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# Conceptual and methodological approaches to shadow economy legalization through fiscal governance

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## Abstract

The shadow economy threatens fiscal resilience by diminishing tax capacity and weakening the foundation of public finances. This study investigates how fiscal tools such as preferential tax regimes, digital transformation, and enhanced budget openness can advance the integration of informal activities into the formal sector. Using cross-country experiences and methodological perspectives, the article outlines a model that combines regulatory enforcement with incentive-based policies to stimulate formalization in transition economies.

**Keywords:** Informal Economy; Fiscal Instruments; Taxation; Digital Reforms; Budget Openness; Formalization; Financial Sustainability

## 1. Introduction

The shadow economy commonly referred to as the informal, hidden, or underground economy constitutes one of the most pressing and persistent challenges in modern public finance and economic governance. It encompasses a wide spectrum of activities that remain outside official statistical records, are not subject to taxation, and operate beyond established legal and institutional frameworks. These activities range from small-scale unregistered trade and casual labor to more complex practices such as tax evasion by formal enterprises. Although the informal sector may serve as a short-term survival mechanism for vulnerable households and small entrepreneurs particularly in contexts of unemployment or weak social safety nets its long-term implications are largely negative. It reduces fiscal revenues, undermines the state's ability to maintain budgetary discipline, distorts fair market competition, fuels corruption, and constrains the government's capacity to finance and deliver essential public services such as healthcare, education, and infrastructure.

Globally, the scale of the shadow economy is remarkable and illustrates both its structural and systemic nature. Empirical estimates show that in advanced industrial economies, informal activities account for 8–15% of GDP, whereas in developing and transition economies the share often reaches between 25% and 50% of GDP (Schneider and Medina, 2018). In some cases, such as Sub-Saharan Africa and parts of South Asia, the shadow economy exceeds the formal sector, becoming the dominant mode of economic interaction. These figures underscore not only the magnitude of the challenge but also the urgency of designing coherent fiscal strategies that combine enforcement mechanisms with institutional reforms aimed at formalization.

Moreover, the persistence of the shadow economy is strongly linked to weaknesses in fiscal governance, inefficiencies in tax administration, and limited institutional trust between the state and economic agents. When taxpayers perceive fiscal systems as overly complex, inequitable, or corrupt, they are incentivized to shift into the informal sphere. Likewise, insufficient budget transparency and misuse of public funds erode compliance and discourage participation

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in the formal economy. International experiences from the digital tax reforms in Estonia to the consumer-driven focalization schemes in Brazil demonstrate that effective solutions must integrate tax policy optimization, digital transformation, and measures that enhance accountability and public trust.

## 2. Literature review

The phenomenon of the shadow economy has been widely investigated for decades, with scholars applying diverse approaches to its definition, measurement, and policy implications. While there is broad consensus that informality undermines fiscal sustainability and weakens state capacity, the debate remains open regarding the primary drivers—taxation, regulation, institutional weakness, or governance failures.

The modern academic study of the shadow economy gained momentum with the pioneering contributions of Tanzi (1999) and Schneider (2005), who emphasized the fiscal burden and regulatory pressures as key determinants of informality. They argued that excessive tax rates or disproportionate compliance costs push businesses and households toward underground operations. Feige (1990) expanded this analysis by framing the shadow economy as an adaptive response to overregulation, opaque institutions, and lack of trust in government.

Later research moved beyond taxation alone, highlighting the behavioral dimension of fiscal systems. Bird and Zolt (2015) stressed that fiscal policy is not limited to revenue mobilization, but also shapes taxpayer behavior and trust in institutions. Their findings indicated that simplifying tax systems, reducing arbitrary exemptions, and broadening the tax base reduce incentives to operate informally. Similarly, Alm and Torgler (2006) as well as Besley and Persson (2014) provided empirical evidence that voluntary compliance increases when taxpayers perceive fairness, reciprocity, and transparency in fiscal governance.

International organizations have also contributed significantly to the literature. OECD (2018) and IMF (2019) emphasized the necessity of complementing deterrence measures—such as penalties and audits—with incentive-based policies, including tax amnesties and reductions in compliance costs, to encourage informal actors to join the formal economy.

In recent years, scholars have increasingly examined the role of digital transformation as a fiscal instrument in reducing informality. Pomeranz (2015), through the case of Chile's VAT reform, demonstrated that third-party reporting and electronic invoicing significantly curtail evasion. Naiomi (2019) showed how electronic receipts and e-filing systems generate positive spillovers by enhancing both enforcement capacity and taxpayer trust. Complementing these findings, De Paula and Scheinman (2010) argued that digital technologies not only reduce concealment but also increase competitive fairness between formal and informal firms. The World Bank (2020) further underlined that digital focalization is particularly crucial for developing and transition economies, where weak administrative capacity and high cash dependence exacerbate informality.

Institutional quality also remains a decisive factor in shaping the effectiveness of fiscal instruments. Schneider and Medina (2018) found that in contexts with weak rule of law and low trust in government, fiscal reforms often fail to deliver expected outcomes. Kaufmann, Kraay, and Zoido-Lobatón (1999) developed governance indicators demonstrating that fiscal reforms cannot succeed in highly corrupt environments unless paired with institutional strengthening. Likewise, La Porta and Shleifer (2014) argued that informality persists not merely because of tax inefficiencies but also due to the inability of the state to provide reliable public goods and services.

## 3. Results and Discussion

In analyzing the legalization of the shadow economy through fiscal instruments, theoretical approaches, international experiences, and practical applications were examined in an interconnected manner. The study reviewed the mechanisms of various fiscal instruments and assessed their prospects for implementation within the national context.

The comparative evidence from advanced economies demonstrates that reducing informality is achievable when fiscal instruments are designed to balance enforcement with legitimacy. In Canada, simplification of tax procedures and targeted incentives for SMEs proved effective in gradually shifting small businesses into the formal sector. Germany's emphasis on integrated tax databases and transaction cross-checks illustrates the importance of institutional coordination and data-driven oversight, ensuring that evasion opportunities are minimized.

**Table 1** Experiences of advanced economies in reducing the shadow economy through fiscal instruments

| Country | Key fiscal instruments | Observed outcomes |
|---|---|---|
| Canada | Simplified tax regime for SMEs, targeted tax credits | Higher compliance among small firms; informal activity fell by 5% over a decade |
| Germany | Integration of tax databases, cross-checking of financial transactions | Significant reduction in tax evasion; shadow economy stabilized at approx. 10% of GDP |
| Sweden | Linking high tax rates to generous welfare benefits and transparency measures | Strong taxpayer trust; shadow economy maintained at one of the lowest levels in Europe (7–8% of GDP) |
| South Korea | Mandatory use of e-invoicing and real-time monitoring systems | Cash transactions decreased sharply; informal retail activity contracted by nearly 30% in five years |

Source: Compiled by the author

Sweden represents a distinctive model in which relatively high tax rates do not stimulate informality because they are closely tied to visible welfare provisions, transparency, and accountability, thereby strengthening the "psychological tax contract" between the state and citizens. South Korea highlights the transformative potential of digitalization, where mandatory e-invoicing and real-time fiscal monitoring systems significantly reduced cash dependence, increased traceability, and curtailed opportunities for hidden transactions.

Collectively, these experiences suggest that advanced economies rely not on a single policy, but on a complementary mix of fiscal strategies: simplification and incentives, technological modernization, welfare legitimacy, and strict enforcement. For transition economies, this indicates the necessity of tailoring fiscal instruments to institutional capacity while simultaneously strengthening trust and transparency.

**Table 2** Main mechanisms of digitalization in legalizing the shadow economy

| Mechanism | Practical Application | Expected Outcome |
|---|---|---|
| Electronic invoicing system | Recording all financial transactions between enterprises in electronic form | Expands the tax base and reduces hidden transactions |
| Online cash registers | Mandatory use in retail trade and service sectors | Reduces cash circulation and fosters a fiscal receipt culture |
| Electronic taxpayer registration | Integrating individuals and legal entities into a unified database | Strengthens tax discipline and limits opportunities for tax evasion |
| Digital monitoring systems | Real-time tracking of financial operations | Increases the efficiency of state oversight and ensures transparency |

Source: Compiled by the author

As shown in Table 2, digitalization plays a central role in reducing the shadow economy. Electronic invoicing and online cash registers strengthen the documentation of transactions, while electronic registration establishes a comprehensive taxpayer base and eliminates systemic loopholes. Digital monitoring systems provide tax authorities with timely and effective oversight mechanisms. Through such a comprehensive approach, economic transparency increases, state budget revenues become more stable, and the quality of economic governance advances to a new stage.

## 4. Conclusion and Recommendations

The analysis of legalizing the shadow economy through fiscal instruments demonstrates that achieving effectiveness requires a comprehensive approach. First, tax policy must be optimized by aligning rates with economic conditions, applying incentives only to targeted sectors, and broadening the tax base. At the same time, the introduction of digital fiscal technologies such as electronic invoicing, online cash registers, and real-time monitoring systems ensures the full documentation of financial operations.

Furthermore, enhancing transparency in budgetary processes, strengthening public oversight of state expenditures, and establishing an open reporting system consistent with international standards are essential for building taxpayer trust. These measures should be reinforced through strong legal and institutional frameworks, the reduction of corruption risks, and the adaptation of advanced foreign practices to national circumstances. Most importantly, cultivating a “fiscal contract” between the state and taxpayers based on mutual trust and a culture of compliance can significantly reduce informal activity.

In conclusion, the legalization of the shadow economy holds strategic importance for the country’s economic development and fiscal stability. The integrated use of the above instruments will expand the tax base, stabilize budget revenues, increase economic transparency, and lay a solid foundation for Uzbekistan’s long-term socio-economic growth.

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