

Article

Reducing the Shadow Economy Through Taxation

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Abstract: This article discusses the social and economic consequences of the shadow economy, the role of the tax system in this regard, as well as strategies aimed at reducing illegal activity by improving taxes. The expansion of the shadow economy can pose a threat to the state budget and lead to social injustice, so it is very important to improve the efficiency of tax administration and the audit system. The article provides practical recommendations aimed at reducing the shadow economy through such methods as modernizing the tax system, strengthening tax control and introducing digital technologies. Also, highlighting the role of international experience and its changes in increasing the efficiency of tax policy, the need to optimize the tax system to reduce the shadow economy in the republic is substantiated.

Keywords: Shadow Economy, Tax Policy, Tax System, Tax Control, Tax Modernization, Economic Efficiency, International Experience, Illegal Activity

1. Introduction

Currently, the development of the shadow economy in many countries of the world is causing serious economic and social problems. The shadow economy is an economic activity that is excluded from official calculations, evades tax payments, or is not controlled by the government. This process not only harms the state budget, but also creates injustice in society, since individuals working in the shadow economy evade taxes and create unfair competition with entrepreneurs and citizens in the official sector. Several factors contribute to the growth of the shadow economy. One of the most important of them is the high tax burden and the excessive complexity of taxes. Also, the ineffective functioning of tax authorities and control systems, as well as the low social awareness of citizens about paying taxes, also contribute to the development of the shadow economy. These problems have a negative impact not only on the economic, but also on the political and social spheres, since the expansion of the shadow economy increases corruption, injustice, and social inequality.

There are efforts to take effective measures to combat the shadow economy worldwide, and many countries are reviewing their tax policies. These include measures such as modernization of the tax system, strengthening tax control and audit, as well as the widespread introduction of digital technologies. These methods can not only increase tax collections, but also make the economy more open and fair. However, improving tax policy alone is not always enough to reduce the shadow economy in a country. In the fight against the shadow economy, it is also important to increase the tax-paying culture of society and explain to citizens the social importance of paying taxes. Such an approach not only legitimizes the economy, but also ensures that paying taxes is perceived as a social

Citation: Izzaev, G. Reducing the Shadow Economy Through Taxation. American Journal of Economics and Business Management 2025, 8(1), 341-346.

Received: 25th Dec 2024

Revised: 28th Dec 2024

Accepted: 18th Jan 2025

Published: 24th Jan 2025



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responsibility in society. From this point of view, increasing the effectiveness of tax policy and tax control, as well as implementing the digital transformation of the economy, are important factors in reducing the shadow economy. The introduction of new technologies, such as digital tax offices and electronic reporting, will facilitate the identification and monitoring of taxpayers. This, in turn, can be an effective solution to reduce the shadow economy and replenish the state budget. Similarly, the optimization of tax policy is not limited to ensuring economic benefits alone. It plays an important role in raising public awareness of tax compliance in society, creating a fair tax system, and strengthening citizens' trust in the state. The transparency and fairness of the tax system, as well as the optimization of the tax burden, will significantly contribute to the reduction of the shadow economy and the formalization of the economy.

Literature review

The study of the complex relationship between the shadow economy and the tax system has been a major topic in many studies. Schneider and Enste [1] have developed methods for estimating the size of the shadow economy and argue that its growth is driven by high tax rates and bureaucratic obstacles. Medina and Schneider [2] have also studied the size of the shadow economy on a global scale and noted the need for comprehensive approaches to reducing taxes. In addition, Tanzi [3] shows that insufficient tax control has led to a significant expansion of the shadow economy in the United States. These studies serve as an important source for an in-depth analysis of the nature of the shadow economy and its interaction with the tax system.

Tax administration and its effectiveness are one of the decisive factors in reducing the shadow economy. The OECD [4] report highlights the positive results of introducing good practices in tax administration and establishing transparent governance. Slemrod and Gillitzer [5] point out the importance of tax audits and the need for serious monitoring by government agencies. Alm and Torgler [6] study emphasizes that the improvement of the culture of paying taxes plays a key role in reducing the hidden economy. Tax rates and strategies to encourage timely payment play a special role in reducing the hidden economy. Allingham and Sandmo [7] used mathematical models to show how high tax rates affect tax evasion and the hidden economy. Feld and Frey [8] note that fair and transparent taxes encourage timely payment. Torgler [9] shows that the formation of a culture of timely payment of taxes depends on the level of trust in the state's economic policy.

Technological solutions and digital control systems on new opportunities to reduce the shadow economy UNCTAD [10] notes the role of digital technologies in tax administration and the role of blockchain technology in increasing tax transparency. OECD [11] shows that the introduction of electronic invoices and documentation systems are effective measures against the shadow economy. These technologies are important in ensuring tax control and information transparency. Russian scholars Bobkov [12] offers practical ways to reduce the shadow economy by simplifying taxes and increasing the transparency of public administration. Lizina [13] focuses on the social determinants of the shadow economy in Russia. He argues that the shadow economy is aimed at optimizing the income of the population and is associated with distrust of taxes. Chomanov [14] studies the effectiveness of fiscal measures in combating the shadow economy in Russia. He notes that measures aimed at simplifying taxes and supporting small businesses are the main tools for reducing the shadow economy. Local scholars Alimov and Isroilov [15] analyzed the causes and consequences of the shadow economy based on an economic model. They emphasized the importance of increasing the transparency of public administration and reducing corruption in order to reduce the shadow economy. Ibragimov [16] discussed the impact of improving tax administration in Uzbekistan on the shadow economy. Umirov [17] studied the relationship between tax policy and the shadow economy in the country and analyzed the possibilities of reducing the shadow economy

by simplifying taxes and facilitating business processes. Rakhimjonov [18] studied the large-scale reforms in the tax and financial sectors in recent years aimed at creating favorable conditions for conducting business activities, improving the investment climate, and further strengthening the confidence of business circles.

2. Materials and Methods

This article uses mixed methodological approaches to analyze the effectiveness of tax policy in reducing the shadow economy. The study uses a combination of qualitative and quantitative methods and analyzes statistical data on the topic under study. Using international experience, effective strategies and best practices for combating the shadow economy are analyzed, and theoretical approaches available in the scientific literature on tax policy modernization and strengthening tax control are studied. The article considers methods aimed at increasing the legal and social responsibility of taxpayers. Based on the results obtained, recommendations for reducing the shadow economy are developed and proposed as strategies that can be applied in practice.

3. Results

The share of the shadow economy in the economic system of Uzbekistan is still significantly high. According to World Bank estimates, in 2022 the size of the shadow economy amounted to 40-50 percent of the country's GDP. The main reasons for this are high taxes, limited tax control, the presence of corruption in some sectors, and the lack of sufficient facilities for small businesses to operate legally. In addition, the failure of employers to formalize employment contracts, high cash turnover, and activities that remain outside of official statistics lead to the expansion of the shadow economy.

In 2023, the reforms adopted by the State Tax Committee and other economic institutions were one of the important measures aimed at reducing the shadow economy. In particular, the expansion of the electronic invoicing system and an increase in the level of digitalization serve to enhance economic transparency. According to the Ministry of Finance, the volume of hidden activities detected as a result of the use of online cash registers increased by 25% from 2022 to 2023. In addition, the introduction of online platforms that reduce the tax burden on business entities and allow for timely and easy tax payment has increased citizens' confidence in taxes. The 2023 International Monetary Fund report noted that the share of the hidden economy in Uzbekistan has decreased by 3-5% compared to GDP [19]. When analyzing the factors affecting the hidden economy in Uzbekistan, it is necessary to analyze the dynamics of changes in cash turnover, which is very unlikely to be taxed (Figure 1).

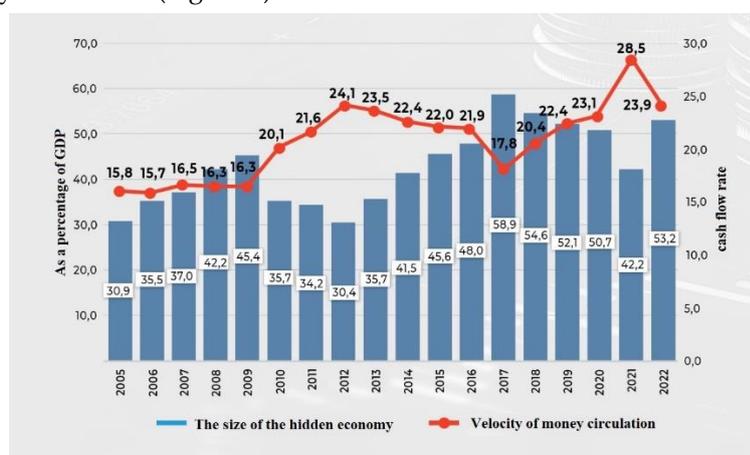


Figure 1. Analysis of the Institute for Macroeconomic and Regional Research (IMTR) on the hidden economy and the velocity of cash circulation¹.

¹ https://imrs.uz/publications/articles-and-abstracts/yashirin_iqtisodiyot

As can be seen from the figure, the share of the shadow economy in Uzbekistan has undergone significant changes from 2005 to 2022. In 2005, the shadow economy accounted for 30.9 percent of GDP, while in 2022 this figure increased to 53.2 percent. During this period, the highest indicators of the share of the shadow economy were recorded in 2019 (58.9%) and 2022 (53.2%). This indicates that the economy has not fully transitioned to the formal sector and the efficiency of the tax administration is not yet sufficient. The turnover rate has also changed over the years. In 2017, a significant decrease in this indicator (17.8) was observed, while in 2021 it reached its highest point (28.5). The increase in the velocity of money reflects the high level of cash use by the population and the increase in transactions outside the formal banking system. In 2022, this indicator decreased slightly and amounted to 23.9. It can be seen that during periods of increased velocity of money, the volume of the shadow economy also increased. This indicates a high tendency of the population and entrepreneurs to engage in informal economic activity. We can say that the decrease in the velocity of money since 2020 is associated with the widespread introduction of digitalization systems and an increase in the level of use of the banking system, as well as the implementation of large-scale tax reforms. It is precisely the tax reforms implemented in the last 5 years that have had a significant impact on the shadow economy. The main factor in this is related to the tax burden, and in 2019-2024, the following important changes were implemented in Uzbekistan to reduce the tax burden (Figure 2).

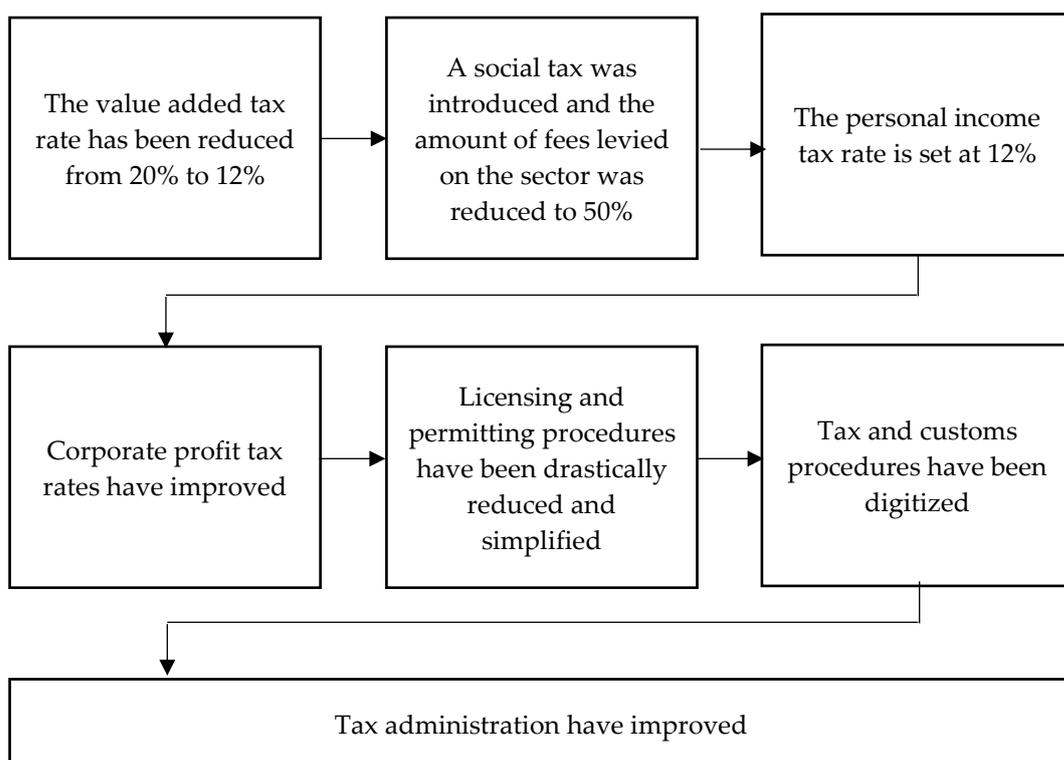


Figure 2. Reforms implemented in Uzbekistan to reduce the tax burden.

4. Discussion

If we consider the best practices of developed countries in the world, which have been able to influence the shadow economy precisely through tax administration and keep the level of the shadow economy to a minimum, Sweden has paid great attention to making the tax system transparent and stable in the fight against the shadow economy. By reducing the payroll tax burden and introducing a high level of control over VAT, it has managed to attract citizens to legal economic activities. Also, the widespread introduction

of electronic payment systems has reduced the need for cash. Today, the shadow economy in Sweden is estimated at around 8% of GDP [20].

Germany has used a high level of tax discipline and modern digital control systems to reduce the shadow economy. This has been achieved, in particular, through the efficiency of the social security system and incentives to motivate tax payment. As of 2024, the shadow economy in Germany will amount to 7.75% of GDP, which is a very low figure [21].

New Zealand has implemented a system called the Single Tax Identification Number (IRD) to reduce the shadow economy. This system requires every citizen to track their economic transactions and avoid tax evasion. Through strict enforcement of laws and the creation of favorable conditions for doing business, the country has managed to keep the share of the shadow economy below 9% [22].

Australia has focused on developing digital systems and encouraging cashless payments to reduce the shadow economy. Taxation and business registration processes have been simplified, which has made it easier to legalize shadow activities. As a result, the share of the shadow economy is currently about 10% of GDP [23], [24].

The experience of these countries shows that effective measures to reduce the shadow economy include increasing tax transparency, using digital systems, and strengthening trust between citizens and the state [25], [26].

5. Conclusion

The growth of the shadow economy poses problems not only in the economic, but also in the social and political spheres. The weakness of tax collection and control systems, as well as the low social awareness of citizens about paying taxes, contribute to the development of the shadow economy. This problem is widespread in many countries, which increases injustice in society, makes it difficult to formalize the economy and harms the state budget.

However, several measures are being successfully used to effectively combat the shadow economy. Modernizing tax policy, introducing digital technologies, and strengthening tax control can increase tax collections and make the economy fairer. Encouraging taxpayers to be socially responsible, increasing the tax-paying culture of citizens, and strengthening trust in the state are also important factors. International experience shows that countries such as Sweden, Germany, New Zealand, and Australia have managed to reduce the shadow economy by strengthening their tax systems with transparent and modern digital controls. These countries are keeping the share of the shadow economy low by encouraging cashless payments, simplifying taxes, and introducing electronic systems. Uzbekistan also needs to continue tax reforms, expand digitalization, and raise public awareness of paying taxes. These measures will be an important step towards reducing the shadow economy and formalizing the economy.

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