

THE PROBLEMS OF TAX ADMINISTRATION LEADING TO THE INCREASE OF THE SHADOW ECONOMY IN UZBEKISTAN

Ergashev Rustam Rajabovich

Chief Specialist, Ministry of Innovative Development of the Republic of Uzbekistan. Independent researcher, Banking and Finance Academy

ABSTRACT

This article analyzes the effectiveness of tax policy reforms in Uzbekistan in recent years. The study found that while the reforms implemented have reduced the tax burden level somewhat, it has led to an increase in compliance costs for taxpayers and an administrative burden on tax administration. As a result, it is caused the decline in the fiscal capacity of the tax system and the emergence of a large tax gap which in turn contributed to the expansion of shadow economy.

KEY WORDS: Tax, shadow economy, tax compliance, tax administration, fiscal capacity, tax principles

INTRODUCTION

The fight against the shadow economy has always played an important role in the fiscal reforms of governments. However, due to its latent nature, states face difficulties in identifying effective measures of reducing hidden economic activity. Countries have resorted to a variety of measures, from harsh sanctions to tax cuts and tax incentives, but despite many reforms, some developing countries still have growing share of informality in the their economy.

In particular, despite the number of implemented reforms in Uzbekistan, during the years of independence, the steady growth of the informal economy has led to a significant loss of state budget revenues. The shadow economy not only reduces state budget revenues by creating two parallel markets and economic institutions in one country, but it also undermines the efficiency of Uzbek government`s economic reforms.

Although the government has set tasks to reduce the share of the “shadow economy” in the country, but the measures taken to date in this direction do not serve to achieve significant positive results. In fact, in his speech addressed to the Oliy Majlis in December 2018, the President of the Republic of Uzbekistan Shavkat Mirziyoyev noted that the share of the informal economy in GDP is significant and has a negative impact on the development of the country. This, in turn, requires the government to take measures to reduce the size of the shadow economy.

To fight against the informal economy, it is utmost importance identifying effective tools and develop appropriate mechanisms for their use. First of all it is required, to identify the state of the shadow economy in the economy and the factors affecting it.

Given the high impact of taxes, it is important to study the factors associated with them and to eliminate shortcomings in the tax system.

This article examines the state of the shadow economy in the Republic of Uzbekistan and the problems in the tax system that contribute to its expansion, and suggests appropriate solutions.

LITERATURE REVIEW

In any country, the most important task of the tax administration is the fiscal duty, that is to say, the tax provision of budget revenues for the planned expenditures of the state. However, in most developing countries, the inefficiency of tax administration in revenue management does not allow to collect the planned amount of tax revenues. In many cases, this is due to the fact that tax policy is not designed in accordance with the socio-economic conditions of the country and the competence of the tax authorities. As a consequence, it leads to the outflow of income to the shadow economy and the creation of large revenues (potential tax base) in the informal sector.

Although the expansion of the shadow economy are explained by the extensive number of the factors, researches suggest that deficiencies in tax policy and political institutions have a major impact on its development. In particular, two types of studies (qualitative and empirical) studied by Schneider and Williams (2013) showed that high tax rates appeared to be a potential factor contributing to the scale up of the shadow economy in both types of the studies (see Table 1). According to them, 35-50% of the factors influencing the growth of the shadow economy in the country are tax factors, and 10-17% are related to the quality of public institutions. Studies also show that tax morale is also a significant (20-25 percent) factor in causing businesses and consumers to operate in the shadow economy. Tax morale, in turn, can be mitigated by eliminating the above factors, mainly because it depends on the capacity of the tax system and the quality of political institutions (Alasfour et al., 2016).

Thus, to combat the shadow economy, first of all, tax policy should be appropriately constructed to the existing socio-economic conditions in the country and it is important to improve the quality of services of tax authorities is a theoretically and practically correct choice.

Table 1. The main factors leading to the expansion of the shadow economy

	Factors	Qualitative research results (12 studies)	Quantitative research results (22 studies)
1	The burden of taxes and social payments	35-38%	45-52%
2	Tax morale	22-25%	-
3	Quality of public institutions (activities)	10-12%	12-17%
4	Labor market regulation	7-9%	7-9%
5	Money transfers (control)	5-7%	7-9%
6	Public Sector Services	5-7%	7-9%

Therefore, this article examines only the aspects of the shadow economy that are related to tax evasion. In this case, the term shadow economy is used to describe “the value of taxable economic activity if reported to the tax authorities.” It is also logical that the greater the scale of the shadow economy, the greater the difference between potential tax revenue and their actual collection (Brooks, 2001).

There are a number of reasons for the occurrence of tax disparities or low levels of tax compliance (taxpayers defiance). In particular, as for Trasberg (2005) the fairness and collection capability of tax authorities is directly related to informal entrepreneurship. According to him, most transition economies suffered from the intensification of the shadow economy in the early stages of market reforms, mainly due to long-term irrational tax policies and a lack of consideration of the capacity of tax administration when setting fiscal targets.

In transition economies, although tax administration reforms are largely concerned with controlling and subsequently reducing the informal economy, the weak development of fundamental principles has led to the growth of the shadow economy in most of these countries in recent years.

Another shortcoming is that long-term tax reforms in these countries have focused more on general changes while maintaining existing tax policies, with insufficient work being done to change tax policy and reform its administration (Hôgye, 2000; Mitra and Stern, 2003). As a result, the high level of informal economic activity have led to the loss of potential budget revenues in these countries, destabilization of the tax morale and other negative socio-economic impacts.

Therefore, in the context of transition economies there is a need for continuous improvement of tax administration or a complete change in its structure.

However, developing a new tax system is a large-scale, time-consuming and ongoing process. This includes not only the adoption of new laws, the establishment of new tax structures and the radical improvement of the tax administration process, but also the change in the behavior of all stakeholders, including taxpayers and tax authorities (Tanzi and Tsibouris, 2000). This is because the formation and strengthening of a “tax culture and ethics” that encourages the voluntary fulfillment of tax obligations is critical to the effective functioning of tax administration (Alm and Martinez-Vazquez, 2000; Nerré, 2001).

At the same time, it is important to identify the reasons why businesses operate in the informal sector and hide their income, and knowing the extent of the impact of these factors will allow countries to adjust their tax policies to eliminate them.

In general, there are a number of reasons for the existence of the shadow economy, and the reasons for the tax gap are mainly divided into three aspects.

First, various theoretical and empirical studies show that the size of the shadow economy is associated with a high tax burden for individuals and businesses. Several authors expand on this reasoning, citing the general burden of state regulation as the basis of the shadow economy (Schneider and Enste, 2000; Johnson and Kaufmann, 2001).

Second, some research suggests that weak tax institutions lead to the shaping of the shadow economy (Gill, 2003). If the legal framework is weak or law enforcement is weak and unstable, the motivation and opportunities for tax evasion will increase.

Strengthening tax administration does not mean that the government should add tax laws or strengthen the enforcement of misformed laws. Because there is a risk that strengthening the order will complicate the tax system and increase the power of the bureaucracy. This, in turn, leads to an increase in tax compliance costs for taxpayers. Especially in transitional democracies, stronger government measures can lead to tax evasion, declining business activity, and corruption.

Excessive corruption is one of the main reasons limiting the government’s tax collection capacity. Corruption undermines public confidence in the tax authorities, disrupts the transparency of the economic environment, and therefore leads to a worsening of tax compliance. For this reason, tax administrations around the world consistently occupy high positions in public organizations with high levels of corruption (Gill, 2003).

The third group of reasons explains the secret economic activity on the basis of historical traditions and the mentality of society. For example, high income from social connections,

personal relationships, and activities in the shadow economy is one of the strongest motivations for people to work informally (Schneider and Enste, 2000). In a sense, supporting the shadow economy also shows citizens' distrust or indifference to the government policies. In particular, previous unfavorable experiences have increased citizens' distrust of their governments in former communist countries, leading to the formation of a view of the shadow economy as a natural state (Lacko, 1999). Therefore, to scale down the size of the shadow economy, it is necessary to focus not on its complete elimination, but on how to reduce its scale and negative consequences, especially its adverse impact on tax administration fiscal capacity.

ANALYSIS OF THE TAX ADMINISTRATION OF UZBEKISTAN

Improving the efficiency of the tax administration in fulfilling its responsibilities and reducing the shadow economy requires that reforms be targeted in the first place. This will allow the tax authorities to collect the maximum amount of tax while maintaining the trust of the taxpayers.

In order to study the extent to which the existing tax system in our country and the tax reforms implemented to improve it reflect the above-mentioned issues, we have analysed changes in tax policy in recent years.

Reforms in Uzbekistan's tax policy and administration and their effect in reducing the share of the informal economy have not yielded the expected results.

To explain this conclusion, we consider the four components that determine the level of tax compliance, including registration as a taxpayer, accounting and reporting, and, timely, complete and accurate submission of tax returns, and timely payment of taxes and other mandatory payments throughout the country (see Figure 1).

As can be seen from Figure 1, despite the reforms implemented, there have been negative changes in most of the tax compliance indicators in recent years. In particular, in 2015-2020, the number of cases of unregistered entrepreneurial activity increased by 17 071, while the number of detected violations of accounting and reporting rules increased by 499. The highest number of tax evasion cases related to non-submission or non-submission of tax returns in the prescribed manner and time was the highest number of violations, which in 2015 amounted to 1 585, and by 2019 this number increased to 48 881, or 31 times. Similarly, the rate of non-filing of tax declarations has increased significantly in recent years.

The number of cases of untimely and incomplete fulfillment of tax liabilities also increased significantly between 2015 and 2019, increasing by almost 19 times (1 850 and 34 398, respectively, over the years).

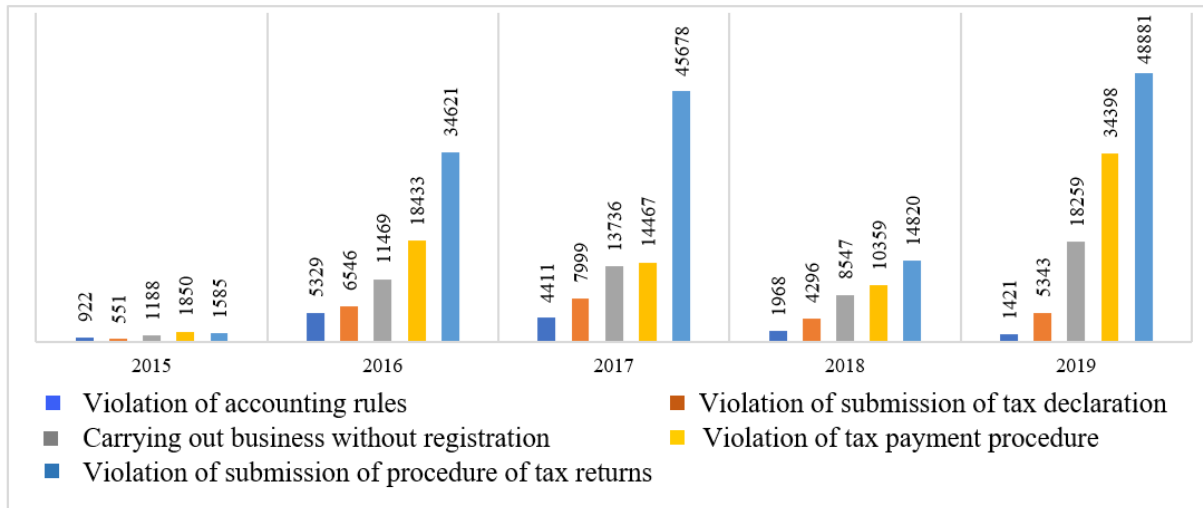


Figure 1. **Status of components of tax compliance in Uzbekistan, 2015-2019**

These negative changes in tax compliance indicators can be explained by a number of shortcomings in tax policy and administration. These shortcomings and suggestions for their elimination are described in more detail below. The situation with the indicators of tax compliance, in part, indicates an increase in the competence of the tax authorities to detect violations, and in part, it indicates an increase in the number of businesses transferring from unofficial to the official sector of the economy.

Analyzing the tax factors that lead to the informal economy, the following shortcomings in the tax policy and administration of the country are considered to reduce the effectiveness of the fight against the economy through tax mechanisms:

- Lack of a clear tax policy aimed at combating the informal economy. In other words, the tax strategy does not specify which types and mechanisms of taxation will be aimed at reducing the share of the shadow economy.
- Failure to take into account the capacity of the tax administration and the cost of tax compliance in the reforms aimed at expanding the taxation framework for income, profits and consumption.
- Failure to eliminate the policy deficiencies, which prevents the full operation of the VAT mechanism in the entire economic chain.
- Lack of incentives to strengthen public control over compliance with tax legislation.

The options to address the shortcomings listed above will be discussed in more detail below in each case.

The first case. The current high level of the informal economy in Uzbekistan is primarily due to the fact that long-term tax policy does not set clear directions for combating the informal sector.

The main reason for this is that although the tax system is more interested in reducing the informal economy, the state tax authorities have not identified specific measures, directions and tasks to combat the shadow economy.

It should be noted that if the tax policy does not work effectively, all the efforts of the state to combat the informal economy will be in vain.

Thus, we can say that the mechanisms of tax policy that lead to the growth of the shadow economy are mainly due to the fact that the tax system does not have sufficient competence to manage the risk of tax compliance.

To this end, to give more freedom to businesses and create favorable conditions, improve the legal framework to eliminate bureaucratic barriers, to give up special tax incentives for monopolies to create a healthy competitive environment in the country, increase the amount and quality of public spending on social protection , effective fight against corruption is important.

In order to ensure all this, it is necessary, first of all, to organize the tax system in the country on the basis of the principles of adequacy, administrative feasibility and sustainability of tax policy.

The above-mentioned principles make it possible to adapt the entire tax policy to the fight against the shadow economy.

However, the establishment of a strategy and mechanism to improve tax compliance to establish full control over the activities of businesses flowing into the informal sector due to tax factors will increase the effectiveness of tax policy.

The second case. as a result of reforms in tax policy in recent years, the coverage of income, profit and consumption taxation has been expanded, resulting in a significant increase in tax revenues.

Table 2. **Comparative analysis of tax revenues paid by legal entities (in million soums)¹**

¹ Prepared by the author on the basis of the data obtained from the State Tax Committee.

Indicators	2017	2018	2019	2020	2017-2020 growth (in times)
Profit tax revenue	1 475.5	3 282.6	16 360.6	28 712.2	19.5
VAT revenue	14 686.2	27 876.5	33 809.8	31 177.4	2.1
Property tax revenue	2 129.7	2 606.1	2 360.2	1 974.3	-1.1
Land tax revenue	1 091.8	1 504.2	2 313.2	2 386.7	2.2
Turnover tax revenue	1 707.6	4 706.5	1 988.7	1 353.9	-1.3

As can be seen from Table 2, there was a positive change in all tax revenues between 2017-2020, with the largest increase in income tax, with revenues increasing 19.5 times. During this period, as a result of tax policy aimed at expanding the base of VAT and land tax, we see that their revenues increased by 2.1 and 2.2 times, respectively.

However, despite the reforms and measures implemented, turnover tax revenues in 2020 decreased by 1.1 and 1.3 times, respectively, compared to 2017.

These changes in tax revenues can be explained as follows.

In particular, the level of tax compliance has improved during this period as a result of the unification and reduction of two tax rates on income taxation, as well as the abolition of mandatory contributions to three types of off-budgetary trust funds. Also, in order to expand the tax framework, from January 1, 2019, small businesses with revenues of more than 1 billion soums were transferred to the profit tax in the prescribed manner.² This, in turn, served to increase the income tax base and the number of payers.

However, an increase in tax revenue does not always indicate a positive indicator or a decrease in tax evasion. In particular, we can see from Figure 2 that while the number of income tax payers increased by a total of 107,000 (or 17-fold) in 2017-2020, the amount of income tax per taxpayer decreased by 1.2-fold during this period. This, in turn, indicates a reduction in the marginal benefit of the administrative costs of controlling a single taxpayer.

This implies that the reforms in tax policy have not been developed in accordance with the capacity of the tax administration (the principle of administrative feasibility), the effectiveness of the tax authorities in monitoring and detecting tax evasion has decreased.

² Decree of the President of the Republic of Uzbekistan No. PF-5755 "On measures to further regulate the provision of tax and customs benefits", June 27, 2019.

We can observe the above situation in other taxes as well. In particular, the abolition of a number of benefits in the VAT system for the period 2017-2020 and the mandatory introduction of VAT for taxpayers with a turnover of more than 1 billion soums from January 1, 2019 increased the number of VAT payers from 6.7 (2017) to 113.5 (2020), an increase of 17 times, while VAT revenue increased 2.1 times. However, the fact that tax revenues per taxpayer have decreased by 8 times indicates that the collection capacity of the tax administration has not been taken into account in this tax either. This, in turn, has led to growing confidence among taxpayers that the tax administration has limited control and detection and punishment of violations. As a result, there has been an increase in tax evasion among business entities, such as cashing out, issuing fake invoices and selling it.

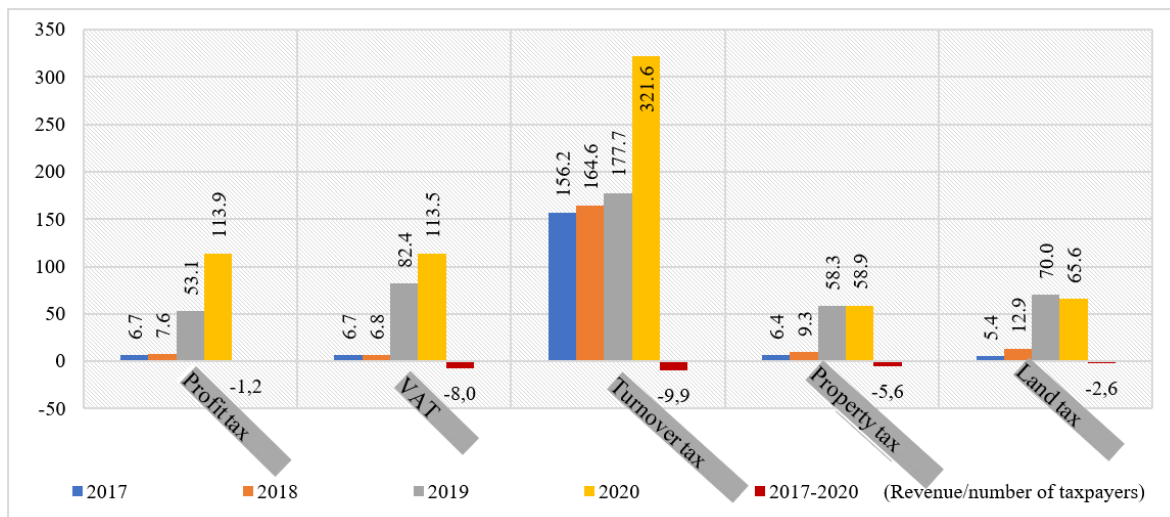


Figure 2. **Changes in the number of legal entities paying taxes over 2017-2020 (in thousands)**³

Similarly, Table 3 and Figure 3.8 show that as a result of the establishment of a turnover tax threshold for individual entrepreneurs, (sole traders with a turnover of more than 100 million soums) also doubled the number of turnover taxpayers and causing a 1.3-fold decrease in tax revenue. As a result, we see that the turnover tax collection per taxpayer has decreased by almost 10 times. This also testifies to the fact that some reforms in tax policy have not been developed in accordance with the capacity of the tax authorities and the ability of taxpayers to pay.

It can be concluded that the above-mentioned tax policy reforms aimed at expanding tax coverage have not been developed in accordance with the capacity of tax authorities and

³Prepared on the basis of data from the State Tax Committee.

taxpayers' ability to pay, which has reduced their efficiency by increasing the administrative burden on tax authorities leading to an increase in the compliance cost of carrying out formal activity. As a result, the level of tax compliance has decreased and the level of shadow economic activity of taxpayers has increased.

Based on the above analysis, we believe that the reforms in tax policy should be developed primarily in accordance with the principles of administrative feasibility of taxation and the solvency of taxpayers.

In this case, there are two main ways to adapt (correct) the tax system to the above principles. These are 1) improving tax administration on the basis of information technology; 2) adjusting tax policy to existing tax administration capacity/capability.

The third case. The role of VAT in combating the shadow economy is significant, and as noted above, it is one of the most effective tax mechanisms in indirectly taxing the informal sector. However, the effectiveness of the VAT mechanism in this regard depends primarily on the extent to which it covers the value chain in the economy and its collection capacity.

In order to study the extent to which the existing VAT mechanism in Uzbekistan has the capacity to perform its function, the collection efficiency indicator (C-efficiency) proposed by M. Keen (2006) was analyzed. This indicator is based on estimating the difference between the actual VAT revenue and the ideal (theoretical) tax revenue that can be levied as a result of taxing all final consumption expenditures in the economy through a single tax rate. The reason for the inclusion of all final consumption expenditures in the tax base is that VAT is a tax aimed at expanding the sources of financing budget expenditures, which is designed to serve as a "money machine" for the state budget.

According to IMF calculations, the VAT mechanism in Uzbekistan is twice as inefficient as its ideal potential (see Figure 3).

As shown in Figure 3, although the number of taxpayers and tax revenue have increased in recent years, the C-efficiency index averaged 0.5 (50 percent). This indicates that there are interruptions in the VAT chain and that the tax administration has little capacity to control and collect taxes.

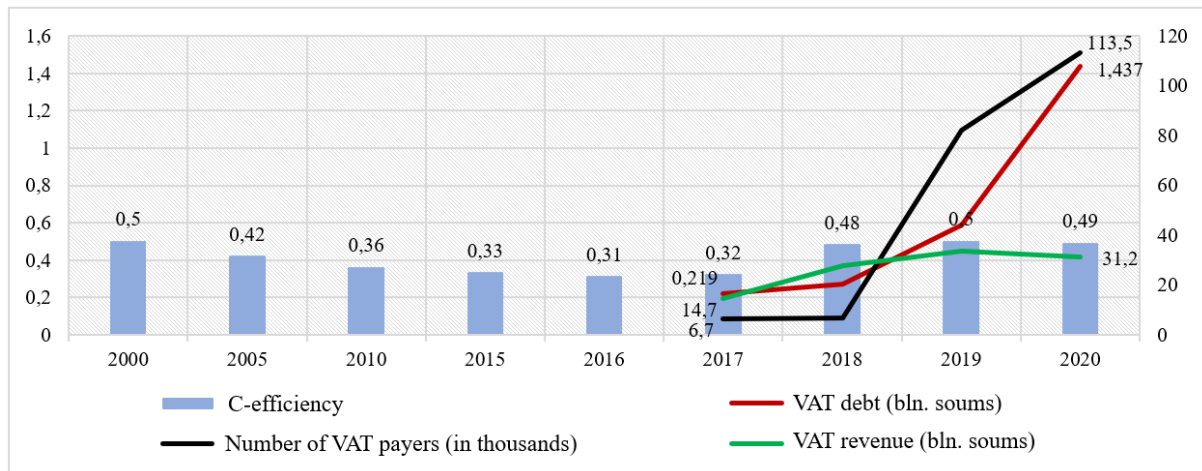


Figure 3. C-efficiency and other indicators of VAT⁴

The main reasons for this deficiencies are explained by the following shortcomings.

Simultaneous application of both VAT and turnover tax in the tax system is a theoretically incorrect practice, causing disruptions in the VAT chain. An analysis of international tax practice has shown that only one type of universal excise tax applies to the tax system at a time. For example, if there is VAT in the system, no additional turnover tax (sales tax) is applied in parallel with it.

According to the research of Rakhmonov and Safarov (2021), the shortcomings that lead to low S-efficiency of the VAT mechanism are mainly described by two factors:

- policy gap - deviation of the current VAT system from the mechanism of taxation of all and only final consumption expenditures (without any benefits and VAT deductions for intermediate products) at a single rate;
- compliance gap - due to the imperfect level of enforcement of the existing VAT system, i.e. the control capacity of the tax administration and the low tax culture.

In order to eliminate these shortcomings and increase the effectiveness of the VAT mechanism in the fight against the shadow economy, it is advisable to do the followings: First, it is proposed to introduce information and communication technologies in the activities of tax authorities in order to organize the storage, processing and efficient use of large amounts of data in the tax administration and reduce hidden activities in the economy, increase transparency and create the same level of competition.

Second, we consider it expedient to introduce artificial intelligence technologies in tax administration in order to reduce the informal economy.

⁴ Prepared on the basis of data from the International Monetary Fund and the State Tax Committee.

CONCLUSION

1. The current state of the shadow economy in Uzbekistan is due to the fact that for a long time there has been no clear direction at the government level to curb it, which in turn has led to the collapse and weakening of not only the tax system but the entire administration and executive power. The main reason for this was the fact that the shadow economy developed in parallel with corruption and through it became possible to circumvent the existing official bureaucratic barriers.

2. Extensive measures to improve tax compliance and thereby reduce the shadow economy have been reflected in the reforms implemented over the past three years. These reforms are mainly aimed at reducing the tax burden and expanding the taxation framework, which has resulted in a multiplier of the number of taxpayers and tax revenues. However, it became clear that the collection capacity of the tax authorities for basic taxes, in particular VAT, profit and income taxes, has decreased.

3. The analysis shows that despite the positive changes in tax policy, the share of the shadow economy has not decreased significantly. It is partly due to the fact that tax policy reforms do not take into account the capability of tax administration, partly due to increased compliance costs for small businesses.

4. The study also assessed the following shortcomings in the tax policy of Uzbekistan as factors that hinder the improvement of the level of compliance:

- The tax strategy does not specify which types and mechanisms of taxation should be aimed at reducing the share of the shadow economy;
- Failure to eliminate systemic problems that prevent the full operation of the VAT mechanism throughout the economic value chain;
- Lack of incentives to strengthen public control over compliance with tax legislation.

5. It has been proved that the implemented changes in the tax legislation do not correspond to the capacity of the tax authorities. In order to adjust tax policy to the capabilities of tax administration, it is necessary to increase the threshold amounts in determining the status of small businesses. In this case, in order to reduce the administrative burden on the taxpayer and the tax authorities, it is necessary to abolish the obligation to submit tax returns for income taxpayers in a strict manner.

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