



Position Paper No. 4

**FOREIGN INVESTORS'
COUNCIL IN LATVIA**
**POSITION PAPER
ON THE SHADOW
ECONOMY**

08.09.2022

Executive summary

The Foreign Investors' Council in Latvia (hereinafter - FICIL) highly appreciates Latvia's commitment to reducing the scale of the shadow economy. However, there are still areas for improvement, particularly regarding effective policy implementation to combat the shadow economy. According to the results of the Shadow Economy Index in 2021 for the Baltic countries, the shadow economy in Latvia grew by 1.1%, reaching 26.6% of the national gross domestic product. In monetary terms, the estimated total lost tax revenue from the shadow economy in Latvia exceeds EUR 2.7 billion¹. Although other shadow economy researchers have estimated lower levels of the shadow economy, Latvia's shadow economy levels are still above the 20% mark². The estimated levels of the shadow economy are notable and negatively affect fair competition and businesses that act according to the law and pay their taxes in full. Moreover, tax evasion creates a large gap in the state budget income, which in turn leads to less public funds available for financing education, social welfare, public safety etc. and a heavier burden on the honest taxpayers. The aforementioned means that it is of the utmost importance to reduce the shadow economy levels in order for the country to become more prosperous and competitive.

There is no single solution to eliminating the shadow economy, however, a way forward to practically reduce the shadow economy should start with ensuring unified governance and by setting clear and ambitious priorities for all, and every public sector institution with the aim of reducing shadow economy levels. All reforms that focus on strengthening governance should improve both transparency and accountability, which would also result in better feedback³ between the public and private sectors that is essential for closer private and public sector cooperation. A single institution should be empowered and assume accountability over reducing the shadow economy, which needs to be aligned with clear, consistent and ambitious aims and key performance indicators (hereinafter - KPI) that when fulfilled, in practice, would result in significantly lower shadow economy levels. Lastly, FICIL also emphasises the conclusion made by a study commissioned by the Ministry of Finance - that close cooperation between the public and private sector can produce significant results in preventing tax evasion and money laundering⁴. Therefore, it is essential that policy-makers, the State Revenue Service (hereinafter - SRS) and other institutions closely cooperate with the private sector while maintaining mutual trust.

1 <https://www.sseriga.edu/shadow-economy-index-baltic-countries>

2 <https://www.fm.gov.lv/lv/media/10381/download>

3 IMF Working paper, "Explaining the Shadow Economy in Europe: Size, Causes and Policy Options"

4 http://petijumi.mk.gov.lv/sites/default/files/title_file/Noziedzīgi_nodarījumi_nodokļu_jomā_PETIJUMS.pdf





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Recommendations

1. Introduce unified governance over reducing the shadow economy

- FICIL recommends introducing unified governance over combating and reducing the shadow economy, with the Ministry of Finance assuming a central role in coordinating and driving the fight against the shadow economy and taking accountability over the results.
- The Ministry of Finance should analyse the allocated resources to combat the shadow economy, evaluating the effectiveness of the current resources and enhance these resources as appropriate.
- Foremost, under the guidance and supervision of the Ministry of Finance, public sector institutions as separate entities should carry out an assessment of their own activities and identify activities or processes that can contribute to reducing the shadow economy. Public sector institutions should undertake a risk analysis and determine what role each entity plays in reducing the shadow economy.

2. Cooperate with the private sector to re-design current legislation and regulations

- All institutions that implement measures to reduce the shadow economy, like the State Revenue Service, should closely cooperate with trustworthy partners within specific and prioritised industries to assist in reviewing legislation and monitoring implemented measures, with the goal of reducing the shadow economy (starting with industries that contribute the most to the shadow economy).
- FICIL recommends reviewing and analysing the current industry specific laws/regulations that do not prevent the shadow economy sufficiently. For example, welfare system payments, child support legislations and processes should be re-worked to eliminate any contribution to increasing the shadow economy.

- FICIL recommends creating a clear, transparent, and motivational process for cases where a business wishes to correct a mistake/practice that it has identified in its past life cycle.

3. Expanding the means of proof to reduce feelings of impunity

- Policy-makers should review the current system of liability for tax evasion by involving the public and private sector to reassess the burden of proof related matters in tax evasion cases. This should be done by the public sector initiating a dialogue on this issue with the relevant stakeholders (legal practitioners, academia etc.) to seek a solution.

4. Improving the role of the State Revenue Service (SRS) in combating the shadow economy

- Improve SRS follow-up of entities that are identified as not fully paying taxes, ensuring that all companies are penalised when breaking the law.
- FICIL suggests allocating greater resources to training and recruiting staff that follow-up corporates suspected of actively participating in/contributing to the shadow economy.
- FICIL recommends the SRS publicly discloses its risk assessment criteria or measures for indirectly identifying taxpayers who are suspected of tax evasion and contributing to the shadow economy in order to facilitate self-regulation of taxpayers and reducing the resources needed from the SRS for active one-by-one tax reviews.
- FICIL recommends simplifying tax calculations of personal income tax and payment of taxes for small companies and private entrepreneurs.
- SRS should improve and work towards greater automatization of processes that it uses when informing and communicating with taxpayers.



Rationale for recommendations

Introduce unified governance over the shadow economy

Combating the shadow economy has been announced as the government's number one priority for many years and a number of framework documents have been developed to achieve this. Among these, the Plan of Reducing the Shadow Economy for 2016-2020 and 2021-2022 have been the key documents. FICIL supports what is stated in the "Shadow Economy Reduction Plan 2021/2022" (hereinafter - the Plan) - that the strategic aims of the plan must become an integrated and targeted activity of all sectoral ministries and state institutions, identifying and evaluating factors that contribute to the shadow economy in sectoral policies and the areas of responsibility of the ministries, implementing the policy measures to reduce the impact of the identified factors.

Currently, the Plan allocates the Ministry of Finance as the key institution to implement its set goals. However, it can be concluded that the main role of the Ministry of Finance in the implementation of the Plan is in the supervision of the implementation of the measures included in the Plan, by providing the responsible implementing institutions with guidance, targets and information on the progress and results. At the same time, all institutions are responsible for the implementation of measures included in the Plan within the specified period. FICIL concludes that the Ministry of Finance, which is the main actor responsible for presenting the results of reducing the shadow economy, is achieving the goals currently only at policy level, but the Ministry of Finance has not assumed a role as driver for reducing the shadow economy levels. The government should assign effective administrative tools and measures for the Ministry of Finance to drive and oversee implementation of actions to reduce the shadow economy through activities by other public sector institutions and set clear accountability for the Ministry of Finance on their actions to reduce the shadow economy. These tools and measures should empower the Ministry of Finance to directly entrust and influence, as well as supervise the activities of the respective institutions in areas aimed at reducing the shadow economy. This also includes proactively reviewing and assessing the


currently allocated resources to combat the shadow economy, if these resources are employed efficiently and effectively to achieve the best possible results. However, it is the responsibility of each public sector institution, including the municipalities, to take the initiative to reduce the shadow economy in their respective areas of competency. Moreover, under the guidance and coordination of the Ministry of Finance all public sector institutions should undertake a risk analysis and determine what role each entity plays in reducing the shadow economy. To better achieve this, FICIL suggests that foremost, under the guidance of the Ministry of Finance, public sector institutions as separate entities should carry out an assessment of their own activities and identify activities or processes that are potentially insufficient to restrict the shadow economy and take the necessary actions to improve.

Cooperate with the private sector to re-design current legislations and regulations

FICIL appreciates the goal stated in the Plan that there is a greater need for sectoral ministries to take the initiative to cooperate with organisations and tax-paying businesses in certain sectors. The public-private cooperation model has proved to be successful, for instance, when the Financial Intelligence Unit cooperated with the private sector to improve anti-money laundering. FICIL believes a similar model can also be used by the responsible institutions, especially the State Revenue Service (SRS), in cooperation with the private sector, therefore, suggesting that the responsible institutions in implementing shadow economy measures come to agreements with specific industries and closely cooperate on implementing the agreed measures and goals.

FICIL would recommend going further than the SRS currently does⁵ and look to create more effective, closer, and comprehensive cooperation agreements. FICIL believes that such public-private partnership working groups should be based on the principles of mutual trust, with the responsible institutions carefully choosing appropriate cooperation partners. The quality of cooperation

⁵ <https://www.vid.gov.lv/lv/sadarbiba-ar-nozaru-asociacijam>



should prevail over the quantity of partners and the number of persons involved. At the same time, in order to promote and ensure transparency in such public-private partnerships, it is necessary to introduce mechanisms that would ensure feedback to businesses which have provided information to the supervisory institutions in good faith and within the set framework of the planned partnership. Feedback would include, inter alia, informing entrepreneurs about the verification, preventive and punitive measures taken to respond to identified cases of the shadow economy.

In addition, as part of this partnership FICIL recommends reviewing and analysing the current industry specific laws/regulations that contribute to increasing the shadow economy. Each public sector institution within their area of competency should closely cooperate with private sector institutions in that industry to review the legislation. Such private sector expertise and practical insight is crucial to improve legislation. However, FICIL suggests going one step further and recommends that all public sector institutions review the established processes, such as the welfare payment system and child support payment processes to identify and amend any shortcomings that can both directly and indirectly contribute to the shadow economy. To significantly reduce the shadow economy, a comprehensive approach is necessary that thoroughly looks at each individual step within processes and systems, instead of applying a one size fits all approach to each sector or industry. To adopt this, it is crucial to involve the relevant stakeholders who can share their insights. Below, FICIL present two examples, one industry specific, and the other generic, where the legislation needs changing to possibly reduce the shadow economy.


Small scale construction projects provide a good example of the approach mentioned above and would apply to the whole construction sector. It is widely known that the biggest contributor to the shadow economy in Latvia has traditionally been the construction sector, which has been confirmed by the annual research done by Prof. A. Sauka and Prof. T. Putniņš in 2021, estimating that the volume of the shadow economy in the construction sector has reached 31.2%, which is an increase from the 28.7% determined in 2020⁶. FICIL, together with cooperating partners in the field of construction (both on the side of customers and builders), have indicated that one of the most problematic situations in terms of the shadow economy within the construction sector is precisely in the construction of small projects. By comparison, in the construction of

large projects, there is both a contract entered into and electronic accounting that significantly reduce the possibility of tax evasion. However, in the area of private housing and other small construction work, there is a clear preponderance of the shadow economy over honest businesses. This is facilitated both by the reluctance of businesses to pay labour taxes by paying “envelope wages”, together with the interest of their customers to minimise construction costs, for example, at the expense of value added tax. In FICIL’s opinion, the SRS and also the State Labour Inspectorate should, among other things, pay attention to small construction projects as part of their future inspections and work with private sector partners in the construction sector to improve and develop regulations to avoid a loss of tax income from small construction projects.

Another generic example of provisions enabling the shadow economy that is not industry specific, is Article 70 of the Labour Law which provides that a salary should be paid to employees in cash and that a bank transfer is possible only in case of a special written agreement. FICIL believes that this is an outdated concept that not only fails to reflect the current business reality, but also passively encourages the shadow economy. Accordingly, FICIL proposes to reverse the respective provision by stating that salaries should be paid via bank transfer by default, and cash payments are possible only in case of a special written agreement between employer and employee.

Furthermore, FICIL recommends creating a clear, transparent, and motivational process for cases when a business wants to correct a mistake/practice that it has identified in a past life cycle, for example, tax arrears from previous periods. Businesses should not feel as though they are being punished for some minor mistakes that they are willing to highlight and explain themselves, and most importantly, to fix. In some cases, a “grace” approach might be established for past actions with the aim of fostering future compliance and presumably the increased amount of taxes paid, for example, in the case of a shareholder change or a change in the management board. It is possible that genuinely mistaken interpretations of tax requirements have arisen in the non-compliance for the taxpayer. In such cases, the taxpayer should be allowed to correct the situation without being dissuaded from doing so by the penalties and technical obstacles in the Electronic Declaration (EDS) System. Policy-makers should develop a procedure on how such mistakes can be corrected if the taxpayer makes a voluntary disclosure.

⁶ <https://www.sseriga.edu/shadow-economy-index-baltic-countries>



Expanding the means of proof to reduce feelings of impunity

FICIL is still hearing the opinion among its members that “in Latvia the probability of being caught and/or punished for tax evasion or fraud is low”. FICIL has already indicated in its previous position reports that the government needs to make the public believe in the inevitability of punishment for cases involving tax violations. One of the most effective means of achieving this would be criminal liability and convictions for tax evasion, in addition to publishing the relevant case materials and providing information about the involved persons/entities. FICIL considers that the current situation of the number of initiated criminal proceedings and court rulings in comparison to the proportion of the level of “envelope wages” is disproportionately small. This is alarming and there is a clear need for immediate adjustments. In addition, the number of initiated criminal proceedings and administrative violation cases are disproportionately small compared to the number of cases that are examined within the administrative process. Also, the number of cases related to non-existent transactions or VAT carousel schemes which are disputed by the SRS are extremely low⁷.

From previous communication with law enforcement authorities, FICIL has concluded that a significant obstacle to the effective prosecution of persons for tax evasion reasons, is the difficulty in obtaining the direct evidence of the committed violation (for example, recording the moment that the payment of an “envelope salary” took place). Direct evidence is necessary to prove a person’s guilt in committing the criminal offences as set out in the Criminal Law.

Therefore, FICIL would propose reviewing the current system of liability for tax evasion by involving the public and private sector to reassess the burden of proof for related matters in tax evasion cases. Taking this into consideration, FICIL proposes the initiation of an inter-institutional discussion on introducing indirect evidence⁸ as a basis for proving a person’s guilt in tax evasion. Furthermore, various widely recognised legal and legal policy theorists and practitioners should be involved in any planned discussions and working groups in order to come to an agreement and strike a good balance between the right of every person to a fair trial and the use of unduly complex evidentiary constructions. FICIL

does not dispute that the presumption of innocence is the cornerstone of the criminal justice system. However, the use of indirect evidence to prove a person’s guilt, in general, does not violate this principle. Moreover, FICIL reiterates the importance of involving legal experts in evaluating the introduction of such measures in practice.


Improving the role of the State Revenue Service (SRS) in combating the shadow economy

Although FICIL conceptually agrees with the position that the fight against the shadow economy is aligned to the risk-based approach, devoting the most resources to sectors with the highest risk and potentially the highest possibility to increase tax payments should not automatically mean increased control of the activities of the largest companies. It is essential to take effective and strict monitoring and prevention measures not only against the largest companies in certain sectors, who are often the largest taxpayers, but also against the medium and small companies, especially if the data available to the SRS indicates a high risk of tax evasion in a specific sector with a high risk of the shadow economy. FICIL wants to emphasise that all companies that act illegally and break the law by avoiding tax payments should be targeted by the SRS. In addition, FICIL understands that the SRS has had to fulfil non-standard actions during the Covid-19 pandemic however, a crisis should not exempt companies from paying taxes and the SRS from enforcing tax collection.

As a result of activities of many smaller dishonest businesses, the total damage caused to the Latvian economy and fair competition may even be several times greater than the damage caused by a few larger companies. At the same time, it can be assumed that the resources devoted to the inspections of smaller enterprises would be significantly less than those devoted to the inspections of large enterprises. A more standardised approach to the control of smaller companies, which would contribute to the effectiveness of the respective checks and audits is also possible and should be considered. It is undeniable that the resources of the SRS are limited, and it will not be possible to check all high-risk medium and small companies on whether they avoid tax payments or whether they are paying “envelope wages”. However, conducting

7 http://petijumi.mk.gov.lv/sites/default/files/title_file/Noziedzīgi_nodarījumi_nodokļu_jomā_PETIJUMS.pdf

8 For example, significantly lower average tax payments compared to the sector of economic activity, information about the person’s abilities and professional skills, information about the person’s previously committed property crimes or administrative violations, information that the property owned by a person is not proportionate to his legal income, the person’s compliance with typologies of criminal offences, etc.



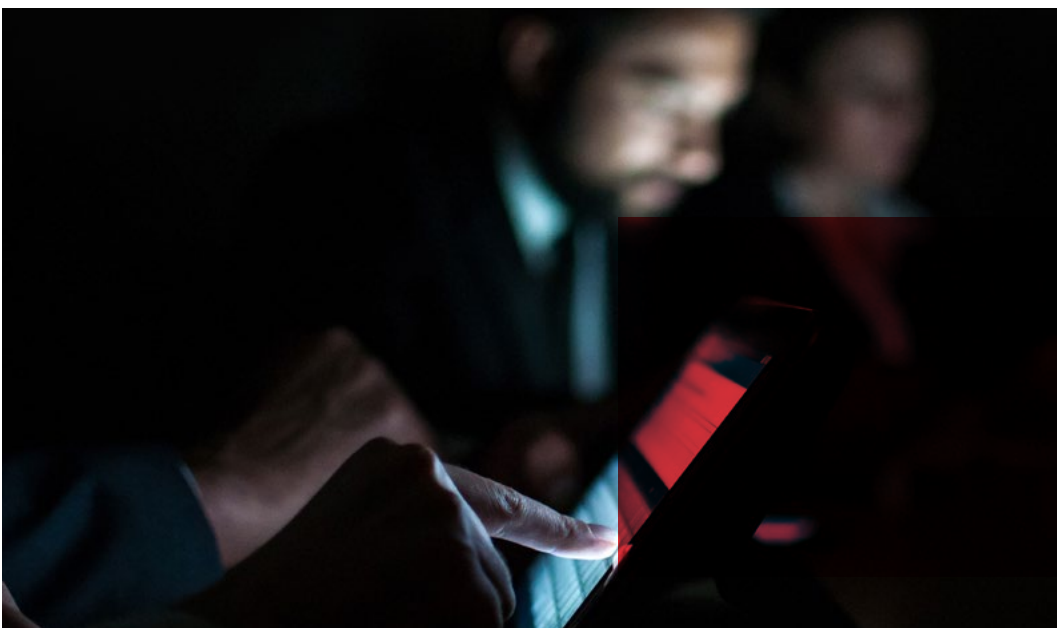
such inspections are necessary and the result of the successful activities of the SRS should be made known to the public through various information campaigns, including publishing comparable data. Such actions of the SRS will also have an indirect effect for companies that have been part of the shadow economy to, in time, start acting legally to avoid being caught and punished. Only a clearly defined and concrete results-based policy of the SRS and other institutions can destroy the public's opinion that the possibility of being punished for operating in the shadow economy is extremely low. Moreover, a chance to change the operating models of small dishonest businesses, by letting them know the high risk of being caught and severely punished, is more realistic, than changing the model that has been practiced for a long time.


Currently, the SRS is not publicly disclosing its risk assessment criteria or measures for indirectly identifying taxpayers who are suspected of tax evasion and contributing to the shadow economy. This results in the need for the SRS to employ more staff to review taxpayers and whether they are meeting such risk markers, deciding on actions to take and starting the communication with the taxpayer. For taxpayers this creates uncertainty and a lack of transparency, as well as a sense that tax authorities are not transparent and thus also need to be prevented from obtaining information (adverse motivation to cooperate caused by actions of the other party). A much more effective way oriented towards cooperation and disclosure would be that taken by some tax authorities (e.g., Germany, UK),

to publish guidelines on what are the markers and criteria that indicate the likelihood of tax avoidance or evasion, as well as thorough instructions/guidance on what is acceptable and what is unacceptable practice and interpretation of tax laws. As a result,

FICIL recommends that the SRS publicly disclose its risk assessment criteria or measures for indirectly identifying taxpayers who are suspected of tax evasion and contributing to the shadow economy. Based on those guidelines and criteria, the taxpayer markers are self-regulating and increase their reported taxable income, which means tax authorities do not have to spend their limited resources on chasing taxpayers one-by-one and can instead focus on investigating more aggressive taxpayers. Such instructions of indirect markers indicating certain economic activity levels can be organised by industry, for example, the number of tables in a restaurant which indicates towards the minimum revenue needed for continuing the business or the amount of water consumption at a hairdresser's salon, indicating the average number of clients and specific amount of revenues per client.

FICIL recommends simplifying the tax calculation of personal income tax and payment of taxes for small companies and private entrepreneurs. Easing the payment and calculation processes would make it easier to comply with tax rules and regulations which would ensure greater collection of taxes without the need for involvement of the SRS in the first place. Currently, small entrepreneurs are subject to cumbersome reporting and compliance





requirements which requires action on different deadlines for different reports. This should be simplified to make it possible for an entrepreneur to easily assess all the requirements necessary and, also deadlines should be synchronised. Tax calculations for small entrepreneurs (particularly if they are below the VAT registration threshold) should be simplified offering some automated solutions.

To increase the effectiveness of the SRS, there is a need to introduce and adopt clear and measurable KPIs for success in combating the shadow economy. Transparent and comparable data for each year should be made public on the SRS's progress against these KPIs. Also, there is a need to start gathering data in a smart way, increase effectiveness of the use of the SRS system (for income declaration etc.) and improve analysis of data and follow-up after a wrongdoing has been identified.

“Smart” KPIs need to be set for improvements in the achievements of the SRS over a number of years which would allow comparison of the development of work in the SRS structures and the entire SRS. It is important for KPIs that reduce the shadow economy to be both ambitious and practically aligned with measures that will be employed to reduce the shadow economy.

FICIL believes that the Ministry of Finance needs to set 4 main areas where the work of the SRS should be measured, and further development achieved:

- Transparency (publishing the key data, key outcome from court cases, rulings issued etc.);
- Increased analysis of data (including external data from tax consultants, other tax authorities, banks) in the targeted work as regards non-compliant taxpayers;
- Increase voluntary compliance;
- Effectiveness of collecting and punishing when taking actions against taxpayers that conduct fraud and tax evasion.

Steps of data analysis should become more elaborated and embedded into the processes of the SRS. The use of artificial intelligence tools on non-compliance patterns and their elimination, comparison, and analysis of various information sources, as well as e-audits need to be developed. In general, the work of the SRS should be aimed at ensuring that compliant taxpayers are being consulted, whilst fraudulent taxpayers have their activities identified and proper tax collection enabled quickly and effectively, whilst continuing to publicise their efforts to contribute to the deterrence factor.





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