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Article



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## THE ECONOMIC IMPORTANCE AND ROLE OF FINANCIAL MECHANISMS IN REDUCING THE SHADOW ECONOMY

**Abstract:** In this article, research was conducted on the role of financial mechanisms in reducing the shadow economy, in addition, the level and direction of influence of the factors in the shadow economy were also studied.

**Key words:** hidden economy, financial mechanism, economic importance, benefits, financial technologies.

**Language:** English

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### Introduction

The problem of reducing the level of the shadow economy and getting more income by reducing it is more important in developing countries.

Research has shown that the extent of the shadow economy in a given country is influenced by various factors, including: the overall tax and social security contribution burden; the complexity of the tax system; business registration costs; management social environment; efficiency of tax administration; attitude to government authority and public spending.

Most of these factors noted by the International Monetary Fund are financial factors. It follows that the level of the hidden economy is caused by the lack of effective financial mechanisms. The financial mechanism is an integral part of the economic mechanism, means of financial incentives, forms and methods of regulating economic processes and relations. The financial mechanism includes the following (Figure 1):

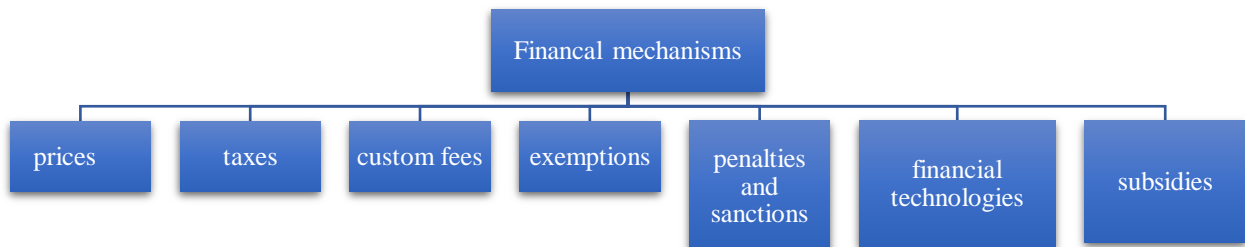


Figure 1. Forms of financial mechanism<sup>1</sup>

<sup>1</sup>Compiled by the author

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All these mechanisms directly or indirectly affect the level of the hidden economy.

If we see the influence of financial mechanisms on the level of the hidden economy, based on the direction of their influence, we can use them to develop appropriate measures to reduce the hidden economy.

### *Price Effects on the Shadow Economy:*

The increase in the price of certain types of products causes an increase in the level of the hidden economy, in particular, the increase in the price of strategically important products can cause some enterprises to switch to the hidden economy. For example, the increase in the price of oil affects the production costs of many producers, the increase in production costs causes them to pay taxes and other costs, so they can operate in the shadow economy in order to avoid the tax burden. Government intervention in pricing to reduce the shadow economy may have a negative impact on the economy or may cause a reduction in product supply.

### *The role of taxes in reducing the level of the shadow economy*

Various studies have shown that the high complexity of taxes, weak or ineffective collection of taxes, lack of incentives to carry out official transactions and payments through official banking channels affect the level of the hidden economy. Another important factor is the level of trust of taxpayers in the government. These factors can be influenced by tax policy and tax administration measures.

In general, a strategy to address the factors that contribute to reducing the size of the shadow economy should be comprehensive, involving all stakeholders, such as the central bank, the banking sector, the ministry of finance or economy, and the tax administration. Taxes play a key role in reducing the level of the hidden economy. Of course, setting tax rates at an optimal level reduces the level of the hidden economy. In this case, the provision of tax incentives can cause taxpayers to not hide their income or claim receipts for the goods and services they purchase. For this, it is necessary to establish the correct formation of the mechanism and control of its operation. The ability of tax administrations to detect the activities of the hidden economy increases significantly when any transaction leaves a trail based on documents. Such means may consist of a simple invoice issued by a business for a good or service, or a recorded payment for a good or service. The starting point for developing a document trail for cash transactions is the requirement to issue a tax invoice for any sale with a price above a certain amount. Research shows that countries have established such legal requirements under existing tax laws; however, the fact that such requirements are not beneficial for both the enterprise and the taxpayer creates the risk that they will not comply with this regulation. Physical controls to

ensure compliance with invoicing obligations are complex and incur additional costs. Nevertheless, some tax administrations devote considerable resources to conducting audits of enterprises, including anonymous test purchases.

Ensuring that traders record their purchases through an online cash register or NKM also serves to reduce the level of the shadow economy. Modern NKM systems provide real-time transfer of sales data to the tax administration database and allow continuous monitoring of individual business operations and changes in sales volume. But there are a number of problems in achieving this. For this practice to be effective, one of the parties must be interested in it. Only then will the efficiency increase.

### *The role of duties in reducing the level of the shadow economy*

High tax rates of customs duties significantly protect domestic economic producers. Therefore, reducing this type of duties reduces the protection of domestic goods against foreign goods and reduces competitiveness. In turn, this situation may force some local producers to leave formal markets and work informally to reduce their costs in order to avoid paying taxes. Naturally, in this process, the size of the hidden economy will significantly increase the level of the hidden economy. increases. In the same way, increased import taxes protect domestic production against imported goods, reducing the incentive to operate in the shadow economy. In order to reduce the level of the hidden economy, it is necessary to choose a high optimal amount of import duties, because the increase in the amount of duties is mainly a burden for consumers, and the lack of competition affects the price and quality of products in the local market, and may even lead to the emergence of a monopoly. Effective organization and conduct of this process directly depends on the institutional system of the state.

### *The role of benefits in reducing the level of the shadow economy*

Measures to ensure voluntary compliance by providing monetary or non-monetary benefits have been introduced in a number of EU countries, that is, the practice of paying taxes on time and in full through various benefits is widely used in the EU countries. Recently, in many European Union member states, the practice of introducing direct tax credits to users of domestic services, i.e. house cleaning, child care, or elderly care services, has been applied, the purpose of which is to enable those engaged in these activities to carry out their activities in the formal economy.

Another type of benefit is cashback on credit/debit card purchases. That is, every citizen receives a certain amount of cashback for purchases made using his credit or debit cards, which serves to reduce the practice of paying wages in "envelopes" in the hidden economy.

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### *The role of financial technologies in reducing the level of the shadow economy*

Currently, it is possible to monitor and accurately calculate the amount of payments using financial technologies. According to a number of theories mentioned above, cash transactions increase the level of the shadow economy because they do not leave a trace in any document. For this reason, measures taken to reduce the level of the hidden economy should be focused on reducing the amount and volume of payments made in cash. Currently, in order to determine the turnover of vending machines installed in crowded places, educational institutions, and various organizations, it is necessary to connect them online to the database of tax authorities using financial technologies. This allows for accurate calculation of the tax base.

The role of grants and subsidies in reducing the level of the shadow economy

When the economy is depressed, businesses are forced to lay off a large number of employees to avoid bankruptcy, and to employ the necessary number of employees informally. According to the theory of John Maynard Keynes, in order to bring the economy out of depression in this situation, the state should be a customer of large enterprises, so that the volume of production in these enterprises will increase and they will employ more people, as a result, the purchasing power of workers will increase. Through this, the state will get the economy out of depression. This reduces the motivation to move to the underground economy.

### *Literature review*

Since financial inclusion ensures the participation of a large sector of the economy in the formal financial system, it creates a positive externality in the economy, as it enables more effective implementation of monetary policy. In fact, high financial inclusion allows interest rates to become an effective policy tool, as Mehrotra, A., and Yetman, J.<sup>2</sup> According to his research, Central Banks facilitate a mechanism through which they can stabilize price levels. As inclusiveness allows for a smoothing of higher consumption, households are able to adjust to changes in interest rates by adjusting the level of savings and loans. Higher financial

inclusion can encourage households to convert their savings into deposits. Khan HR<sup>3</sup>. and Tombini, A<sup>4</sup>. concluded that high levels of financial inclusion make interest rates a relatively powerful and key policy tool. As financial inclusion increases, monetary reserves begin to convert from currency in circulation to interest-bearing deposits in the banking system. This allows most economic activity to be controlled by interest rates. Khan HR<sup>5</sup>. the larger the informal sector, the more difficult it is to implement and control monetary policy, as the decisions of more households and small business owners are independent of central banks' monetary policy. In addition, financial inclusion encourages people to move from a cash economy to a banking economy, so their financial transactions can be tracked.

Mehrotra, A. and Yetman, J<sup>6</sup>. clarifies that when more agents are included in the formal financial system, output volatility increases relative to inflation volatility because financial agents are better able to change their investment and savings decisions. Therefore, as financial inclusion increases, central banks will be able to focus on stabilizing prices and thereby increasing financial stability. In some countries, central banks focus on the core price index to determine inflation targets, but the choice of this price index can sometimes be wrong. Mbutor, MO, & Uba, IA<sup>7</sup> analyzed the effect of the level of financial inclusion on the effectiveness of monetary policy in Nigeria from 1980 to 2012. Their results support the claim that higher levels of financial inclusion play an important role. However, when the variable of number of bank branches was included, this result did not hold, actually showing a negative relationship. This shows that the purpose of banks in opening new branches is mainly to seek more profit, but not to increase financial opportunities.

### **Research methodology**

In this study, the models related to the reduction of the shadow economy through financial mechanisms and the level and direction of the influence of the factors influencing the shadow economy were analyzed.

### **Analysis and results**

<sup>2</sup>Mehrotra, A., & Yetman, J. (2014). Financial Inclusion and Optimal Monetary Policy, (Working paper No. 476). BIS. Retrieved from <https://www.bis.org/publ/work476.pdf>

<sup>3</sup>Khan, HR (2011, November 4). Financial Inclusion and Financial Stability: Are They Two Sides of the Same Coin? Lecture presented at BANCON 2011. Retrieved from <https://www.bis.org/review/r111229f.pdf>

<sup>4</sup>Tombini, A (2012): "Opening remarks", IV Fórum Banco Central sobre Inclusão Financeira, Porto Alegre, 29 October.

<sup>5</sup>Khan, HR (2011, November 4). Financial Inclusion and Financial Stability: Are They Two Sides of the Same Coin? Lecture presented

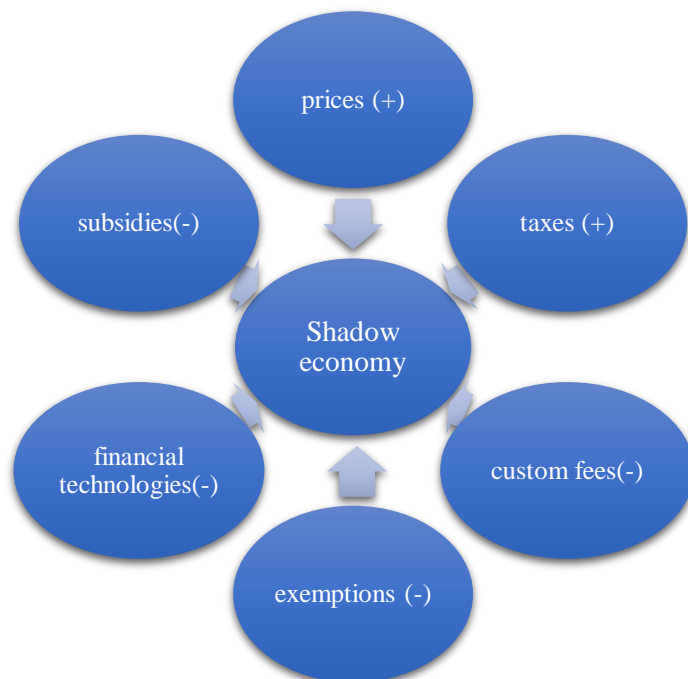
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<sup>6</sup>Mehrotra, A., & Yetman, J. (2014). Financial Inclusion and Optimal Monetary Policy, (Working paper No. 476). BIS. Retrieved from <https://www.bis.org/publ/work476.pdf>

<sup>7</sup>Mbutor, MO, & Uba, IA (2013). The impact of financial inclusion on monetary policy in Nigeria. *Journal of Economics and International Finance*, 5(8), 318-326. doi: <https://doi.org/10.5897/JEIF2013.0541>

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**Figure 2. The direction of influence of financial mechanisms on the level of the hidden economy<sup>8</sup>**

It is possible to influence the level of the shadow economy through the financial mechanisms shown in Figure 2. The (+;-) symbols next to each mechanism represent the direction of the mechanism's effect.

Many scientists around the world have used different terms to describe and analyze the phenomenon of the hidden economy. One of the most convincing studies, in our opinion, is conducted by Williams and Schneider, who state that there are various adjectives and nouns (vocabulary) describing unrecorded economic activities, which cover any possible activity from an individual to an enterprise.<sup>9</sup> Analyzing these terms, it was found that the main idea is transactions (financial or non-financial) that have been omitted by official authorities. The large-scale activity of the underground economy is an undeniable fact, which means that there is a lack of universally accepted definition. Considering the conclusions and ideas of Williams and Schneider, we have different results<sup>10</sup>.

The measures taken to reduce the share of the underground economy in the Republic of Uzbekistan consist of the following 5 sections:

As a result, the negative effects of the secret economy on society and the state, which are widespread in foreign countries, have been identified and they are:

- Violation of the competitive environment and non-transparency;
- Decrease in quality and quantity of products;
- Reduction of tax revenues to the state budget;
- Increasing the tax burden to support social and economic institutions;
- Consisted of a slowdown in economic growth.

At the same time, the methods of assessing the hidden economy, widely used in foreign countries, were studied and divided into two categories: direct and indirect. Direct methods are based on direct observations and tax audits, while indirect methods are transactional, currency-based methods.

Consists of the demand method, the energy consumption method, the difference between cost and income statistics, the difference between official and actual labor force, and the MIMIC model.

Most studies consider only one factor, the tax burden, as the cause of the shadow economy. Other factors (such as the impact of regulation, the attitude of taxpayers to the state, tax ethics, etc.) are not taken into account, since reliable data are not available for most countries. It is possible that if these other factors also affect the level of the shadow economy, the level of the shadow economy may be higher than reported in most studies.

<sup>8</sup>Compiled by the author

<sup>9</sup>Williams, CC and Schneider, F. (2016). *Measuring the Global Shadow Economy: The Prevalence of Informal Work and Labor*. Edward Elgar Publishing, UK

<sup>10</sup>Williams, CC and Schneider, F. (2016). *Measuring the Global Shadow Economy: The Prevalence of Informal Work and Labor*. Edward Elgar Publishing, UK

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Determining the level of hidden economy through Multiple Indicators Multiple Causes (MIMIC).

In this method, several causes and many effects of the shadow economy are clearly addressed. The methodology uses relationships between observable causes and effects of an unobservable variable to estimate the variable itself, in which case the books are kept to identify the hidden economy.<sup>11</sup>

The MIMIC model is a special type of structural equation modeling (SEM) based on the statistical theory of unobservable variables developed by Zellner (1970) in the 1970s, which is widely used in research in many fields.<sup>12</sup> The MIMIC model is a theory-based approach to confirm the effects of a set of exogenous causal variables on a latent variable (the level of the latent economy), as well as the effects of macroeconomic indicator variables on the latent economy.

In our opinion, determining the extent of the underground economy is that the underground economy remains an unrecorded process (hidden variable), the causes of illegal behavior, the tax burden and intensity of regulation, and indicators that reflect illegal activities, such as foreign exchange demand and official working hours. is calculated through the influence of

Disadvantages of calculation by these methods include:

One major problem with approaches such as MIMIC or demand-side accounting for currency is that they use causal factors such as tax burden, unemployment, self-employment, and regulation to make people do what they do or ask their friends and neighbors for something. are responsible. Thus, do-it-yourself work, help from neighbors or friends, and legally purchased materials from the "shadow" economy are included in these approaches to

calculating the hidden economy. This means that in these approaches, self-made work, help from neighbors, legally purchased materials, and the "common" underground economy are valued.

According to the Decree of the President of the Republic of Uzbekistan No. PF-6098, relief was granted to the following areas:

- To construction enterprises;
- Catering establishments;
- To those engaged in real estate activities.

In addition, commissions and structural structures were established, consisting of the Ministry of Economic Development and Poverty Alleviation, the Ministry of Finance, the Central Bank, the State Tax Committee and the State Statistics Committee. Another financial factor affecting the level of the hidden economy is financial inclusion.

Financial inclusion is critical for central banks to stabilize financial systems and manage monetary policy effectively, as higher financial inclusion can significantly change the behavior of consumers and firms.

### Conclusion

The hidden economy affects all sectors of the economy, and its high level is explained by the presence of economic and social problems in the state and the ineffective functioning of financial mechanisms.

There are a number of methods for determining the level of the hidden economy, the most effective of which is the ratio of cash to demand deposits.

The definitions of the hidden economy of the researchers who conducted research on the detection and reduction of the hidden economy are also fundamentally different from each other.

Fiscal and monetary tools are the main tools for reducing the level of the hidden economy.

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<sup>11</sup>Loayza, NV (1996), The Economics of the Informal Sector: A Simple Model and Some Empirical Evidence from Latin America, Carnegie-Rochester Conference Series on Public Policy 45, 129-162.

<sup>12</sup>Zellner, M. (1970). Self-esteem, reception, and influenceability. *Journal of Personality and Social Psychology*, 15(1), 87-93.

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