

## **INFORMAL EMPLOYMENT AND INCOME TAXATION IN UZBEKISTAN**

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### **Abstract**

*This article is devoted to the consideration of issues of the informal employment and the level of imposing taxes on the population's income in the economy of Uzbekistan in terms that quite a big part of the employed population is not taxed. In addition, the article reveals basic problems related to the taxation of income and their social consequences. In reliance upon these statements, the article represents the ways to reduce informal employment in Uzbekistan through improving the system of the income taxation.*

**Key words:** *shadow economy, income tax, taxation mechanism, tax system, tax regime, informal employment, income declaration.*

### **Theoretical background of income taxation: literature review**

The problems of an income tax are based on a solid theoretical background, and the scientific literature sources provide many different views on the issues of improving income taxation. In particular, according to Smith's principle of equality (fairness), each person must pay taxes in compliance with his income and solvency (Smith, 2000). The essence of this principle is that, firstly, taxpayers must pay in the amount proportional to the consumed goods produced by the government, and secondly, taxation should take into account the tax ability of payers as well.

Another outstanding representative of the classical school, Jean-Baptiste Say, noted that there should be a certain threshold for the collection of income tax (Pushkaryeva, 2003). Definitely, a certain level of income of taxpayers should be taxed without creating

an extra burden. Otherwise, taxpayers will either conceal their income or protest against the tax system.

In developing the theoretical background of income taxation, the point of view of A.Wagner deserves a particular consideration. In his research he raises the question of how to choose the right source of taxation, i.e. whether tax should be levied on the income or capital of certain individuals or whether all segments of the population should be taxed (Ramazanova, 2014).

The role of the marginalism school representatives (C.Menger and others) is very significant in developing theoretical foundations of the progressive mechanism of income taxation (Akinin et al., 2008). Their views constituted the basis for the formation of the principle of vertical fairness in taxation of income.

Arthur Laffer, a follower and supporter of the views of J.Say, comes to the logical conclusion that there is a scientific justification for the quantitative relationship between income tax rates and budget revenues, and therefore it can be concluded that tax revenues can be increased not only by raising a tax rate, but also by reducing the tax burden to an acceptable level. In his opinion, the heavier the tax burden on income, the greater the likelihood that taxpayers will be more likely to avoid taxes because people do not work only for paying taxes (Chernik et al., 1996).

From the point of view of Laffer, optimal tax burden is somewhere between 20% proposed by Keynes and 40% proposed by former French President V. Giscard d'Estaing. Having considered this issue more comprehensively, it should be noted that he offers 30 percent rate as the optimal rate for the collection of an income tax (Mayburov and Ivanov, 2010).

The scientific works of S. Fischer, R. Dornbusch, and R. Schmalenzi should be noted within the framework of the problem of income taxation on an equitable basis. They considered such categories as principles of taxation, horizontal and vertical fairness of taxation, equality of taxation (Fischer, Dornbusch, Schmalenzi, 1997). Horizontal fairness requires equality and commonness in taxation. That is, a tax must be paid by all members of the society, and the same tax should be levied on the same income. Vertical fairness implies taxation at a higher rate of wealthy people with high incomes in society and, conversely, less taxation is intended for the poor people or persons with disabilities. This complies with the principle of "solvency", which should be applied in any tax system proposed by the European Commission (EC, 2004). According to this principle, a tax

burden on income should be distributed based on the solvency of taxpayers. This principle is basically applied to individuals.

### **Shadow economy and taxation**

An analysis of the scientific literary sources and a study of the experience of countries have demonstrated that the scale of the informal economy and the level of the tax burden in the legal (formal) economy are closely connected with each other. As the scope of the shadow economy expands, the number of taxpayers decreases, and the fiscal burden of the government falls on the shoulders of this narrow range of taxpayers who timely and accurately pay all taxes required. This, in turn, discourages conscientious taxpayers from operating formally and induces them to shift into the shadow economy. On the contrary, the formation of an optimal taxation rate and a fair distribution of the tax burden enable taxpayers to operate transparently without concealing their income.

Jamolov (2005), who has done a research on the issues of eliminating the shadow economy through the tax mechanism, has noted that as a result of the expansion of the shadow sector in the economy, the state budget will lose significant financial resources. This situation requires from a government further strengthening the fiscality of tax system. This, in turn, complicates the situation of those who are legally operating and imposes an additional tax burden thereto.

The researches illustrate that the following essential factors can cause the shadow economy expansion (see Table 1).

Table 1.

### **Main factors which can cause the shadow economy expansion**

	Factors	<u>Option 1</u> Results of 12 researches (%)	<u>Option 2</u> Results of 22 empiric researches (%)
1	Burden of taxes and social payments	35-38	45-52
2	Social culture	22-25	-
3	Quality of public agencies (their performance)	10-12	12-17
4	Regulation of the labour market	7-9	7-9
5	Money transfer (supervision)	5-7	7-9
6	Public sector services (their condition)	5-7	7-9

Source: Schneider F., Williams C. (2013)

The data presented in Table 1 illustrates that high tax rates constitute a potential reason for the amplification of the shadow economy in both studies. The tax burden accounts for 35-50 percent of the factors which make an impact on the growth of the shadow economy in the country.

With this aim, since 2019 Uzbekistan has sharply reduced the tax burden on the economy, especially in relation to wages, by decreasing a number of taxes and cutting tax rates down. However, the analysis of the changes have shown that the reduction of the tax burden itself is not enough to curb informal employment and the shadow economy in Uzbekistan. The scale and level of the shadow economy depends more on the mechanisms of taxation, as well as the level of professionalism of the public tax authorities. This is because the shadow economy is relatively expanded in the countries with developing and transition economies, i.e. in countries where the tax system and tax administration have not been adequately developed yet.

### **Reasons and current problems of reforming the system of income taxation in Uzbekistan**

Literature review shows that there are two axes of income taxation, namely, horizontal fairness and vertical fairness. Horizontal fairness implies that equal income should be taxed equally. According to vertical fairness, higher incomes should be taxed at higher rates. Therefore, the government should develop tax tools to ensure the principles of social justice in the formation of its tax system. Such tools are generally represented by progressive income tax rates, excise taxes and social tax benefits. The mechanisms specified are required to ensure vertical tax fairness. It should be noted, that the fact of the commonness of the tax system is sufficient for horizontal fairness. Unfortunately, we must note that in Uzbekistan, to some extent, both axes of taxation are violated. The main reason for non-compliance with the principle of horizontal fairness of income taxation is that a significant part of the country's population does not pay an income tax.

Before the tax reform conducted in 2019, the reasons why the majority of the economically active population did not pay taxes could be divided into three main groups:

- exemption of certain categories of individuals from tax obligations without social justification;

- establishment of special (preferential) tax regimes for business entities in the status of individuals, including dekhkan farms;

- informal employment (shadow economy).

Concerning exemption of certain categories of citizens from tax obligations without any social reason, until 2019, employees of state militarized authorities, the judicial system and the prosecutor's office, as well as management personnel of joint-stock companies from among foreign citizens, were exempted from paying an income tax.

However, we have justified (Niyazmetov, 2017) that such benefits are not in compliance with the principle of social justice, have a discriminatory nature and herewith undermine both horizontal and vertical fairness and in 2019-2020 the majority of them were canceled.

Moreover, there exist some preferential tax regimes for certain categories of self-employed individuals. These include people performing concert and entertainment activities, craftsmen (including their workers) and members of dekhkan farms. Individuals of these categories have no obligation to pay an income tax or a fixed tax.

The third reason why the majority of the economically active population is not taxed is informal employment. To solve this problem, a tax burden on wages in Uzbekistan was significantly reduced in 2019. In particular, an income tax rate was set at 12% instead of progressive rates from 0 to 22,5%. The rate of single social payment (since 2020 - social tax) has been reduced from 25% to 12%. Compulsory insurance contributions to the pension fund in the amount of 8% deducted from wages of employees were canceled. As a result, the total tax burden associated with wages decreased 1,4 times on average. However, these amendments have not completely eliminated the problems of taxation of income of individuals in Uzbekistan.

As the analysis shows, the ratio of the total number of persons paying an income tax (including fixed tax levied in special regimes) to the employed population in the economy over the 5 years preceding the reforms (2013-2017) amounted to 30% on average. In 2018, this indicator constituted 32,7%, and in 2019 – 37,5% (see Table 2). On average, these figures show that 2/3 of the employed population in the economy do not pay income tax for various reasons.

Table 2

**Comparative analysis of the employed population and the number of individuals paying income tax, thousand people**

Indicators	2013	2014	2015	2016	2017	2018	2019
Number of the population employed in the economy	1252 3,3	1281 8,4	1305 8,3	1329 8,4	1352 0,3	1327 3,1	1354 1,1
Number of individuals paying income tax (including fixed tax)	3486 ,1	3576 ,9	3682 ,0	4077 ,5	4211 ,4	4340 ,3	5079 ,5
Share of the employed in the economy population which is subject to taxation, %	27,8	27,9	28,2	30,7	31,1	32,7	37,5

Source: Developed by the authors on the basis of the data of the State Committee on Statistics and the State Tax Committee.

As can be seen from Table 2, the employment rate in the economy in 2013 amounted to 12,5 million people, and by 2019 it has reached 13,5 million. The number of individuals, who are paying an income tax, increased from 3,5 million in 2013 year to 5,1 million in 2019. In reliance upon this data it is obvious that currently 8,5 million people who are employed in the economy in Uzbekistan do not pay an income tax.

If a series of reforms in the tax administration system carried out in 2018 ensured an increase in the share of income tax payers this year to 32,7%, then as a result of a tax cut on labour and the abolition of income tax privileges for employees of militarized state bodies, courts and prosecutors, this indicator amounted to 37,5% in 2019. However, it is clearly seen, that the share of the economically active population that is not taxed, still exceeds 60%.

An analysis of the general level of taxation of the population's income in the republic shows that in Uzbekistan, on average, 2,8% of the total income of the population is subject to income tax (see Table 3).

Table 3

**Common level of taxation of the population's income, in percent**

<b>Indicators</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>
The ratio of income tax (including fixed tax) to the total income of the population	3,1	3,2	2,8	2,7	2,7	2,6
The ratio of income tax to total income from wage labour and property income*	6,2	7,0	5,9	5,5	6,0	5,7
The ratio of fixed tax to self-employment income**	1,4	1,3	1,1	1,2	1,3	1,0

\* Together with the income of hired workers who are fully and partially exempted from taxes

\*\* Together with the income of dekhkan farms, from concert and entertainment activities and the income of craftsmen.

Source: Developed by the authors on the basis of the data of the State Committee on Statistics and the State Tax Committee.

As it is obvious from Table 3, the ratio of income tax to the total income from wage labour and property income of the population in 2013-2018 averaged 6,1% and the ratio of fixed tax to self-employment income over the years amounted to 1,2% on average.

It should be noted two general conclusions – negative and positive – can be made from the analysis stated above.

The negative conclusion is that, the tax reforms in Uzbekistan have not improved the mechanism of income taxation. On the contrary, the abolition of the progressive mechanism has almost neglected social orientation of the country's tax system and caused the fact that Uzbek tax has become different from the international practice in many respects. In other words, the principle of vertical fairness of taxation was not fully observed in our country. Herewith, these amendments in the income tax mechanism did not facilitate achieving full horizontal fairness, as we saw that the level of informal employment in the economy did not significantly decrease, despite a sharp reduction in the tax burden on labour remuneration.

The positive conclusion is that Uzbekistan has a great opportunity to enhance a fiscal significance of income taxes. Since 2/3 of the population employed in the economy do not still pay income tax, it is possible to enhance tax revenues and, thus, reduce a tax burden improving the mechanism of this tax.

Researches and observations illustrate that income from certain types of activities in Uzbekistan is not regulated by law or taken under tax control. If we pay attention to various types of activities on the country, we will witness that the majority of them are carried out informally. For example, the most construction and repair works (especially for individuals), home appliances repair, intermediary services in the sale of housing, tutoring, sewing, renting, servicing in private houses and the like, remain outside the tax control territory and thus are not taxed. The reason for this is either the complexity of the official (legal) procedure for the implementation of the above and other small types of activities, as well as the payment of taxes therethrough or the seasonal nature of certain types of activities.

These unregulated activities constitute the part of an economy that is not prohibited by law and is considered to be even a non-shadow part of the economy, which can easily be transferred to the formal economy. To achieve this aim, it's enough to launch a flexible income taxation mechanism. This is an income taxation mechanism based on universal declaration. This mechanism plays an essential role in taxing informal economy in Uzbekistan and, therefore, in reducing a tax burden, in particular, consumption taxes. Although this mechanism is widely applied in many countries throughout the world, its introduction into practice in Uzbekistan has been delayed for unknown reasons. This mechanism has not been reflected even in the Tax Code (2019) in new wording.

Representatives of scientific and practice communities have an opinion that the population is not yet ready for this system as there are no guarantees that this mechanism will work efficiently, which, consequently, may cause the population being in a difficult situation.

The “non-taxable minimum” category has to be developed to ensure comprehensive and smooth operation of the income taxation mechanism, based on universal declaration. This category is based on the “subsistence level (living wage)” category, which expresses the value of the “consumer basket”.

Currently, in all developed countries and in most developing countries, the above categories are considered to be significant elements of the socio-economic policy of these countries.



The subsistence level, or the minimum amount of income required for living, essentially represents a poverty threshold. That is, if a person or a family has an income below the minimum income level for survival, such a person (family) is considered poor.

A non-taxable minimum equal to the subsistence level should be considered as a standard social deduction and a special element of the mechanism of taxation of personal income on the basis of declaration. That is, this deduction should be provided to any citizen (family), regardless of what he does or what income he earns. In other words, the standard social deduction should be considered as a tax-free income, represented by so-called poverty threshold.

When a person's income is in this framework, he or she is automatically exempted from an income tax. This mechanism provides an opportunity to restore justice in taxation by abolishing all socially unjustified privileges. Nevertheless, social benefits must be applied in addition to the standard social deduction for persons with disabilities, single mothers with many children and other citizens in need of such social protection. In our opinion, social incentives for individuals awarded various orders and medals should be implemented through the budget mechanism, and not through the provision of tax benefits.

### **Conclusion**

1. In reliance upon theoretical background considered above, it can be concluded that income taxation should be based on two principles: horizontal and vertical fairness. According to horizontal fairness, taxpayers must pay the same amount of tax under the same economic conditions (opportunities). The principle of vertical fairness stipulates of income taxation based on a progressive mechanism.

2. Recent tax reforms carried out in Uzbekistan have not resulted in the improvement in the income tax mechanism. On the contrary, the abolition of the progressive mechanism almost neglected social orientation of the country's tax system and caused the fact that Uzbek tax has become different from the international practice in many respects. Thus, the country abandoned the principle of vertical fairness of the income taxation.

3. The analysis has shown that a total burden of the income tax in Uzbekistan falls onto 37,5% of the population employed in the economy (in 2019). This indicator averaged 30% over the last 5-6 years preceding the tax reform. In other words, 2/3 of the population employed in the country's economy are not subject to the income tax for various reasons. The major reason is informal employment. Obviously, the principle of horizontal fairness in taxation is not observed in Uzbekistan.

4. Meanwhile it should be noted that Uzbekistan has a great opportunity to enhance a fiscal significance of the income tax. Since 2/3 of the population employed in the economy do not pay an income tax, it seems possible to enhance tax revenues and, thus, reduce a tax burden by improving this tax mechanism. Herewith, the most efficient tool is a taxation mechanism based on the universal declaration of income.

5. A progressive mechanism is an essential element of the income taxation system based on universal declaration. Therefore, for comprehensive and smooth operation of this mechanism and ensuring the principle of vertical fairness, it is required to determine the amount of the minimum income that is not taxable on the basis of the category of “subsistence level”, which represents the “consumer basket” value.

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