

Popii Maksym,
Master of International Business, Hult International Business School
Primierova Olena
Associate Professor, NaUKMA

THE CONSEQUENCES OF THE SHADOW ECONOMY

The shadow economy, also called the underground or informal economy, is a wide and complex phenomenon that includes very different types of activities — from underreporting legal income to illegal trade and unregistered employment. International organizations such as the OECD, IMF and ILO usually define it in the broad sense of the “non-observed economy,” which combines hidden but legal work, illegal production, informal sector employment, and household production for own use. Such a framework allows cross-country comparisons and makes it easier to understand how shadow activities influence economic performance and public policy [6, 7].

Most studies show that the shadow economy is persistent and quite large. Medina and Schneider, for instance, estimated that across 158 countries during 1991–2015 the average size was around 31.9% of GDP [5]. Of course, the scale differs a lot depending on institutions, income levels and regional specifics. While in some cases informal activities help people survive or provide short-term jobs, in the long run the negative consequences dominate. They undermine fiscal revenues, distort fair competition, and reduce incentives for firms to modernize or invest in productivity. Moreover, a big shadow sector usually means weaker public goods provision and lower trust in the state.

The fiscal effects are maybe the most obvious. Shadow wages, undeclared trade and contraband reduce tax revenues and social contributions. In Ukraine, according to estimates by CASE Ukraine, the consolidated budget in 2021 lost between UAH 291 and 465 billion [1]. The largest component was hidden wage payments, followed by customs violations. This is a huge amount compared to national expenditure needs and it shows why the issue is

not only technical but strategic. Without proper revenues it is impossible to maintain defense, infrastructure or health care in a sustainable way.

Beyond revenues, there are broader macroeconomic consequences. Many empirical papers demonstrate a negative correlation between the size of the shadow economy and long-term growth. The logic is clear: informality lowers productivity, discourages innovation, and prevents firms from gaining access to formal finance. In the short run, informal jobs or businesses can be seen as a buffer, but when informality becomes systemic, it suppresses modernization. On product markets, firms that do not pay taxes or contributions can offer lower prices, which undermines those who operate legally. Over time this weakens competitiveness and discourages investment in quality and human capital.

The impact on the labor market is also significant. Informal jobs often lack contracts, social security, or opportunities for professional growth. Workers in such jobs face higher risks of accidents or income loss and usually earn less. As the ILO reports, informality is strongly linked to vulnerability of households, especially in developing and transition economies [3]. In this sense, the shadow economy contributes to income inequality and makes social protection systems fragile.

Institutional aspects should not be underestimated either. When many people and businesses avoid paying taxes, the overall tax morale declines. Citizens lose trust in institutions, thinking that compliance is unfair if “everyone else” evades. This creates a vicious circle: low trust leads to more shadow activity, which then reduces the quality of public services and feeds back into mistrust. The reliability of official statistics also suffers, since national accounts cannot fully capture unobserved activities. Moreover, informal channels are often used for money laundering and other financial crimes, which raises risks for the AML/CFT system and demands stronger interagency and international cooperation [2].

Ukraine provides a good example of how diverse shadow activities can be. Large-scale tax evasion schemes and small-scale informal employment are only weakly related to

each other and therefore require different policy approaches. Combating customs fraud and major evasion needs strong risk-based enforcement and data analytics, while reducing informal jobs requires lowering entry barriers to formality and creating real incentives for small businesses. International experience suggests that combining enforcement with simplification works best: when paying taxes is easier and more beneficial, and enforcement is credible, the size of the shadow economy gradually declines.

To conclude, the systemic consequences of the shadow economy are clearly harmful. It undermines fiscal sustainability, slows growth, increases inequality and erodes institutions. For Ukraine, as for many other countries, tackling the shadow economy is not just a fiscal matter but also a key condition for reconstruction and integration into European frameworks. The strategy should be multidimensional: better enforcement, smarter use of data, incentives for formalization, and above all improvement in the quality of public services so that taxpayers can see a clear return on their contributions.

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