



PUBLIC PERCEPTION OF GOVERNMENT EFFORTS AGAINST THE SHADOW ECONOMY: INSIGHTS FROM COLOMBO DISTRICT, SRI LANKA

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ABSTRACT

The shadow economy operates outside official channels, making it difficult for the government to accurately measure its size and impact. This phenomenon significantly undermines tax revenues and economic governance; however, Sri Lanka lacks comprehensive empirical data on citizens' perceptions of initiatives to combat the shadow economy. This study examines the effect of government interventions on reducing shadow economic activities in the Colombo District of Sri Lanka. To conduct this research, an opinion survey was performed using random sampling, gathering data from 150 respondents representing public, semi-government, and private sector employees in the Colombo District. The data were analyzed using SPSS software, applying descriptive statistics, correlation, and regression analysis to derive empirical insights. The results revealed that government intervention significantly reduces activities within the shadow economy in this area. Respondents expressed a strong belief that existing regulations and financial incentives play a key role in decreasing the size of shadow economic activities. However, their confidence in tax policies and enforcement measures was noticeably lower and insignificant. The findings of this study can serve as a valuable reference for regional policymakers when evaluating the effectiveness of current practices and regulations, as well as for adjusting strategies to control the shadow economy in the Colombo District.

KEYWORDS: Colombo district, government intervention, shadow economy, perception survey.

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1. INTRODUCTION

The shadow economy, also known as the hidden or underground economy, has a wide range of productive economic activities that operate beyond the scope of government regulations and taxation (Giedraitis et al., 2023). Shadow economic activities are not reported in formal economic estimations such as Gross Domestic Production (GDP) and also avoid government regulations and taxation procedures (Schneider, 2023; Schneider & Buehn, 2017). Despite numerous policy measures, there is limited empirical evidence on how the public perceives the effectiveness of these interventions in Sri Lanka. This gap in understanding undermines efforts to tailor responsive policy. This study investigates public perceptions of government strategies to mitigate the shadow economy in the Colomo district.

Shadow economic activities caused substantial revenue losses by avoiding taxation and regulatory oversight, thereby undermining public finances (Samaranayake & Dayaratna-Banda, 2015; Kenton & Mansa, 2022). Thus, such transactions are not subject to government taxation or other regulatory frameworks and hinder the public finances (Schneider, 2023; Samaranayake, 2017; Kannangara & Wu, 2023). Eventually, this generates adverse effects on the effort by the government to reduce budget deficits (OECD, 2017).

Additionally, larger shadow economies can negatively affect social welfare programmes. The agents who are involved in the illegal, hidden or informal businesses and transactions are used to staying away from contributing to the social security systems, and it affects the social welfare programmes (Schneider & Buehn, 2017; Canelas & Nino-Zarazua, 2021).

Governments have implemented various measures to address this negative socio-economic impact and combat the shadow economy. These measurements include tax reforms such as incentives to encourage taxpayers, changes in the regulations, enforcement of law, and public awareness (OECD, 2017; Mara et al., 2023; Mathias & Wardzynski, 2023).

However, the effectiveness of such measures depends on how governments apply them with a clear understanding of the variations in the socio-economic characteristics of the particular economy (Schneider, 2023; Samaranayake & Dayaratna-Banda, 2015; Gerxhani & Cichocki, 2023). Thus, assessing and understanding how a government, particularly the Sri Lankan government, performs with its strategies to mitigate the shadow economy is crucial.

There are various attempts by researchers to estimate the size of the Sri Lankan shadow economy (Samaranayake & Dayaratna-Banda, 2015; Samaranayake, 2017; Samaranayake & Dayaratna-Banda, 2019; Kannangara & Wu, 2023). However, there is a pressing need for further empirical observations to understand how the shadow economy affects the government, economy, and day-to-day life of the citizens in the ground reality in Sri Lanka. To initiate this, we designed this survey to understand how citizens felt about the role of the government in combatting the shadow economy. Therefore, this study presents the outcomes of the first empirical survey conducted in Sri Lanka to extract the citizens' perceptions of the effectiveness of government intervention strategies in reducing the shadow economic activities in the Colombo district.

Understanding the Shadow Economy

The literature considers defining the shadow economy a complex task due to its multifaceted nature. (Samaranayake, 2017; Kannangara & Wu, 2023). The shadow economy often includes a variety of productive economic activities that operate outside formal procedures (Williams, 2025; Schneider et al., 2010). For instance, illegal and hidden transactions, unreported or informal employment, tax evasion, and smuggling are a few examples of such activities (Zhanabekov, 2022; Gerxhani & Cichocki, 2023).

The complexity of its characteristics also makes it difficult to estimate the size of the shadow economy (Schneider, 2023; Schneider & Buehn, 2017). Differences in socio-economic elevation, cultural norms, and policies can make the estimates for the shadow economy different between regions and countries and also across internal boundaries within a country (Alfoul et al., 2022). The shadow economy

was even considered a necessary evil for underdeveloped economies until a former mechanism was established (Samaranayake, 2016).

Various approaches to estimating the shadow economy exist, and they are mainly categorized into two broad methods: ‘direct’ and ‘indirect’ approaches to measuring the size of the shadow economy (Schneider & Buehn, 2017; Samaranayake & Dayaratna-Banda, 2015). Direct approaches collect data to estimate the shadow economy using surveys, interviews, and administrative reports (Schneider & Buehn, 2017; Samaranayake, 2017).

Indirect approaches primarily rely on systematic statistical techniques used on national databases and economic indicators to estimate and forecast the size of the shadow economy (Medina & Schneider, 2018; Berdiev et al., 2023). For instance, all the attempts to estimate the Sri Lankan shadow economy in literature are based on one of the leading indirect approaches, Structural Equation Models - SEM (Schneider, et al., 2010; Samaranayake & Dayaratna-Banda, 2015; Samaranayake, 2017; Kannangara & Wu, 2023). SEM forecasted the size of the Sri Lankan shadow economy as a percentage of GDP for a series of years.

Government Intervention Strategies

The government’s intervention strategies to combat the shadow economy are mainly the tax policy reforms, regulatory reforms, law enforcement and public awareness (Wahua et al., 2023; OECD, 2017; Mara et al., 2023; Mathias & Wardzynski, 2023). Tax reforms are targeting simplifying the tax burden on citizens and providing incentives to improve tax compliance (Wahua et al., 2023). Relaxing the tax base and tax incentives may eventually retain the citizens in the formal mechanism and discourage participation in the shadow economy (Kelmanson et al., 2019).

The regulatory framework of a government is also an essential tool in mitigating the shadow economy. The regulations can be tailored to alleviate the administrative burden on individuals and businesses, encouraging their participation in the formal economy (Mara et al., 2023). Furthermore, the regulations can enhance fairness, competition, and equal rights within the markets, thereby retaining citizens within the

formal sector (Samaranayake & Dayaratna, 2015; Kannangara & Wu, 2023).

A solid legal framework and transparent and efficient mechanisms for law enforcement are also essential tools for governments (Williams et al., 2015; Williams, 2023; Mathias & Wardzynski, 2023). This can discourage citizens from being involved in illegal businesses and transactions. Mathias & Wardzynski (2023) emphasized the importance of investing sufficient resources in law enforcement and the effectiveness of legal actions in reducing the public presence in shadow economic activities. Further, governments are used to facilitate public awareness sessions to educate people about the disadvantages of participating in the shadow economy (Wibowo & Hariadi, 2025; OECD, 2017).

However, such intervention strategies can vary in effectiveness across different countries and contexts (OECD, 2017; Samaranayake & Dayaratna, 2019; Mathias & Wardzynski, 2023). Thus, the present study contributes to the literature by examining the perceived effectiveness of government intervention strategies by eliciting the public perception from a sample of Sri Lankan citizens. The following sections will elaborate on the survey elements, key findings, and a note on the contribution to unravelling the effectiveness of government intervention strategies in combating the shadow economy in Sri Lanka.

2. METHODOLOGY

A structured opinion survey was selected to collect perception-based data using a sample of the active labour force from the Colombo district and utilized simple statistical techniques for comparison across government interventions, and to assess four hypotheses based on the conceptualized effect of four government intervention strategies to combat and mitigate the shadow economy. Colombo district was selected due to its economic centrality, population density, and diversity of employment sectors, making it a representative urban center for understanding shadow economic dynamics.

A few government intervention strategies can be identified such as tax policies, enforcement measures, regulations based on literature (Wahua et al., 2023; OECD, 2017; Mara et al., 2023; Mathias &

Wardzynski, 2023) and also include 'economic incentives' which appear as a subsidiary to significant interventions in previous literature (Schneider & Buehn, 2017; OECD, 2017; Samaranayake & Dayaratna-Banda, 2019) to serve as the independent variables. Thus, this literature assists us in designing a framework (see Figure 1) incorporating these independent variables to observe their potential impact on reducing the shadow economic activities in the Colombo district.

Data collection involved administering a questionnaire to 150 respondents, including public, semi-government, and private sector employees in the Colombo district. Random sampling was employed to guarantee inclusivity and representativeness. The questionnaire covered the key demographics of the participants and their perceptions of government intervention strategies.

The data was collected over two months in 2024 and analyzed using the Statistical Package for the Social Sciences (SPSS), which enables descriptive statistics, correlation analysis, and regression analyses to generate output. Throughout the research process, ethical considerations were prioritized to uphold integrity, confidentiality, and respect for the rights of participants. This survey allows us to collect and analyze the citizens' authentic experiences and perceived efficacy of the government's role in addressing the shadow economy in Sri Lanka.

As described before, perceptions of tax policies, enforcement measures, regulations, and economic incentives are potential sources of a government's actions to combat the shadow economy. The dependent variable is the perception of 'the reduction in the size of the shadow economy in the Colombo district'. Therefore, by collaborating on the potential actions, we aim to analyze the impact of government interventions on mitigating the shadow economy. We introduced the conceptual framework below to illustrate this purpose.

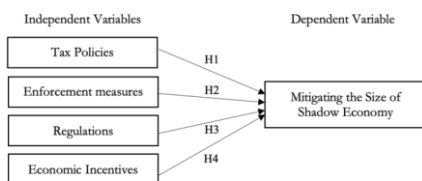


Figure 1: Conceptual Framework

The following hypotheses were developed based on the conceptual framework shown in Figure 1 and by consulting prior literature on the topic.

H1: Tax policies are mitigating the size of the shadow economy of the Colombo district.

H2: Law enforcement measures are mitigating the size of the shadow economy of the Colombo district.

H3: Regulations are mitigating the size of the shadow economy of the Colombo district.

H4: Economic incentives are mitigating the size of the shadow economy of the Colombo region.

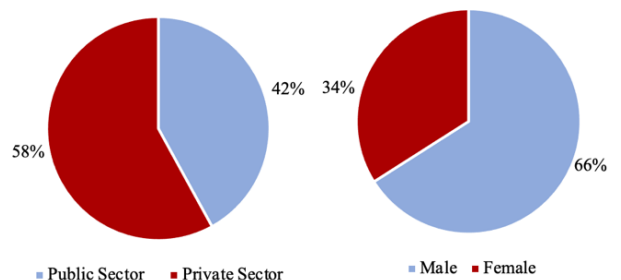
The hypothesized impact of each independent variable on the dependent variable, the perception of the reduction in the size of the shadow economy (RES).

$$RES_i = \beta_0 + \beta_1 TP_i + \beta_2 EM_i + \beta_3 REG_i + \beta_4 EI_i + \varepsilon_i \quad (1)$$

The estimates for the linear effect of the average of perceptions on Tax Policies (TP), Enforcement Measures (EM), Government Regulations (GR), and economic incentives (EI) on RES have been conducted following the hypotheses and the model. In addition, descriptive statistics of key demographics, correlation analysis, and graphical illustrations were used to improve the details of our analysis.

3. RESULTS AND DISCUSSION

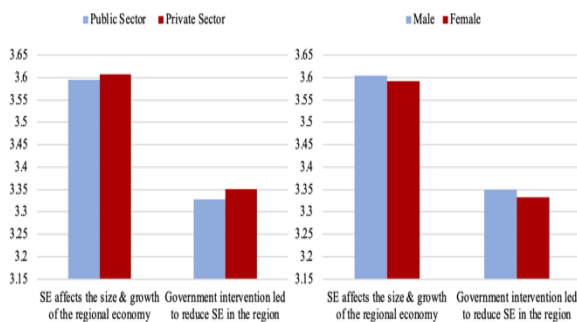
The study found that government regulations and economic incentives significantly reduce shadow economy activities in the Colombo district. In contrast, tax policies and enforcement measures were perceived as less effective.



Figures 2 & 3: Employees' working sector and gender composition

The measures in this study are based on perceptions of employees who serve in private and public organizations. The majority of the sample consisted of private sector employees, which is 58 percent. The rest of the 42 percent are from public organizations. Furthermore, the gender composition of our sample is dominated by males, as 66 percent of the respondents are males, and 34 percent are females, out of 150.

Figures 4 and 5 below compare the respondents' key demographics and their average perceptions on 'the impact of shadow economy on the regional economy' and our dependent variable, 'the impact of government intervention on the reduction in the size of shadow economy'. This highlights how the heterogeneity in the profession and gender of the respondents affects their beliefs about the shadow economy.



Figures 4 & 5: Employees' perceptions

Figure 4 illustrates how the perceptions of employees on the shadow economy vary based on their profession. The average perceptions of private and public sector employees about the shadow economy's significance in affecting the regional economy's size and growth vary around 3.6 out of the 5-point Likert scale. This means that private and public sector employees have a moral agreement based on their beliefs regarding the prevalence and significance of shadow economic activities in the Colombo District. Further, the respondents representing both sectors moderately agreed that government intervention significantly reduces the shadow economy. The average perception is not significantly different between sectors. Yet, it stays below the confidence they had when they had beliefs in the adverse effect of the shadow economy on the regional economy. The gender-based comparison also demonstrated the same

patterns as in Figure 5 and no apparent difference between the perceptions of males and females.

Table 1 presents the central tendencies of the study's main variables, including their mean values, standard deviations, minimum values, and maximum values. The dependent variable, "the impact of government intervention on the reduction in the size of the shadow economy", will be referred to as 'SE size reduction' and was evaluated by 5-point Likert scale questions.

Table 1: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
SE Size Reduction	150	1	5	3.46	.783
Tax Policies	150	1	5	3.39	.825
Enforcement measures	150	1	5	3.24	.842
Regulations	150	1	5	3.41	.881
Economic Incentives	150	1	5	3.29	.837
Valid N (listwise)	150				

The mean value of this variable is 3.46, suggesting that respondents' opinions about the size of the shadow economy are commonly more in line with the middle of the scale (3.46 is close to the 3 value), which denotes a rather neutral view. This could be a sign of the respondents' varied mindsets, with some expressing a stronger belief that the government is intervening in the decreasing activities in the shadow economy and others displaying the opposite.

Through a set of five Likert scale questions, all four independent variables also vary between 3.2 and 3.4, and the average measures of perceptions tend toward neutral opinions.

However, the large sum of squares (1921.270) and mean square (12.894) for "Between People" as in Table 2 indicate that there are substantial differences in responses between different participants. The variance within people, the sum of squares (98.284), mean square (4.095), and significant F-value (7.349, $p < .000$) indicate there is a significant variation between the different responses. The ANOVA results show significant variability between individuals and their responses, indicating that the perceptions of government intervention's effectiveness in mitigating the shadow economy vary widely.

Table 2: Analysis of Variance & Reliability

		Sum of Squares	df	Mean Square	F	Sig.
Between People		1921.270	149	12.894		
Within People	Between Items	98.284	24	4.095	7.349	.000
	Residual	1992.756	3576	.557		
Total		2091.040	3600	.581		
Cronbach's Alpha = 0.957		N of Items: 25				

The ANOVA table and reliability statistics assess the dataset's reliability. It is determined by Cronbach's alpha and the significance of value in the ANOVA table, as shown below. It should be stated that the data set is more reliable when the Cronbach alpha value is more than or equal to 0.7 and the significance value is $P < 0.05$. According to the following table, Cronbach's alpha is 0.957, higher than 0.7, and the significance value (0.000) is less than 0.05. This means that the internal consistency of data collection is much stronger, and the research instrument can be trusted and produce accurate outcomes.

To test the normality of the data set, we used the skewness and kurtosis values as shown in Table 3 below. The general criteria for accepting the normality of the data set are that the skewness value for each variable should be less than 1, and the kurtosis value should be in the range of +2 to -2. According to the table below, the skewness statistic for all variables is less than 1, and the kurtosis statistic for all variables falls within the range of +2 to -2. Consequently, our data set adheres to the normality assumption.

Table 3: Skewness and Kurtosis statistics

	N	Skewness	Kurtosis
	Statistic	Statistic	Statistic
SE Size reduction	150	-.781	1.023
Tax Policies	150	-.563	-.039
Enforcement measures	150	-.522	.218
Regulations	150	-.812	.424
Economic Incentives	150	-.317	.128
Valid N (listwise)	150		

Then, the test for linearity between the dependent and independent variables is tested as in Table 4, and the significance value of deviation from linearity for the

dependent variable and each independent variable is 0.054, 0.063, 0.125, and 0.05, respectively. All these values are more than 0.05, indicating that we have enough evidence to accept the null hypothesis, which means there is a linear relationship between the dependent and independent variables.

Table 4: Significance values of deviation from linearity

	Sig. value of deviation from linearity
SE size reduction*Tax policies	0.054
SE size reduction *Enforcement measures	0.063
SE size reduction*Regulations	0.125
SE size reduction*Economic incentives	0.05

Then, the estimated regression model and its overall significance are shown in Annexure I and Annexure II. The results show that the model is significant, $F(4,145) = 69.859$, $p < 0.001$, $R^2 = 0.658$. The R-squared value of 0.658 indicates that approximately 65.8% of the reduction in the activities of the shadow economy can be explained by the combined effects of the independent variables. Then the causal effects of each independent variable on the dependent variable, 'SE size reduction', are given in Table 5 below.

Table 5: Causal effects

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.712	.178		3.993	.000
	Tax Policies	.043	.077	.045	.555	.580
	Enforcement measures	.056	.068	.060	.822	.412
	Regulations	.350	.080	.394	4.379	.000
	Economic Incentives	.374	.066	.399	5.665	.000

a. Dependent Variable: Economy Size Reduction

Out of the four independent variables that represent different modes of government intervention, Tax policies and Enforcement measures do not have a significant impact on SE size reduction, as their respective t-values (0.555 and 0.822) are less than 2, and their corresponding p-values (0.580 and 0.412) are more than 0.05. However, Regulations and economic incentives significantly impact the size of the shadow economy because their respective t-values (4.379 and 5.665) are more significant than 2, and p-values (0.000 for both variables) are less than 0.01. Therefore,

regulations and economic incentives significantly influence the mitigation of magnitudes in the shadow economy based on the t-values and p-values in the regression model. We can write the estimated regression model based on the coefficients and their significance as follows,

$$RSE = 0.712 + 0.043TP + 0.056EM + 0.35REG + 0.374EI \quad (2)$$

(0.178)*** (0.77) (0.68) (0.80)*** (0.66)***

According to the results of the unstandardized coefficient beta values, regulations and economic incentives have a large and significant impact on reducing the size of the shadow economy through government intervention, since their beta values are 0.350 and 0.374. A complete (100%) improvement in respondents' beliefs on the effectiveness of government regulations and economic incentives will reduce the prevalence of shadow economic activities by 35% and 37%, respectively.

Further, the regression outcomes led us to observe a lack of evidence to reject the null hypothesis, which states that tax policies do not have a significant impact on the mitigation of activities in the Sri Lankan shadow economy and that enforcement measures do not have a significant effect on the mitigation of activities. We have enough evidence to reject the null hypothesis, which states that regulations do not significantly impact the mitigation of activities in the Sri Lankan shadow economy, since the t-value is 4.379, greater than 2. The p-value is 0.000, which is less than 0.05.

Table 6: Summary results of regression analysis

Hypothesis	t-values	p-values	Conclusion	Decision
H1	0.555	0.580	t-value is less than 2 and the p-value is more than 0.05	Do not reject the null hypothesis
H2	0.822	0.412	t-value is less than 2 and the p-value is more than 0.05	Do not reject the null hypothesis
H3	4.379	0.000	t-value is more than 2 and the p-value is less than 0.05	Reject the null hypothesis
H4	5.665	0.000	t-value is more than 2 and the p-value is less than 0.05	Reject the null hypothesis

4. CONCLUSION

The regression results of this study indicate that government intervention significantly influences reducing the shadow economy in the Colombo district. Specifically, respondents strongly believed that prevailing regulations and economic incentives have a substantial impact on reducing the size of shadow economic activities. At the same time, their

confidence in tax policies and enforcement measures was lower and statistically insignificant. Our findings align with those of Kelmanson et al. (2019) and Zhanabekov (2022), as they suggest that tax policies and government measures do not significantly mitigate the shadow economy. However, in contrast, the work of Torgler et al. (2012), Schneider (2012), and Samaranayake (2017) revealed that tax policies significantly impact the reduction of activities in the shadow economy.

Statistical evidence supported that the participants believe government intervention through regulation and economic incentives successfully reduces the size of the shadow economy. The influence of regulations should be carefully assessed in this case since tight regulations in economic policy, including the labour policy, eventually encourage participation in the shadow economy (Schneider, 2012; Samaranayake & Dayaratna-Banda, 2019; Wiseman, 2024). Further, the perception measures were taken from different dimensions, assessing the regulatory framework on informal and illegal economic activities. Our findings were supported by the empirical findings of Schneider (2012), Samaranayake (2017), and Kannangara & Wu (2023).

The economic incentives could have been used mainly to motivate the labour force in the formal economy. This can be achieved through transparent tax cuts, tax reliefs on individuals (Torgler et al., 2012; Schneider & Buehn, 2017; Wahua et al., 2023) and businesses and by offering satisfactory wages in the formal sector (Samaranayake, 2017; Samaranayake & Dayaratna-Banda, 2019). Thus, findings can serve as a reference point for regional policy when assessing the effectiveness of current practices and laws and adjusting their tactics to control the shadow economy in the Colombo district.

This study is limited by its reliance on quantitative data, which may not fully capture the nuanced personal or contextual insights, and the focus on urban areas limits the generalizability to rural or other regions. Specific variables used in this survey are related to government intervention that might exclude a few vital factors, such as cultural factors and technological advancements. Additionally, this study highlights the potential opportunities for further

research, such as comprehensive regional and national surveys, to observe and generalize the perceived effectiveness of government intervention in mitigating the shadow economy in Sri Lanka. Also, qualitative approaches such as interviews or focus groups to explore citizens lived experiences can deeply capture the nuance of the policy gaps existing in the context.

These findings suggest that Sri Lanka's current regulatory frameworks and incentive-based approaches are aligned with public expectations. However, the perceived ineffectiveness of tax and enforcement measures indicates a need for targeted reforms, such as simplifying tax structures and strengthening legal enforcement transparency to improve compliance and reduce shadow activities. Incorporating these insights into national development and fiscal planning could enhance the credibility and reach of existing government strategies.

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6. ANNEXURES

Annexure I: Model Fitness (a)

Model	R	R Square	Adjusted Square	R Std. Error of the Estimate	Durbin-Watson
1	.811 ^a	.658	.649	.464	2.053

a. Predictors: (Constant), Economic Incentives, Enforcement measures, Tax Policies, Regulation

b. Dependent Variable: Economy Size

Annexure I: Model Fitness (b)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	60.146	4	15.036	69.859	.000 ^b
	Residual	31.210	145	.215		
	Total	91.356	149			

a. Dependent Variable: Economy Size

b. Predictors: (Constant), Economic Incentives, Enforcement measures, Tax Policies, Regulations