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SHADOW ECONOMY: CAUSES, CONSEQUENCES, AND FORMALIZATION STRATEGIES

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Abstract

In Uzbekistan, the shadow economy remains a persistent and complex issue that hinders sustainable economic development and fiscal transparency. The shadow economy—comprising unregistered employment, undeclared income, and informal business operations—has historically emerged due to high tax burdens, bureaucratic complexity, limited access to finance, and insufficient trust in public institutions. This paper investigates the structural and behavioral causes of informality in Uzbekistan, alongside its socio-economic consequences, including reduced tax revenues, limited social protection coverage, and market inefficiencies. Particular attention is given to sectors such as agriculture, retail trade, and construction, which exhibit high levels of informality. The study reviews the government's ongoing formalization strategies, including digital tax systems, cashless payment initiatives, regulatory reforms, and the promotion of entrepreneurship through simplified registration and licensing procedures. Comparative analysis with international best practices provides insight into how Uzbekistan can further reduce informality while supporting inclusive economic growth. The findings suggest that an integrated approach—combining regulatory simplification, improved institutional trust, and socio-economic incentives—is essential for transitioning towards a more transparent and resilient economy.

Keywords: Shadow economy, informal employment, Uzbekistan, tax reform, institutional trust, formalization strategies, economic policy

Introduction

The shadow economy, often referred to as the informal or underground economy, encompasses a wide range of economic activities that are not recorded in official statistics and fall outside government regulation or taxation. While it exists in nearly every country, its scale and implications are especially pronounced in developing and transition economies, including Uzbekistan. As the country continues its ambitious economic reforms and moves toward greater integration with global markets, the presence of a substantial informal sector poses serious

challenges to transparency, competitiveness, and sustainable development.

In Uzbekistan, the shadow economy has been shaped by a combination of historical, institutional, and socio-economic factors. During the post-Soviet transition period, the lack of efficient market institutions, excessive state control, and weak enforcement mechanisms created fertile ground for the proliferation of unregistered businesses and undeclared income. Even today, despite improvements in governance and regulatory frameworks, informality remains widespread, particularly in labor-intensive sectors such as agriculture, construction, retail, and services.

The informal economy undermines the effectiveness of public policy by eroding the tax base, distorting competition, and limiting access to social protection for workers. It also hampers accurate macroeconomic planning, as large portions of economic activity remain undocumented. At the same time, many individuals and small enterprises operate informally not out of choice but necessity—often due to barriers in the formal sector such as complex regulations, high compliance costs, or limited access to finance and legal protection.

Recognizing the adverse effects of the shadow economy, the government of Uzbekistan has initiated several reforms aimed at promoting formalization. These include digitalization of tax administration, simplification of business registration, introduction of electronic invoicing, and policies to incentivize legal employment. However, addressing informality requires a more comprehensive and balanced approach—one that goes beyond enforcement to also address the root causes of informality and improve the business environment.

This paper seeks to explore the underlying causes of the shadow economy in Uzbekistan, analyze its economic and social consequences, and assess the effectiveness of existing and proposed formalization strategies. By drawing on both national data and international best practices, it aims to provide actionable policy recommendations for reducing informality and building a more resilient, inclusive, and transparent economic system.

Literature review on the topic

The study of the shadow economy has attracted significant scholarly attention over the past decades due to its implications for economic development, governance, and public finance. Researchers have approached the topic from multiple angles, analyzing its size, structure, causes, and policy responses across different countries.

One of the foundational contributions in this field comes from Friedrich Schneider, who has extensively quantified the size of the shadow economy using indirect methods such as the currency demand approach and MIMIC (Multiple Indicators Multiple Causes) models. Schneider (2016) estimates that in many transition economies, including those in Central Asia, the informal sector may account for more than 30% of GDP, thus representing a significant portion of total economic activity.

Loayza (1996) emphasized that high tax burdens and weak institutions are primary drivers of informality in developing countries. His model demonstrates that when the cost of being formal—due to taxes and regulations—exceeds the perceived benefits, individuals and firms tend to remain in the informal sector. This theory is particularly relevant to Uzbekistan, where overregulation and complex bureaucracy have historically contributed to informality.

In the context of Uzbekistan, several studies have attempted to estimate the shadow economy and its structural roots. A report by the Asian Development Bank (ADB, 2020) noted that despite notable economic reforms in recent years, Uzbekistan still faces challenges in tax administration, business formalization, and labor market regulation. Similarly, a World Bank (2022) diagnostic

highlighted that informality in Uzbekistan is particularly acute in agriculture and trade, where employment is predominantly unregistered and transactions are often cash-based.

Uzbek researchers such as K. Tursunov (2021) and B. Komilov (2022) have emphasized that informal employment persists due to limited job opportunities in the formal sector and insufficient social safety nets. Their analyses indicate that formalization efforts must be accompanied by improvements in institutional trust, financial inclusion, and small business support policies.

Comparative literature from Eastern Europe and the Caucasus (e.g., Georgia, Armenia, and Ukraine) suggests that successful reduction in shadow economy levels is often tied to transparent governance, simplified tax regimes (such as fixed or unified tax systems), digital infrastructure development, and robust anti-corruption measures (Kaufmann & Kaliberda, 1996; OECD, 2018).

In addition, recent studies by UNDP (2023) and the International Labour Organization (ILO) advocate for a "dual approach" to formalization: combining coercive measures (inspections, penalties) with incentive-based policies (tax holidays, access to microcredit, social benefits). This strategy is gradually being introduced in Uzbekistan as part of the government's "Digital Uzbekistan – 2030" strategy, which promotes e-government services, electronic tax reporting, and biometric business registration.

Overall, the literature indicates that formalization of the shadow economy is not only an economic issue but also deeply linked to governance, trust, and the inclusivity of institutions. Uzbekistan's path forward requires integrating global lessons while adapting policies to local socio-economic conditions.

Analaysis

1. Causes of the Shadow Economy in Uzbekistan

The shadow economy in Uzbekistan is driven by a complex mix of structural, institutional, and behavioral factors. Among the most significant contributors are the tax and regulatory burdens placed on small and medium-sized enterprises (SMEs). High tax rates, combined with complex reporting requirements and bureaucratic inefficiencies, increase the cost of doing business in the formal sector. As a result, many businesses operate informally to avoid compliance costs.

Bureaucratic opacity and corruption further fuel informality. Delays in obtaining licenses, inconsistent enforcement of regulations, and opportunities for rent-seeking behavior among officials create disincentives for legal registration. In this context, informal operations become a rational economic choice, especially for microenterprises and seasonal businesses.

Limited access to formal finance also pushes individuals into informality. Many small-scale entrepreneurs cannot meet collateral requirements for bank loans or navigate formal credit systems, forcing them to operate outside legal channels. This is particularly evident in rural and peri-urban areas where financial institutions have limited penetration.

Additionally, sociocultural norms and low trust in government institutions contribute to informal practices. A long-standing tradition of informal labor arrangements, particularly in family farming and construction, persists despite regulatory reforms. Weak enforcement mechanisms and limited public awareness about the benefits of formality further perpetuate the cycle of informality.

2. Consequences of the Shadow Economy

The prevalence of the shadow economy has far-reaching economic and social implications for Uzbekistan. One of the most direct consequences is the erosion of the national tax base. When significant portions of income and business activities remain unreported, the government loses

critical revenue needed for infrastructure, education, and healthcare. This places a disproportionate burden on compliant taxpayers and limits the state's ability to invest in inclusive development.

Another major consequence is unfair competition. Informal businesses avoid taxes and labor regulations, allowing them to offer goods and services at lower prices than formal enterprises. This distorts market competition, discourages investment in quality and innovation, and creates a hostile environment for responsible entrepreneurship.

Informality also leads to labor insecurity. Workers in the informal sector often lack employment contracts, social insurance, health benefits, and legal protection. This increases their vulnerability to exploitation, poor working conditions, and income instability. The informal economy also exacerbates gender inequality, as women are overrepresented in unregulated and low-paid segments of the economy such as home-based work or street vending.

From a macroeconomic perspective, high levels of informality reduce the effectiveness of economic policy planning and forecasting, as a large share of economic activity goes undocumented. It also impedes financial sector development, since informal actors rarely use banking services, which lowers financial inclusion rates and constrains monetary policy transmission.

3. Formalization Strategies and Policy Recommendations

Efforts to reduce the shadow economy in Uzbekistan must address both the incentives for informality and the barriers to formality. The Uzbek government has taken notable steps in this direction, including the digitalization of tax systems, introduction of electronic invoicing, and streamlined business registration processes. However, more needs to be done to ensure that formalization is not only mandatory but also beneficial.

Regulatory simplification should remain a priority. Licensing requirements, tax codes, and labor laws must be made more transparent, efficient, and user-friendly, especially for micro and small enterprises. The expansion of e-government platforms can help reduce discretion, increase transparency, and lower compliance costs.

Tax policy reform is essential to shift from punitive to incentive-based approaches. Introducing lower, flat, or turnover-based taxes for microbusinesses can encourage voluntary compliance. Pilot programs such as tax holidays or reduced-rate regimes for newly formalized enterprises should be scaled up.

To support transitions from informality to formality, access to finance must be enhanced through inclusive banking services, simplified credit programs, and the expansion of microfinance institutions. Digital payment systems and mobile banking can also help integrate informal actors into the financial system.

Building institutional trust is a long-term but crucial objective. Public campaigns to raise awareness of the benefits of formalization—such as access to social protection, legal rights, and government support—can reshape perceptions. Simultaneously, measures to combat corruption and improve service delivery at local levels will increase citizens' willingness to engage with formal institutions.

Finally, international cooperation and knowledge-sharing should be leveraged to adopt proven models from countries that have successfully reduced informality. Georgia's electronic tax system, Colombia's formalization incentives, and India's financial inclusion schemes offer

Conclusion and Recommendations

The shadow economy in Uzbekistan presents a multifaceted challenge with deep roots in the country's economic history, institutional structure, and socio-cultural landscape. While informal activities may provide short-term survival strategies for individuals and microenterprises, they undermine long-term economic development by reducing fiscal revenues, weakening public services, and distorting market dynamics.

This paper has explored the primary causes of informality in Uzbekistan, such as high tax burdens, complex regulations, limited access to finance, and low institutional trust. It has also outlined the consequences of a large informal sector, which include labor insecurity, inequality, tax evasion, and macroeconomic inefficiency. At the same time, the study has identified several promising formalization strategies adopted both locally and internationally.

Based on the findings, the following key recommendations are proposed for reducing the shadow economy and fostering inclusive growth in Uzbekistan:

1. Simplify and streamline regulatory frameworks

Overly complex administrative procedures should be replaced with transparent, digitalized, and cost-effective processes for business registration, licensing, and tax compliance. This will reduce barriers to formalization and enhance trust in state institutions.

2. Introduce targeted tax incentives for small businesses

A simplified tax regime for micro and small enterprises—such as flat-rate or turnover-based systems—can promote voluntary formalization. Temporary tax reliefs or exemptions for newly formalized firms may serve as effective transitional measures.

3. Expand access to financial services

Promote financial inclusion through mobile banking, microcredit programs, and support for informal entrepreneurs. Strengthening rural and community-level banking infrastructure will help bring underserved populations into the formal economy.

4. Improve public awareness and education

Public information campaigns should highlight the long-term benefits of formal employment and legal business operation, including access to social services, pensions, and legal protection. Collaborations with business associations, trade unions, and civil society can improve outreach.

5. Strengthen institutional trust and fight corruption

Citizens' willingness to formalize depends on the perceived fairness and efficiency of public institutions. Anti-corruption reforms, improved service delivery, and accountability mechanisms must accompany technical reforms.

6. Adopt a balanced enforcement–incentive model

Enforcement should be fair and proportionate, focusing on large-scale tax evasion and abusive practices. Meanwhile, incentives—such as easier access to state procurement and credit programs—should reward formalization.

7. Leverage international experience

Uzbekistan should continue engaging with international partners such as the World Bank, ILO, and UNDP to adopt and adapt global best practices. Pilot programs based on successful models in similar economies should be tested and scaled accordingly.

In conclusion, transitioning from informality to formality is not a one-time event but a long-term

process that requires integrated policy coordination, institutional reform, and stakeholder engagement. By addressing the root causes of the shadow economy and implementing a strategic mix of reforms, Uzbekistan can build a more resilient, inclusive, and transparent economic future.

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