda>

⁹ Article 7¹: <http://lex.justice.md/viewdoc.php?id=311735&lang=1>

¹⁰ <https://www.globalgovernmentforum.com/how-electronic-payments-can-bridge-the-tax-gap/>

¹¹ http://europa.eu/rapid/press-release_IP-18-1403_en.htm

provisional authorisation without meeting all the requirements imposed by the licensing legislation. In addition, when participants comply with the commitments concerning their participation in the sandbox, authorities may derogate from the sanctioning regime provided for by the legislation. Last but not least, supervisory authorities assume the right to have a personalized approach to each initiative in order to ensure that the interest of the end-consumer is observed. Subsequently, after the testing period, if the product is found to be suitable for the market, the participants submit the dossier to obtain all the authorisations according to the legislation in force. As demonstrated, in countries such as the UK, this favourable approach of authorities can give rise to innovative ideas concerning the digitalisation of financial services and electronic payments. As regards the Republic of Moldova, some important services could be developed in the field of remittance transfers or concerning a payment ecosystem that includes entrepreneurs who currently operate without cash-register machines, including in cooperation with tax authorities.

7. Carry out campaigns to inform the public about the simplicity and efficiency of using electronic payments.

Very often, the society is not aware of the benefits of adopting information technologies, but the Government has the responsibility to educate the citizens in this respect. For example, people can pay their bill at banks only during certain hours and they also must pay certain fees. Instead, the electronic payment applications of banks offer the possibility to pay the bills remotely without any fees. Being aware of the benefits of using cashless transactions could affect the general behavior of the population, with people less likely to withdraw cash from the ATM. As a result, the share of such transaction in the economy will decrease.

Cashless payment can contribute to the efforts of fighting against corruption. Removing cash entirely should not be an objective pursued by authorities, because its presence is extremely important for people who are not included in the financial circuit, insignificant transactions or to the activities of enterprises and small traders. However, taking into account the speed of technological development and the role of cash in sustaining corruption, popularisation of cashless payments must be considered as an important measure for supporting and cleaning the economy.