POLICY BRIEF

Kingsgate Advisors Institute

Unlocking the Tax Revenue Potential of the Shadow Economy in Nigeria: Issues and Policy Options

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DEC. 2025

Executive Summary

Nigeria's fiscal operations have continued to yield expansion in fiscal deficit amidst rising expenditure and inadequate revenue. The revenue challenge is rooted in volatile oil prices and production constraints, as well as an inefficient tax system that has consistently yielded a wide tax gap. Among other drivers of a wide tax gap in Nigeria is the existence of a large informal economy, which can be harnessed to narrow the tax gap.

Generally, the shadow economy covers all economic activities that are intentionally hidden from regulatory oversight for different reasons, including tax evasion. It is usually marked by heavy reliance on cash-based transactions, unregistered businesses, and informal employment. It is driven by high unemployment, low trust in institutions, complex tax systems, and limited access to finance. Although it provides income for millions, it also reduces government revenue, distorts policy effectiveness, and limits access to social protections. Available data indicate that the average size of the shadow economy in Nigeria was 55.1 per cent of GDP for the period from 2010 to 2020. Nevertheless, recent estimates indicate that the size of the shadow economy contracted to 30 per cent of GDP in 2023, due to reforms aimed at improving the ease of doing business and promoting financial inclusion.

In addition to existing policies targeted at improving the ease of doing business and enhancing financial inclusion, the implementation of the Tax Reform Acts 2025 would simplify tax administration, widen the tax base, close loopholes for tax evasion, and encourage voluntary tax compliance, among other benefits.

This brief, therefore, recommends:

i.   Simplification of business registration and tax processes using a model similar to agent banking for wide coverage;
ii.   Deepening financial inclusion and incentivizing infrastructure for digital payments;
iii.   Strengthening and enforcing regulations on property rights and anti-corruption measures; and
iv.   Leveraging extensive use of technology and Artificial Intelligence in automating tax assessment and monitoring compliance.

Expanding the formal economy through financial, tax, and business inclusion holds enormous potential for unlocking significant tax revenue to meet growing fiscal needs and engendering economic growth and development in Nigeria.

1.   Introduction

Nigeria's fiscal operations have been characterised by a shortfall in budgetary revenue, amidst rising expenditure and widening fiscal deficit. A higher fiscal deficit often necessitates recourse to additional debt accumulation, with its attendant debt service costs. The revenue challenge from the oil sector is attributed to volatility in the price of crude oil and low crude production volumes. On the other hand, the performance of non-oil revenue (mainly tax revenue) has also been sub-optimal. These developments have drawn the attention of policymakers to the imperative of ramping up revenue generation through an efficient tax system.

Tax administration refers to the implementation of tax laws to achieve their objectives. If there are good tax policies and laws that are poorly administered, the objectives of taxation will not be achieved. Tax Administration should, therefore, be efficient and cost-effective, in line with international best practices.

Regrettably, tax administration in Nigeria is plagued by numerous challenges, including weak tax enforcement and compliance, a narrow tax base, and the prevalence of a large informal sector, also known as the shadow economy. A large shadow economy undermines tax potential, widens the tax gap, and weakens tax capacity. This policy brief, therefore, provides actionable policy interventions on the need to expand the size of the formal economy to achieve optimal tax revenue generation and economic growth in Nigeria.

2.   The Shadow Economy

The shadow economy encompasses all legal economic activities that result in the production of goods and services intended for the market but deliberately concealed from regulatory oversight to circumvent tax obligations, avoid social security contributions, evade labour market standards, and prevent disclosure to statistical authorities (Schneider et al., 2010). In other words, the shadow economy is marked by excessive cash-based transactions, unreported income, tax evasion, regulatory non-compliance, and unregistered economic activities or business operations. Tax evasion is a significant aspect of the shadow economy, which involves concealing and misrepresenting income through dubious means such as falsifying records and claiming false deductions. In some cases, the shadow economy also includes illegal activities such as smuggling, human trafficking, kidnapping, etc. The shadow economy can also be described as informal, underground, hidden, unregulated, unofficial, or a parallel economy. The level of informality is attributed to factors like the complexity of taxes and the tax system; poor tax enforcement mechanisms; inefficient banking system; low public trust in the government; the quality of public services, the state of the formal economy; and the level of labour market participation (Awasthi & Engelschalk, 2018).

The relationship between the shadow economy and tax revenue performance has received considerable attention in the literature. On one hand, existing studies report a negative and significant relationship between the shadow economy and the tax revenue collection (Dokas et al., 2024; Ishak & Farzanegan, 2020; Awasthi & Engelschalk, 2018). On the other hand, factors such as tax complexity and weak tax enforcement are found as drivers of informality (Awasthi & Engelschalk, 2018; Neck et al., 2012).

This implies that policy measures should not only aim to shrink the size of the informal economy but also to eradicate tax complexities and regulatory bottlenecks that serve as fertile grounds for the thriving of an underground economy in Nigeria.
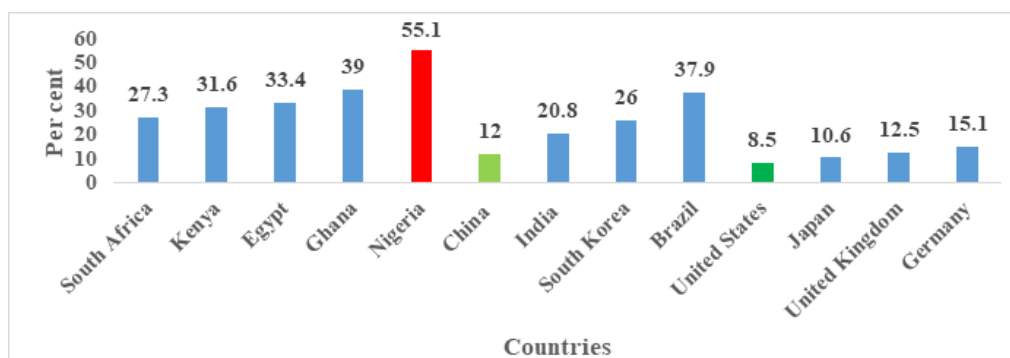
3. The Size of the Shadow Economy in Nigeria

There are three primary methods for determining the size of the shadow economy: direct, indirect, and model-based (statistical) approaches. The direct approach involves the use of responses from surveys of individuals and businesses to determine the size of the shadow economy. Additionally, the direct approach involves conducting audits to identify discrepancies in the National Accounts. The indirect approach is based on the use of macroeconomic indicators of the size of the shadow economy over time. This approach includes the currency demand method (observe unusual increase in the use of cash relative to GDP), tax gap analysis, electricity consumption, and labour market indicators. The model-based approach utilises statistical models to estimate the size of the shadow economy, employing observable indicators and causal variables. Examples of model-based techniques include, multiple in-

dicators, multiple causes (MIMIC) and Dynamic Stochastic General Equilibrium (DSGE) model.

The MIMIC method, as proposed by Schneider et al. (2010), utilises a combination of multiple causes of the shadow economy and multiple indicators related to changes in the size of the shadow economy to determine the size of the underground economy. A database of the size of a shadow economy as a percentage of GDP for several countries has been developed by Elgin et al. (2021) based on Schneider et al. (2010). The available data (Figure 1) indicate that the size of the shadow economy as a percentage of GDP in Nigeria averaged 55.1 percent between 2010 and 2020. However, the average size of the hidden economy for the same period was significantly lower in peer countries, at 27.3 per cent, 31.6 per cent, 33.4 per cent, and 39.0 per cent for South Africa, Kenya, Egypt, and Ghana, respectively. For emerging market economies like China, Brazil, India and South Korea, the average size of the informal economy between 2010 and 2020 was 12.0 per cent, 37.9 percent, 20.8 percent and 26.0 percent, respectively. The size of the shadow economy for the United States, Japan, United Kingdom and Germany between 2010 and 2020, averaged 8.5 per cent, 10.6 per cent, 12.5 per cent and 15.1 per cent, respectively.

Figure 1 Average size of the shadow economy (% of GDP) between 2010 to 2020
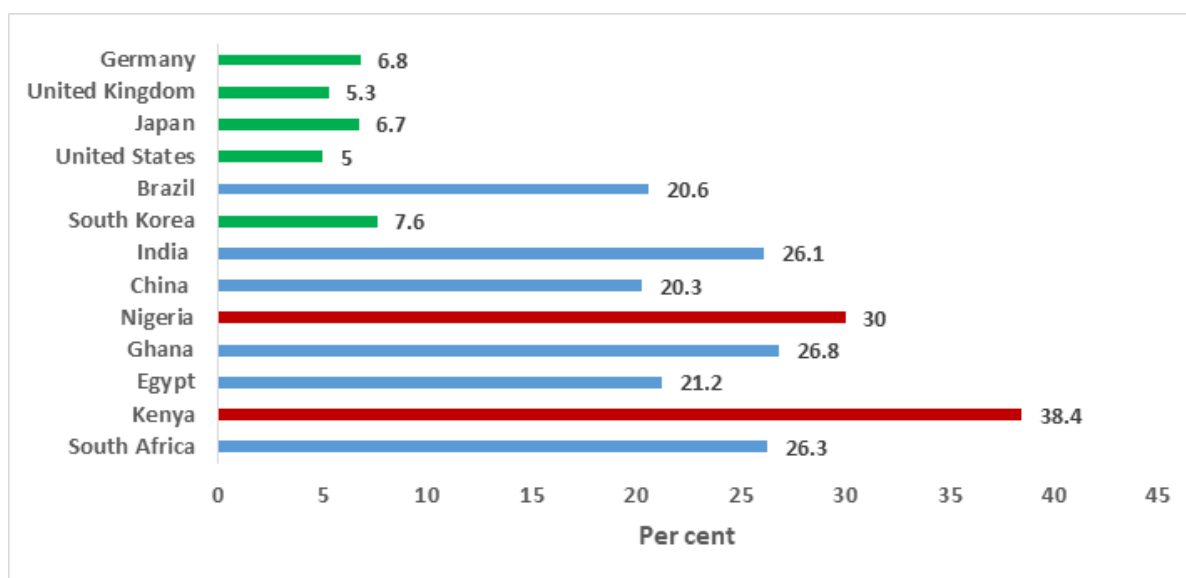

Source: Informal economy data from Elgin et al. (2021)

It can be observed from the figure above that Nigeria, with 55.1 percent has the largest average size of the shadow economy among the selected countries during the reviewed period. This implies a lost opportunity for ramping up tax revenue as a chunk of the tax base lies in the informal economy, possibly resulting in a wider tax gap.

Ernst &Young (2025) provides a more recent estimate of the size of the shadow economy for 2023, covering several countries, including the selected countries in Figure 1. The estimates shown in figure 2 indicate that the size of the shadow economy is lower than historical averages for most of the countries except China, India and Kenya. This means that the shadow economy may likely continue to shrink across several countries as the effect of deliberate policy measures continue to unfold.

Specifically, the estimate shows that the size of the shadow economy in Nigeria was 30 per cent in 2023, indicating a significantly lower value compared to the historical average of 55.1 per cent between 2010 and 2020. This development is not unrelated to the impact of specific reforms aimed at enhancing the ease of doing business, simplifying taxes and tax payments, deepening financial inclusion, and promoting a cashless economy.

Figure 2 Estimated size of shadow economy (% of GDP) in 2023

Source: Ernst & Young (EY) (2025). Shadow economy exposed: estimates for the world and policy paths.

4. Issues in the Shadow Economy in Nigeria

A) Cash-based transactions
One of the most prominent attributes of a shadow economy is the prevalence of cash-based transactions, with a popular saying, "cash is king". A recent report indicates that about 54 per cent of business owners in the shadow economy preferred cash payment for

The transaction of certain businesses in cash is one of the mechanisms by which individuals and entities conceal taxable profits. Through this, they are able not only to manipulate their records and turnover figures for tax reduction purposes but also to eliminate all third parties' information related to their transactions. This is one of the primary reasons why the Central Bank of Nigeria introduced the "Cashless" system to help tackle this issue in major Nigerian cities.

The drive towards a cashless economy in Nigeria began in 2012, with the Central Bank of Nigeria (CBN) issuing various guidelines to limit the use of cash in transactions due to the high costs associated with cash management, the risks involved in using cash, and the prevalence of the informal economy. The most notable development in Nigeria's journey toward a cashless economy has been the 2023 demonetization policy, marked by the redesign of some naira denominations. This led to a steep drop in currency outside banks and further triggered an explosion in the adoption of electronic payments. Furthermore, the launch of the National Financial Inclusion Strategy in 2012, among other subsequent interventions, has resulted in the significant drop of the financial exclusion rate to 26 per cent in 2023, from 46 per cent in 2010 (EFInA, 2023). However, the exclusion rate remains substantial for economic agents in the informal sector where some people rely on informal savings groups and other suitable arrangements.

B) Ease of doing business
A business environment characterized by bureaucratic bottlenecks, regulatory opacity, corruption, weak infrastructure and insecurity often creates a fertile ground for a shadow economy to thrive. Ease of doing business shows whether there are clear regulations guiding business processes and they are easy to follow. Broadly, ease of doing business encompasses processes such as business registration, access to electricity, contract enforcement, cross-border trading, and tax payment, among others.

Although historical data suggests a weak ease of doing business, the most recent data highlights Nigeria's progress in the ranking of countries on ease of doing business, jumping to a rank of 131 out of 190 countries in 2019, from a rank of 146 in 2018 (World Bank, 2020). The improvement is attributed to the reforms championed by the Presidential Enabling Business Environment Council (PEBEC), established in 2016, as well as changes to specific provisions of existing laws related to business regulations. On 6th September 2021, the World Bank Group discontinued the Doing Business Project following the release of an independent audit that revealed data manipulation, data irregularities, and other integrity concerns. However, in 2024, the World Bank launched the Business Ready (B READY) report 2024 to replace the Ease of Doing Business.

C) Trust in political leadership
One of the main drivers of tax compliance is trust in political leadership, stemming from the effective and efficient provision of public goods and services that justify tax payment. However, tax evasion and low compliance are rife in jurisdictions characterized by a high level of distrust in political leadership due to corruption and inefficiencies.

D) The Nigerian Tax Reform Acts 2025
The Tax Reform Acts of 2025 were borne out of

the need to overhaul the Nigerian tax system to boost revenue generation, improve the business environment, drive effective and efficient tax administration and spur economic growth. The Tax Reform Acts comprise four laws: The Nigeria Tax Act (NTA), The Nigeria Tax Administration Act (NTAA), The Nigeria Revenue Service Act (NRSA), and the Joint Revenue Board Act (JRBA). Collectively, the four Acts aim to simplify and codify Nigeria's tax laws, enhance tax efficiency and equity, promote voluntary tax compliance, broaden the tax base, and achieve a tax-to-GDP ratio of 18% by 2026.

Some of the key reforms in the Tax Reform Acts that are tailored to improve the ease of doing business and incentivize participation in the formal economy include the following:

i.   The NTA provides for an increase in the tax exemption threshold for small companies and businesses from N25 million to N100 million. The exemption covers Companies Income Tax (CIT), Capital Gains Tax (CGT) and the newly introduced Development Levy.
ii.   The NTA also makes a clear provision for the taxation of digital assets and digital currencies, thereby expanding the tax base.
iii.   The NTAA provides for the assessment, filing and payments of taxes using a uniform technology-based platform.
iv.   The NTAA makes a Tax Identification Number (TIN) and electronic filing mandatory for all taxable entities.
v.   The NTAA also contains bank transactions reporting thresholds for individuals and firms, and provides for penalties against tax evasion and other harmful tax practices.

5. Policy Options

The following policy options are required to shrink the underground economy, incentivize formalization and enhance tax revenue collection.

A. Improving the ease of doing business

Although relevant authorities have continued to implement measures aimed at improving the ease of doing business in Nigeria, there is still more work to be done in terms of simplifying the process of registering new businesses, providing affordable infrastructure, upholding the rule of law, protecting property rights, combating corruption, and reducing bureaucratic red tape.

Key policy interventions, some of which are already contained in the new four tax Acts, include the following:
i.   Deploy agent business registration model similar to agent banking model to drive, sensitize and simplify the registration of new businesses in urban, rural and remote areas;
ii.   Strengthen and uphold laws and regulations that protect property rights and minimise corruption;

B. Simplifying taxes and the tax system

The complexity of taxes and the tax system hinders tax compliance, leading to suboptimal tax revenue collection. The new laws, born out of the 2023/2025 fiscal policy and tax reforms, are designed to unify taxes and create a platform for easy registration, assessment, and payment of taxes. This is being done by employing technology such as the TAX PROMAX solution and e-invoicing. Fortunately, the Nigeria Tax Reform Acts 2025 contain provisions for simplifying taxes and intensive use of technology in tax assessment, filing and payments.

For instance, Section 23 (1) and (2) of the Nigeria Tax Administration Act 2025 mandate a taxable person making a taxable supply to use the Electronic Fiscal System (EFS) for recording and reporting all supplies and shall be responsible for maintaining accurate records of all transactions passing through the EFS. A notable example of the EFS introduced by the FIRS is the VAT automation and e-invoicing system. Furthermore, Section 71(i) empowers a tax authority to deploy any technology to automate tax administration processes, including tax assessment, collection, accounting, and information gathering.

Other areas of policy interventions include:

i.   Ensure the strict implementation of the ownership of a Tax Identification Number (TIN) as a requirement for opening bank accounts, for tax inclusion.

ii.   Make Tax Identification Number (TIN) a crucial requirement for government interventions, grants and other transfer payments.

iii.   Borrow the agent banking model to develop an agent tax model, to sensitize, simplify and facilitate tax payment in all locations across the country.

iv.   Deepen the use of technology for automated tax assessment, filing and payment, and employ artificial intelligence for compliance monitoring and tax analytics.

C.   Deepening the cashless and financial inclusion policies

The widespread use of cash often facilitates economic activities in the underground economy as it provides an avenue for concealing such activities. Therefore, authorities should consider intensifying the drive for financial inclusion and implementing a cashless policy to expand the formal economy. Although these measures are being implemented in Nigeria, they can be incentivized through the continuous provision of targeted interventions tied to requirements such as evidence of bank account ownership and tax registration.

6. Conclusion

The shadow economy continues to hinder Nigeria's tax revenue potential, despite the ray of hope from recent reforms and policy interventions. The narrowing of the size of the shadow economy relative to its historical trajectory demonstrates the effectiveness of measures aimed at simplifying taxation, promoting financial inclusion and improving the ease of doing business.

However, the policy gains can be consolidated and sustained by implementing the relevant provisions of the 2025 Tax Reform Acts, incentivizing the expansion of digital payment infrastructure, and regaining and solidifying public trust in institutions and political leadership. Therefore, addressing the drivers of a shadow economy and promoting formal economic inclusion in Nigeria holds immense potential for expanding the tax base, increasing tax revenue, narrowing fiscal deficits, and ultimately stimulating economic growth and development.

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