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UKRAINE

SELECTED ISSUES

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Approved By

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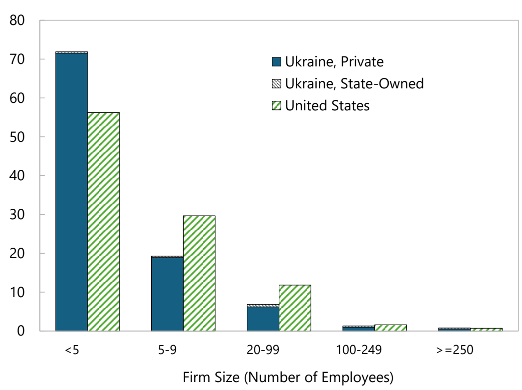
CONTENTS

THE CASE FOR GROWTH-FRIENDLY TAX REFORMS

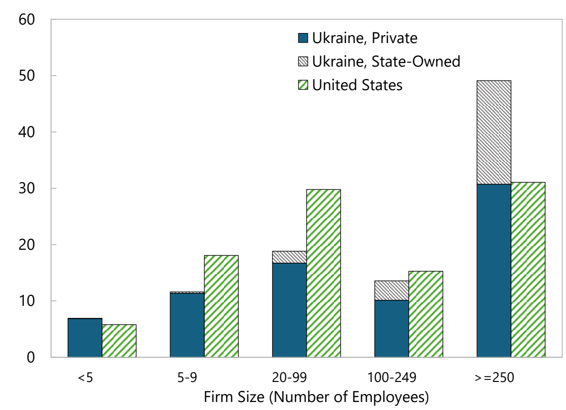
1. Firm-level data suggest a lack of business dynamism in Ukraine. In countries with a dynamic business environment, small productive firms have incentives to grow, small unproductive firms are forced to exit, and large but less productive firms are forced to shrink, resulting in a firm size distribution where medium-sized firms account for a large share of employment. In contrast, Ukraine like many emerging markets has a firm size distribution that is characterized by a "missing middle": there is a large mass of small businesses (Figure 1a) and a relatively high concentration of employment in large companies (Figure 1b). This size distribution is the result of small productive firms having few incentives to grow and large unproductive firms facing little competition for resources. Relatedly, Akcigit et al. (2025) find that young firms account for a relatively small share of employment in Ukraine.

Figure 1a. Ukraine: Percentage of Firms by Firm Size



Sources: State Statistics Service of Ukraine; U.S. Census Bureau; and IMF staff estimates.
Note: Dataset excludes individual entrepreneurs. Data for Ukraine is for 2024; Data for the U.S. is for 2023.

Figure 1b. Ukraine: Percentage of Employees by Firm Size

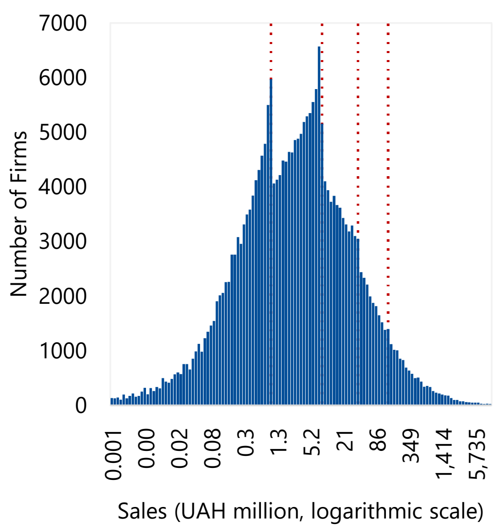


Sources: State Statistics Service of Ukraine; U.S. Census Bureau; and IMF staff estimates.
Note: Dataset excludes individual entrepreneurs. Data for Ukraine is for 2024; Data for the U.S. is for 2023.

2. Removing distortions, including through tax reforms, would foster growth by improving productivity. Business dynamism raises aggregate productivity by reallocating resources from less productive to more productive firms (see, e.g., Hsieh and Klenow, 2009). Various policy levers can shape a country's productivity distribution, including competition policy, access to finance, labor market flexibility, strength of the bankruptcy regime, or the size of the public sector. This paper focuses on the role of the tax system.

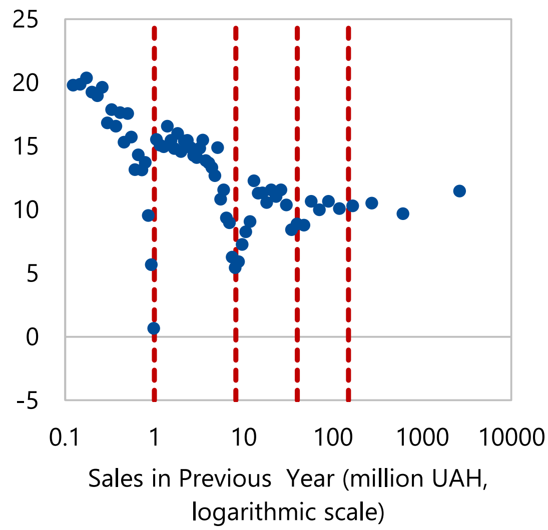
3. Ukraine's size-based business tax regimes incentivize firms to stay small. The Simplified Tax regime, with two groups for private entrepreneurs and a third group for legal entities, replaces the income tax and VAT with a single turnover tax.[1] In addition, there is a turnover threshold (UAH1 million) for mandatory VAT registration (for firms in the general tax system), a threshold for simplified profit tax accounting (UAH40 million), and a threshold (UAH150 million) below which businesses are exempt from complying with transfer pricing rules. At each threshold, the change in tax regime implies very high effective marginal tax rates. Figure 2a documents how the firm size distribution in Ukraine exhibits clusters around the turnover thresholds, especially for VAT registration and the Simplified Tax. Figure 2b shows that firms in the neighborhood of these thresholds have fewer incentives to grow, as crossing the threshold has large tax implications.

Figure 2a. Ukraine: Firm Size Distribution in 2024



Sources: State Statistics Service of Ukraine; and IMF staff estimates.
Note: dashed vertical lines represent turnover thresholds for (from left to right): VAT registration, Simplified Tax group 3, simplified CIT accounting, and transfer pricing rules. Dataset excludes individual entrepreneurs. In Figure 2b, each point represents a group of 3000 firms of similar size. Median sales and growth rates are shown.

Figure 2b. Ukraine: Sales Growth in 2024 by Size Group (in percent)



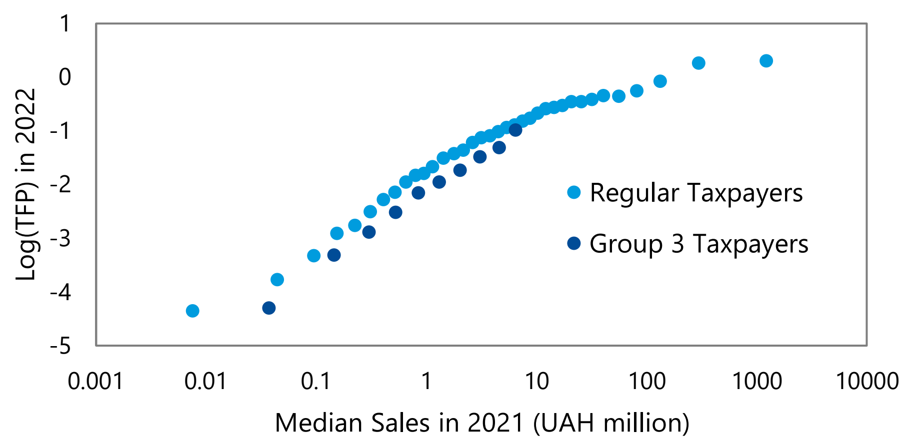
Sources: State Statistics Service of Ukraine; and IMF staff estimates.
Note: dashed vertical lines represent turnover thresholds for (from left to right): VAT registration, Simplified Tax group 3, simplified CIT accounting, and transfer pricing rules. Dataset excludes individual entrepreneurs. In Figure 2b, each point represents a group of 3000 firms of similar size. Median sales and growth rates are shown.

4. **The Simplified Tax creates an uneven playing field, shielding less productive firms from competition and distorting supply chains.** While the turnover tax for simplified taxpayers does not systematically reduce the tax burden relative to the profit-based CIT, the VAT exemption allows firms under the Simplified Tax to charge lower prices. As a result, Simplified Taxpayers are able to compete despite lower productivity. Figure 3 illustrates that they are systematically less productive than regular taxpayers. Even after controlling for size and industry, the productivity differential is around 33 percent. Removing the VAT exemption could increase competition by

[1] A fourth group provides generous tax preferences for the agriculture sector.

forcing some less productive smaller firms out of the market, allowing their resources to be reallocated to more productive larger firms. Moreover, downstream firms that are non-VAT-payers benefit if their suppliers are also VAT exempt. Hence, the Simplified Tax system likely distorts production decisions implying that supply chains may be less efficient. Research on other emerging markets has provided evidence of supply chain distortions created by VAT exemptions.[2]

Figure 3. Ukraine: Productivity by Firm Size and Tax Status



Sources: State Statistics Service of Ukraine; and IMF staff estimates.
Note: Dataset excludes individual entrepreneurs. Each point represents a group of firms of similar size. Group 3 refers to the third group of the Simplified Tax. Group median sales and productivity are shown. Log(TFP) is measured as deviation from industry average.

5. The Simplified Tax encourages informal activity and tax evasion. In the 2024 Ukraine Tax Compliance Cost Survey, respondents estimated that businesses similar to their own declared only 61.1 percent of actual annual revenue and 52.2 percent of wages for tax purposes. Size-based criteria for preferential tax regimes create strong incentives for such underreporting of turnover in order to avoid losing eligibility. Moreover, regular taxpayers, to reduce their competitive disadvantage against simplified taxpayers, may resort to tax evasion schemes to reduce their costs.

6. The Simplified Tax facilitates tax evasion. The Simplified Tax can be abused to underreport wages to avoid PIT and social security contributions. For example, due to loopholes in the Labor Code, regular employees are often hired as independent contractors registered in group 3 of the Simplified Tax. Moreover, individuals or entities registered under the Simplified Tax can be used by regular businesses to shift funds – through the purchase of fake invoices, thereby facilitating the payment of undeclared wages in cash (see Betliy, 2010). In addition, the Simplified Tax facilitates VAT fraud through several schemes. First, the existence of VAT exempt retailers creates a market for smuggled (and hence VAT free) consumption goods, especially electronics. Second, there exists a black market in which VAT exempt Simplified Taxpayers illegally sell their VAT invoices to regular VAT paying businesses.

[2] See De Paula and Scheinkman (2010) for Brazil and Gadenne, Nandi, and Rathelot (2020) for India.

7. **Distorted accounting to game the tax system is limiting the number of bankable firms.** In addition to financial misreporting, the size thresholds have also led to the artificial splitting of companies. Rather than forming a single large company, a business may organize itself as a collection of smaller companies or individual entrepreneurs, each below the relevant turnover threshold and hence eligible for beneficial tax treatment. One adverse consequence of such distorted accounting and financial misreporting is that such firms' financial statements do not document their true size and financial performance, making it difficult for them to obtain bank loans, which could hurt their capacity to invest. The Simplified Tax system therefore creates economic inefficiencies due to firms forgoing investment opportunities in order to remain under the Simplified Tax. This issue is not just limited to simplified taxpayers. Regular taxpayers who use tax evasion schemes to reduce their costs in order to compete with simplified taxpayers also cannot obtain bank financing due to the absence of clean accounts. In 2025, the share of business investment financed through bank loans was only 5 percent, with 72.2 percent financed internally through retained earnings.

8. **Reform considerations.** Simplified corporate income tax regimes to support small businesses are common around the world. What sets Ukraine's Simplified Tax system apart is the size of the scheme and the generous VAT exemption threshold, together with the many opportunities for abuse. While the National Revenue Strategy provides a medium-term road map to phase out the Simplified Tax, the timeline is uncertain. In the meantime, reforms in several areas could address the main challenges created by the Simplified Tax and size-based policies more generally:

- To reduce businesses' reluctance to switch from the Simplified Tax into the general tax system, the State Tax Service (STS) needs to transform itself into a service-oriented institution that facilitates compliance (including through pre-populated tax returns) and applies a truly risk-based approach to compliance management and audit. The Simplified Tax was introduced in 1998 in response to the prohibitively high costs of complying with the regular tax system, with numerous state and local taxes, often with differentiated rate schedules. At that time, there was also no tax code, and tax administration was decentralized. Since then, the tax system has been considerably streamlined, leading to an improvement in Ukraine's position in international rankings (see, e.g., Betliy et al., 2010). Even so, tax compliance and interacting with the STS remain burdensome. In the 2024 Ukraine Tax Compliance Cost Survey, respondents expect to be less exposed to the tax authorities if they register under the Simplified Tax and thus do not register for VAT.
- Anti-avoidance rules against splitting of businesses to remain below the VAT threshold should be introduced.
- The VAT exemption for Simplified Taxpayers with turnover above the VAT registration threshold should be abolished.
- For businesses below the mandatory VAT registration threshold, additional incentives could be provided to encourage VAT registration. For example, making VAT registration a prerequisite to participate in public procurement would be a powerful incentive for VAT registration.

Alternatively, a level playing field between VAT payers and non-VAT payers in public procurement, e.g., by conducting public procurement tenders based on prices excluding VAT, would reduce the current competitive disadvantage of VAT payers. Moreover, existing subsidy programs could be targeted towards registered VAT payers.

- Risk-based tax administration should put more scrutiny on taxpayers near the relevant turnover thresholds, i.e., those with greater incentives to cheat. Moreover, better risk analysis and enforcement measures are needed to tackle the issue of business splitting.
- Changes to the Labor Code and the Tax Code are needed to reduce the practice of fake self-employment, while changes to transfer pricing rules would address the practice of shifting taxable income into businesses registered as Simplified Taxpayers.

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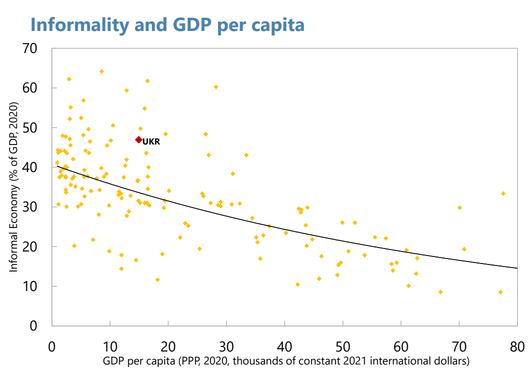
INFORMALITY IN UKRAINE: DIMENSIONS, ENABLING FACTORS, AND POLICY LEVERS

A. Dimensions of Informality in Ukraine

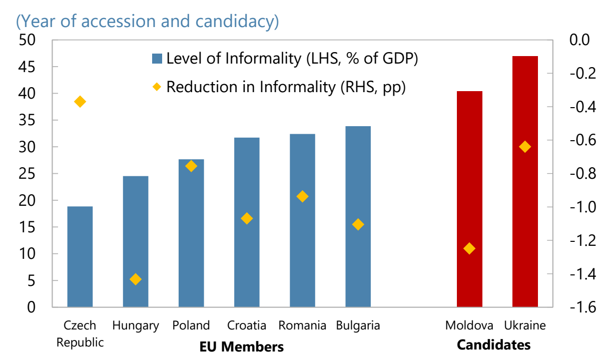
1. Informality remains pervasive in Ukraine, imposing significant economic and social costs. It spans both fully unregistered economic activity and undeclared work within formal firms, distorting competition by placing a heavier burden on compliant firms, weakening fiscal capacity through lower tax and social contribution revenues, and leaving workers without adequate social protection or firms without access to finance. Ukraine's shadow economy is estimated at roughly 35–45 percent of GDP, among the highest in Europe (Medina and Schneider, 2018; Shadow Economy Index, 2019; Elgin et al, 2021) and above the EU average of 15–20 percent of GDP (Medina and Schneider, 2018), with notable reductions observed during EU accession[1]. About 24 percent of Ukraine's employed population works informally in some capacity reflecting a diverse set of arrangements, including both employment in unregistered firms and undeclared or non-compliant work within formal enterprises (ILO, 2018). Informality also imposes economic costs by locking labor into unproductive activities; model-based estimates show that reducing informal labor by 10 percent would increase real GDP by about 1pp (see Box 1). Looking ahead, demobilization poses an additional risk—without active labor market intervention, returning soldiers may gravitate toward informal self-employment, potentially reversing formalization efforts.

Figure 1. Selected Countries: Economic Cost of Informality



Sources: PWT 11.0, World Bank Informal Economy Database, and IMF staff calculations.
Data comprises cross-country sample.

Figure 2. Dynamics of Informality



Sources: World Bank Informal Economy Database, and IMF Staff Calculations.
Note: Informality (% of GDP) for EU members refers to the level at the time of EU accession. For Moldova and Ukraine, informality refers to 2020 levels. Reduction in informality is the change from 2013 to 2020.

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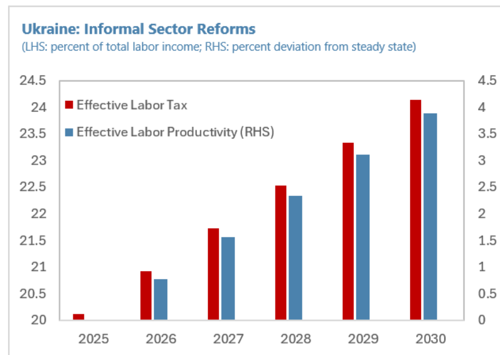
[1] We rely on Multiple Indicators Multiple Causes (MIMIC) estimates from the World Bank Informal Economy Database (Elgin et al., 2021), which infer the likely size of the shadow economy from observable indicators and drivers of informality rather than direct measurement. The shadow economy comprises market-based economic activity concealed from public authorities to avoid taxes, social contributions, labor regulations, or administrative requirements. These estimates should be interpreted as approximate, cross-country comparable indicators rather than precise measures, as they rely on a combination of indirect macro-level models and direct micro-level surveys that reflect limited timeliness and perceptions and should therefore be interpreted with caution.

Box 1. Ukraine: Quantifying the Gains from Reducing Labor Market Informality[1]

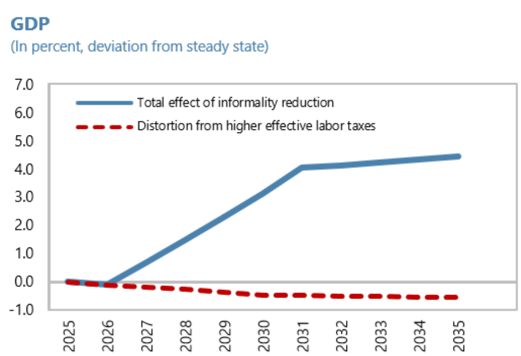
The IMF's DIGNAR-19 dynamic general equilibrium model (Buffie and others, 2012) is used to assess the macroeconomic effects of a 50 percent reduction in the level of informality. The model assumes a starting level of informality of about 30 percent of the labor force, in line with current staff estimates.[2] Informal workers are represented as paying no labor taxes and lacking access to credit. The simulation assumes that over a five-year period starting from 2026, 10 percent of the initial stock of informal workers transitions to the formal sector each year, with two effects:

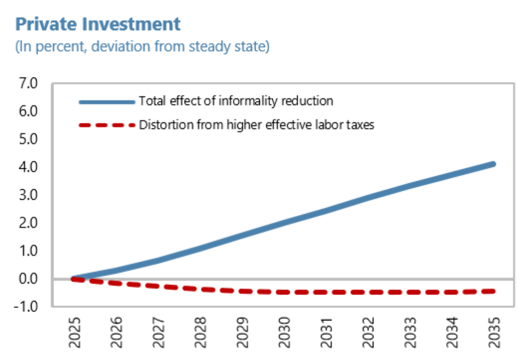
1. **Tax compliance increases** as the tax base expands to encompass previously informal workers, raising the effective tax on total labor income.
2. **Labor productivity increases** by 3.88 percent over five years, assuming that formal workers are about 33 percent more productive than informal workers—akin to the productivity difference between Simplified Taxpayers and VAT taxpayers.



The transition of informal workers into the formal labor force lifts GDP and private investment by about 5 percent over 10 years. The distortionary effects of higher effective labor taxes—which depress the employment of former informal workers—result in a modest loss of around 0.5 percent of GDP. This loss is fully offset by the more productive use of labor in the formal sector, which results in a gain of 5.5 percent of GDP.

Box Figure 1. Ukraine: Macroeconomic Effects of Informality Reduction





Source: IMF staff calculations; Note: Reform effects are estimated using IMF DIGNAR-19 model.

[1] Prepared by Sneha Agrawal and Frank Zhang.

[2] Informal activity is estimated at 35-45 percent of GDP, or about 30 percent of total economic activity (informal plus formal GDP).

2. Informality in Ukraine takes several distinct forms, spanning unregistered activity, undeclared work within formal firms, misuse of the simplified tax regime, and sector-specific evasion:

- *Informal employment in unregistered firms*: A significant share of workers is employed in enterprises that operate completely off the books, often small family businesses or firms in sectors like agriculture, trade, and personal services that avoid registration to evade taxes and regulations. Workers in these enterprises lack formal labor contracts and do not contribute to social insurance.

- *Undeclared work within formal firms (envelope wages):* It is common for registered companies to underreport employees' salaries or hire some staff entirely informally. Employers pay part of the wages officially and the rest through "envelope wages", typically cash or prepaid debit cards, to avoid payroll taxes. Studies estimate that roughly 30 percent of total wages in Ukraine are paid under the table and about 19.8 percent of firms underreport the number of employees to the authorities (Shadow Economy Index, 2019). This practice is widespread in sectors like construction, manufacturing, retail, and hospitality, where cash and quasi-cash transactions facilitate underreporting.

- *Disguised self-employment via the simplified tax system:* The so-called third group of Ukraine's Simplified tax system, intended to support small entrepreneurs, is frequently abused to disguise employment. Instead of hiring staff on labor contracts, some firms engage workers as individual entrepreneurs (known as "FOPs") who pay only a 6 percent turnover tax and a minimal social contribution. This allows both the firm and the worker to avoid the much higher tax burden on wages (personal income tax and a 22 percent social security contribution). This practice is common in IT and professional services, as well as in restaurants and telecoms (IMF, 2016; ILO, 2018; CES, 2021). By 2024, about 0.7 million taxpayers had joined group 3 of the simplified tax regime (many effectively working as contractors) (CES, 2026).

- *Sectoral manifestations.* Construction often relies on cash payments to workers and unregistered subcontractors; retail trade commonly underreports sales; and hospitality businesses may maintain dual accounting systems to evade taxes. Illicit trade is widespread in tobacco, fuel, and electronics. For instance, illicit cigarettes account for approximately 16 percent of total consumption, resulting in estimated annual fiscal losses of around UAH21.9 billion in 2024 (Growford Institute, 2024; Globsec, 2022; KPMG, 2025; Kantar, 2025). In e-commerce and electronics, importers have exploited a loophole exempting low-value parcels (under EUR 150) from VAT, enabling widespread under-declaration of goods. In telecommunications, large firms have fragmented into multiple small legal entities to remain under the Simplified Tax thresholds and reduce tax liabilities—a practice that undermines the integrity of the tax system (CES, 2021).

- *VAT chain manipulation:* Informality also manifests itself through deliberate disruption of the VAT chain thus undermining its integrity. In sectors such as wholesale trade, construction, and government procurement, firms may underreport purchases or sales, use shell companies to generate fraudulent input VAT claims, or operate without proper invoicing. Weak enforcement and gaps in electronic invoicing have historically allowed such manipulation to persist (CES, 2021).

B. Enabling Factors of Informality

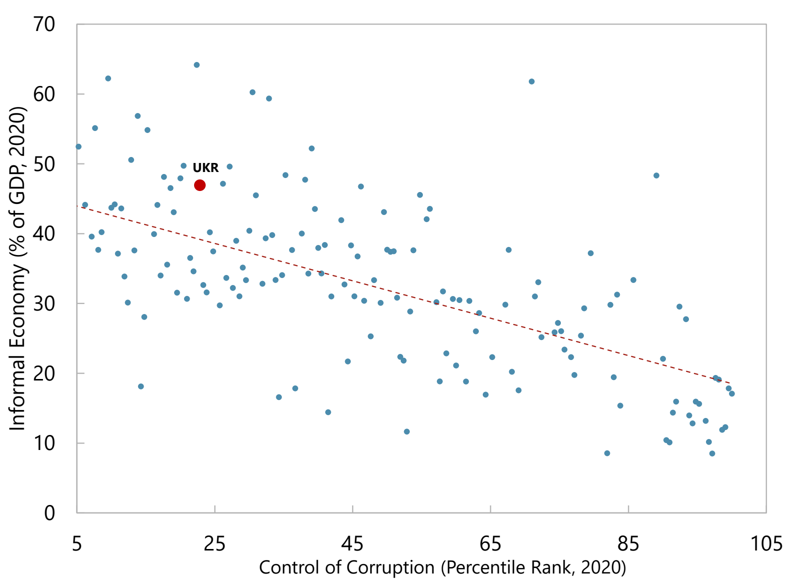
The high level of informality reflects deep-rooted structural issues and mutually reinforcing structural distortions that weaken incentives for formal participation across both firms and workers. These span fiscal and regulatory design features that create incentives for arbitrage, institutional weaknesses that limit the credibility of enforcement, and financial and administrative frictions that raise the costs of compliance. At the same time, persistent reliance on cash and quasi-cash transactions and gaps in financial inclusion constrain transparency and access to formal finance, while low perceived returns to formalization—reflecting weak links between contributions and benefits and limited trust in public institutions—further reduce willingness to comply. Together, these factors create a low-risk, high-reward environment for informality and help explain its persistence despite recent reforms and increased digitalization.

Figure 3. Ukraine: Marginal Personal Income Tax and SSC Rates

Sources: OECD Economic Surveys: Ukraine 2025, and IMF staff calculations
Note: Marginal tax rates relate to a single person without dependents. The OECD average is shown at 67%, 100% and 167% of average wage (AW) earnings. OECD data refer to 2023, for Ukraine data refer to the policy rules in place in January 2025. For OECD and peers, personal income tax rates refer to combined (central and sub-central government) rates, and employer social security contributions include payroll taxes. For Ukraine, Group 1 and Group 3 marginal rates are calculated at 100% of the average wage in 2024, of UAH 21473 per month. For Group 1 (self-employed), the marginal rates shown reflect a personal income tax rate of 10% of the subsistence wage (UAH 2920 monthly), a military tax of 10% of the minimum wage (of UAH 8000 monthly) and a social security contribution rate of 22% of the minimum wage. For Group 3 (self-employed), the rates shown are based on gross income being equal the average wage rate, with a personal income tax rate of 5% and a military tax rate of 1% of this income, and a social security contribution rate of 22% of the minimum wage.

3. Ukraine's simplified tax regime creates significant distortions by incentivizing labor reclassification and tax arbitrage, thus undermining the tax base and fair competition. While Ukraine's labor tax wedge is slightly lower than regional peers, the sharp difference in effective taxation between wage employees and self-employed FOPs creates strong incentives for regulatory arbitrage (IMF, 2016; OECD, 2025). Despite the 2016 reduction in the employer social security contribution (SSC) rate from 40 to 22 percent, the incentive for firms to reclassify employees as FOPs persists; FOPs remain exempt from SSCs and subject only to low turnover taxes allowing firms to significantly reduce labor costs by reclassifying employees as contractors. Originally intended to support micro-enterprises by reducing compliance costs, the simplified tax system has however become a major channel for tax avoidance and labor reclassification. This has led to an erosion of the tax base and resources for social protection while distorting competition. Firms exploiting the simplified regime enjoy an unfair cost advantage, including some large companies that split into multiple small entities to stay under simplified tax thresholds (see accompanying SIP). Beyond the tax benefits, such splitting increases opacity and anti-money laundering (AML) compliance risks: individually small entities attract less scrutiny, while inter-entity transactions can obscure payment flows. Firms operating under the simplified regime are either prohibited from issuing VAT invoices (Groups 1 and 2) or may opt out of VAT registration entirely (Group 3), preventing downstream firms from claiming legitimate input VAT credits. This facilitates evasion (including via underreported sales and gray imports) and discourages formal sector linkages, fragmenting supply chains and reducing tax transparency (IMF, 2023; CES, 2026).

Figure 4. Selected Countries: Corruption and Informality

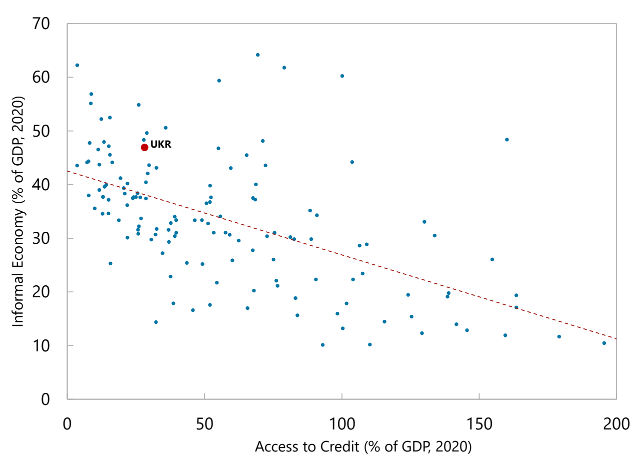


Sources: World Bank Informal Economy Database; Worldwide Governance Indicators, D. Kaufmann (Natural Resource Governance Institute and Brookings Institution) and A. Kraay (World Bank); and IMF staff calculations.
Note: The control of corruption index captures perceptions of the extent to which public power is exercised for private gain; it ranges from 0 to 100, with higher values indicating stronger control of corruption. These indicators are derived from perception-based data and should be interpreted with caution.

4. Weak institutions and selective enforcement undermine compliance incentives, creating a low-risk environment for evasion and reinforcing informality. Both tax administration and labor inspection systems have long suffered from limited capacity and integrity problems. Enforcement of laws against unregistered business activity and undeclared work has been inconsistent, and prior to the war, labor inspections were minimal relative to the size of the workforce, with corruption frequently reported (IMF, 2016). According to the World Bank Enterprise Survey, over a third of firms in 2019 felt obliged to offer "gifts" to tax officials during inspections. Such practices undermine deterrence: when penalties can be bargained away or avoided altogether, compliance becomes optional (World Bank, 2020). Combined with cumbersome court processes and slow contract enforcement, these factors create a low-risk, high-reward environment for evasion. When detection is rare, sanctions light, and formal institutions perceived as untrustworthy, operating in the shadow economy becomes a rational strategy (IMF, 2016; Schneider and Williams, 2013). Weaknesses in labor regulation and enforcement further contribute to informality. Recent ILO technical assessments of the draft Labor Code highlight gaps in employment classification, the use of fixed-term, part-time, or civil-law contracts, limited labor inspection powers, and short appeal periods for dismissals. These shortcomings undermine deterrence against undeclared work and disguised employment, and contribute to uneven enforcement, reinforcing incentives to operate informally.

5. Despite recent progress in digital payments, persistent reliance on cash and cash-like alternatives transactions alongside gaps in financial inclusion sustain informality by limiting traceability and constraining access to formal finance.

Figure 5. Selected Countries: Access to Credit and Informality



Sources: World Bank Informal Economy Database; World Bank, World Development Indicators; IMF IFS; and IMF staff calculations.
Access to credit is proxied by domestic credit to the private sector (% of GDP). Data comprise a cross-country sample.

- *High use of cash and cash-like alternatives* facilitate informality because transactions lack a clear audit trail. While Ukraine has historically been cash-intensive, recent evidence points to a marked shift: between 2021 and 2026, cash withdrawal transactions declined from 65.7 million to 35.2 million, contactless payments rose from 72.9 million to 394.7 million; while active payment cards rose from 35.7 million to 65.4 million between 2020 and 2025—a notable change given the wartime population decline (NBU, 2026a; 2026b). Nevertheless, many small firms continue to rely on cash or its electronic equivalents, limiting transparency[3].

- *Financial inclusion constraints* compound these dynamics in both directions: small entrepreneurs with limited access to banking services or who found banking costly opt to remain cash-only, while informal firms—lacking verifiable financial statements, transparent income streams, and collateral—find themselves excluded from formal finance, trapping them in a cycle of cash-based operations (Cash Essentials, 2022; NBU, 2024). These constraints are particularly acute in the hospitality sector, which is dominated by small firms with volatile revenues and limited collateral. In rural areas, informal credit arrangements often substitute for bank loans, going hand-in-hand with informal business practices. At the same time, some firms may choose to remain informal as a strategy to benefit from tax optimization, reducing their demand for formal finance. Nonetheless, increased digital payments in recent years (and war-related shifts to cashless transfers) combined with tighter financial monitoring could contribute to improved traceability of cash equivalent transactions over time.

6. Administrative and regulatory burdens increase the cost and complexity of formalization, encouraging firms to remain informal or rely on non-standard employment arrangements. Ukraine's business climate is characterized by heavy bureaucracy—requiring numerous permits, licenses, and complex tax filing requirements—place a disproportionate burden in time and money on small businesses. As a result, some micro entrepreneurs choose not to register at all, or to register under the simplified tax system but then underreport turnover, citing complex rules. While progress has been made (e.g., online business registration and tax filing simplifications in the 2010s), many procedures remain onerous and frequent regulatory changes and inconsistent interpretations create uncertainty. These challenges are particularly pronounced in the hospitality sector, where firms rely on seasonal and flexible labor but face difficulties formalizing such arrangements. Rigid contract structures, administrative burdens related to hiring and dismissal, and payroll taxation make it costly to adjust staffing in line with demand, contributing to widespread use of informal contracts and disguised self-employment (ILO, 2018). More broadly, complex and sometimes unclear labor rules, combined with weak safeguards against abuse of non-standard contracts, further encourage firms to bypass formal employment relationships altogether. Recent ILO findings also point to gaps in employment classification and the regulation of fixed-term and other non-standard contracts. In this context, informality is perceived as a simpler and more flexible alternative to full compliance (IMF, 2016; World Bank 2020; OECD 2025).

7. Low perceived benefits of formal participation, combined with weak trust in public institutions and entrenched social norms, reduce incentives to formalize and reinforce informality. Informality in Ukraine is reinforced by two mutually reinforcing factors: weak perceived benefits from formal participation—reflecting modest social benefits and a weak link between

[3] Since 2021 electronic receipts and online cash registers have been mandatory for simplified taxpayers in Groups 2 and 3—a reform temporarily suspended during martial law, but subsequently reinstated from October 2023 with reduced sanctions for FOPs, and with full penalties restored from August 2025.

contributions and entitlements—and long-standing social norms of limited confidence in the effectiveness of public institutions. This reduces incentives to formalize, for employees as much as for employers; employees see little reason to push back against informal arrangements, while formalization often adds administrative burden without clear benefits (IMF, 2016; Shadow Economy Index, 2019). Cultural factors may further entrench informality; during the post-Soviet transition and subsequent crises, informal work became a survival strategy and gained social acceptance (Torgler, 2003; ILO, 2018; Shadow Economy Index, 2019). Older workers often remain outside formal systems, while younger professionals—particularly in IT—are more inclined to formalize under new frameworks such as *Diia City*[4] – albeit under preferential tax and employment arrangements. At the same time, while the war has deepened financial pressures, it has also strengthened civic solidarity, suggesting scope to rebuild trust and gradually shifting norms toward formality (Lutsevych, 2024; UNU-WIDER, 2025; Frizell et al., 2025).

C. Policy Levers to Reduce Informality

Addressing informality requires a comprehensive approach that simultaneously tackles the incentives to evade and the capacity to enforce, while also trying to shift norms and improve the state's service delivery to rebuild trust. No single policy can solve an entrenched problem; instead, fiscal, regulatory, and institutional changes must go hand-in-hand. Sustainable progress depends on changing taxpayer behavior and making non-compliance costly through stronger compliance risk management, while simplifying procedures, and enhancing enforcement. Drawing on international experience, successful formalization strategies combine sticks and carrots: lowering the costs and raising the benefits of formality ("carrots") while increasing enforcement against evasion ("sticks"). The key policy levers across tax and non-tax domains are set out below, along with considerations for sequencing and trade-offs.

Strengthen Enforcement and Governance

8. Strengthening risk-based compliance and analytical capacity across institutions—supported by stronger inter-agency coordination and data sharing—is critical for detection and deterrence. This includes:

- *Enhance risk-based compliance and analytical capacity:* Strengthening the analytical capacity of key compliance institutions—including the State Tax Service (STS), Economic Security Bureau of Ukraine (ESBU), the labor inspectorate, State Customs Service, and the State Financial Monitoring Service (SFMS)—is essential to detect and deter informality, and should be supported by adequate resources and staffing to strengthen enforcement capacity. The STS should adopt a modern compliance-risk management framework that uses data analytics to flag likely evaders; firms should be selected for audits on a risk-based basis, guided by metrics such as unusually low contribution ratios or turnover just below reporting thresholds or where the effective SSC rate—the ratio of actual SSC paid to total labor costs—is low to help identify firms

[4] Diia City is a special legal and tax regime for IT companies, introduced in 2022, offering preferential tax rates and flexible employment arrangements to stimulate Ukraine's digital economy.

paying envelope wages (Kelmanson et al., 2019). The labor inspectorate can complement these efforts by focusing on high-risk sectors such as construction, retail trade, hospitality and markets through targeted, unannounced inspections.

- *Enhance data sharing and interagency cooperation*: A data-driven approach enables fairer and more efficient enforcement: compliant firms face fewer checks, while persistent evaders are detected. Integrating databases across tax, customs, pensions, and social insurance would enable a unified view of each taxpayer, while expanding data coverage to include non-tax payers; third-party data—such as electricity use or satellite imagery, as successfully applied in other countries to identify unregistered properties and construction activity—could further improve risk-based targeting (World Bank, 2018; Cui and Yao, 2024; IMF, 2024). Enhanced inter-agency coordination is equally important in strengthening detection; for example, NBU guidance requires banks to report business-splitting patterns (a form of tax evasion under the simplified tax regime) to the SFMS, which has expanded access to administrative registries (from around 32 to 49) and uses network-based analysis—an improvement over individual suspicious transaction reporting—to identify patterns across linked entities and clients, combining bank and administrative data to detect schemes such as business splitting and VAT fraud. SFMS subsequently notifies STS and ESBU, which can take actions such as ex-ante screening of VAT refund claims and, where needed, suspension of high-risk transactions.

9. Reducing red tape and simplifying compliance can encourage formalization by lowering administrative costs and making compliance more accessible and predictable for firms. Streamlining business registration, licenses, and permits, and modernizing labor regulations for small firms can lower compliance costs reduce administrative complexity. Clearer rules also improve enforcement efficiency by distinguishing genuine evasion from unintentional non-compliance (IMF, 2016; ILO, 2018). Ukraine should continue to expand digital services through the *Diia* platform, integrating tax, labor, and social security reporting into a single online interface, reducing both the administrative burden on firms and the scope for discretionary enforcement. At the same time, care should be taken that special regimes such as *Diia* City, while supporting formalization in the IT sector, do not replicate the distortions of the simplified tax system by creating new avenues for regulatory arbitrage.

10. Improving access to justice and dispute resolution is essential to strengthen trust in formal institutions and support incentives for formalization. Trust in formal institutions depends on reliable legal recourse. Efficient, impartial courts and predictable tax dispute mechanisms encourage firms to stay formal and reduce the need to rely on informal networks. Ongoing judicial reforms, improvements to collateral enforcement and the development of alternative dispute resolution mechanisms for commercial cases should be accelerated. Clear, independent appeal channels within the STS would further strengthen taxpayer confidence and reduce reliance on courts by improving the effectiveness and credibility of administrative dispute resolution (World Bank, 2021; IMF, 2013).

11. Stronger criminal enforcement can enhance deterrence in addressing tax evasion. In Ukraine, as in most jurisdictions, tax evasion is a crime. But criminal prosecution of tax evasion is rare, with only 12 indictments and 2 convictions for tax evasion under Art. 212 of the Criminal Code in 2025.[5] And, unlike in most other jurisdictions, there are no prison sentences for tax evasion (other than excise fraud or smuggling). The low number of criminal investigations (1,013 investigations in 2025) compared to other jurisdictions reflects a high threshold for criminal liability and the fact that abusive practices which are banned in other countries remain in a legal gray zone in Ukraine as it is not explicitly prohibited (e.g., splitting of companies to avoid taxes). The low number of indictments may also be due to the fact that Art. 212(4) of the Criminal Code waives criminal liability if taxes and penalties are paid before an indictment. Addressing these gaps requires both stronger enforcement capacity and legislative reform.

Increasing the Benefits of Formality

12. Enhance social protection and public services can strengthen incentives for formalization by increasing the perceived benefits of compliance and reinforcing trust in the state.*:* Encouraging workers to choose formal employment requires strengthening the quality and credibility of benefits linked to contributions. While comprehensive improvements are not fiscally feasible in the near term, even modest, well-targeted steps, such as improving access to healthcare under Ukraine's evolving publicly funded healthcare system will make formality more attractive and help build trust in the system. Healthcare access is particularly important: workers, especially younger ones, value near-term health benefits more than deferred pension entitlements (IMF, 2016). On the firm side, linking eligibility for public procurement, export licenses, concessional credit, and reconstruction contracts to compliance with the reformed tax system would make formality a prerequisite for opportunity; recent steps under the program to level the playing field for VAT taxpayers in public procurement are an important step toward aligning incentives for formalization. Delivering better public services and visible rewards for compliance will reinforce trust in government and strengthen Ukraine's social contract (IMF, 2016; ILO 2018).

13. Facilitate finance for small formal businesses is essential to break the cycle of informality by improving financial inclusion and strengthening incentives for transparent operations: Ukraine's reliance on cash has sustained informality by leaving transactions unrecorded and untaxed. Limited banking infrastructure, and weak financial literacy, especially in rural areas restrict access to formal finance. Before the war, only about two-thirds of Ukrainians had bank accounts, and fewer than one in five small firms had access to a bank loan (World Bank, 2020). While recent progress has been encouraging, access remains uneven and further efforts are needed:

- *Recent progress, but persistent constraints:* Recent progress has been fruitful, driven by the *NBU*'s *Financial Inclusion Strategy (2020)*, *Law on Payment Services (2023)*, and wartime initiatives such as *Power Banking* and digital transfers through *Diia* (NBU, 2023; 2024). Government-supported lending programs, such as "5-7-9," have helped sustain SME credit during the war, but access remains uneven, reflecting constraints such as collateral requirements and limited credit histories, and difficulties in providing reliable, verifiable financial information required for banks'

[5] For comparison, for Poland the OECD reports 3041 prosecutions and 2619 convictions (out of 2756 court decisions) for tax evasion in 2021 (see Fighting Tax Crime – The Ten Global Principles: Country Chapters, May 2024).

credit risk assessment (NBU, 2025; CES, 2024). High informality compounds this challenge directly: firms that underreport income or operate off the books lack the credit histories and audited financial statements lenders need to assess risk, trapping them outside formal credit markets (OECD, 2026). This reflects in part stricter post-crisis lending standards, which require banks to assess not only borrowers' financial statements but also their ownership and group structure, thereby placing greater emphasis on financial transparency and verifiable financial reporting (Bazhenova, 2023).

- *Access to finance should be expanded*, including by strengthening targeted credit guarantee schemes, such as provided by IFIs, that leverage private sector lending while limiting fiscal risks. Enhancing existing credit registries—which are fragmented across multiple bureaus—and expanding access to administrative databases (e.g., tax and pension data) would reduce information asymmetry and improve risk assessment. A step in this direction is already operational: citizens can now share verified income, tax, and social insurance data with banks via the Diia portal, creating a practical link between tax compliance and credit access. The law on *"On Credit History"* (pending in parliament) would further improve accuracy and timeliness of credit information (OECD, 2026). Complementary efforts to support microfinance, cooperative lending, and fintech solutions can lower transaction costs and reduce barriers for first-time borrowers. Overall, improving access to finance in Ukraine will depend less on relaxing lending standards and more on improving formality which strengthens the availability and use of reliable data for credit risk assessment.

14. Reinforcing digitalization alongside tightened monitoring can reduce opportunities for informality by increasing transaction traceability while keeping new risks in check. Ukraine should build on recent progress in digitalizing payments and government services to make informality harder and compliance easier.

- *Expanding electronic transactions* reduces opportunities to conceal income while simplifying compliance through automation. Key measures include: requiring salaries above a modest threshold to be paid via bank transfer, offering incentives for small merchants to install point of sale (POS) terminals, and running public campaigns promoting the convenience and safety of cashless payments. Consumer reward schemes such as "receipt lotteries," have been shown to improve VAT compliance by turning consumers into third party monitors (Naritomi, 2019); Portugal's "Lucky Invoice" lottery encouraged consumers to demand official receipts. Continued investment in broadband and smartphone access is essential, as digital infrastructure underpins both e-filing and electronic payments (Cui and Yao, 2024). On the government side, expanding e-services for permits, licenses, and reporting will reduce face-to-face interactions, lower petty corruption, and simplify formalization. Leveraging Ukraine's strong IT sector and platforms like *Diia* can help embed digital governance as a core feature of a transparent, modern economy. Sustaining the shift to cashless payments through the wider use of electronic cash registers, POS networks, and initiatives under NBU's Cashless Economy Program, including instant payments, open banking, and the digital hryvnia[6] pilot can broaden financial inclusion and reduce transaction costs (NBU, 2023).

- *Enhanced monitoring*: Expanding digital payments requires active oversight to prevent misuse: the NBU has identified so-called "money drops"—individuals paid to route shadow revenues through personal accounts to disguise them as ordinary transfers—as a significant risk, and has responded by tightening the financial monitoring requirements for the banking system and payment system providers, imposing P2P transfer limits, increasing NBU monitoring capacity through the use of tax-IDs, and proposing legislation for a high-risk accounts register (NBU, 2024; 2025). The banking sector and payment services providers have also agreed a memorandum to improve transparency in the payments market (NABU, 2026).

15. Targeted support for vulnerable groups, subject to fiscal space, is essential to facilitate transitions into formal employment and ensure that formalization is inclusive and sustainable. Helping informal workers move into formal jobs requires improving transitions and job matching, alongside training, inclusion programs, and social protection. Programs such as the "Obriy" re-skilling initiative can support formalization by helping displaced and informal workers transition into formal employment, particularly by improving matching into sectors with formal job opportunities. This is particularly relevant in the demobilization context, where well-designed reintegration programs will be key to channeling returning soldiers toward formal employment (OECD, 2025). The ILO (2018; 2023) highlights that targeted re-skilling and apprenticeship schemes can help youth and rural workers access formal employment, while cooperative models can support small producers and home-based entrepreneurs. Once resources permit, post-war employment and recovery programs should integrate de-shadowing objectives—ensuring that formalization goals are embedded within broader reconstruction and job-creation efforts. Strengthening social safety nets—such as minimum income schemes or public works programs—ensures that enforcement does not penalize the poorest (IMF, 2023). Active labor market policies, combined with retraining for demobilized soldiers and other displaced workers and inclusive recovery programs, can gradually channel the workforce into the formal economy, particularly as reconstruction creates new job opportunities (World Bank, 2023).

16. Reducing informality also requires public communication and shifting social norms. Public campaigns can link tax compliance to Ukraine's reconstruction, defense, and EU accession. Showcasing success stories of compliant firms, while explaining the personal risks of envelope wages, can gradually shift attitudes. Education and civic programs can embed this message over time. Building a culture of compliance—where paying taxes is seen as part of European integration and nation-building—will be essential for lasting progress.

[6] The National Bank of Ukraine is piloting a central bank digital currency (e-hryvnia), aimed at supporting retail digital payments, improving financial inclusion, and enhancing the transparency and efficiency of payment systems.

Tax Policy Measures

17. Reforming the simplified tax system and reducing distortions in labor taxation is central to leveling the playing field and strengthening incentives for formal employment. The overarching priority is to reduce the gap in tax burden between formal employment and other work arrangements, primarily by refocusing the simplified tax regime on genuine micro-entrepreneurs (see accompanying SIP). This includes enforcing existing rules and closing remaining loopholes for abuse, including those related to the misclassification of employment relationships as envisaged under the IMF-supported program, and abolishing the VAT exemption for simplified taxpayers above the general VAT registration threshold. Only once these distortions are addressed, and subject to fiscal constraints, targeted measures to narrow the labor tax wedge should be considered and limiting SSC arbitrage. Gradually reducing the gap in tax burden between formal employment and other work arrangements should be considered if consistent with financing and debt sustainability constraints, and only after careful assessment by the MOF. Options could include lowering SSC rates for employees—fully offset by base-broadening or PIT adjustments—or by gradually raising SSC contributions of high-earning self-employed persons and FOPs (IMF, 2016). Any changes should preserve pension sustainability and be paired with stronger enforcement to prevent continued underreporting. Without effective enforcement, however, firms may simply retain the gains from lower contribution rates—continuing to underreport wages or keep workers off the books—rather than using the savings to formalize employment or increase declared payrolls.

18. Strengthening VAT and customs compliance is essential to reduce evasion, level the playing field, and secure revenue by improving risk-based controls. Effective VAT administration requires refining risk-based invoice controls and automated cross-checks, building on the electronic VAT invoicing system, while reducing unnecessary administrative burden on compliant taxpayers. More targeted audits and ex-ante screening of VAT refund claims would improve enforcement and reduce reliance on costly manual verification. Adopting EU-compatible customs systems and introducing digital excise tracking—the e-Excise system, due for full launch in November 2026, ensuring careful design and adequate testing—for alcohol and tobacco would further strengthen compliance (IMF, 2023; AmCham Ukraine, 2024). Eliminating exemptions for low-value inbound postal deliveries—a measure embedded in program conditionality—would close a loophole that enables widespread under-declaration in e-commerce and align Ukraine's VAT policy with EU standards, thus helping ensure that all imports, regardless of value, are subject to proper taxation, improving revenue collection and reducing opportunities for informal trade. In this context, the Verkhovna Rada adopted a law on digital platform reporting—aligned with EU DAC7 standards. Once enacted, the law will require platforms to report seller income to the STS from 2027, helping bring gig economy and marketplace income into the formal tax net.

19. Subject to fiscal space, targeted and time-bound incentives can support formalization by lowering entry costs and strengthening rewards for compliance. Temporary, targeted, and time-bound incentives can be considered to encourage firms to transition into the formal economy, subject to a strict assessment by the MOF of their compatibility with fiscal targets. Microenterprises entering the formal sector could be eligible for small "formalization grants" to offset initial compliance costs such as bookkeeping or e-invoicing equipment, potentially supported by donor or reconstruction programs. Access to benefits such as public procurement contracts—could be limited to tax-compliant firms, creating clear rewards for transparency and discouraging informal competitors (see accompanying SIP). The ultimate goal is a simpler, broad-based system where sustained compliance replaces the need for preferential regimes (IMF, 2023; ILO, 2025; J-PAL, 2022).

D. Conclusion: The Path Forward

20. Tackling informality is a long-term endeavor with no silver bullet. It would expand the tax base—vital for strengthening social protection, reconstruction financing, and restoring debt sustainability—while leveling the playing field and improving financial inclusion for tax-paying businesses and advancing Ukraine's path toward EU membership by demonstrating rule of law and institutional credibility. Experience from other European countries shows that sustained reforms can substantially reduce informality (Kelmanson et al, 2019; Medina and Schneider, 2018; Cui and Yao 2024). Ukraine now faces a pivotal moment: as it rebuilds its cities and infrastructure, it can also rebuild its social contract, ensuring that all citizens and firms contribute fairly and benefit visibly from public goods. With coordinated reforms, transparent communication, and steady political commitment, Ukraine can bring much of its economy out of the shadows and anchor its recovery on a more formal, inclusive, and resilient foundation.

21. While political economy considerations should guide sequencing, implementation should proceed for already-committed reforms. Near-term measures should focus on broadening the tax base and strengthening compliance, while efforts to reduce tax rates or expand benefits could occur only when fiscal space becomes available, which is unlikely in the near term. In key areas—particularly the removal of distortionary VAT exemptions—decisive political commitment is required. Gradual implementation would help ease adjustment costs and maintain public support; a well-designed transition, including as envisaged under the IMF-supported program, should focus on strengthening tax administration to reduce compliance burdens and raising the general VAT registration threshold to exempt genuinely small firms, so that reforms target abuse rather than penalize legitimate micro-enterprises. Subject to fiscal space, part of the resulting fiscal gains could be redeployed toward targeted compensatory measures—such as support for compliant small firms—to facilitate transition and build political support.

22. Over the medium term, sustained reductions in informality will hinge on increasing and communicating the benefits of formality while raising the costs of remaining informal. This includes expanding digital payments and access to finance, alongside tightened monitoring and risk-based enforcement to raise the costs of informality and lock in earlier gains. Sustained stakeholder dialogue will be essential to sequence and communicate reforms credibly—particularly where adjustment costs are significant, such as phasing in higher SSC contributions for the self-employed, which should be accompanied, subject to fiscal space, by commensurate strengthening of pension entitlements and social benefits to maintain fairness and public support. Throughout, monitoring and evaluation will be essential: the authorities should establish a robust framework using tools such as MIMIC-model estimates, surveys, or administrative data to track progress and assess whether policies are achieving the desired results.

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