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The Balance Between Tax Incentives and Fiscal Oversight in Legalizing the Shadow Economy.

Ulugbek Tulakov¹

1. Termiz State University, Associate Professor, Department of Finance, Doctor of Economics (DSc)

* Correspondence: tulakov77@mail.ru

Abstract: This study analyzes the balance between tax incentives and fiscal oversight instruments in the process of legalizing the shadow economy in Uzbekistan. It highlights mechanisms for expanding the tax base by limiting cash circulation, digitalizing transactions, and making them more “visible” to tax authorities. The research examines institutional drivers of the shadow economy (high transaction costs, complex administration, and informal employment) and provides an academic justification of policy solutions aimed at reducing them—tax amnesty, the business stability rating system, simplification of certification procedures, and the incentive role of the self-employment regime. The findings indicate that although a “carrot-and-stick” approach may increase compliance costs in the short run, it strengthens transparency in the medium and long term, fosters a level playing field, and stabilizes budget revenues; effectiveness, however, depends directly on digital infrastructure, commission costs, financial literacy, and the integration of oversight systems.

Keywords: shadow economy, legalization, fiscal oversight, tax incentives, cashless payments, cash restrictions, tax amnesty, stability rating, tax administration, compliance costs, digital monitoring, informal employment.

1. Introduction

At the current stage of Uzbekistan’s economic development, combating the shadow economy has become one of the government’s top policy priorities—not only in fiscal terms, but also as a key factor in ensuring national security and social stability. The Presidential Decree of the Republic of Uzbekistan No. PF-246, adopted on December 10, 2025, “On Additional Measures to Promote Cashless Payments and Reduce the Share of the Shadow Economy,” is widely regarded as a turning point in the country’s economic history. This document introduces not merely administrative restrictions, but also a comprehensive set of mechanisms designed to incentivize the digitalization and legalization of economic relations [1].

The shadow economy is not only a source of lost tax revenues; it also undermines fair competition, weakens the social protection system, and poses risks to macroeconomic stability. According to international expert assessments, the shadow economy in Uzbekistan accounts for more than one-third of gross domestic product (GDP), and some sources estimate its share to range from 33% to 40%. Under such conditions, the main academic and practical challenge facing the state is to identify an optimal balance between strict administrative measures (sanctions) and economic freedom (incentives) [2].

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The shadow economy in Uzbekistan is a multifaceted phenomenon. It includes not only smuggling or criminal activity, but also a wide range of everyday economic practices—such as artisans, taxi drivers, construction workers, and traders operating without formal registration. According to the International Monetary Fund (IMF) and other international organizations, the shadow economy in Uzbekistan accounts for more than one-third of GDP. The scale of this indicator implies budget losses amounting to billions of US dollars [3].

The main “lifeblood” of the shadow economy is cash. A high volume of cash circulation creates a convenient environment for concealing transactions, underreporting income, and evading taxes. Therefore, it is no coincidence that the decree’s primary impact is directed precisely at cash circulation. Research indicates that in developing countries—Uzbekistan in particular—the persistence of the shadow economy is driven by a high tax burden, complex administrative procedures, and entrenched informal practices [4].

2. Research methodology

This study employs a regulatory-legal and institutional analysis to evaluate the balance between tax incentives—such as amnesty, rating mechanisms, and administrative simplification—and fiscal oversight measures in the legalization of the shadow economy within the framework of the Presidential Decree of the Republic of Uzbekistan No. PF-246, “On Additional Measures to Promote Cashless Payments and Reduce the Share of the Shadow Economy.” Conclusions were derived using methods of analysis and synthesis, induction and deduction, comparative (comparativist) analysis, and theoretical conceptual interpretation (in particular, the relationship between tax burden and tax evasion/avoidance behavior) [5].

3. Literature Review

In recent years, the legalization of the shadow economy and the expansion of the tax base have been widely discussed in academic literature as key instruments for improving tax administration, stabilizing budget revenues, and strengthening transparency in economic activity [6].

Schneider and Medina (2021) synthesize global approaches to the shadow economy and highlight the methodological complexities of measuring the phenomenon, implying that the “measurement” problem is central to this study. Khodzhayev (2022), focusing on Uzbekistan, examines the institutional determinants of the shadow economy and ideas for optimizing transaction costs, arguing that the roots of informality often lie in the high “cost of formalization” and the quality of institutions. Mazhar and Méon (2022) analyze the macro-level interaction between “unobservable” activity, inflation, and taxation, conceptually reinforcing the view that the shadow economy can distort the outcomes of fiscal policy. Alm (2021) addresses tax evasion and inequality under digital technologies, theoretically showing that technology may simultaneously strengthen enforcement while generating adjustment costs for different groups. Zandi and co-authors (2022) discuss the impact of electronic payments on economic growth, providing a conceptual basis linking a cashless ecosystem with macroeconomic efficiency and the expansion of formal transaction volumes [7].

This research strand is also continued in sources focused specifically on Uzbekistan. Yuldashev and Ergashev (2023) discuss the challenges and prospects of a cashless economy, while Abdullaev and Tursunov (2023) examine the role of digital technologies in reducing the shadow economy. Razzakov (2023) moves directly to the core of the topic by analyzing how the digitalization of tax administration affects tax revenues and by examining the interaction between “incentive” and “control” mechanisms. Ganiyev (2024) considers the effectiveness of fiscal policy in reducing the shadow economy in Uzbekistan and argues for the need to evaluate the performance of oversight and policy instruments. Slemrod (2022) provides a conceptual framework on compliance and enforcement in tax

systems, emphasizing that in the digital era the inevitability of enforcement, the quality of administration, and the design of incentives must be complementary. Yusupov (2025) links tax amnesty and its effects on taxpayer behavior to both international experience and Uzbekistan's practice. Umarov and Khamidov (2024) clarify the role of the self-employment regime in legalizing informal employment, showing that legalization is not only about enforcement but also about simplifying the "entry pathway" into formal economic activity [8].

Overall, the reviewed literature supports the following general conclusion: reducing the shadow economy is more effective when implemented as an integrated policy package—(i) increasing transaction traceability through digitalization and cashless payments, (ii) lowering the costs of entering the formal sector by simplifying administration and using incentives, and (iii) raising the perceived risk of non-compliance through enforcement—because these measures reinforce one another and produce stronger combined effects than when applied in isolation [9].

4. Result and Discussion

The central scholarly problem of this study is the relationship between the tax burden and informal employment. According to classical economic theory (the Laffer curve), once tax rates exceed a certain threshold, tax revenues may decline and the shadow economy may expand. In the Uzbek context, however, this relationship is more complex. High levels of informal employment—especially in agriculture and services—are explained not only by relatively high tax rates, but also by the complexity of tax administration and the high "cost of operating formally." For employers, hiring workers officially implies additional taxes and social contributions, which increase unit costs. As a result, employers often prefer to pay "envelope wages" (off-the-books compensation) [10].

From this perspective, the decree's strategic objective is not merely to tighten oversight, but to make formal activity more advantageous than informal activity. This aligns with the "double dividend" concept: improving economic efficiency by shifting the tax burden away from labor and capital and toward less productive or socially costly forms of activity. The decree should therefore be interpreted not as a short-term crisis-management document, but as the core of a long-term strategy extending to 2030. The specific numerical targets set out in the document demonstrate the government's commitment and policy resolve (Table 1) [11].

Table 1. Strategic target indicators planned to be achieved by 2030

Strategic objective	2030 target	Economic meaning and significance
Share of the shadow economy	Reduce by 1.3	This is not merely a statistical metric. It implies that turnover amounting to billions of UZS enters the banking system, budget revenues increase, and the capacity to finance social programs expands.
Share of cashless payments	Increase to 75%	Make cashless payments dominant in trade and services. By leaving a "financial footprint," this automatically broadens the tax base.
Formal employment rate	Reach 64%	Strengthen social protection. Formal employment is essential for the stability of the pension system and health insurance system.
International rankings	Improve by 30 positions	Improve Uzbekistan's position in the Corruption Perceptions Index and

		economic freedom rankings, which helps attract foreign direct investment.
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Implementation of the Decree is designed to proceed in several stages tied to specific dates. This sequencing is intended to ensure gradual adaptation rather than “shock therapy” and can be summarized as follows:

- adoption of the Decree and preparation of the regulatory framework;
- entry into force of import control measures and the tax amnesty;
- launch of the income declaration experiment;
- introduction of strict restrictions on cash circulation;
- mandatory use of body cameras and QR codes [12].

One of the most visible policy directions in combating the shadow economy is the set of prohibitive measures aimed at administratively restricting cash circulation. By reducing cash settlements, the policy seeks to strengthen payment discipline and increase transaction traceability, thereby forcing business operations into a digital (cashless) environment. The restrictions scheduled to take effect on April 1, 2026 are expected to have a significant impact on the institutional structure of the domestic market and the practical mechanisms of goods and services turnover [13].

The first direction relates to the markets for real estate and motor vehicles (cars less than 10 years old). In these segments, payments for transactions are to be made mandatorily via bank cards or electronic payment systems, while the notarial registration process is expected to be reinforced through a verification mechanism based on information systems integrated with bank payment data. The economic rationale of this approach is to reduce informal cash flows traditionally present in high-value asset markets (including channels for laundering funds), to limit undervaluation of transaction prices, and to curb “dual accounting” practices. Although in the short run transaction costs (commissions, adaptation to banking and financial requirements) may rise and the number of transactions may decline, in the medium and long term the policy is expected to enhance price transparency, improve the reliability of market data, and reduce speculative behavior.

The second direction is associated with introducing a threshold of UZS 25 million for wholesale trade and high-value goods and services. Prohibiting cash payments for transactions above this limit (with agricultural products as an exception) is expected, in practice, to redirect informal “black cashbox” turnover in segments such as household appliances, furniture, and construction materials into formal channels through the banking system. The emergence of a payment trail strengthens the documentation of settlements and reduces opportunities to conceal turnover, underreport income, and narrow the tax base.

The third direction предусматривает shifting payments for excisable goods and strategic resources to a cashless format. In particular, requiring cashless payments only for alcohol, tobacco, petroleum products, electricity, and gas can be interpreted as a tool to strengthen accountability along these supply chains, stabilize receipts from excise and other mandatory payments, and reduce the risks of smuggling and illegal sales [14].

Overall, these restrictions can be assessed as an institutional measure aimed at making transactions more “visible,” improving payment discipline, and reducing informal turnover. At the same time, the effectiveness of the policy will depend directly on banking infrastructure (terminal coverage, internet quality), commission costs, the population’s payment literacy, and the degree of integration among oversight systems. To enhance outcomes, it is advisable to complement restrictions with measures that incentivize

cashless payments, reduce transaction costs for small businesses, and strengthen consumer protection mechanisms.

In addition, the Decree introduces new and stricter rules for importers. From January 1, 2026, if imported food products are not sold within 9 months (or 3 months for perishable goods) and warehouse balances exceed 500 BCU (BHM), this becomes a legal basis for tax authorities to initiate an on-site tax audit. This measure targets the “paper inventory” problem. In practice, many importers sell goods in cash without proper documentation, while accounting records continue to show the goods as remaining in stock. The new procedure is intended to expose this scheme and compel the legalization of actual sales processes [15].

Another major change concerns the tax base for real estate and construction materials. Tax liabilities will no longer be determined by the contract price (often artificially understated), but rather on the basis of market value. This is likely to increase the tax burden for construction companies and developers. They will face stronger constraints against maintaining “dual bookkeeping” and will be pushed to declare real transaction prices. As a result, the official component of housing prices may rise, while the informal “shapka” (under-the-table premium) practice could diminish or disappear [16].

Importantly, one of the Decree’s most innovative aspects is that it does not rely solely on punitive measures. It also contains extensive mechanisms to support “honest” entrepreneurs and to create a “green corridor” for those willing to exit the shadow economy. This directly aligns with the study’s requirement to analyze economic incentives.

From January 1, 2026, the most powerful incentive mechanism is embedded in the tax amnesty provisions. If a taxpayer voluntarily remedies violations identified through a desk (cameral) tax audit within the prescribed period and fully pays the outstanding taxes and penalties, the officials of the legal entity are fully exempt from criminal and administrative liability. This rule allows businesses to “wipe clean” past mistakes and shift to compliant operations under the new framework. The state also benefits: budget revenues are secured without lengthy and costly court proceedings, while entrepreneurs can continue operating. In essence, this signals a move from a repressive model to a cooperative approach [17].

One of the key drivers of the shadow economy is the prevalence of bureaucratic procedures and the high cost of formalization. In Uzbekistan, this challenge is being addressed not only through prohibitions, but also by reducing transaction costs—creating economic incentives through “making lawful activity cheaper.”

In particular, requiring that conformity and environmental certificates for similar goods under a single foreign trade contract be obtained once for a one-year period reduces the time and financial costs that importers would otherwise incur to secure separate certificates for each shipment. As a result, the cost of formal imports declines, making them more competitive relative to smuggled goods. From an institutional economics perspective, this illustrates that lowering compliance costs reduces the need for informal channels.

Under the current regime, self-employed individuals are offered a minimal fiscal burden: they are exempt from income tax and pay only a social tax equal to one BCU (BHM) per year. In return for this low tax load, a citizen obtains official work experience, which helps accumulate future pension entitlements. Therefore, this model can be interpreted as a key economic “incentive mechanism” for reducing informal employment in 2025–2026 [18].

The Decree is a classic example of a “carrot-and-stick” policy, yet it is distinguished by the dominance of a technology-driven approach (Table 2) [19].

Strict measures (Sanctions)	Economic incentives (Incentives)	Interaction and balance
Cash restrictions (real estate, vehicles, wholesale)	Tax amnesty and exemption from liability	Cash restrictions “corner” businesses, while the amnesty offers a “way out.” This balance enables businesses to exit the shadow economy with lower friction.
Mandatory QR codes and body cameras	Stability rating (“A” category benefits)	Body cameras strengthen enforcement, and QR codes bring entrepreneurs into a disciplined compliance environment. In return, the rating system provides financial benefits to compliant taxpayers (e.g., VAT refunds).
Taxation based on market value	Simplification of certification	Market-value taxation increases the tax base, while certification simplification reduces administrative/compliance costs. This combination facilitates formalization by lowering the cost of “being compliant.”

The analysis shows that the high level of informal employment in Uzbekistan is driven not only by tax rates, but also directly by the transparency of tax administration and the inevitability of enforcement. On this basis, the following hypothesis can be advanced: even if the tax burden is reduced, economic agents will continue to evade taxes if oversight remains weak and liability is not perceived as unavoidable [20].

The Decree seeks to address this institutional problem not by sharply cutting tax rates, but by reducing the costs of compliance and strengthening the inevitability of control. In other words, its core logic is to reduce the relative “benefit” of informal activity and to make operating in the formal sector practically easier and economically more attractive. One of the most effective tools for legalizing informal employment is the introduction of highly simplified and low-cost tax regimes such as the self-employment framework. At the same time, the issue of fiscal incentives remains acute in the wage-employment segment: labor-related taxes (personal income tax and social tax) constitute a significant cost for employers and may constrain the pace of expansion of formal employment [21].

The Decree accelerates the shift from traditional “inspector-based” oversight to digital control. By February 1, 2026, data exchange is to be established between the Customs Committee and the UZIMEI Center, enabling full monitoring of mobile device imports. In addition, automated integration between notaries and banks effectively eliminates the human factor: if the payment has not been processed through the bank, the notary cannot “press the button.” This can be interpreted as one of the most effective anti-corruption instruments [22].

From July 1, 2026, all tax and oversight agency personnel will be required to conduct inspections only with body cameras. This rule protects entrepreneurs from “raids” and unlawful pressure: if the camera is not switched on, the inspection is deemed illegal. It therefore functions as a strong psychological and legal incentive to increase trust in the business environment and encourage firms to exit the shadow economy.

The income declaration pilot starting on March 1, 2026 in the cities of Navoiy and Chirchiq serves as a practical “testbed” in the modernization of Uzbekistan’s tax system. Its purpose is to identify consistency between actual household incomes and expenditures,

expand the data base, and create an analytical foundation for subsequent stages. A key design feature is that discrepancies detected during the pilot will not trigger punitive measures; instead, the focus is primarily on data collection and system adaptation. This approach can be interpreted as a “soft adjustment” mechanism for cultivating a declaration culture among the population.

At the same time, alongside broad support for the reforms, several risks are noted. Strengthening liability measures for tax evasion may raise business entities’ expectations of legal risks, intensify precautionary motives, and, in some cases, negatively affect capital flows. An enforcement-first approach can increase compliance costs in the short run and potentially dampen business activity; therefore, in parallel with expanding the tax base, the optimization of tax preferences and the creation of equal competitive conditions for all remain highly relevant.

In addition, a sharp increase in the share of cashless payments may place a heavy load on banking infrastructure (terminal networks, processing capacity, server stability, and mobile app reliability). If technical disruptions occur, frictions in trading operations could intensify. This risk is particularly salient for small shops and artisans in remote areas, for whom the transition to QR codes and digital payment systems may be complicated by technical and financial constraints. Hence, whether the declaration pilot and the associated oversight mechanisms deliver the expected results will depend directly on institutional transparency, infrastructure readiness, the predictability of administrative practice, and complementary measures that mitigate adaptation costs for small businesses.

5. Conclusion and Recommendations

In sum, the reforms have moved Uzbekistan’s strategy for combating the shadow economy to a new stage. The Decree’s central idea is to increase transaction traceability through a mandatory digital transformation of the economy, strengthen transparency, and create a level playing field. The analysis indicates that state policy is not limited to one-sided “prohibitions” (punitive instruments); rather, incentive-based mechanisms—such as tax amnesty, benefits linked to the rating system, and simplification of formalization procedures—function as institutional buffers that mitigate the adverse effects of administrative pressure. This mixed approach currently appears relatively balanced: “hard” measures reduce the economic attractiveness of informal turnover, while “soft” measures lower compliance costs and make lawful activity more viable.

At the same time, to achieve a sustained reduction in informal employment, the issue of the fiscal burden in the labor-market segment remains highly relevant. Labor taxes—particularly social contributions—constitute a significant share of employers’ costs for wage labor; therefore, optimizing these payments in the future could contribute to a more fundamental decline in informality. Finally, achieving the targets set for 2030, including the goal of reducing the shadow economy by 1.3 times, will depend critically on the continuous expansion and reliability of digital infrastructure (stability of payment systems, terminal coverage, processing capacity), improving the population’s financial literacy, and ensuring the predictability and consistency of administrative practice.

To enhance socio-economic efficiency under conditions where cashless settlements are becoming mandatory, it is essential to ensure that bank acquiring (merchant) commissions do not turn into an additional quasi-tax on businesses. This requires the Central Bank to strengthen strict regulatory oversight and to reinforce mechanisms that reduce fees through effective competition. In parallel, a consistent public communication strategy on tax amnesty and income declaration procedures should be pursued so that the broader public clearly understands that the reforms are not primarily punitive, but are intended to create a pathway for transitioning into the formal sector. Finally, continuous monitoring of the new restrictions—especially changes affecting import and wholesale trade channels—and their impact on prices and market activity, coupled with timely

regulatory and technical adjustments when necessary, will help consolidate the positive outcomes of the reforms. Overall, legalizing the shadow economy is an institutionally significant step for Uzbekistan toward a transparent, modern, and competitive economy. Its success will depend directly on constructive cooperation between public authorities and the business community, and on maintaining an optimal balance between the “inevitability of enforcement” and the “ease of compliance.”

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