



Article

Levying Taxes on the Shadow Economy

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Abstract: The shadow economy (also known as the informal or underground economy) is a pressing issue in economic policy for many countries today, including Uzbekistan. This article provides a comprehensive analysis of identifying, assessing, and taxing the shadow economy. It explores the nature of the shadow economy, the reasons for its formation, its economic and social consequences, and its impact on the formal economy. The article also sheds light on how these processes can be regulated through the tax system. In particular, the article examines international experiences in combating the shadow economy, including the leading approaches of countries such as the European Union, the United States, the Russian Federation, and South Korea, and develops proposals and recommendations tailored to the conditions of Uzbekistan. The study analyzes the size of the shadow economy and the measures being taken against it, based on the Tax Code of the Republic of Uzbekistan, data from the State Tax Committee, statistics from the World Bank, the International Monetary Fund, and other international organizations. The article also proposes mechanisms such as the use of modern digital technologies to identify shadow economic activity, increasing the efficiency of tax administration, encouraging cashless payments, and optimizing tax incentives. The author argues that reducing the shadow economy can increase state budget revenues, expand the tax base, and ensure macroeconomic stability. This article serves as a useful resource for economists, tax policy specialists, government officials, and researchers working in the field of digitalization of the economy. The research results provide an important basis for developing strategic decisions aimed at reducing the share of the shadow economy in Uzbekistan and increasing the effectiveness of its taxation.

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Keywords: Shadow Economy, Informal Economic Activity, Taxation Mechanisms, Tax Policy, Tax Administration, Tax Base, Economic Transparency, Tax Evasion, State Budget Revenues, Tax Offenses, Fiscal Policy, Economic Control, Digital Tracking Systems, Types of Non-Taxable Activities, Economic Security, Tax Audit, Hidden Income, Unregistered Employment, Illegal Trade, Institutional Capacity of Tax Authorities

1. Introduction

In the current processes of globalization and economic integration, one of the most important tasks facing states is to ensure sustainable growth in budget revenues, expand the tax base, and attract all layers of economic activity into the formal sector. From this perspective, the size of the shadow (informal, underground) economy, the ineffectiveness of measures to combat it, and the existing legal and institutional gaps in this area pose a significant threat to tax policy and public finance. Therefore, identifying, analyzing, and improving the mechanisms for taxing the shadow economy is extremely relevant for any developing state, especially Uzbekistan[1]. The shadow economy is generally understood as economic activity hidden from official accounting, not reflected in state statistics, and

avoiding taxes and social contributions. The existence of this activity not only reduces state budget revenues but also violates the principles of tax fairness, disrupts the competitive environment, negatively affects the investment climate, and, ultimately, undermines socio-economic stability. In the process of tax and trade reforms being carried out by the President and the Government of the Republic of Uzbekistan in recent years, significant measures are being taken to reduce the shadow economy[2]. In particular, mechanisms such as electronic invoices, online cash registers (OCRs), digital tax certificates, and tax monitoring systems are being introduced. At the same time, the effectiveness of these measures, the impact of the mechanisms for taxing the shadow economy in real practice, and the issues of addressing existing problems require deep scientific analysis. The structure of the shadow economy is diverse and includes: illegal labor, entrepreneurial activities without a license or registration, artificial reduction or concealment in financial reports, an excessive share of cash turnover, and other similar economic activities. These aspects complicate its identification. In such a situation, the role of the state is not only to strengthen tax control but also to stimulate the transition from the shadow economy to the formal sector through economic incentives, social protection, and financial inclusion. The purpose of this article is to study modern mechanisms for taxing the shadow economy, analyze problems in the existing legislation and institutional system, review the experience of foreign countries, and develop improved directions for regulating this area in Uzbekistan[3]. In particular, the article highlights the role of digital technologies and automated analysis tools based on artificial intelligence in identifying the shadow economy. Also, this study develops recommendations aimed at stabilizing the state financial policy, expanding the tax base, and improving the business environment by reducing the size of the shadow economy. It should be emphasized that the reduction of the shadow economy is an important factor not only in fiscal stability but also in combating corruption, social equality, and ensuring sustainable economic growth. For this reason, the issue of taxing the shadow economy remains relevant not only for tax authorities or economists but also for the general public, politicians, and representatives of the private sector. Its effective regulation, ensuring the principles of accuracy and transparency, ensures the reliable operation of the tax system. After all, attracting more activity to the formal economy, which is seen as the economic strength of the state and the foundation of civil society, is a priority for every modern society[4].

Literature Review

The concept of the shadow economy (hidden economy, underground economy, informal sector) is interpreted differently in economic literature. Basically, it is described as forms of economic activity that are not controlled by the state, not taxed, and not reflected in statistical reports. This section systematically analyzes the literature related to the shadow economy and its taxation. Theoretically, the first substantive studies on the shadow economy date back to the mid-20th century[5]. Swedish economist G. Alm and American scientist A. Shleifer attribute the causes of shadow economic activity to factors such as high tax burden, excessive regulation, and unreliable state institutions. Among Uzbek scientists, Professor A. Abdullaev, in his scientific article "Informal Economy: Essence and Assessment Methods," emphasizes that the shadow economy is an obstacle to the systematic reform of the economy. Also, M. Yusupov, in his research, develops a system of indicators to identify shadow activity and tries to assess the volume of hidden economic activity based on these indicators. Materials published by international organizations, in particular, the World Bank, the International Monetary Fund (IMF), the OECD, the ILO, and the UNDP, are important in studying the global consequences of the shadow economy and strategies to combat it. The OECD report notes negative aspects such as the failure to expand the tax base, the reduction of state budget revenues, and the disruption of the competitive environment in countries with high informal sector employment[6]. In particular, it is shown that the level of informal employment in Latin America, Africa, and Asian countries is 40-60%. This means that it is necessary to improve

taxation mechanisms. The World Bank's 2020 "Doing Business" report found that the shadow economy is widespread in countries with low tax administration simplicity and transparency. Therefore, it is recommended that such countries pay taxes electronically, reduce the tax burden, and introduce benefits. Although the Tax Code of the Republic of Uzbekistan (2020 edition) does not directly indicate measures against hidden economic activity, it is intended to influence this area by strengthening tax administration and control mechanisms. In particular, Article 12 stipulates that any economic activity entity must be registered as a taxpayer[7].

In the statistical bulletins published by the STC (State Tax Committee) in 2022–2024, some positive changes were noted in the difference between the formal sector and the informal economy, the reduction in the number of unregistered entrepreneurs in the street trade, service, and construction sectors. Presidential Decree No. PQ-449 (March 1, 2023) introduced the obligation for small business entities to leave a "digital footprint" in the tax system. This approach is an important step in disclosing the hidden economy[8].

In recent years, a number of articles on tax

I. Karimov, in his article "The Shadow Economy and Its Impact on the Tax Base," emphasizes that this activity threatens macroeconomic stability.

D. Shodmonov, in his research, highlighted the effectiveness of using AI (artificial intelligence) and data analysis technologies in identifying the shadow economy.

Other scientists, such as N. Mahmudova, have deeply analyzed the psychological factors and social causes of tax evasion.

Also, many approaches to the topic have been developed through master's theses and doctoral dissertations. In particular, proposals have been made to strengthen integration into the formal economy in Uzbekistan based on international experience.

Statistical manuals, especially the annual reports of the State Statistics Committee of the Republic of Uzbekistan on the labor market, employment rate, and economic activity, are used to assess indirect indicators of the shadow economy. For example, in 2022, it was shown that 28% of the population over 18 years of age did not participate in formal employment (the workplace is not registered, not taxed). This indicator shows the serious existence of a hidden labor market in the country and allows us to relate this situation to the tax base. Recently published scientific articles and analyzes of international organizations have stated the importance of influencing the shadow economy through digitalization – that is, through the introduction of fiscal technologies, POS terminals, QR-code settlements, and online cash registers. Uzbekistan has made significant progress in this area in recent years. The increase in the volume of formalized trade through "Tax Mobile Applications" is seen as an important step towards formalizing hidden turnover[9]. The above literature analysis shows that taxing the shadow economy not only ensures fiscal stability but also serves to formalize the economy, shape fair competition, and increase social protection of the population. In this area, theoretical literature, practical legislation, international experience, statistical sources, and technological approaches must be studied in close connection with each other.

2. Materials and Methods

The study of the problem of taxing the shadow economy is a multifaceted and complex process that includes an analysis of economic, institutional, social, and legal factors. The following methodological approaches and analysis methods were used in the study:

First of all, the study analyzed the essence, components, and forms of manifestation of the shadow economy based on a systematic approach. Through this approach, the following were studied:

- a. The boundary between the formal and informal economy;

- b. Types of shadow activity (e.g., unregistered entrepreneurship, cash turnover, illegal labor, etc.);
- c. Its impact on gross domestic product (GDP), tax revenues, and the state budget [10].

Due to the lack of direct statistical data in determining the size of the shadow economy, indirect methods of assessment were used:

- a. "Electricity consumption method";
- b. "Cash to GDP ratio method";
- c. Tax audit gap analysis;
- d. The difference between the tax base and actual revenues was assessed based on open data provided by the State Statistics Committee of the Republic of Uzbekistan, the Central Bank, the STC, the World Bank, the IMF, the OECD, and other international organizations[11].

In studying taxation mechanisms and approaches, the Tax Code of the Republic of Uzbekistan, Presidential Decrees, Government Resolutions, STC Regulations and Regulations were analyzed. On this basis, the following were studied:

- a. Clear definition of the tax base and object;
- b. Procedure for identifying subjects of informal economic activity;
- c. Mechanisms for implementing tax administration (e.g., cadastre system, online cash registers, QR-code based invoicing).

The experience of Uzbekistan was compared with developed and developing countries of the world (Russia, Kazakhstan, Turkey, Germany, South Korea). In particular:

- a. What tax mechanisms have been introduced in these countries to combat the shadow economy;
- b. What results have experiences such as "tax amnesty" and "formalizing informal labor" given;
- c. The role of technological tools such as QR-fiscal control, digital cadastre, and automated monitoring of bank transactions was assessed.

A scenario model was created to predict the future reduction of the shadow economy and the increase in taxation. It was based on the following:

- a. Increasing the level of voluntary declaration by reducing the tax burden;
- b. Determining the expansion of the taxable base by incentivizing the formalization of informal activities;
- c. Projected figures for tax revenues as a result of increased control using new technologies.

Figure 1 shows the estimated 30% share of the shadow economy in the structure of the Uzbek economy. This illustrates how significant the weight of activities not subject to taxation, hidden from accounting (cash trade, unregistered labor, informal services, etc.) is in the economy.

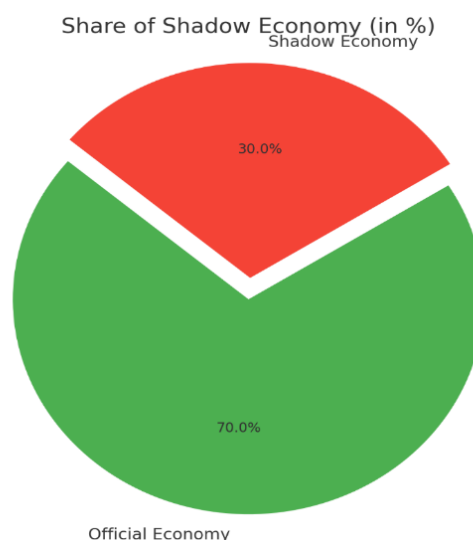


Figure 1. Share of the Shadow Economy (in percent).

The study examined the theoretical basis of the concept of “shadow economy”. Based on research by the World Bank, IMF, Friedrich Schneider (a leading scholar on the shadow economy), and the OECD:

a) “Tax morale” - social attitudes towards paying taxes; b) “Institutional trust” - the level of trust in tax-related organizations; c) “Compliance cost” - the impact of costs in the tax system on entrepreneurial activity, were studied. These methodological approaches served as the main scientific tool for assessing the size of the shadow economy in real conditions, identifying opportunities for taxing it, and developing practical proposals. These approaches provided the research with a level of comprehensiveness, soundness, and reliability[12].

3. Results and Discussion

For the economy of Uzbekistan, the existence and high volume of the shadow economy not only negatively affects the state budget but also disrupts the transparency of the economic system, the fair formation of the competitive environment, and macroeconomic stability. The results of the analysis carried out in this article showed that the existing system for taxing the shadow economy is not sufficiently effective and that several factors are contributing to its expansion. Firstly, based on the available statistical data, it is estimated that the volume of the shadow economy in the country can reach 30-40 percent of the gross domestic product (GDP). This situation means that almost a third of the economy remains outside the formal circulation and the state tax system cannot use it[13]. This leads to the loss of a significant part of budget revenues. In particular, informal employment in the labor market, cash turnover in the service and trade sectors, rental relations, and individual activities often remain outside the control of the state. Secondly, the following factors were identified as the main reasons for the expansion of the shadow economy: High tax burden and complexity in regulation: in some cases, business entities prefer to generate income through informal activities rather than conducting legal activities. Insufficient automation of tax administration and excessive dependence on the human factor: this increases the risk of corruption and creates opportunities for informal activities. Incomplete introduction of digital technologies: for example, the incomplete introduction of online cash registers leads to the lack of formal accounting in the trade and service sectors. Low tax culture of the population: some citizens consider paying taxes not as an obligation, but as a heavy burden. This increases distrust in the tax system[14]. Thirdly, in world experience, there are effective mechanisms for identifying and taxing the shadow economy. In particular, in Scandinavian countries, the level of the shadow

economy is ensured to be below 10 percent due to a high level of digitalization, electronic tax declarations, strict control over bank accounts, real-time turnover monitoring, and information exchange systems. In Uzbekistan, although reforms in this area are ongoing, full results have not yet been observed. Fourthly, a number of resolutions and decrees of the President of the Republic of Uzbekistan have defined the fight against the shadow economy as a priority direction. In particular, Resolution No. PQ-4871 of October 30, 2020, approved a program of measures to combat the shadow economy. An analysis of the implementation of this program shows that, although there are results in some areas, many problems remain unresolved in practice. In particular, there are shortcomings in local control mechanisms, professional training of tax inspectors, and integration of information technologies. Fifthly, it is necessary to introduce simplified tax systems for formalizing shadow activities, gradually abolish tax benefits, provide social protection through the formal sector, widely introduce digital technologies, create information exchange systems, and, most importantly, strengthen a fair and cooperative approach to taxpayers. Based on the analysis, it can be concluded that it is not enough to rely only on administrative measures in taxing the shadow economy. To achieve long-term effective results, the following are important: Complete digitalization of tax administration: it is necessary to fully implement systems that allow monitoring tax turnovers in real time - for example, ERP, CRM, SKNO, online cash registers, and other electronic systems[15].

Involving civil society: ensuring the specific participation of the population in exposing shadow activities, that is, strengthening systems for citizens to report through anonymous notifications.

Motivational and incentive mechanisms: expanding economic incentives such as benefits, loans, and grants for entrepreneurs who have conducted formal activities.

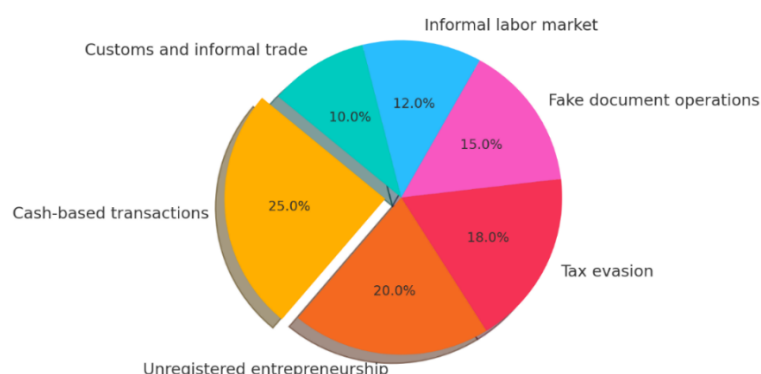
Strengthening international cooperation: joining international information exchange systems to identify shadow income and hidden accounts abroad (e.g., the OECD's CRS system).

Simplicity and fairness in tax policy: strengthening the approach through optimal tax rates, the principle of progressivity, and the advantages of choosing the formal sector.

Figure 2 depicts the main sources forming the shadow economy, which indicate the directions that need to be given priority in taxation:

- a. Cash circulation (25%) - has the largest share and is the main reason for the tax-hidden turnover.
- b. Unregistered entrepreneurship (20%) - activities not registered with the state pose a high risk.
- c. Tax evasion (18%) - is carried out in various ways.
- d. Activities based on forged documents (15%), the Informal labor market (12%), and Customs and cross-border trade (10%) - as uncovered or uncontrolled areas, play an important role in tax policy.

Main Sources of the Shadow Economy (Focus Areas for Taxation)

**Figure 2.** The main sources shaping the underground economy.

Also, the issue of eliminating the shadow economy requires not only the state's, but also the conscious participation of the entire society, especially business entities and citizens. The state's task is to create a legal and institutional basis for this process, ensure transparency, and encourage public oversight.

4. Conclusion

The shadow economy is economic activity that may exist in the economic system of any country but is not reflected in official statistics and remains outside the control of the state. The existence of these types of activities leads not only to a decrease in tax revenues but also to negative consequences such as macroeconomic instability, disruption of a fair competitive environment, difficulties in implementing the state's fiscal policy, and inconsistent operation of the social protection system. In particular, in countries such as Uzbekistan, which are gradually transitioning to a market economy, reducing the shadow economy is one of the priority directions of the state's economic policy. Based on the analysis, it was found that the main manifestations of shadow economic activity include: entrepreneurship not officially registered, payment of wages in "envelopes", illegal import-export operations, operations carried out through fake enterprises, and other illegal sources of income. These activities not only lead to a narrowing of the tax base but also to a weakening of the population's trust in social justice. Therefore, identifying, assessing, and strengthening mechanisms for taxing the shadow economy is one of the urgent tasks of state policy. The measures being implemented to tax the shadow economy, including digitizing tax administration, improving cadastre systems, widely introducing electronic invoicing and online cash registers (OCRs), and increasing the financial literacy of citizens, are achieving positive results in identifying small-scale activities. In addition, the reforms being carried out by the state, that is, easing the business environment, reducing the tax burden, and simplifying the tax code, also serve to bring the shadow economy "out of the shadows and into the light". Nevertheless, it is believed that in order to ensure a complete solution to the problem, in-depth reforms should be carried out in the following priority areas: Conducting tax policy in a stimulating form – in this regard, it would be useful to optimize tax rates to legalize small and medium-sized businesses, widely introduce simplified tax systems, and provide tax benefits to newly formalized entrepreneurs. Strengthening the monitoring system through digital technologies – it is necessary to monitor all money circulation in the economy through digital platforms, make bank operations transparent, and organize control effectively by dividing taxpayers into risk groups.

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