FOREIGN INVESTORS' COUNCIL IN LATVIA

POSITION PAPER on COMBATTING THE SHADOW ECONOMY

Position Paper No. 5

FICIL

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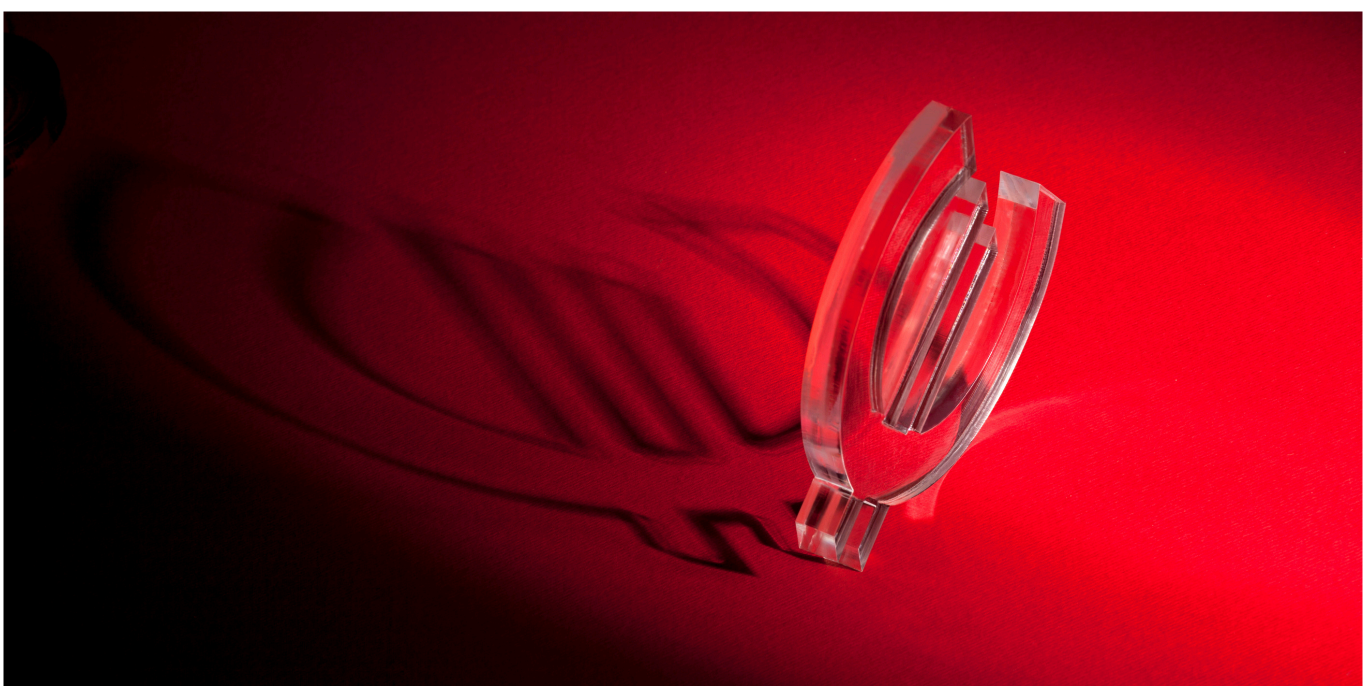
EXECUTIVE SUMMARY

The shadow economy in Latvia remains a significant challenge, with estimates suggesting that uncollected taxes from this sector could amount to between 2 and 3.6 billion euros.[1] Despite efforts being made,[2] shadow economy levels have risen since 2016, with its first slight decrease last year.[3] The recently approved "Shadow Economy Reduction Plan for 2024-2027" marks a bolder and more comprehensive approach, setting a concrete aim. However, the success of this plan hinges on effective implementation, strong cross-sectoral cooperation, and the involvement of key stakeholders.

While this year FICIL notes the positive and regular communication with the General Director of the State Revenue Service (SRS), and personnel at the Ministry of Finance (MoF), we continue to emphasise the importance of empowering the MoF with the necessary tools and mandate to oversee and drive forward the plan's implementation. This includes ensuring that each sectoral ministry takes responsibility for reducing the shadow economy within their areas of influence and that public sector institutions actively participate in these efforts.

In order to combat the shadow economy more effectively, it is crucial to reduce the feeling of impunity for tax violations, by strengthening enforcement, ensuring efficient cooperation of the authorities, re-evaluating the effectiveness of penalties, and expanding the means of evidence. The recent introduction of a taxpayer rating system is a positive step, but FICIL recommends refining it to motivate compliance, and account for the diversity of taxpayer behaviours. Additionally, improving the analytical capabilities and communication strategies of the State Revenue Service (SRS), through advanced data analytics and greater transparency, would improve the identification of compliance risks and encourage voluntary conformity. These combined efforts should not only reduce the shadow economy levels, but foster fair competition.

1 "Shadow Economy Reduction Plan for years 2024 – 2027" (link)
2 Two plans. One for years 2016-2020, and the other – for 2021-2022. "Action Plan of State Institutions for Limiting the Shadow Economy for 2016-2020" (link). Informative Report "On the Implementation of Measures of the Shadow Economy Limitation Plan for 2021/2022"' (link)
3 SSE Riga "Shadow Economy Index for the Baltic Countries" (link)



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- Reduce the feeling of impunity by ensuring efficient cooperation of the authorities, re-evaluating the effectiveness of penalties for violations, giving more powers to the SRS and beginning discussions on expanding the means of evidence.

- Ensure that the SRS publishes their "risk markers" to increase taxpayers' self-compliance.

- Implement a transparent, simple, and fair tax system with clearly communicated reforms that extend beyond budgetary goals. Ensuring predictability and continuity across successive governments is crucial for long-term business planning and sustainable economic development.

- Enhance the SRS's analytical capabilities and communication strategy, and improve the quality of its services to encourage and motivate taxpayers.

- Ensure a more appropriate segmentation of the SRS rating system to better reflect the current situation.

RATIONALE FOR RECOMMENDATIONS

Ensure effective implementation of the "Shadow Economy Reduction Plan for 2024 – 2027", while granting the appropriate mandate and tools to the Ministry of Finance to ensure the plan is implemented, in order to achieve results. Strengthen the cross-sectoral (horizontal) cooperation among state institutions – key stakeholders in reducing the shadow economy level.

In early 2024, the government approved the "Shadow Economy Reduction Plan for 2024 – 2027"[4] (the Plan). Compared to the previous plans, the document is more comprehensive and includes overarching horizontal tasks. Although not necessarily ambitious, for the first time the new Plan sets a concrete KPI of the shadow economy level to be reduced by 1% of the GDP by 2027.

The MoF has assumed the role of coordinating the Plan's implementation by creating and chairing a specific management and coordination work group (for curbing the shadow economy), that meets regularly to share progress and to attempt to deal with any bottlenecks. FICIL has been invited to at least two of the management and coordination working group meetings, but it is yet to be seen how closely stakeholders will be involved. To increase the accountability and transparency, and to enable the private sector to follow the progress of the plan, **FICIL suggests inviting key stakeholders to all the management and coordination working group meetings.**

There are also plans to oversee the progress at meetings at the highest political level (prime minister level), although it remains to be seen in what format and how often this will occur. Combatting the shadow economy may not be a top priority for the government, as it is mentioned only once out of 40 tasks in the Government's Action Plan.[5]

Although the MoF is technically responsible for the Plan, it has not specifically been assigned as the responsible institution for achieving all the goals. Instead, the Order of the Cabinet of Ministers[6] sets out that each sectoral ministry is responsible for the implementation and monitoring of tasks in their respective sectors. **FICIL continues to advocate for the government to assign the MoF effective administrative tools, measures, and a clear mandate to drive forward and oversee the implementation of actions to limit the shadow economy.** This includes empowering the MoF to directly influence and supervise the activities of relevant institutions and ensuring resources are efficiently allocated to achieve the best results.

Each public sector institution, including municipalities, must take the initiative to reduce the shadow economy in their areas of control. Under MoF guidance, institutions should conduct risk analyses to determine which areas are crucial to act upon. **FICIL suggests that public sector entities assess their activities to identify and improve processes that are inefficient in restricting the shadow economy.**

A suitable methodology should be developed to effectively monitor the Plan. The effectiveness of the actions taken should be evaluated at least once a year, starting from the Plan's implementation. Given the long-term nature of the Plan, it is important to quickly apply any lessons learned to ensure that future activities aimed at reducing the shadow economy are well-planned. The results of these evaluations should be made public.

Reduce the feeling of impunity by ensuring efficient cooperation of the authorities, re-evaluating the effectiveness of penalties for violations, giving more powers to the SRS and beginning discussions on expanding the means of evidence.

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4 "Shadow Economy Limitation Plan for 2024–2027"
5 "On the Government Action Plan for the Implementation of the Declaration on the Intended Activities of the Cabinet of Ministers Led by Evika Siliņa" (link)
6 "On the Development of the Shadow Economy Limitation Plan for 2023–2025" (link)

There continues to be a widespread opinion in the business environment, that it is profitable to be dishonest. This includes companies that constantly commit violations in certain areas (for example, exceeding the maximum permissible weight in cargo transportation), because the chance of being caught is minimal or even non-existent. **FICIL believes there is insufficient monitoring and control of compliance in various areas of activity, and even when violations are detected by the responsible authorities, the penalties, when imposed, are often so symbolic that it is more profitable to continue non-compliance.** Therefore, it is necessary to re-evaluate the effectiveness of penalties for violations and ensure such penalties, which, by reason of their nature and extent, should prevent future non-conformities, as well as the inevitability of such penalties.

FICIL welcomes the latest SRS activities and public communication in respect of informing taxpayers (both legal and natural persons) about potential tax non-compliance[7] thereby reducing the feeling of invisibility in society.

SRS admits that, although it witnesses many violations, the existing control mechanisms cannot completely prevent tax evasion. Therefore, FICIL conceptually supports the need to adopt amendments to the Law "On Taxes and Duties" on the possibility of issuing “tax control invoices” by SRS on the basis of numerical calculations, thus both limiting and preventing tax evasion in the future.

Improvements in cooperation and information exchange between the SRS and other authorities, such as the State Environmental Service (SES), are still necessary. For instance, some building material manufacturers continue to misuse permits for polluting activities, by applying for categories that do not match their actual activities, allowing them to bypass stricter environmental regulations. The SES often only checks whether the category applied for is formally correct, instead of using company financial data to determine if more stringent requirements should apply. Additionally, there are cases where companies operate without the required permits for polluting activities. Despite previous recommendations, the situation remains unchanged.

FICIL believes it is crucial for the government to instil public confidence in the inevitability of punishment for tax violations. Also, the OECD reiterates that strengthening enforcement should play a key role in reducing shadow economy levels.[8] An effective approach would be to effectively enforce criminal liability and convictions for tax evasion, while working with the non-taxpayers to instil a feeling that they are being monitored, thereby reducing the feeling of invisibility and impunity.

A greater probability of being caught when not paying taxes, and more serious consequences, should reduce the number of people involved in the shadow economy activities.[9] Currently, the number of initiated criminal proceedings and court rulings is disproportionately small, compared to the prevalence of “envelope wages”. With estimates that envelope wages contributed to more than 45% of total shadow economy levels,[10] in the first 8 months of last year, only 29 criminal proceedings for “envelope wages” were initiated.[11] This is an alarming discrepancy and indicates an urgent need for adjustments. The number of criminal proceedings and administrative violation cases is also disproportionately low compared to the number of administrative process cases. Additionally, cases related to non-existent transactions or VAT carousel schemes disputed by the SRS are extremely rare.[12]

Discussions with law enforcement authorities have revealed that a major obstacle to effective prosecution for tax evasion is the difficulty in obtaining direct evidence (e.g., recording the moment an “envelope salary” is paid). Direct evidence (e.g.,

7 Examples include, recent news that SRS will approach construction companies that pay atypically low wages (link) or that SRS have identified approx. 70,000 residents that have significant income discrepancies and will send out notifications to them starting from September" (link)
8 OECD Economic Survey: Latvia 2024, p. 54.
9 SSE Riga “Shadow Economy Index for the Baltic Countries 2009-2023” (link)
10 ibid
11 "Results of SRS activities in reducing 'envelope' wages and monitoring sanctions at the EU's external border" (link)
12 "Research Report 'Criminal Offenses in the Field of Taxes and the Legalization of Criminally Acquired Funds. Boundaries, Typologies, and Case Law'" (link)

recording the moment an "envelope salary" is paid). Direct evidence is required to prove guilt under the Criminal Law.

To address this, **FICIL proposes reviewing the current liability system for tax evasion**. This should involve both the public and private sectors reassessing the burden of proof in tax evasion cases. **FICIL suggests initiating an inter-institutional discussion on using indirect evidence[13] to prove guilt in tax evasion cases**. Legal experts and policy theorists should be involved in these discussions to balance the right to a fair trial with the need for effective evidence. FICIL acknowledges that the presumption of innocence is a cornerstone of the criminal justice system. However, using indirect evidence to prove guilt does not violate this principle. Legal experts should evaluate the practical implementation of such measures.

Ensure that SRS publishes their "risk markers" to increase taxpayers' self-compliance.

FICIL would like to reiterate its message from previous position papers (2023) regarding the need for the SRS (State Revenue Service) to enhance transparency and consistency. This can be achieved by providing detailed guidelines and instructions to taxpayers on tax law interpretation, as well as outlining general and industry-specific practices, financial indicators, and other factors that suggest tax non-compliance.[14] The tax authority's secrecy and unwillingness to provide extensive and clear guidelines on taxpayer behaviours that are against the tax law and interpretations, have multiple negative consequences. The secrecy increases the sense of uncertainty among taxpayers and the number of requests for interpretation and confirmation from SRS, thereby increasing the resources needed to answer each question. It also increases the perception of SRS as a repressive institution whose purpose is to catch and punish taxpayers, and charge penalties and late payment fees, rather than proactively warn and inform on tax application and interpretation, as well as tax risk criteria. It also prevents self-regulation of taxpayers, and thus the need for tax authorities to devote resources to notifying each taxpayer individually on potential breaches and non-compliance.

Transparency and proactive publishing of the newest interpretations, approaches, and guidelines from tax authorities, as demonstrated by countries such as Germany, UK, France, and the Netherlands, increase taxpayer trust, as well as clarity on the application of tax regulations for both SRS consultants and taxpayers. Thus, it helps to reduce uncertainties, promotes compliance, and ensures that taxpayers have the necessary information to meet their tax obligations.

We believe it is reasonable to expect that this initiative should also have a positive effect on tax revenues, as more taxpayers would self-regulate and reduce their shadow economy presence to ensure that they are not approached and audited by SRS. However, this would be most effective by strengthening the data analytics capacity of SRS to utilise multiple factor risk indicators, to identify the highest shadow economy operators and target them proactively and purposefully.

Implement a transparent, simple, and fair tax system with clearly communicated reforms that extend beyond budgetary goals. Ensuring predictability and continuity across successive governments is crucial for long-term business planning and sustainable economic development.

Latvia's tax system is generally more complex than those of its neighbours.[15] It is well-established that complex and burdensome tax and regulatory systems contribute to the growth of the shadow economy.[16] To combat this, the tax policy should be more balanced and straightforward, with the

13 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.
14 FICIL (2023) "Position Paper on Level Playing Field" (link), page 8
15 According to 2022 report on Tax complexity, Latvia ranks 16th, while Estonia 2nd and Lithuania 6th (link)
16 Alban Aslani and Friedrich Schneider (2024) "A review of the driving forces of the informal economy and policy measures for mitigation: an analysis of six EU countries"

legislative process being timely and transparent. By improving tax administration, reducing regulatory burdens, and enhancing transparency, the incentives for "shadow" activities driven by "exit" factors can be diminished.[17] Additionally, promoting human capital and improving labour market operations would address the informality caused by "exclusion" factors.

FICIL believes that the existing high levels of the shadow economy, combined with low public trust in the government,[18] are critical factors to consider before reforming the overall tax system or implementing significant changes in any specific tax. The pandemic-induced recessions in many OECD countries have led to significant government deficits and rising. public debt-to-GDP ratios, which are likely to create medium-term pressures to raise tax rates. This, along with higher inflation rates and rising energy costs, has worsened household incomes and increased incentives to participate in the shadow economy.[19] The extent of the shadow economy will significantly impact the success of any tax reform.[20]

FICIL emphasises the need for a transparent, simple, and fair tax system that supports sustainable economic development. Tax reform must be predictable and its aim clear, that should stem beyond just budgetary considerations, ensuring that the successive governments uphold the implemented changes, thereby allowing businesses to plan for the long term, without fear of sudden changes. Taxes should be considered within a broader context, taking into account their impact on competitiveness, reducing inequality, and supporting regional development process, and to avoid situations where amendments have to be revised after their adoption.

Enhance the SRS's analytical capabilities and communication strategy. Improve the quality of SRS services to encourage and motivate taxpayers.

SRS plays a crucial role in ensuring tax compliance, fostering a fair economic environment and reducing the shadow economy. **FICIL believes by enhancing its analytical capacity and communication strategy, the SRS can significantly improve its service quality and motivate compliance among taxpayers**. Therefore, we outline the following key suggestions:

Investing in advanced analytics tools

Latvian tax authorities are part of a number of agreements regarding disclosure and information exchange, nevertheless we have not observed that this information might have been used in enquiries or targeted control measures. The enquiries and decisions are based on single source data without review of all the information available to the government institutions. The SRS should implement state-of-the-art data analytics tools to process and analyse large volumes of tax data from several sources. This would enable the SRS to identify compliance risks earlier, and more accurately and efficiently.

Measure the results of data analysis

Develop metrics to assess the impact of data analytics on tax compliance and revenue collection. This could include tracking the reduction in tax evasion, the increase in fraud cases detected at the early stages, and the overall improvement in tax revenue.

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17 Ibid
18 In 2023, 29% of Latvians reported high or moderately high trust in the national government, well below the OECD average of 39%. Latvians place more trust in other people (60%), the police (52%) and courts and the judicial system (48%) than in the national government (29%). OECD Survey on Drivers of Trust in Public Institutions 2024 Results – Country Notes: Latvia
19 Friedrich Schneider (2024) "Revised version: Development of the Shadow Economy of 36 OECD Countries up to 2024: Due to a Modest Recovery of most OECD Countries a Slight Decrease", page 6
20 Sena Kimm Gnangnon (2023) "Effect of the Shadow Economy on Tax Reform in Developing Countries" (link)

Continue developing the communication tools and channels

The presentations of the SRS explaining various matters increased over 2022 and 2023. Nevertheless, they tend to be on the formal side. The questions received by the helpline, as well as questions received during the presentations and anonymised rulings should be published with regularity, in a number of weeks rather than months.

Ensure a more appropriate segmentation of the SRS rating system to better reflect the current situation

At the beginning of this year, a rating system was introduced to assess specific taxpayers. FICIL welcomes this initiative, where each corporate taxpayer receives a rating based on their behaviour, with explanations provided both in general and more specifically to each taxpayer's assessment criteria. However, **FICIL believes the system lacks sufficient categories to effectively motivate any gradual improvements in compliance behaviour.** Currently, almost half of taxpayers are assigned a B rating.[21] We recommend introducing at least three subcategories (e.g., B1-3, B Top-Low or BA-C) to differentiate companies based on their behaviour more effectively.

It was anticipated that compliant businesses (rated A) would use this system as a tool to encourage their partners to improve their ratings. We suggest that the SRS assesses whether this effect can be observed through data analysis by early 2025.

The current system that rates individual companies doesn't account for less typical, yet common business scenarios, such as company groups and the sharing of specific functions within these groups. This limitation may arise from the SRS's systems, which mainly focus on individual taxpayers. To increase acceptance of the rating system, it is essential that the SRS shares both positive feedback and areas for improvement that they have identified or received. **While some benefits for companies with an A rating were introduced in 2024, the system needs a wider range of incentives to motivate taxpayers to change their behaviour.**

21 Based on data up to 1st of April, B rating is assigned to 44% of all corporate taxpayers (link)

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