



FOREIGN INVESTORS' COUNCIL IN LATVIA

POSITION PAPER
on
COMBATTING THE
SHADOW ECONOMY

Position Paper No. 5



30.10.2025



EXECUTIVE SUMMARY

The shadow economy remains one of Latvia's most persistent challenges, accounting for 21.4% of the state's GDP in 2024, with undeclared or "envelope" wages making up half of the total. Beyond the fiscal losses, widespread non-compliance undermines fair competition, reduces trust in public institutions, and weakens Latvia's investment climate. Tackling these issues requires clear legislation, transparent enforcement, and long-term commitment to change.

FICIL therefore stresses that combating the shadow economy must remain a top priority for Latvia's government. In the current context of rising budgetary pressures and increasing demands on public services, reducing the shadow economy is not only about revenue – it is about building trust, fairness, and resilience in the economy. FICIL therefore outlines three priority recommendations to combat the shadow economy.

The priority is to strengthen taxpayer trust by improving tax compliance through clearer legislation and consistent, transparent guidance.

This recommendation has two focus areas:

1. **Simplifying legislation** – ensuring clarity, removing unnecessary requirements, and rewriting structurally outdated laws;
2. **Strengthening the State Revenue Service (SRS) communication** – ensuring consistency, transparency, and proactive publication of interpretations.

The second recommendation focuses on tackling tax non-compliance, avoidance, and evasion through a dual strategy of **real-time data analysis** and **expanded evidence standards**, designed to reduce the sense of invisibility and impunity that enables tax evasion.

The third recommendation focuses on the comprehensive implementation of the Shadow Economy Reduction Plan for 2024–2027, the necessity to ensure its annual effectiveness evaluation and transparent progress tracking, while carrying out communication and education campaigns regarding the societal impact of the shadow economy and the link between tax compliance, the quality of public services, national development and defence.

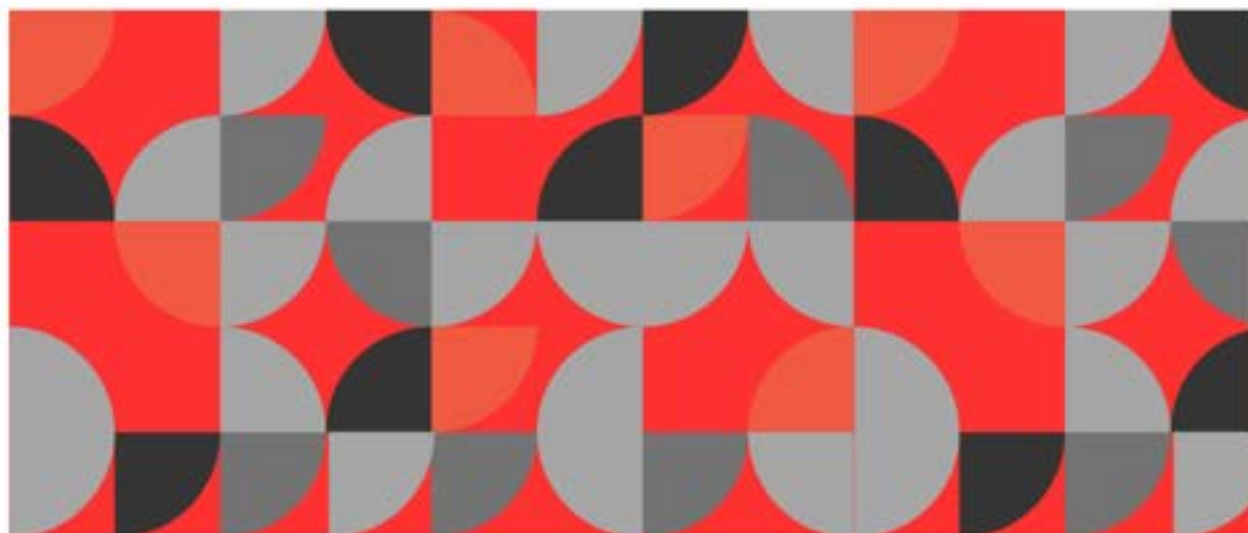


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RECOMMENDATIONS

- Improving Tax Compliance through Legislative Clarity and Transparent Guidance:** Simplify and modernise complex tax laws, strengthen consistency in SRS communication, and ensure transparent, accessible guidance to reduce misinterpretation, enhance fairness, and build taxpayer trust
- Strengthen Coordination in Implementing the Shadow Economy Plan:** Ensure full implementation of the Plan, with a priority on horizontal measures, supported by independent evaluation, transparent progress reporting, and sustained public awareness campaigns to secure lasting compliance and trust
- Reducing the Sense of Invisibility and Impunity Among Tax Evaders:** Deploy AI-driven real-time monitoring and expand the use of indirect evidence to improve detection, deliver timely taxpayer feedback, and ensure that violations face meaningful and consistent consequences





RATIONALE FOR RECOMMENDATIONS

I Improving Tax Compliance through Legislative Clarity and Transparent Guidance

Latvia's shadow economy, despite a slight reduction, remains high, accounting for **21.4% of GDP in 2024**, with envelope wages forming the single most significant component at **50% of the total**. According to the Shadow Economy Index for the Baltic Countries, there is a strong negative correlation between involvement in the shadow economy and satisfaction with the tax system and the government. This means that **low trust in state institutions, the complexity of regulation, and the perceived unfairness of tax administration** are associated with higher participation in the shadow economy¹.

Complex and ambiguous laws make compliance difficult, creating an uneven playing field. Larger firms with access to professional advice manage the system, while smaller businesses and individuals often opt out entirely. This reinforces the shadow economy, where many justify non-compliance by pointing to the sheer complexity of the rules. International experience shows that clearer, more accessible legislation and transparent guidance can help reduce participation in the shadow economy.

Focus areas of the recommendation:

- **Simplifying legislation** – ensuring clarity, removing unnecessary requirements, and rewriting structurally outdated laws;
- **Strengthening SRS communication** – ensuring consistency, transparency, and proactive publication of interpretations.

I Simplify and Rewrite Complex Legislation

The Personal Income Tax Law is a notable example, as it affects the most significant number of taxpayers yet contains circular references and structural inconsistencies. A complete rewrite, similar to the 2012 VAT Law reform, would improve clarity, reduce misinterpretation, and ease the administrative burden on both taxpayers and the SRS. Going forward, all new tax laws and amendments should be tested against a "simplicity filter" to ensure they are the clearest and least burdensome way to achieve their goals.

FICIL recommends that the Ministry of Finance systematically review tax laws with three objectives:

- **When implementing tax changes, focus also on finding the most straightforward and least administratively burdensome means** for both taxpayers and tax authorities;
- **Rewriting overly complex legacy legislation** that has evolved over decades into structures difficult for even experts to interpret;
- **Establish a formal commitment to tax policy stability, whereby no new tax increases are introduced until the shadow economy is reduced to a defined threshold** (e.g. 10% of GDP).

I Strengthen SRS Communication and Transparent Guidance

FICIL acknowledges that in recent years the SRS has become more proactive in guiding taxpayers, including through its website, methodological materials, and responses to frequently asked questions.

¹ "SSE Riga "Shadow Economy Index for the Baltic Countries 2009–2024"



Building on this progress, FICIL has in the past recommended that the SRS publish audit risk criteria to motivate self-regulation (2024) and emphasised that transparency and predictable rules are critical to reducing the shadow economy and attracting investment (2023). Similar transparency is now needed for all interpretative guidance to further strengthen trust in the tax authorities and government.

FICIL therefore recommends that the SRS continues to enhance its role as a proactive consultant, not only an enforcer, by:

- **Ensuring internal consistency** in advice and interpretation across departments, including between methodology units, consultation units and tax auditors. The SRS must eliminate silos by creating unified interpretation protocols, supported by a shared database and regular alignment meetings;
- **Publish all interpretations provided to taxpayers** – whether private rulings or email consultations – in a searchable, anonymised format. This would ensure equal access to guidance, prevent the creation of a two-tier system, and reduce the administrative burden of repeatedly answering the same questions;
- **Modernise Guidelines with Enhanced Search and Historical Transparency:** While the SRS has improved its guidance, further modernisation is crucial. This includes implementing an AI-powered semantic search, topic clustering to help taxpayers find all relevant guidance in one location, and a complete historical archive that shows all previous interpretations (currently, once guidelines are updated, there is no access to historic versions on the home page to see the changes in the interpretations);

I Reducing the Sense of Invisibility and Impunity Among Tax Evaders

Latvia's shadow economy remains high, at 21.4% of GDP in 2024, with envelope wages accounting for 50% of the total. The Shadow Economy Index reveals that smaller firms are disproportionately involved, with size being strongly linked to participation. Although the SRS holds extensive data and risk indicators, its reliance on periodic assessments (quarterly or annual) and focus on high-value cases leaves many smaller taxpayers invisible, thereby reinforcing tax evasion as a norm.

FICIL recommends that the SRS introduce AI-powered real-time pattern recognition to detect anomalies and promptly notify taxpayers, while also expanding the use of indirect evidence in tax evasion cases. This dual approach would address invisibility, where taxpayers believe their activities go unnoticed, and impunity, where violations face weak consequences due to restrictive evidence standards or low penalties.

Focus Areas of the Recommendation:

- **Real-time data pattern analysis** – ensuring immediate detection of anomalies and prompt taxpayer notification;
- **Expanding the use and acceptance of indirect evidence** – strengthening enforcement and reducing impunity in tax evasion cases.

I Real-Time Pattern Analysis and Immediate Taxpayer Notification

Latvia's current tax risk assessment system relies on predetermined indicators, which are processed periodically rather than continuously. Although the SRS has accumulated extensive tax risk data, these static parameters fail to identify emerging evasion patterns in real-time.



Notifications about income discrepancies have shown results by raising awareness that the authorities monitor bank activities; however, such alerts should be regular and real-time, rather than occasional campaigns.

In addition, risk evaluation remains manual and overly focused on large underpaid amounts, leaving many smaller taxpayers effectively invisible despite signs of non-compliance.

The recent studies show that 7% of entrepreneurs believe the likelihood of being caught for tax evasion is zero. In comparison 15% believe less than 10%². Similar findings appear in *Sauka and Putniņš' Shadow Economy Index for the Baltic Countries 2009–2024*.

FICIL recommends that the SRS use AI and machine learning for continuous monitoring and real-time communication on taxpayer discrepancies by:

- **Implementing systems that detect anomalous patterns across both structured and unstructured data**, following international best practices. For example, Australia's AI models have identified over \$530 million in unpaid taxes and prevented \$2.5 billion in fraudulent claims. OECD data shows that 72% of tax administrations already use AI, with 74.4% applying it specifically to detect tax evasion and fraud;

- **Notifying taxpayers immediately when irregularities are observed, requesting explanations for atypical transactions or operational changes.** This mirrors practices in leading OECD countries, where real-time communication reduces invisibility by showing active monitoring and enabling voluntary corrections before penalties accumulate. While 85.2% of tax authorities have big data capabilities, only about half currently use analytics for real-time fraud detection, highlighting the opportunity for Latvia to align with the most advanced administrations.

I Expanding Acceptance of Indirect Evidence

Although taxpayers are legally responsible for providing correct tax calculations, enforcement authorities face very high evidentiary standards. In practice, the SRS must "catch taxpayers by the hand" to assess underpaid taxes, while courts often accept explanations for inconsistencies without requiring more substantial proof. Penalties are also too weak, typically limited to identified amounts without being extrapolated to the likely scale of evasion. Addressing these limitations requires a combined approach: **real-time monitoring to create visibility and change behaviour, together with expanded evidence standards to ensure that detected violations face meaningful consequences.** This dual strategy would eliminate the sense of impunity that fuels widespread evasion and, over time, help shift social norms towards greater tax compliance through visible and consistent enforcement.

² Journal Nr 31.07.2025 article "Does the government has strength to combat shadow econmy?" (Vai valstij pietiek spēka apkarot šnu ekonomiku?)



FICIL recommends expanding the use of indirect evidence in tax assessments by:

- **Broaden legal provisions for indirect evidence** – Expand existing rules and introduce new ones to allow wider use of indirect evidence. Tax authority staff must have strong business knowledge to distinguish between regular and suspicious activity. Benchmarking principles for under-declared salaries are a step forward, but multiple indicators should be combined for credible cases;
- **Accept statistical improbabilities with reverse burden of proof** – Use algorithmically detected anomalies as preliminary evidence, requiring taxpayers to provide explanations. This reduces the excessive evidentiary burden on the SRS and strengthens accountability;
- **Implement lifestyle and wealth analysis** – Enhance monitoring through annual wealth declarations and reporting on changes in residency. The UK's HMRC Connect system provides a model that cross-references financial, property, and digital data to uncover undeclared income;
- **Apply network analysis to detect evasion schemes** – Adopt tools like Australia's ANGIE system to map taxpayer relationships and reveal coordinated avoidance patterns;
- **Raise penalties for repeated non-compliance** – Increase consequences for persistent violations so that detection risk and penalties outweigh the benefits of shadow activity.

I Strengthen Coordination in Implementing the Shadow Economy Plan

FICIL reaffirms its strong and unanimous support for the comprehensive implementation of the Shadow Economy Reduction Plan for 2024–2027. While the Plan represents a significant step forward, improvements are needed to ensure its full effectiveness, transparency, and impact.

FICIL therefore calls for prioritising horizontal measures, such as indirect tax calculations, cash flow transparency, and promoting the payment of FICIL, therefore calls for prioritising horizontal measures, such as indirect tax calculations, cash flow transparency, and promoting the payment of salaries primarily in non-cash form; conducting annual effectiveness evaluations with independent oversight; ensuring transparent public progress reporting; and launching long-term awareness campaigns to shift societal attitudes toward tax compliance.

Focus areas of the recommendation:

- **Ensuring full implementation with emphasis on horizontal measures** – applying indirect tax calculations and cash flow transparency tools, as well as promoting payment of salaries primarily in non-cash form across the economy to strengthen monitoring, competition, and compliance;
- **Launching strategic public awareness campaigns** – communicating the societal impact of the shadow economy and building long-term support for compliance.

| Ensuring full implementation with emphasis on horizontal measures

The Shadow Economy Reduction Plan represents a significant agreement between the government and social partners; however, its impact depends on its complete and consistent implementation. Particular emphasis must be placed on horizontal measures such as indirect tax calculations, cash flow transparency, and the promotion of salary payments primarily in non-cash form. Although this might encounter resistance, it provides systemic oversight across the economy. Unlike sector-specific tools, these instruments strengthen monitoring of cash circulation, enhance competition, and improve compliance.

To safeguard effectiveness, FICIL supports the Ministry of Finance's initiative to conduct annual evaluations, with horizontal measures kept at the centre of the assessment.

Independent scrutiny by the State Audit Office is also crucial, and its recommendations should be integrated into the evaluation process. Given the sharp increase in national defence financing, comparable oversight mechanisms should also be applied to defence-related expenditures to ensure efficient use of public funds and to prevent risks of misuse.

Transparency is equally critical: regular public reporting on implemented measures and their impact is essential to ensure accountability, strengthen trust, and secure broad support for the Plan.

FICIL recommends that the government ensure full implementation, independent evaluation and transparent progress tracking of the Shadow Economy Reduction Plan by:

- **Implementing the Plan in full and within agreed timeframes**, ensuring consistent execution across all ministries and agencies;
- **Prioritising horizontal measures** such as indirect tax calculations, cash flow transparency and promotion of payment of salaries primarily in non-cash form;

- **Integrate independent evaluation into the implementation cycle**, conducting annual assessments focused on horizontal instruments and incorporating recommendations from the State Audit Office;

- **Ensure transparent public reporting**, with regular publication of progress updates and measurable impact indicators to reinforce accountability and public trust;

- **Introduce enhanced oversight mechanisms for defence-related expenditures** to ensure transparent, efficient, and accountable use of public resources.

I Launching strategic public awareness campaigns

Reducing the shadow economy requires not only more vigorous enforcement but also a shift in public attitudes. Currently, reforms such as increased transparency in cash transactions face scepticism, underscoring the need for sustained communication. Public information campaigns must highlight the societal costs of the shadow economy, explain the link between tax compliance and the quality of public services, and show why eliminating illicit practices is vital for national development and security.



One-off campaigns are not enough. Communication must be sustained, strategic, and tailored to different social groups to build a broad understanding and support. Over time, this will help reduce resistance to reforms and foster a culture of compliance.

FICIL recommends that the government promote strategic public awareness by:

- **Communicate the societal impact of the shadow economy**, highlighting the costs for fairness, competition, and state capacity;
- Explain the link between tax compliance and the quality of public services, demonstrating tangible benefits for citizens and businesses;
- Underscore the strategic importance of eliminating illicit practices for national development and defence, particularly in the current geopolitical context;
- Design and deliver long-term communication campaigns tailored to diverse social groups, ensuring sustained awareness and lasting behavioural change.





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