AN EFFECTIVE APPROACH TO REDUCING THE LEVEL OF SHADOW AND INFORMAL ECONOMY IN UZBEKISTAN

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ABSTRACT

This article delves into the urgent matter of reducing the shadow economy in Uzbekistan. It investigates the shadow economy's far-reaching effects on stability and underscores the significant disparities in its size and institutional structures among different nations. The study concludes that curtailing the shadow economy is primarily feasible through bolstering economic digitization, implementing targeted oversight measures, and encouraging business entities to engage in the formal economy.

Keywords: shadow economy, economic security, national interests, economic-political risks, global competition, internal and external threats, national security concept, cybersecurity, internal and external audit institutions, anti-corruption measures.

INTRODUCTION

The shadow economy is pervasive in every country, regardless of political systems, living standards, or other socio-economic factors. A comprehensive approach to reducing the shadow economy, as seen in international practice, involves increasing penalties for those operating within it, developing precise and practical regulations, and simplifying legislative processes. Given the unique characteristics of each nation's economy, comprehensive reforms are crucial and are designed differently across countries. For instance, while high tax burdens are prevalent in European Union member states, the level of shadow economy remains lower compared to nations with lighter tax burdens. This suggests that reducing the shadow economy solely by lowering tax burdens and simplifying tax administration is ineffective.

In the current era of financial technologies and artificial intelligence development, addressing the shadow economy requires in-depth research, incorporating potential trends, and implementing new mechanisms or refining existing ones. Previous studies have focused on reducing the shadow economy through labor market standards and macroeconomic indicators. The primary objective of advancing methodologies for reducing the shadow economy via financial mechanisms is to adapt to modern trends,

changes in financial markets, and the proliferation of financial technologies. These developments expand opportunities for income concealment from public authorities, necessitating the identification of new factors and introducing changes to existing methodologies to provide more accurate calculations and achieve substantial reductions in the scale of the shadow economy.

LITERATURE REVIEW

Renowned economists and scholars who have thoroughly studied the issue of reducing the shadow economy provide several key recommendations:

Simplification of the tax system and reduction of tax burdens: Friedrich Schneider [2] emphasizes that simplifying tax systems and reducing tax burdens can diminish incentives for engaging in informal economic activities. According to Schneider, high taxes may drive businesses and individuals toward the shadow economy. Streamlining tax processes and lowering rates make participation in the formal economy more appealing.

Enhancing digitization and financial transparency: Economists from the International Monetary Fund advocate for promoting digitization as a practical measure against the shadow economy. Digital financial systems and online payment mechanisms reduce unlawful cash transactions and facilitate the monitoring of economic activities.

Strengthening institutional quality and reducing corruption: Bulgarian economist and former World Bank Chief Economist Simeon Djankov [3] highlights the importance of robust institutions and anti-corruption measures. He argues that corruption and weak institutions erode trust in formal systems and drive individuals toward informal activities.

Promoting transitions to formal activities through education and incentives: Friedrich Schneider also underscores the importance of education and awareness programs to foster a positive attitude toward tax compliance. Explaining the significance of public services and taxes can increase adherence to tax obligations.

Expanding social protection and labor rights: Richard M. Bird, a professor at the University of Toronto [4], suggests that enhancing social protection and labor rights increases the appeal of formal employment while reducing the likelihood of informal work. Access to benefits such as healthcare and pensions makes the formal sector more attractive.

Implementing growth-oriented economic policies: Renowned economist Vito Tanzi [5] asserts that growth-oriented economic policies can indirectly reduce the shadow economy. Economic growth, by creating more jobs in the formal sector, reduces reliance on the informal economy.

These scholarly works analyze the theoretical foundations of the shadow economy, centered on strategies for reducing it and aligning economic growth trends with the influence of various factors. These studies highlight that shadow economic activities often

entail direct or indirect avoidance of tax obligations, and the factors contributing to tax evasion undeniably affect the shadow economy.

RESEARCH METHODOLOGY

This article's methodology integrates deduction, abstraction, classification, generalization, comparative analysis, theoretical interpretation, and analytical methods. Through bibliographic research, the study identifies the necessity and contributing factors for ensuring economic security in the socio-economic development of various regions.

Analysis and Findings: The shadow and informal economy exists in every country, regardless of the political system, citizens' standard of living, and other socio-economic factors.

Many terms exist to describe what this article refers to as the shadow economy, each with its own definition. Recently, a consensus has emerged that the shadow economy includes all legal but intentional hidden economic activity that contributes to the gross domestic product [6]. So, generally, it can be said that the shadow economy is defined as all legal production and provision of goods and services deliberately concealed from public authorities to avoid regulatory or tax burdens.

According to Medina and Schneider (2018), the shadow economy includes concealment to avoid paying taxes and social security contributions, meeting certain legal standards such as minimum wages or safety standards, and complying with certain administrative procedures.

This definition sets the shadow economy apart from related concepts such as the Underground Economy, which refers to illegal activities, or the Informal Household Economy, which consists of household activities that do not need to be registered according to national legislation. While overlap may exist, these two sectors are usually excluded from the shadow economy.

According to data from the International Monetary Fund, the average size of the shadow economy in 158 countries studied between 1991 and 2015 accounted for 31.9% of their gross domestic product (GDP), with significant variation across regions and countries due to specific factors.

From 2003 to 2022, data from 36 European countries and the Organisation for Economic Co-operation and Development (OECD) were analyzed using the MIMIC model. This analysis estimated the share of the shadow economy in these countries at 15.96% of GDP in 2022, accounting for the impact of the COVID-19 pandemic since 2020. Additionally, evaluations of the Baltic States for 2023 revealed that the shadow economy constituted 22.9% of GDP in Latvia, 17.9% in Estonia, and 26.4% in Lithuania.

In Uzbekistan, results derived using the MIMIC model indicate that the shadow and informal economy peaked during the tax inspection moratoriums and the COVID-19 pandemic (2018–2020). This can be attributed to the relaxation of oversight during the

moratorium period, which allowed some enterprises to employ aggressive tax evasion measures, leading to a decline in tax discipline among business entities.

According to the model, the shadow economy in Uzbekistan represented 60% of GDP in 2020. This figure sharply declined by four percentage points in 2021 but increased by two the following year.

It is important to note that the MIMIC model results are sensitive to several modeling choices but are in line with other estimates of the size of Uzbekistan's shadow economy.

The results are particularly sensitive to the choice of the variables that are included in the model. Moreover, these models only yield relative estimates of the size of the shadow economy, which need to be combined with pre-existing baseline figures. Therefore, the choice of the baseline estimate should be approached with care.

Finally, the model evaluates informal, shadow, and criminal economic activities collectively so the shadow economy level alone can be hard to be estimated using this model.

Addressing these challenges may require far-reaching reforms to reduce disincentives for covert activities, increase the transparency of public institutions, and support the transition to the formal sector.

Comprehensive reforms that target the factors incentivizing informal activities enhance the transparency of government institutions, and facilitate the transition to the formal sector hold the potential to address these issues significantly. This potential for change should inspire hope and optimism among policymakers, economists, and researchers.

Based on the above, it can be inferred that the prevalence of the shadow economy remains a pertinent issue even in relatively developed and rapidly advancing economies. Experts in the field attribute the elevated levels of shadow economies in certain countries to several common factors. These include administrative burdens (such as the complexities associated with legally establishing and operating a business, labor regulations, safety standards, and mandatory social payments, as well as compliance with administrative requirements), high tax burdens, non-adherence to principles of fairness in the tax system, the complexity of the tax structure, the presence of special privileges and preferences resulting in unfair competition, low institutional quality of governance, unemployment, corruption, and limited financial literacy and tax culture among the population.

It is also important to note that although accurately assessing the size of the shadow economy is challenging, monitoring this indicator is crucial for several economic and social reasons:

Macroeconomic distortions: Shadow economic activities hinder accurately reflecting socio-economic processes and trends in macroeconomic calculations and

policy decisions. This can lead to significant errors in forecasts and decision-making. For example, suppose formal economic activity declines while the shadow economy grows, and this dynamic is not accounted for in monetary and fiscal policymaking. In that case, the government may continue implementing policies such as expanding the money supply, offering budgetary incentives, or stimulating demand. Such actions could result in economic "overheating" and escalating inflation rates.

Labor market misjudgments: Failure to accurately measure the scale of informal employment and the shadow economy can adversely affect employment policies. If informal workers are classified as unemployed, the unemployment rate may appear higher than it truly is, potentially prompting the government to adopt expansionary policies in conditions that may not be necessary.

Impact on monetary policy: Comparing the money supply against an underestimated formal GDP can negatively influence state economic policy.

In developed countries, the relatively lower prevalence of shadow economic activities can be attributed to several factors, including higher levels of financial literacy and tax compliance among the population and businesses and elevated degrees of digitization and transparency within their economies.

A study analyzing data from 114 countries from 2002 to 2015 revealed an inverse correlation between the degree of digitization and the size of the shadow economy; as digitization levels increased, the shadow economy tended to shrink. Moreover, the findings indicated that more significant internet usage reduces shadow economic activities [7].

However, the study also identified a U-shaped relationship in this context, suggesting that it becomes essential to align digital advancements with institutional reforms beyond a certain threshold of internet penetration. Such alignment is necessary for the declining trend in the size of the shadow economy to stall.

As in many other developing countries, Uzbekistan's shadow economy exceeds the global average. Although efforts to reduce the shadow economy have been consistently undertaken, these measures were not systematized and institutionalized until 2020. Specifically, starting in 2020, inter-agency collaboration was established with the creation of national and regional commissions to reduce the shadow economy.

It is worth noting that in Uzbekistan, the reduction of the shadow economy has primarily been achieved through measures aimed at increasing the level of digitization in the economy, ensuring targeted control mechanisms, and incentivizing the participation of business entities in the formal economy.

For the first time in the country’s history, in August of this year, the State Statistics Committee officially announced the results of an assessment of the shadow and informal economy conducted in collaboration with specialists from the International Monetary Fund.

According to these findings, the share of the shadow and informal economy in GDP stood at 35.5% in 2023, marking a consistent decline since 2017.

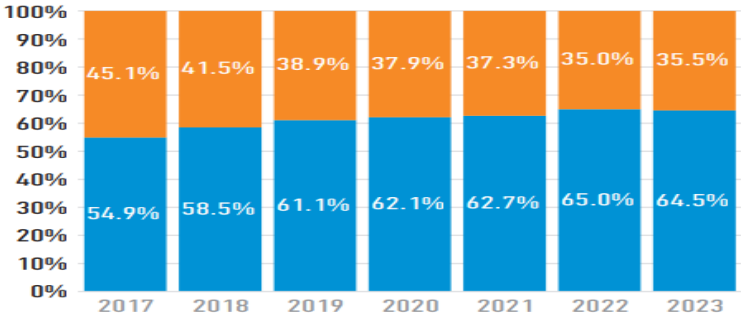


Fig 1. The share of the shadow and informal economy in GDP (in %)[1]. [8]

Furthermore, 49% of the shadow and informal economy is concentrated in the services sector, 37% in agriculture, 8% in construction, and 6% in the industrial sector. This assessment resulted in a more accurate reflection of the unobserved economy within the national GDP, leading to an 11% increase in the GDP figure, equivalent to $10.7 billion.

Without intensified efforts to curb the shadow economy's scope, this issue will likely evolve into a significant economic risk, undermining the country's short- and long-term financial and social stability. Economically, a large informal sector constrains the government’s ability to efficiently collect revenue (budgetary income), as a substantial portion of economic transactions occurs outside formal channels. This reduces fiscal inflows, limiting public infrastructure, healthcare, and education investment.

Additionally, businesses operating within the informal economy often evade taxation and regulatory obligations, granting them an unfair competitive advantage over legitimate enterprises. This disrupts fair market competition and exacerbates income inequality. Socially, informal employment, characterized by non-compliance with labor laws, leaves workers in the shadow economy without access to benefits such as healthcare, paid leave, and pensions.

From a broader societal perspective, a large-scale shadow economy can erode public trust in government institutions. Prolonged participation in informal and shadow activities by a significant portion of the population may foster a sense of distrust in state institutions, diminish perceptions of accountability for legal violations, and weaken adherence to laws.

Recent reforms have maintained a high pace of economic growth but, in parallel, have also sustained a significant scale of shadow and informal economic activity. For example, although monetary and fiscal reforms implemented since 2018 have

[1] Information and analysis portal of "Economic Review" magazine Review . en

considerably expanded the tax base underpinning budget revenues, the size of the shadow and informal economy has not decreased proportionally to these gains.

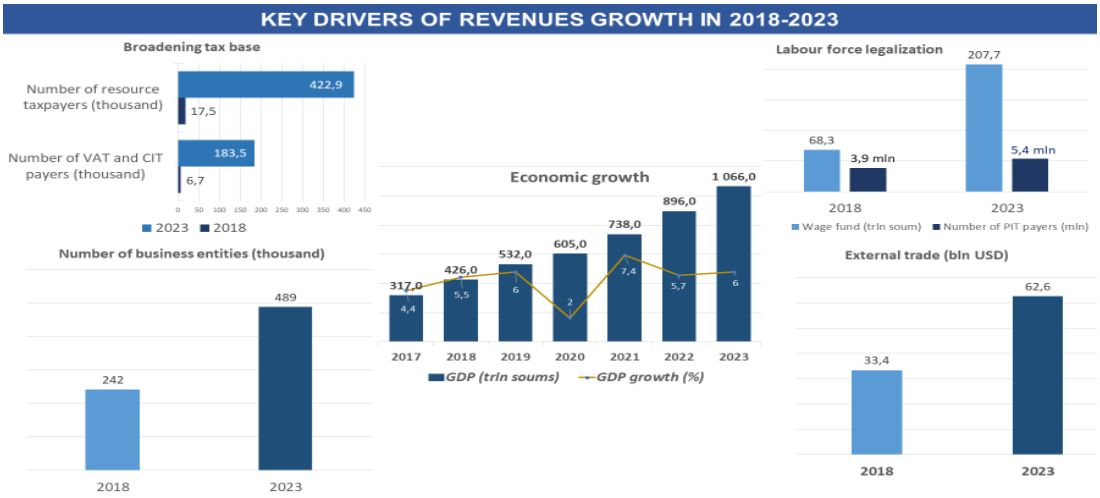


Figure 1. Key drivers of revenues growth in 2018-2013

Over the past five years, the majority of measures recommended by international experts to reduce the scope of the underground economy have been implemented, reflecting Uzbekistan's unique characteristics in this endeavor.

Since 2019, the number of taxes has been reduced from 13 to 9 (excluding the special mining tax regime), and the types of tax controls have decreased from 5 to 3. Additionally, nearly all processes within tax administration have been streamlined through digitization. Introducing the Tax Risk Assessment System (Compliance Risk Management) has enhanced the targeting and efficiency of tax controls. Furthermore, the tax burden on small and medium-sized enterprises has been alleviated, primarily through reductions in the rates of all tax categories. Simultaneously, the number of individualized tax benefits and preferences has significantly decreased, among other reforms.

BUDGET REVENUES AND TAX RATES IN 2018-2023

Tax rates changes (EOP)

T/r	Tax type	2018	2022	2023
1	Value added tax	20%	15%	12%
2	Corporate income tax	16%	15%	15%
3	Personal income tax	4 scales (7.5-22%)	15%	12%
4	Dividends tax	10%	5%	5%
5	Property tax :			
	property tax for legal entities	5%	1.5%	1.5%
	property tax for individuals	0.2%	0.28 %	0.28%
6	Social tax for private sector	15%	12%	12%
	Number of taxes	13+5	9	9

State budget revenues growth trend

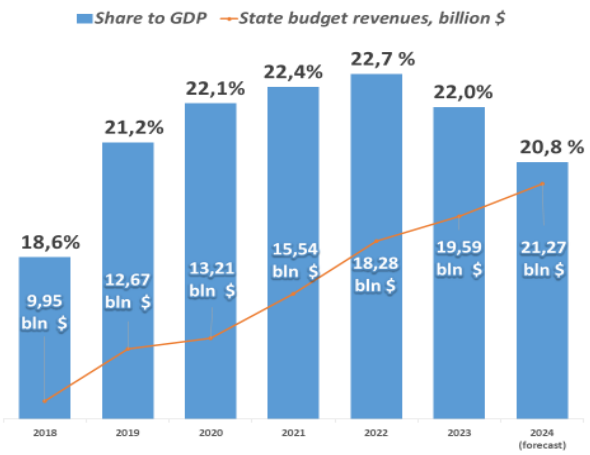


Figure 2. Budget revenues and tax rates in 2018-2013

The improvement of Uzbekistan's position by 32 ranks in Transparency International's Corruption Perceptions Index (from 153rd place in 2019 to 121st place in 2023) also demonstrates the effectiveness of the country's anti-corruption efforts.

However, despite implementing measures that align with the recommendations of nearly all scholars and international experts, the share of informal and underground economic activities remains substantial. Moreover, no significant reduction in shadow activities has been observed following the reforms above. The share of budget revenues as a percentage of GDP peaked in 2022 and has declined since 2023.

The limited effectiveness of the measures mentioned above can be primarily attributed to the absence of strategic approaches by the responsible ministries and agencies tasked with combating the shadow economy. These entities have focused predominantly on the operations of government institutions. At the same time, insufficient attention has been directed toward enhancing the active participation of the population and business entities in these efforts.

According to the draft law on "The State Budget of the Republic of Uzbekistan for 2025," proposed by the Ministry of Economy and Finance, state budget revenues are projected to amount to approximately 19% of GDP from 2025 to 2027. Precisely, GDP is estimated at 1,630 trillion soums with revenues of 308.5 trillion soums in 2025, GDP at 1,866 trillion soums with revenues of 353 trillion soums in 2026, and GDP at 2,125 trillion soums with revenues of 406 trillion soums in 2027.

These projections suggest that in the medium term, the share of budget revenues relative to GDP is anticipated to remain stable without increasing introductory tax rates. However, maintaining this level indicates that the collection efficiency of taxes is unlikely

to improve significantly, and there remains a risk that the current scale of the shadow and informal economy will persist.

Consolidated budget parameters summary of the Republic of Uzbekistan for 2025 and the targeted projections for 2026–2027.

T/p	Indicators	Forecast for 2025	Targeted projections	
			2026	2027
1.	GDP, trln soums	1 630	1 866	2 125
2.	GDP growth rate, in Percentage Terms	6,0	6,1	6,3
3.	Consumer Price Index Compared to December of the Previous Year, in Percentage Terms	7	5-6	5
4.	Consolidated budget revenues, trln soums	431,1	496,4	564,9
5.	State budget revenues, trln soums	308,5	353,7	406,1

Curbing the shadow and informal economy and increasing the share of budget revenues relative to GDP in the short, medium, and long term through enhanced compliance with tax legislation among business entities could maintain the budget deficit within 3% of GDP.

CONCLUSION AND RECOMMENDATIONS

The shadow economy represents a significant obstacle to the socio-economic development of Uzbekistan. Its size, accounting for a considerable share of GDP, highlights the presence of unfair competition from shadow economy participants against the formal sector, resulting in losses to state revenues amounting to trillions of soums and it fosters a societal perception of disregard for the rule of law.

The analysis above underscores that reducing the shadow economy cannot be achieved solely through heightened regulatory control, tax burden reduction, or tax system simplification. Instead, a comprehensive approach is required.

From a legal perspective, effectively reducing the share of the shadow economy in GDP necessitates the adoption of a unified strategic document. This document should clearly define the responsibilities of each relevant agency, facilitate monitoring of task implementation, and enable the evaluation of actions undertaken through strategic, tactical, and operational performance indicators. Such an approach would ensure a more systematic effort by the government in this domain.

Economic policy should aim to sustain progressive, inclusive economic growth while maintaining macroeconomic stability, fostering de-monopolization, and promoting competition. It should also prioritize the balanced development of regional economies and

creating sustainable, high-productivity jobs. A well-developed labor market infrastructure and the availability of various forms of flexible employment would facilitate the formalization of many jobs.

At the same time, it is paramount to balance increased accountability for legal violations with measures to enhance the participation of individuals and businesses in the formal economy. This involves increasing the precision of enforcement mechanisms, ensuring inevitable consequences for breaches of legal requirements, and incentivizing formal economic engagement while bolstering public oversight.

Moreover, it is crucial to foster societal intolerance toward the shadow economy phenomenon while simultaneously enhancing the attractiveness of formal economic participation compared to informal operations and improving transparency and digitization levels within the economy.

Without achieving these objectives, the fight with the shadow economy to levels that do not pose economic risks will inevitably require a prolonged, sustained effort over many years.

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