



The Peculiarities of Encouraging the Transition of Untaxed Business to the Formal Sector

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Abstract

This article is devoted to the peculiarities of encouraging the transition of untaxed business to the formal sector. In addition, some features of the untaxed (informal) business have been investigated, as well as the advantages of the shadow economy and recommendations on the transfer of untaxed business to the official one in Uzbekistan have been formulated.

Keywords: *Encouragement; Transition; Untaxed Business; Formal Sector; Shadow Economy; Poverty Reduction; Income Distribution; Formalization; Policy; Untaxed Sector; Small Enterprises*

Introduction

Recently the role of the untaxed sector in the economy of Uzbekistan has increased. Small enterprises operating outside the official legal framework make a significant contribution to the increase of employment and revenue of the country. However, the informal nature of these enterprises results in the limited access to financial resources, lack of legal protection, and difficulties in monitoring and taxation. Recognizing the significance of formalization, this research paper aims to explore the ways to improve policies that encourage the transition of untaxed businesses to the untaxed sector.

Although the unofficial economy in Uzbekistan is an essential means of livelihood for many, it faces obstacles to its integration into the formal sector. The lack of a comprehensive policy framework to address the unique challenges of transitioning from informal to formal status hinders progress in this regard. Understanding the dynamics of the untaxed business and improving policies that encourage their formalization are crucially important to ensure economic development and stability in Uzbekistan. By clarifying the challenges and proposing efficient solutions, this research aims to contribute valuable insights that inform policy decisions and promote a more regulated business environment.

This study is primarily focused on the activities of enterprises operating in some sectors of Uzbekistan, and the results cannot be fully generalized for all sectors. In addition, it is appropriate to take into account limitations related to data availability and the changing nature of economic conditions in a country.

Literature Review

While the pandemic has been devastating, its impact has been particularly severe on the informal sector (World Bank, 2020). Because of their prominence in the service sector, workers and employees in the informal sector were more likely to experience significant income losses during job losses or lockouts (Schotte et al., 2021). Relying on these literary sources one can witness how urgent the issue of the informal sector is.

Since their first definition in 1973, the concepts of the untaxed (informal) sector and the shadow economy have been the subject of research in labor economics (Hart, 1973). Governments and politicians began to include the shadow economy in their agenda, which ended up with the formal inclusion of the shadow economy. To date, there are many policies and interventions targeting the informal economy. The most common approach to policy development is formalization (Williams and Round, 2007). Formalization policies range from improving access to lending facilities to providing training and other business development services to untaxed businesses. Other activities are aimed at strengthening the links between the untaxed sector and formal economy.

Formalization makes a favorable impact on the economic growth, employment generation, labor productivity, working conditions and social protection (Tijdens et al., 2015). On the other hand, the shadow (informal) economy is associated with low-quality institutions (Loyaza et al., 2005). Informal businesses are harmful to the economy because they often underreport employment, evade taxes, and threaten formal firms by circumventing the costs of regulation and copyright infringement (Schneider et al., 2011). Consequently, the formalization of untaxed businesses is a strategic step required to unlock potential economic growth, enhance competitiveness, create jobs, and capture government revenues from taxation.

Despite many efforts by policymakers to shape the shadow economy in the formal character, there is still a knowledge gap regarding systematic evidence on the effects of these formalization interventions. There is little information about robust responses to formalization policies and interventions, and there is conflicting evidence in the literary sources about their success. Meta-regression analysis (MRA) has been used in various fields of economics, such as labor economics (Grimm and Paffhausen, 2015), international economics (Demena and Bergeijk, 2017) and development economics (Havránek et al., 2016), however, there is no meta-analysis covering the effects of private sector policies on firm formalization. There are two reviews that focus on policies that facilitate formalization (Grimm and Paffhausen, 2015; Bruhn and McKenzie, 2014). Bruhn and McKenzie (2014) argue that increased enforcement may result in the higher formalization rates and that there may be fiscal benefits from formalizing large untaxed firms. The second study presents a systematic analysis appraising the results of private sector interventions on employment generation without particular attention to informality (Grimm and Paffhausen, 2015).

Results and Discussion

We know that governments promote formalization through a variety of interventions, from simplifying registration procedures to strengthening enforcement. These interventions can be divided into three main policy approaches: reducing costs and simplifying procedures; expanding incentives; enhancing the compliance level.

In addition, some interventions are accompanied by information and awareness campaigns. Currently if we look at the experience of the countries throughout the world, a lot of research and practical activities are being carried out on formalizing the activities of the untaxed sector. In the framework of these studies, we have shaped some important aspects in Figure 1 below.

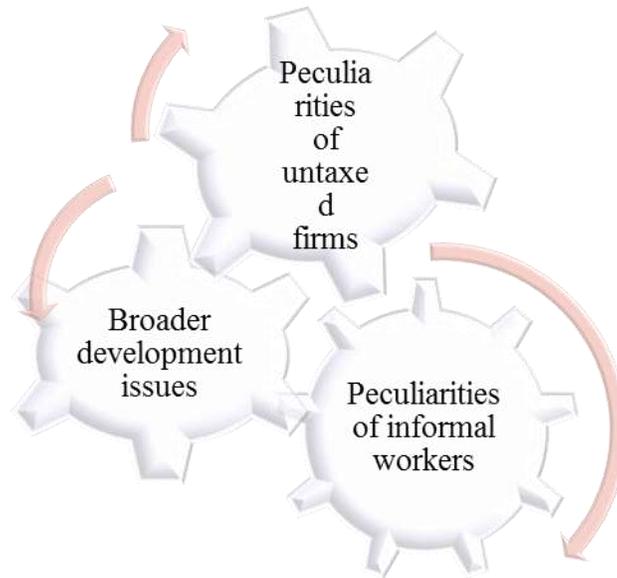


Figure 1. The peculiarities of the untaxed sector [1]

Below we consider some features in reliance upon the research:

Peculiarities of informal workers. Compared to workers in the formal sector, workers in the informal sector are generally less skilled and less paid, and have less access to financial and social safety nets (Loayza, 2018). They often live and work in crowded conditions and conduct all transactions in cash—factors that contribute to the spread of disease (Suriso and Galeotti, 2020). People with the most prevalent informality are more likely to fall into poverty if they have to pay out-of-pocket for health emergencies. This can answer the question of how important is the transition to the formal sector.

Peculiarities of informal firms (untaxed businesses). Informal firms are generally labor intensive and are more common in the service sector. Such firms have been particularly hard hit by measures to reduce social interactions (Panizza, 2020). Informal firms rely on internal funds, which makes them particularly vulnerable to cash flow disruptions caused by mitigation and other control measures (Farozi, 2014). As we can see, the problem of informality is noticeable with another feature. If we look at the above situation regarding workers as a social issue, its economic weakness is evident in the case of companies.

Broader development issues. In countries where informality is prevalent, governments have limited resources and few administrative structures to effectively deliver well-targeted aid to those most in need (Muralidharan et al., 2016). More precisely, a larger informal economy is associated with weaker economic, fiscal, institutional and development outcomes. Countries with below-average levels of informality have GDP per capita of about one-quarter. In any case, it indicates that the shadow economy has no future and is full of threats. For this reason, its weaknesses always ensure its weakness and create constant threats to the stability of the activities of its participants. Thus it is essential to shift from the untaxed sector to the formal sector, which is a one-time activity level, after the members of the society have no ground for the future.

Furthermore, it should be emphasized that the relationship between the informal and the formal economy is complex and different processes can affect their dynamics in different ways (Table 1).

Table 1. The differences in the transition from the informal (shadow) economy to the formal economy [2]

Indicators	Specification
Priority	The informal economy often demonstrates resilience to economic hardship. Many engage in informal activities out of necessity, and these sectors can adapt quickly to changing circumstances.
Impact	The informal economy includes a wide range of activities, from street vendors to small entrepreneurs. This activity contributes significantly to employment and can serve as a stepping stone for individuals to enter the formal economy.
Policy-based	The transition from the informal sector to the formal sector is not always straightforward. This requires supportive policies, infrastructure and an enabling business environment.
Social and economic	The existence of the problem of trying to integrate informal workers into the formal economy while solving problems related to employment, social protection and fair wages.
Share	In some regions, the informal economy constitutes an important part of the overall economic activity.

While there are problems with the informal economy in general, its role in providing livelihoods to a significant portion of the world's population must also be admitted. It should be noted that it is essential to implement a unified approach that takes into account the specific conditions of different regions and the needs of informal to solving the complexities associated with the formalization of economic activities.

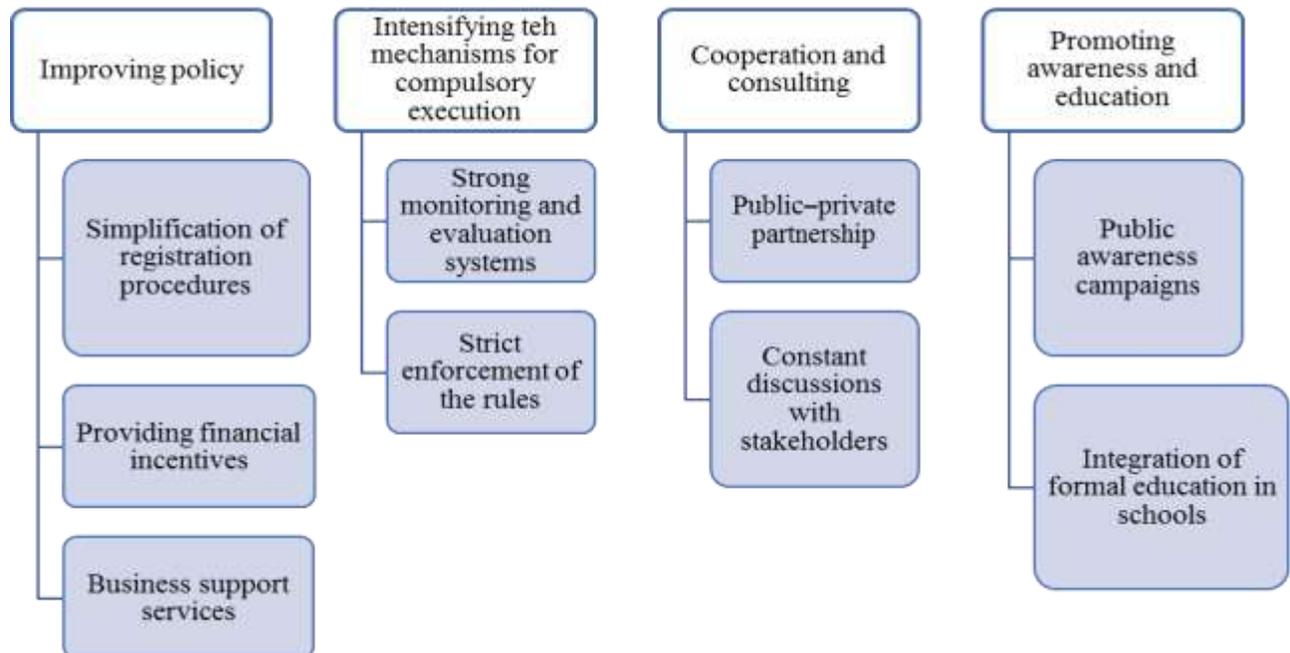


Figure 2. Recommendations for encouraging the transition of informal business to the formal sector in Uzbekistan [3]

As shown in Figure 2, successful transition of informal businesses to the formal sector in Uzbekistan requires a multifaceted and integrated approach that addresses various aspects of policy improvement, implementation mechanisms, cooperation and consultation, as well as awareness and education.

In terms of improving the policy: to facilitate transition from informal to formal status, the government is recommended to simplify business registration processes. This includes digitizing registration procedures, reducing bureaucratic hurdles, and providing user-friendly resources to guide entrepreneurs through the registration process; introducing targeted financial incentives to encourage informal businesses to formalize their activities. This may include tax incentives, subsidies or grants for businesses that successfully transition to the formal sector, thereby easing the financial burden of compliance and formalization; facilitated business support services, including academic curricula programs and mentoring initiatives, should be put in place to help informal entrepreneurs understand and meet formalization requirements. Partnerships with industry associations, NGOs and educational institutions can make these support services more effective.

Intensifying the mechanisms for compulsory execution: robust monitoring and evaluation systems should be put in place to monitor the progress of clearance efforts. This involves using technology to collect and analyze real-time data, allowing authorities to identify bottlenecks and adjust interventions accordingly; improving enforcement mechanisms against business entities operating in the untaxed sector, ensuring consistent application of penalties for non-compliance. This includes strengthening the capacity of regulatory bodies and law enforcement agencies to address issues related to tax evasion, labor practices and other regulatory violations.

Fostering collaboration and consultation: public-private partnerships should be encouraged to develop cooperation between the government and the business community because by involving stakeholders such as the private sector in the formation and implementation of partnerships, a more unified and effective approach to promoting formalization can be achieved; regular consultations should be held with stakeholders, including informal business, industry associations and civil society representatives. These measures ensure that they are informed by the experiences and perspectives of those directly affected, leading to more inclusive and effective strategies.

Promote awareness and education: comprehensive public awareness campaigns should be launched to educate informal businesses about the benefits of formalization and the support available. It consists of massive measures including multimedia campaigns, seminars and public relations programs to effectively disseminate information; integrate education on formalization and business compliance into educational programs and, if necessary, develop awareness of the significance of working in the official sector from an early age in school education. This approach serves to form the culture of compliance and entrepreneurship in the future generations, makes an impact on the increase of financial literacy and the development of legal consciousness in the future.

Conclusion and recommendation. In conclusion, the recommendations provide a comprehensive framework that addresses the multifaceted challenges associated with the transition of untaxed businesses to the formal sector in Uzbekistan. The success of these measures depends on their efficient implementation and continuous adaptation to the changing needs of enterprises and the economic situation. A collaborative and consultative approach involving government, business, and civil society is essential to achieving sustainable and inclusive economic formalization in Uzbekistan.

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