



THE NATURE OF THE SHADOW ECONOMY, ITS CHALLENGES, AND ITS INFLUENCE IN DEVELOPING COUNTRIES' ECONOMIES

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Article history:	Abstract:
Received: 11 th June 2022 Accepted: 14 th July 2022 Published: 24 th August 2022	The shadow economy is a concern in every state. It should be acknowledged that overcoming the shadow economy is one of the most pressing issues facing state regulation and administration. The shadow economy is defined as economic activity that is intentionally concealed from the government and public. This activity occurs outside of the purview of governmental regulation and accountability. This article discusses the shadow economy, its challenges, and its importance in emerging countries' economies.

Keywords: *Shadow Economy, Shadow Sector Of The Economy, Tax Rates, Developing Countries.*

In the economics, there are numerous explanations of shadow occurrences. To describe them, words like "shadow," "criminal," "dark," "destructive," "informal," "illegal," and so on are utilized. There are currently no consistent, widely acknowledged criteria for defining the idea of the shadow economy, resulting in a wide range of interpretations of these words by professionals.

The interpretation of the shadow economy is connected to its essence, which may be described from several perspectives. The notion of the shadow economy is often defined using economic-statistical, legal, and ethical perspectives. According to the economic and statistical perspective, the shadow economy is officially unaccounted for, kinds of economic activity that are not represented in official statistics. Economic processes that violate legal rules are referred to as "shadow processes" in the legal world. "Shading" is described as economic activity that breaches universally recognized moral principles from an ethical standpoint. While establishing the borders of the shadow economy in different ways, all of these techniques highlight its core feature—its hidden nature.

The shadow economy is evolving on its own. It is governed by its own rules and ethical standards. The income received is not recorded by official statistics authorities. Profits from shadow economic businesses can be concealed. The following types of shadow sectors are distinguished [1]:

- the white-collar economy It is inextricably linked to formal economic activities. It occurs in businesses where personnel utilize their positions to gain illegitimate money. This involves corruption, which occurs when officials

- participate in business operations that violate the law.
- the gray or informal economy operates independently of the official economy. Its presence is frequently related with the strengthening of the state's regulatory function and an increase in the tax burden.
- the criminal or black economy This is a distinct style of management in which the subjects interact according to their own set of laws and regulations.

The shadow economy is said to exist in all countries, regardless of socioeconomic development level.

The bigger the proportion of the economy in the shadow sector, the less stable the national economy. State policy in the realm of economic management should consider the causes for the emergence of the shadow sector and encourage firms to transition from the gray to the white economy.

The shadow economy reveals itself to a larger extent through corruption, money laundering, and tax evasion. Despite the fact that there are mechanisms in place to counteract these occurrences, people are discovering new ways to bypass them in order to maximize their own gain.

The overall situation of a country's economy determines the circumstances for the establishment of the shadow economy. Because the shadow economy impacts economic processes such as investment, commerce, budget formulation, and distribution, it poses a substantial danger to any country's economic security, and the difficulty of measuring its scale becomes worldwide.



The viciousness of the tax burden is now regarded as one of the key drivers in the rise of the shadow economy in practically all studies. Although the economic core of taxes is the deduction of voluntary contributions to support state expenditures in order to deliver public benefits to all citizens, voluntary implementation of such an operation may be challenging in practice. As a result, the "stowaway problem" may exist, as well as the fact that taxpayers limit their involvement in the funding of public goods by not trusting governmental institutions. The origins of this mistrust are poor property and contract protection, ineffective anti-corruption legislation, insufficient regulation of commercial operations, and fiscal policy that favors restricted interest groups. All of these characteristics are common in nations with transitional economies.

Higher tax rates have two potentially offsetting effects: the direct effect increases the incentive to hide activities "in the shadows," but the indirect effect encourages production in the official sector by providing a better legal environment due to increased state revenues and the ability of the state to provide essential public services, such as the application of laws and the rule of law. However, an increase in the tax burden may result in an increase in tax violations, reducing tax revenues and increasing the tax burden on an ever-decreasing percentage of taxpayers who follow the rules. This "vicious loop" occurs as a result of high tax rates, which encourage bribery and other forms of tax evasion, resulting in this type of "chain reaction." As a result, a corrupt taxation system that favors a small group of individuals can undermine all attempts to construct a fair and efficient fiscal system in the country. Corruption thrives in situations when existing tax rates are exaggerated, as has been and continues to be witnessed in nations with transitional economies, such as the former Soviet bloc states of Eastern Europe and the republics of the former Soviet Union [2].

Each country's influence of the tax burden on the size of the shadow economy has its unique features. High income tax rates, for example, have a unique influence in the United States, while in Russia, high rates of deductions to social security funds and high rates of value-added tax assist the growth of the practice of disguising income. High rates of export and import taxes have a particularly negative impact in countries pursuing a protectionism strategy [3].

Excessive control of economic activities is another major component in the growth of the shadow economy. This is mostly evident in governmental acts such as a prohibition on the circulation of any goods or services, administrative intervention in the pricing process, excessive bureaucratic authority, ambiguity, and limited controllability of criteria for bureaucratic judgments. The economy's high degree of regulation,

along with the law's lax and discretionary application, produces an unusually fertile environment for shadow operations. Corruption thrives in such environments.

A few publications have conducted empirical analyses of the link between corruption and the shadow economy, but the authors of research that address this issue observe that in nations where corruption is more prevalent, the shadow economy is greater. Some studies have identified a direct relationship between a drop in the country's degree of corruption and the size of the shadow economy. All of the research indicated that increased corruption contributes to the rise of the shadow economy [4].

Some economists believe that the implications of shadow economic activity cannot be determined unequivocally. Many forms of shadow economies objectively aid rather than impede the growth of the legitimate economy. So, for example, the Swiss economist D. Kassel emphasizes the shadow economy's positive functions in the market economy as "economic lubrication"—smoothing out differences in the economic conjuncture through resource redistribution between the official and shadow economies; "social shock absorber"—mitigation of undesirable social contradictions (in particular, informal employment improves the financial situation of the poor); and the "built-in stabilizer" (unofficial income is used to purchase goods and services in the legal sector, "laundered" criminal capital is taxed, etc.) [5].

However, the overall influence of the shadow economy on society is harmful rather than good. Here are only a few instances of how the shadow economy harms public wellbeing:

- When environmental and safety regulations are violated by "moving into the shadows," societal welfare suffers as a result of increased danger to customers or employees, or environmental harm.
- The state loses money since taxes are not collected and licenses are not granted. As a result of these losses, the state may raise tax rates or impose new levies to fund its expenditures, resulting in even more distortions and incentives to "go into the shadows."
- Because the magnitude of the shadow economy is difficult to quantify, policymakers may make inaccurate judgements of economic policy based only on statistics describing the legal economy. The shadow economy renders official data (on unemployment, labor force participation, income, and consumption) untrustworthy. Policies



and initiatives based on untrustworthy statistical data may be ineffective [6].

- Everyone who engages in unethical behavior breaches the law and maybe some moral underpinnings of society. After breaking one law and avoiding penalty, a person may be enticed to break another. As a result, some criminal behaviors might incite others, undermining society's legal and moral basis [7].

For comparison, we shall look at and compare the shadow economy in industrialized and developing nations.

Developed countries have advanced socioeconomic development. The majority of the population works in the service industry. This industry accounts for half of the total gross domestic product. The developed world is in the process of transitioning from an industrial to a post-industrial civilization. They have effective social support services and flexible taxation regimes. Education and medical are of high quality, and the government and significant private companies are investing in the advancement of science and technology.

The shadow economy exists in industrialized countries, despite good social and economic conditions. The researchers examined the global shadow economy and its variations between 1991 and 2015 [8]. According to the data, unlawful revenue makes for one-third of the overall volume of the global economy. The majority of unauthorized trade occurs in developing and impoverished nations. However, there is a white-collar, gray-collar, and criminal economy in industrialized nations.

Developed nations are dealing with the withdrawal of a portion of the network business to the official one more successfully. However, this procedure is highly difficult and time-consuming, necessitating an integrated strategy. During the study period, South Korea's proportion in the shadow economy fell from 29% to 19% [8]. The rise and fall of its proportion in industrialized nations is mostly determined by the stage of the economic cycle. However, illicit work has a detrimental impact on the economy. Furthermore, the big shadow sector enhances cash flow, which encourages funds to be withdrawn from public financial circulation.

The shadow economy is more frequently connected with corruption in wealthy countries. Large firms that place their operations in developing nations sometimes use offshore zones to remove a portion of their earnings from the economy. As a viable sales market, developed countries attract illicit activity. As a result, the solution to the problem of the negative impact of the shadow economy is dependent on the

coherence of the state's legislative, executive, and judicial systems.

The forms and structure of the shadow economy varies between developed and developing nations. Criminal activity forms the foundation of the economy in various countries, including Somalia, Nigeria, and Colombia. Contract manufacturing generates significant money for several governments. China, Ukraine, and Russia are singled out in this section. That is, huge firms in underdeveloped nations are active in the shadow economy. Illegal business thrives at the middle and small business levels in industrialized countries.

The unlawful economy in these nations is expanding in reaction to more governmental intervention in economic processes as well as a higher tax burden. Entrepreneurs are withdrawing funds from the nation and shifting their financial earnings to secure banking systems. The repercussions of these measures are increasingly disastrous for emerging countries. The domestic economy's insecurity is exacerbated by a shortage of funding, the loss of trained workers, and a general reduction in the population's quality and level of life.

Because people are getting into the habit of hiding their income from the authorities, bringing the shadow economy into the legal domain will be much more difficult. Entrepreneurs do not see the planned advantages as an inducement to shift to government activity.

In affluent countries, the illicit economy is actively growing and solidifying its positions. Through corruption, threats, and fraud, it regularly infiltrates the highest echelons of government. The intimate relationship between the governmental apparatus and criminal structures damages the national economy. The authorities are unwilling to change the present structure. As a result, corporate legalizing initiatives in emerging nations are unsuccessful.

There is a shadow economy in every country on the planet, regardless of economic development level. It cannot be eradicated altogether, although its size can be lowered. Despite the fact that the presence of the shadow sector in the country's economy has certain good repercussions, the shadow economy has a detrimental influence on the growth of any state. Because shadow activity generates enormous incomes in the tens of billions of dollars, it is extremely difficult to depart it, because income from any form of activity is dramatically decreased after leaving the shadow.

In some poor nations, such as Nigeria, the shadow economy outnumbers the official economy, but in certain rich countries (the United States and Japan), it accounts for less than 10% of GDP [9]. These nations' experiences can be valuable in formulating ways to



counteract the shadow economy, which poses a substantial danger to each country's economic security.

According to ACCA experts [10], there will be no major diminution in the scale of the global shadow economy in the near future. It will take on new forms, making it much more difficult to detect, quantify, and perhaps manage.

<file:///C:/Users/User/Downloads/pi-shadow-economy.pdf>

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