

# Foreign investors' viewpoint on the Shadow Economy in Latvia

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FOREIGN INVESTORS  
COUNCIL IN LATVIA

in cooperation with



SSE RIGA

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# Foreword

The Foreign Investors' Council in Latvia (FICIL) represents thirty of the largest companies from various countries and sectors that have made significant investments in Latvia as well as international chambers of commerce and the Stockholm School of Economics in Riga. Our corporate member companies represent approximately 30% of all foreign direct investment in the share capital of companies in Latvia and contribute approximately 15% of total budget revenues.

The overall size of the shadow economy in Latvia, the presence of unethical and/or illegal behaviour, problems relating to the rule of law and good governance were mentioned among the top concerns for foreign investors in the recent FICIL Sentiment Index. We can see that investments in Latvia are currently held back due to the shadow economy, the persisting doubts over the overall business environment and the fears of distorted competition: not only is this true for the existing investors but also for new potential businesses that evaluate the investment climate. This is one of the reasons why this year FICIL wanted to look deeper into the issue of the shadow economy in Latvia and views of the existing foreign investors regarding its causes, efficiency of the actions taken so far and suggestions for decreasing it.

Shadow economy, sometimes also called the parallel or the illegal economy, is a widespread phenomenon in many countries. It has many definitions and characteristics since it is constantly developing and adjusting to the changes that Governments make in their efforts to decrease its levels and negative effects on the economy and the society. Shadow economy is not only about not paying taxes or not reporting income. We must look further than that. Violating transportation regulations and legislation on extra working hours or bypassing the rules of construction process and certification of construction materials will also contribute to it. Not only are these activities illegal and reduce state revenues; they also harm companies that work legally by reducing their competitiveness and damage the image of the country thus reducing its attractiveness for foreign investors.

We can observe that shadow economy tends to be lower in countries with transparent and clear legislation, well established rule of law and functioning court systems, strong and efficient government institutions and responsible society.

As the suggestions for decreasing the shadow economy presented in this survey show, the solution is a set of activities encompassing all Government authorities and ranging from a predictable tax system, education of society to incentives and simplification of the system and legislation governing the business environment. There are many opportunities that are already there and just need to be fully deployed: for example, making the various electronic databases in different institutions compatible and producing and putting to good use the aggregated information, moving towards wider use of electronic payment systems in a country where the IT sphere is highly developed.

On behalf of FICIL, I hope that this report and suggestions thereof will contribute to a better climate for investment in Latvia and will help achieve a sustainable and long term economic growth.



**Girts Greiskalns**  
Executive Director  
Foreign Investors'  
Council in Latvia

# Introduction



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The aim of this report is to introduce policy makers and the wider public with the views of foreign investors on the fight against the shadow economy, and suggestions for the improvement of the combating activities. This report is based on in-depth interviews with the members of the Foreign Investors' Council in Latvia (FICIL), which helped define the overall view on the initiatives and success towards combating the shadow economy in Latvia. In addition, it is based on the analysis of the information provided by Firms.lv concerning private companies in Latvia, which helped analyse the contribution of foreign owned companies to the Latvian economy.

We acknowledge that the process of determining the size of the shadow economy is ambiguous and requires a more thorough analysis of the overall economy, while in this report we decided to focus on the opinion of foreign investors and their suggestions on ways to decrease the extent of the shadow economy in Latvia. For the purpose of defining the size of the shadow economy, we use calculations from prior research and define the shadow economy as:

*«Activities that are productive and legal but are deliberately concealed from public authorities to avoid payment of taxes or compliance with regulations».<sup>1</sup>*

The following report provides summary opinions of foreign investors along with their suggestions for policy initiatives towards combating the shadow economy.

We hope this report will help you better understand the concerns foreign investors have, as well as emphasizing the urgency for introduction of effective measures for combating the shadow economy.

<sup>1</sup> Measuring the Non-Observed Economy – a Handbook (OECD-IMF-ILO-CIS Stat, 2002).

# Executive summary

Companies with foreign capital operating in Latvia generate almost half of revenues and pay slightly more than half of all taxes in the economy. The shadow economy has been named by foreign investors as one of the key obstacles for continuing successful operations in the country, as it distorts fair competition. More than that, it was named as one of the reasons preventing further investments in Latvia by companies with foreign capital that already operate in the market.

In-depth interviews with foreign investors performed in spring 2016 demonstrate that the most problematic aspects of shadow economy for the latter are **envelope salaries**, issues with **public procurement**, general **corruption** and **unrecorded revenues**.

Foreign investors suggest that the shadow economy in Latvia persists primarily due to **insufficient controls and enforcement** in combination with **low expected penalties when caught**. Secondly, foreign investors consider that tax payments are avoided as **paying taxes does not provide visible benefits** to those who comply with the law, and finally they observe an overall **culture of tax avoidance** in the country.

Talking about activities implemented by governmental authorities to date in order to fight the shadow economy, foreign investors see potential for improvement. They note a positive effect from the electronic declaration system, implementation of reverse VAT charge in a number of industries prone to be in the shadows, as well as the zero declaration and the very idea of introducing micro-company taxation. At the same time foreign investors note that not all initiatives introduced reached their goals like micro taxation, or are stuck like the so-called “white list” initiative.

Finally, and most importantly, the foreign investors provided practical suggestions on fighting the shadow economy in the short and longer term. The primary recommendation is to **agree on general tax policy** among all involved governmental bodies and **stay consistent** to see the effects of the system work. Secondly, foreign investors call for **stronger enforcement and increased punishment**, noting it should be directed at the companies in the black list, paying taxes at a below average level compared to the industry peers. Next, foreign investors emphasize the need for **creating tangible benefits of paying taxes** including introduction of tender qualifying criteria in the procurement law. To continue, foreign investors recommend to **continue the transfer to electronic exchange of documents**, emphasizing the need for connection between the systems of various government agencies and regulators (e-health, e-education, e-customs etc). Finally, it has been proposed to **decrease the tax burden and simplify payment of taxes for small business** in order to motivate them to come out of the shadows. To reach a long term effect it is recommended to focus on **educating youth** from an early age and **changing the image of the State Revenue Service** by means of well thought out **PR campaigns** paying taxes and **employee training**.

An integrated implementation of all named activities would definitely make a positive long term effect ensuring fair competition among industry players, more taxes collected by the government and tax collections used for the benefit of tax payers.

# About this report

The methodology for this report was prepared by Arnis Sauka (Stockholm School of Economics in Riga) in cooperation with FICIL members and KPMG.

The report has been compiled by KPMG (Julijs Masane-Ose and Armands Ikaunieks).

Information for the report was collected through in-depth interviews with foreign investors, which included FICIL members and other foreign capital companies from the "White list" of companies (the State Revenue Service list of in-depth cooperation partners).

Foreign investors were interviewed during the period February to April 2016 by FICIL board members and transcribed by FICIL employees Anita Mengote and Marta Jaksone, as well as the representatives of Stockholm School of Economics in Riga.

In order to investigate the significance of foreign capital companies in Latvia in relation to local capital companies, we start the report with an analysis of the impact that foreign capital companies have on the Latvian economy. Information on the companies was kindly provided by Juris Rožkalns from Firms.lv.

The report continues with an overview of recent studies on the topic of shadow economy, outlining key findings and development over years, as well as provides a brief comparison across the countries.

Following the structure of interview questionnaire, the report consists of three main parts:

## **A. Determinants and causes of the shadow economy in Latvia: investors' viewpoint**

In this section, foreign investors were asked questions that aimed to establish their general view on the topic and the main causes for the shadow economy in Latvia.

## **B. Evaluation of previous and current activities to decrease the shadow economy in Latvia**

In this section, foreign investors evaluated the effectiveness of the measures taken to date to combat the shadow economy, and assessed the benefits of these measures. In particular, foreign investors evaluated the effectiveness of the so-called "White list" initiative.

## **C. Suggestions for reducing the shadow economy in Latvia**

The third section of the report focuses on the foreign investors' suggestions on how to reduce the shadow economy in Latvia.

Interviewees were asked two types of questions where they were able to either evaluate a statement on a scale from 1 to 7 or were asked to provide specific examples and comments. The values on the slider for each question represent the average value, which has been assigned by the foreign investors to the corresponding question.

Throughout the report we provide direct quotes by the foreign investors in an anonymized fashion.

# Foreign capital companies in Latvia

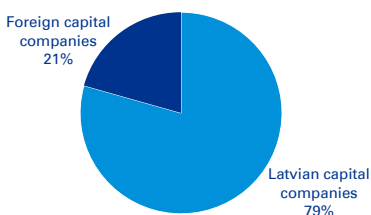
Based on data from annual reports submitted in 2014 companies with revenue above EUR 145 thousand generate 98% of all reported revenues in the economy while representing 18% of all companies that had submitted annual reports for 2014 (22 thousand out of 122 thousand companies).

We divide the companies into groups based on ownership, where foreign capital companies are those that have an investment by a foreign entity of at least 51%.

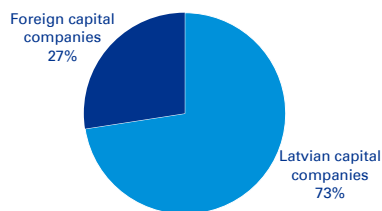
Companies have been selected based on direct and second-level ownership (companies that are owned by a local company which is owned by a foreign entity).

A little more than one fifth (21%) of the selected companies are owned by a foreign entity. The 21% of the foreign owned companies at the same time account for 27% of employees, 46% of total revenue, 51% of taxes and 37% of mandatory social insurance contributions.

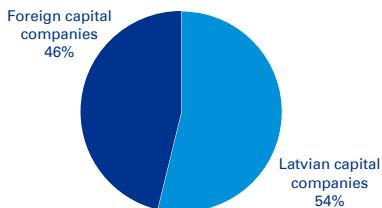
**Number of companies (2014)**



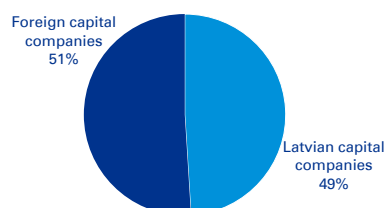
**Number of employees (2014)**



**Total revenue (2014)**



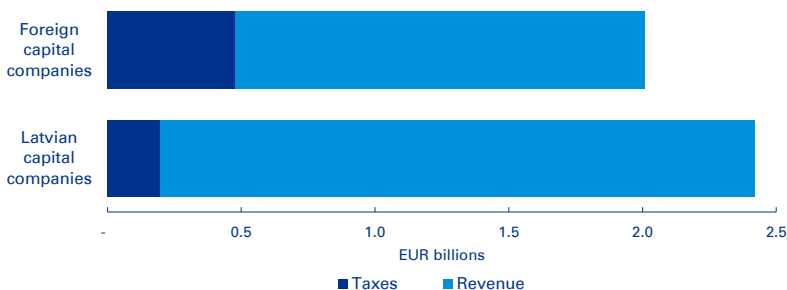
**Total taxes (2014)**



Further in the report, we overview the current and previous initiatives in combating the shadow economy in Latvia. One of such activities is the "White list", a list compiled and maintained by the State Revenue Service for an in-depth cooperation program. Based on the information provided by FICIL, the

latest list includes 55 companies (31 foreign and 24 local). It becomes obvious from the comparison of these companies that foreign capital companies on this list pay in total taxes 2.4 times the amount the local companies do and account for almost 10% of the total taxes in the economy.

**Companies on the "White list"**



Note: Taxes include mandatory social insurance contributions.

# Shadow economy at a glance

Informal activities, such as tax evasion and the underground economy, have a long-term impact on the development of economies and have increasingly received attention from policymakers and scholars in a number of fields. Despite on-going attempts, however, the literature is yet to arrive at a consensus on what the best or most reliable methods are of measuring the shadow economy. This, in turn, has hampered research efforts aimed at understanding the shadow economies: their size, their determinants, their relation to the stages of economic development, and their responsiveness to various policy measures.

The size of the shadow economy in Latvia has been analyzed by several studies, including Feige and Urban (2008) who estimate the size of the shadow economy using a modified electric consumption approach (MEC) and currency deposit ratio approach (CDM). They estimated that the size of the shadow economy in Latvia in the closest available year (2009) was 36.6% of GDP. The European Commission's Special Eurobarometer (No. 284, "Undeclared work in the European Union") uses a survey-based method involving approximately 1,000 face to face interviews in 27 EU member states during 2007. According to Eurobarometer (2007), 17% of individuals in Latvia admit to receiving envelope wages.

There are, two more recent studies that estimate the size of the shadow economy in Latvia and the other two Baltic countries. Using an indirect 'multiple indicator multiple cause' (MIMIC) method (see OECD, 2002; and Buehn and Schneider, 2013 for a review of the methods used to measure the size of shadow economy), Schneider (2016) estimates the shadow economy in Latvia to be 24.7% of GDP in 2014 and 23.6% of GDP in 2015.

These numbers closely correspond to those reported by Putniņš and Sauka (2016) who use a direct method (interviews with company managers; see Putniņš and Sauka, 2015). Putniņš and Sauka (2015) estimate the shadow economy in Latvia to be 23.5% of GDP in 2014 and 21.3% in 2015. Both studies (Schneider, 2016; and Putniņš and Sauka, 2016) find that the shadow economy in Latvia is relatively large, yet decreasing in 2015 as compared to 2014.

One of the benefits of the method applied by Putniņš and Sauka (2015) is that not only is it able to estimate the size but also the determinants of the shadow economy. Putniņš and Sauka (2016) show that the contraction of the shadow economy in Latvia in 2015, as compared to 2014, has been driven by the decrease in two main components: underreporting of business income and underreporting of envelope wages. Even though envelope wages are still a major problem and account for a considerable fraction of the shadow economy, especially in certain sectors, the majority of the shadow economy (approximately 45%) in Latvia takes the form of underreported business income. The highest level of shadow economy, according to Putniņš and Sauka (2016), is observed in the construction sector.

Putniņš and Sauka (2016) also report that small companies tend to operate 'in the shadow' more often than large companies do; however, the differences across the company size categories are not significant and some large companies contribute considerably to the shadow economy. When it comes to attitudes, companies in Latvia appear relatively satisfied with the State Revenue Service and relatively dissatisfied with the government's tax policy and support to entrepreneurs.



# Shadow economy at a glance

According to Putniņš and Sauka (2016), dissatisfaction with the government's tax policy and support increased in 2015. This, in turn, most likely has a negative impact on the size of the shadow economy in the country as firms that are dissatisfied with the tax system or the government might be expected to engage in shadow activities to a greater extent; while satisfied firms would do it to a lesser extent. Furthermore, the level of tax evasion and deliberate misreporting among companies in Latvia is proportionate to the perceived probability of getting caught and to the expected penalties for being caught.

Finally, one more recent survey on the shadow economy in Latvia was conducted by Žukauskas (2015). This study draws on surveys of representative populations in Lithuania, Latvia, Estonia, Poland, Sweden and Belarus, aiming to elicit public perceptions as well as involvement in certain shadow economy activities. Similar to Putniņš and Sauka (2015), Žukauskas (2015) also reports higher dissatisfaction and greater involvement in the shadow economy in Latvia, as compared to Estonia and Lithuania. Inhabitants of Latvia, as a result of being less satisfied with the quality (or quantity) of services provided by the government, see 'little reason' for paying taxes.

Latvian inhabitants are also less satisfied with the amount of labour taxes and thus choose to receive a bigger part of the salary 'in an envelope' (undeclared). According to Žukauskas (2015), as many as 58% of Latvian inhabitants agree that it is justifiable to work under a contract yet receive a part of the salary in an envelope. In Lithuania and Estonia the corresponding numbers are 43% and 34%. Also, receiving all of one's salary in an envelope is more accepted in Latvia (by 42% respondents) compared to Lithuania (24%) and Estonia (23%).

The relatively high estimates of the size of the shadow economy in Latvia across a number of studies highlight the need for continued reforms and actions that aim to combat the shadow economy in Latvia. It follows from the results of the study carried out by Putniņš and Sauka (2016) that the current significant gap in the size of the shadow economy between Latvia and the neighbouring countries (after the gap was nearly closed in 2012) partly reflects a reduction in the Latvian policy efforts to combat shadow activity. Their findings suggest that reforms need to be focused on underreported business income, and also specifically on the construction sector, which contributes substantially to the shadow economy.

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Part A.

Determinants and  
causes of the shadow  
economy: investor's  
viewpoint

# 1. Determinants of the shadow economy: investor's viewpoint

## 1.1. Extent to which the shadow economy is a problem for companies in Latvia

The majority of the foreign investors interviewed indicate that the shadow economy creates unfair competition (a destructive impact on competitiveness of the companies that pay all taxes), and there is a significant market distortion in industries where the proportion of the shadow economy is high.

Foreign investors perceive that there is a clear motivation for companies working in the local market to engage in the shadow economy to increase their competitiveness. According to some foreign investors, this type of competitiveness to some extent stems from the perception that the local workforce has of the economy, the tax system and social security. 'Envelope salaries' are a double-edged sword, as businesses would not be able to evade social security taxes without consent from the employees.

Based on the definition of the shadow economy provided earlier, the employee related contribution to the shadow economy ('envelope salaries' and unreported employment) is estimated at 54.5%<sup>2</sup> of the shadow economy in Latvia.

Foreign investors note that it is common in Latvia to tolerate the shadow economy, as the general perception of the population is that by paying taxes they get nothing in return.

<sup>2</sup> Sauka A., Putniņš T. SHADOW ECONOMY INDEX for the Baltic countries 2009-2014. (May 2015).

## 1.1. To what extent is the shadow economy a problem for companies in Latvia?



«Companies operating in the shadow economy have an advantage. If your company is not [operating in the shadow economy], you find it difficult to be competitive.»

- Energy company

«We have seen some improvement, but the progress has stopped. It is a problem that envelope salaries are generally accepted as a practice.»

- Manufacturing company

«Recruitment of staff is another area where we face a problem – we pay all the taxes and therefore become uncompetitive in the local market. Especially, it is a problem with young people who do not care about paying taxes or their pensions in the future.»

- Service company

«Very hard to understand [the shadow economy] coming from abroad. The regulatory platform is similar to other EU member states. Unfortunately, the reality is very different. It contradicts often with what you have been promised. Often the issues you bump into relate directly to the shadow economy – it is a cash economy in big part.»

- Finance and banking company

«The shadow economy creates unfair competitiveness between those who pay taxes and those who do not, which has a snowballing effect – not enough money is collected from taxes, therefore taxes are raised and it again affects the companies that actually pay the taxes thus worsening competition even more. For some time it pushes the tax-paying companies to become more effective but at some point the burden becomes too heavy.»

- Wholesale and retail company

## 1.2. To what extent is the shadow economy a problem for foreign investors in Latvia?



«For us it is a particular problem in the retail sector with envelope salaries and smuggling, and rigged construction tenders, creating an unequal playground.»

### - Manufacturing company

«For us it is more linked to our cooperation partners. We have criteria for cooperation partners – sometimes the choice with whom to work is not very big at the end and often we end up not paying the smallest price because of that. We are very strict on that issue.»

### - Wholesale and retail company

«It makes it [hard] for foreigners to invest; locals are more used to this issue, which has roots in the local culture.»

### - Real estate company

«High taxes on salary make low paid workers in labour intensive industries vulnerable. Law abiding companies become uncompetitive.»

### - Energy company

«Very often we just do not compete [in projects] if the proportion of the shadow economy is too big. We pay all taxes, so even if our price is competitive, the turnover is small. The difference in price might even be 20%, because the smaller companies that work in construction pay 50% of their taxes, but we pay 100%. So we compete with quality, guarantee, timing of implementation of the project, etc.»

### - Asset management company

«[Extent of] the shadow economy undermines reputation of Latvia on the international business arena.»

### - Professional assurance and advisory services company

# 1. Determinants of the shadow economy: investor's viewpoint

## 1.2. Extent to which the shadow economy is a problem for foreign investors in Latvia

Although not all foreign investors indicate that the shadow economy causes direct problems for their businesses, the majority of the respondents have indicated that their business is at least indirectly affected by the shadow economy by: a poorer choice of cooperation partners, lower State budget due to low income from taxes, perception of the overall business environment.

The main concern for foreign investors is the distorted competitive market landscape due to the shadow economy. They note that the companies engaging in the shadow economy are more competitive at the cost of evaded taxes.

Companies in regulated markets, such as banking, see a lower impact of the shadow economy, while production companies note that they have to deal with the shadow economy on a daily basis.

Some foreign investors note that the existence of the shadow economy negatively impacts the level of foreign direct investment in Latvia, as well as prevents foreign investors from making decisions on further expansion and impacts their long-term prospects for staying in Latvia.

# 1. Determinants of the shadow economy: investor's viewpoint

## 1.3. Extent to which the size of the shadow economy is an obstacle for further inflow of foreign capital in Latvia

It is the overall sentiment of foreign investors that the shadow economy is a considerable problem that hinders the inflow of additional capital in Latvia.

The majority of foreign investors indicate that they lacked information about the extent of the shadow economy. Had they known it the consequence would have been a lowered foreign direct investment inflow in Latvia.

Additionally, foreign investors indicate that communication from the State has been insufficient for them to make fully informed decisions about investing in Latvia, which forces them to hold back from investing.

In addition, foreign investors note that while the level of the shadow economy in the country is an important factor, it should be viewed in relation to other factors such as how predictable and stable the tax policy system is, how transparent the legislation is, etc. They conclude that the more predictable the business environment, the safer is the investment climate.

1.3. To what extent is the size of the shadow economy an obstacle for further inflow of foreign capital in Latvia?



«Because of the shadow economy in Latvia, previously we decided not to pursue an investment in Latvia totalling 77 million EUR.»

- **Manufacturing company**

«Outside/new investors do not have full information, knowledge or understanding of the existence of the shadow economy. If they knew, the consequence would be lowered FDI inflow.»

- **Energy company**

«It is important for an investor to see future for improvements. Otherwise investments can easily go to Estonia or Lithuania instead.»

- **Manufacturing company**

«[Our] factory needs a huge investment to get it up to the standards of our own company. But honestly, we question how predictable the environment in Latvia is. The decision on further investment is on the table and unfortunately I am not very sure what the decision will be.»

- **Manufacturing company**

«We have a strong position in the market, so for us it is not an obstacle. However, if this was a new market, we would rethink whether to invest in it or not. This question is on our mother company's agenda all the time – how big the shadow economy is, what is the state doing to reduce it, etc. There is a lack of clear information from the State Revenue Service and the Ministry of Finance that would help understand the extent of the shadow economy and the tendencies, so it is very difficult for us to make forecasts.»

- **Wholesale and retail company**

«For making serious business decisions/ investments the extent of the shadow economy in the country plays a major role. It is important to calculate return on investments in the long run and it is impossible if state authorities are changing the 'rules of the game' every year.»

- **Manufacturing company**

## 1.4. Would you agree that for companies in Latvia it is justifiable to cheat on tax if one has the chance?



«[...] there are industries, where one cannot compete in the market, if you pay [all] taxes.»

- Finance and banking company

«If you have to compete against companies that do not pay taxes, you should consider your ability to work in the particular country.»

- Pharmaceutical company

«We need confidence and trust that taxes are spent in the right way. [Currently] people do not have that trust.»

- Real estate company

«It is the scale of Latvia that often is a problem – the market is small, it is difficult to make business, so in a way I understand that especially in the very first phases it is difficult to pay all the taxes and survive. If the system was more simple and friendly (especially for small companies and start-ups), more would pay taxes.»

- Technology and communications company

«It is common here for companies to think: if you know how to cheat and have an opportunity to do it – then why not. It is because of the incapacity of the state to protect itself, it is because of a total lack of trust that the tax paid will be used reasonably. It is also like a protest: the general understanding why one should pay tax is very low, close to zero.»

- Finance and banking company

«I think it is the heritage and the way people think in Latvia. I remember when the road tax was increased Latvian news portals were full of comments and suggestions on how to avoid paying it.

For some people it is a way of saving money – many people in Latvia still live in very poor conditions. Interestingly, if you earn 1000 in Latvia you pay more tax than in Finland, whereas if you earn 5000 - you pay less. »

- Energy company

# 1. Determinants of the shadow economy: investor's viewpoint

## 1.4. Justification to cheat on taxes

The grading assigned by the foreign investors includes two main views on the problem – one group of foreign investors agrees that it is very complicated (nearly impossible) for new companies to comply with all taxes and sustain their operations and another group does not find any justification for tax evasion, regardless of the company's position in its lifecycle.

Foreign investors admit that there are industries where cheating on taxes is a common industry practice, which without the help of the highest regulatory authorities is not possible. Companies that engage in such industries and are willing to pay all taxes instantly become less competitive and are faced with a choice of either closing the business or engaging in the shadow economy. A typical example for such an industry is construction.

In addition, foreign investors observe that tax evasion is related to the general perception of the population that the taxes paid would not be used reasonably, i.e. they do not see the connection between taxes and services.

Foreign investors also note that the system for tax collection is very complex. According to them, if this system was more simple and friendly (especially for small companies and start-ups), more would pay taxes.

# 2. Main causes of the shadow economy in Latvia

In response to the request to indicate the main causes of the shadow economy in Latvia, foreign investors named five primary areas of importance. These areas are arranged according to their importance as indicated by foreign investors.

## 2.1. Weak controls and enforcement

One of the most frequently mentioned causes of the shadow economy in Latvia is the ineffective enforcement of controls against the shadow economy. Based on the view of the foreign investors, the weak enforcement is a consequence of several reasons. Most notable of which are: weak punishment of criminals that get caught, which creates a feeling of impunity for the criminals and degrades the image of the system in the eyes of honest people, and motivation (financial and moral) and competence of employees of the regulatory authorities.

According to the foreign investors, current level of control does not contribute to healthy functioning of the economy.

### 2.1. Main causes of the shadow economy:

«You have to start with law enforcement to achieve something. You can blame the culture, but this is above all.»

- Finance and banking company

«Weak sanctions against those who do not pay taxes or participate in schemes. For example, in the Gan Bei affair, the tolerance towards their activities is not understandable. You get caught in criminal activities and no punishment follows.»

- Finance and banking company

«Local tax office as such has not changed the perception that it is not a punitive body, but a cooperative body for wealth distribution for the sake of society. In the model of Estonia, more has been taken from Scandinavia and this perception has been changed. Here in Latvia, the State Revenue Service has a quite negative perception. They are not teaching how to pay taxes, but taking from you your last shirt.»

- Real estate company

«[...]the major problem is that authorities are not willing or not competent to catch the "big fish", but concentrate on small business as they don't have resources to defend themselves.»

- Energy company

«Nobody is sitting in jail for cheating on taxes, if so, others would reflect about what they are doing, even prominent examples are just "under investigation" without any negative effect on those individuals, they are still getting more influence on political decisions.»

- Transport, logistics and freight company

«Absurd attitude from the controlling institutions.»

- Wholesale and retail company

«Impotence of the State Revenue Service and financial police, viewed as corrupt, is a big part of the problem. At the moment correction of mistakes happens primarily through repressive channels.»

- Finance and banking company

«Steep and sudden excise tax increases, weak EU external border control (inflow of cheap duty products from third countries), insufficient capacity of law enforcement bodies, inadequate remuneration and motivation system for SRS employees, policies creating barriers to legitimate trade of the excise goods.»

- Manufacturers' association

## 2.2. Main causes of the shadow economy:

«Lack of willingness from the government to take action.»

- **Manufacturing company**

«Misuse of tax revenue by the government.»

- **Energy company**

«Ministries and public institutions have an attitude of “I am the boss” instead of serving the people.»

- **Service company**

«There is too much political influence in the main business sectors of Latvia and limited trust in the financial authorities/government. Weak border control and involvement of high officials in various illegal schemes are also a major reason. Such sectors are – port business, transit, construction, energy, trading in excise goods, cars, etc. On a lower level – taxi services, public services, food markets, etc.»

- **Manufacturing company**

«Underground lobbying: The lack of a lobbying law makes it possible for certain industries or even individuals to exercise a direct influence on laws.»

- **Transport, logistics and freight company**

«Small country - friends and business interests are protected.»

- **Manufacturing company**

«[...]a constantly changing coalition, no commitment to long term plans, no one fully responsible.»

- **Finance and banking company**

«There is no consistency from the government about the tax policy, lack of clarity and lack of predictability.»

- **Finance and banking company**

«Certain industries are so corrupted that you cannot work in that sphere if you want to be honest. The government and the SRS have to look for other ways to fight the shadow economy.»

- **Finance and banking company**

«Lack of stability in the tax system – you are never sure what will happen in a year’s time. There is no predictability.»

- **Wholesale and retail company**

## 2.2. Corruption and political games

As another cause of the shadow economy, foreign investors indicate the inability of the government to take necessary actions towards tackling the problem of the shadow economy, which raises the question about the integrity of the government in the context of corruption, cronyism and political games for private benefit.

Foreign investors perceive the government and other authorities as unwilling to change the current situation, where they are able to use state funds according to their discretion, exercise authoritative control and lobby private business interests.

Several of the foreign investors indicate their concern about the close ties of the political elite with the private business in Latvia, both in terms of pure lack of a lobby law, as well as involvement of officials in illegal activities.

On top of the inactivity of the government, foreign investors indicate inconsistency of the executive work due to changing political allies and the lack of a long term vision.



### 2.3. No visible benefits/stimuli to pay taxes

As a concluding major cause of the shadow economy, foreign investors indicate the lack of stimuli and visible benefits for people to pay taxes. As it has been put by a foreign investor, people feel that they do not receive adequate return for taxes they pay. In that sense, benefits for those who are paying all taxes are the same as for those that do not – everyone has to wait in the same line to doctors, receive the same welfare support, etc.

Since there are no visible benefits for paying all taxes on the individual level that would be an incentive to become legal (healthcare, education, social security, pensions, etc.), people rather support the shadow economy. Foreign investors believe it is due to the lack of trust in the government, which lacks predictability, long term planning and sense of responsibility.

### 2.3. Main causes of the shadow economy:

«People need to see the benefits of paying taxes. For example, better roads and health care. If they cannot see benefits from government expenditure, there is less of an incentive to pay taxes.»

- **Technology and IT company**

«People do not see the reason for paying tax – they do not feel they receive something back. People do not see they gain a lot from authorities (schools, welfare, police etc.).»

- **Manufacturing company**

«[.]somehow taxation feeds the grey economy too. People do not feel they get anything in return for their tax payments, therefore it feels that the outcome is the same whether you pay taxes or not.»

- **Energy company**

«Trust is a very serious issue. When I sometimes raise the importance of paying taxes, as a contra argument I get a question - Do you believe in the pension system in 20 years from now? Myself as a Finn, I do, but most Latvians, I am afraid, do not.»

- **Energy company**

«People do not pay tax because they do not believe the money is spent well (education, health etc.). Cause – constantly changing coalition, no commitment to a long-term plan, no one fully responsible.»

- **Finance and banking company**

«Employees are happy with envelope salaries because they also do not believe in the future, their pensions, availability of health care etc.»

- **Wholesale and retail company**

«If there were benefits to be in the system (i.e., pay the taxes, be employed etc.), people would do it. But if the benefit is the same either you work or not, of course people will chose not to work. The system needs to have stimuli to make people act in the way you want them. The system has to be designed to make people be honest.»

- **Pharmaceutical company**

## 2.4. Main causes of the shadow economy:

«Large income disparity gives incentive to people to do something about it, it increases interest to bypass laws in order to get more income.»

### - Pharmaceutical company

«Relatively high tax burden as compared to the income level/price level for goods and services sold in Latvia.»

### - Professional assurance and advisory services company

«Tax policy, tax burden. If the burden was decreased, for example, the labour tax, it would make it easier for people to legalise their activities.»

### - Wholesale and retail company

«Overall, the salary level of people in general and people with authority in government is still too low. It is tempting for many people to gain something extra for themselves.»

### - Manufacturing company

«Construction business (where the grey part of the business is 50%), a great concern that it is impossible to compete with other companies unless you enter the shadow economy yourself because everyone else does so.»

### - Real estate company

«Inadequacy, unfairness with salary taxes. Too high salary tax.»

### - Manufacturing company

«Current legislation does not really allow new companies to survive being 100% legal – they are forced to avoid some tax simply to survive. There could be some flexibility in the system for that.»

### - Wholesale and retail company

«Tax rates, especially for SMEs are too big. Micro-tax was a very good initiative. Unfortunately, there were no anti-avoidance rules and controlling, and this idea was heavily abused.»

### - Wholesale and retail company

## 2.4. High income tax and social disparity

Foreign investors indicate that the current income disparity in Latvia works as an incentive for people to engage in the shadow economy.

The deducted proportion of taxes, compared to the price level of goods and services, is too high, which further deepens the social disparity. What is important, foreign investors indicate that the overall salary level of officials is too low, which causes them to get involved in illegal activities.

Additionally, foreign investors indicate that the tax burden for companies is so overwhelming that they are forced not to pay all taxes, so that they could continue to operate.

Of incentives implemented to date, foreign investors appraise the micro company tax in Latvia, which unfortunately is being abused due to the lack of consideration in the development phase.

## 2.5. Cultural effect

The third most popular cause of the shadow economy in Latvia named by foreign investors is rooted in the culture. Although there is no consensus on the reasons for this cultural effect, the most notable is the still existing mind-set from both Soviet times, when people had restricted freedoms, and 1990s, when after the restoration of independence laws were incomplete and sometimes written in favour of some groups of people, which fostered distrust in the system.

Although this serves as the basis of the whole business environment, in the eyes of foreign investors the cultural effect is not being accordingly considered at the government level and not enough is being done to improve it.

One of the outcomes of this cultural effect is the high tolerance by the public towards businesspeople who have accumulated wealth through illegal means, which in an example by one of the foreign investors shows the distorted values of people in Latvia.

## 2.5. Main causes of the shadow economy:

«The mind set of people – legacy of the Soviet era.»

- **Asset management company**

«It is part of the business culture.»

- **Energy company**

«Moral norms of the society.»

- **Finance and banking company**

«Historical reasons which originate in the time when there was the transition from the Soviet system to an open economy.»

- **Finance and banking company**

«[...]culture – is anyone thinking about this at the government level? How to change it? I have not heard somebody there would care about it.»

- **Wholesale and retail company**

«We are a relatively young country and economy, so historically we probably simply do not have yet the culture of paying taxes. And then there are possibilities available due to the lack of control or insufficient control.»

- **Wholesale and retail company**

«It is the story of how Latvia developed – those who created the general legal and business environment in the early nineties, they created it on the basis they were familiar with and they understood themselves. In a way, it was selfish, it was in their own interests and not in the interests of the entire society.

Look at the magazine Forbes this month – the second most successful business-woman there is Ināra Vilkaste [found guilty of bribery]. Role models are completely wrong!

Why an oligarch [politician, who is accused of bribery, money laundering and abuse of power] is among the most popular politicians?

To sum it up, I see two main reasons: hierarchy of values and historical aspects.»

- **Finance and banking company**

«Mentality of the people. It will change, the younger people are already different.»

- **Wholesale and retail company**

### 3.1. Main aspects of the shadow economy:

«Envelope wages; the unclear status of the self employed.»

- **Finance and banking company**

«Envelope salaries is a huge uncontrolled amount of money that avoids any control by the State.»

- **Manufacturing company**

«Workers are not well protected because they are not fully employed/ paid openly.»

- **Energy company**

«[...]the minimum salary is paid officially and the rest of it in an envelope. This is a big problem and the situation will not improve unless changes are made to the legal/court process.»

- **Real estate company**

«Labour intensive companies, industries with blue collar workers, in particular, have low incentive to pay well. There is enormous bureaucracy and administration connected with the salaries paid to workers.»

- **Manufacturing company**

«We do suffer from the lack of workforce and thus we also feel a big pressure on salaries. It is very difficult to fill up vacancies. In this critical situation, the fact that somebody is ready to pay 30 to 40 EUR more than I can (by way of avoiding taxes) makes a big difference! It is a real fight for people that is so difficult due to the shadow economy.»

- **Wholesale and retail company**

«The most problematic by far is public procurement. If we look at the procurement process for projects that are funded by the EU, competition in those are a circus. The role of LIAA is a nonsense.»

- **Finance and banking company**

«We witness a strong indirect effect of the shadow economy in Latvia on our company. Companies that compete with the lowest price in procurements usually buy the lowest quality products and thus in most cases automatically deteriorate the quality of the procured item. In cases when the quality is evidently low, we are the ones being blamed for the low quality products, when it is the winner of the procurement, who chose to use the lowest quality materials.»

- **Manufacturing company**

## 3. The most problematic aspects of the shadow economy in Latvia

Foreign investors indicate four main aspects that cause most of the shadow economy problems in Latvia.

### 3.1. 'Envelope salaries'

'Envelope salaries' are named by foreign investors most often. Since most of the foreign investors compete for the same employees as the companies that offer the possibility to receive a larger net salary without paying all taxes, it is an important aspect for the employers. As mentioned earlier, employee related tax evasion is one of the main sources of the shadow economy, which is why foreign investors emphasize the need to improve the system of personal income tax calculation as well as the collection and control process.

### 3.2. Public procurement

Public procurement is indicated by foreign investors as the second most important aspect of the shadow economy. In many cases, public procurement actually fosters growth of the shadow economy due to the rule to select the lowest price bid as the winner of a tender. By the help of envelope salaries, applicants are able to offer lower prices and thus win a tender even from the State. Foreign investors note that in such cases the State is actually worse-off despite the fact that it pays a lower price up front. The savings from the procurement are usually lower than if the winner paid all taxes and the State had to pay a higher price.

### 3.3. Corruption, bribery

Corruption is a sensitive issue and foreign investors indicate that there are several levels of it in the public administration. Foreign investors recognize two main types of corruption: (i) the one where officials most often in the controlling institutions are paid to turn a blind eye to some type of violations and (ii) large scale corruption that involves public officials or organized groups making decisions that help them extract public funds.

Additionally, it is indicated by foreign investors that the current remuneration in the public administration is not motivational and should be significantly improved to reduce the extent of corruption.

### 3.4. Unrecorded sales/illegal sale of goods

As the fourth aspect of the shadow economy foreign investors indicate a common practice by the local companies to do business by not recording sales, this way avoiding paying taxes.

Foreign investors indicate that the price is highly linked with the amount of excise tax and value-added tax. The increase in both of these taxes incentivises people to engage in the shadow economy.

## 3.2. Main aspects of the shadow economy:

«[...]construction is a big issue – to win a contract you need to pay 20% for getting it. I know some are simply not participating in tenders for these reasons.»

- **Finance and banking company**

«Corruption could be split in these parts:

1) Small corruption (like the case of the State Revenue Service official's case of having large sums of cash at home);

2) Big corruption (like in «Latvian railway» and state procurements) bribes are included in the total price of a contract and then it is taken out somehow from the legal system.

And here it is a combination of both. If policemen take 20 EUR it is not good, because it is already in the culture, which helps make corruption acceptable at higher levels.»

- **Finance and banking company**

«Corruption in tenders, public procurement – also a systemic thing. It is a mind-set here unfortunately.»

- **Finance and banking company**

«In construction – public tenders, cashback to the organizers and other practices cause exorbitant costs to the State budget.»

- **Manufacturing company**

«Shadow economy – cash – bribery – corruption all go together.»

- **Finance and banking company**

«Low salaries of the government employees. The government should reduce the number of employees by 75% and triple the salaries of the remaining ones.»

- **Manufacturing company**

«Although certain positive trends are observed and the legal market of cigarettes is stabilizing, the illegal market remains a very big problem. Due to cigarette smuggling, which amounts to 25% according to the latest Nielsen survey data on illicit trade in cigarettes in Latvia the national budget annually loses approximately 80 million EUR in revenues (excise and value added tax).»

- **Manufacturers' association**

# 4. Determinants for size of the shadow economy in Latvia

In order to establish the importance of different determinants of the size of the shadow economy in Latvia, foreign investors were asked to evaluate nine determinants by grading them on a scale of 1 (no significant effect) to 7 (very negative effect, increases shadow economy) and provide comments on particular determinants.



At a first glance, there are three distinctive effects with the highest value: Public procurement process, low likelihood of getting caught, and low penalties, which are followed by a negative evaluation of the work by controlling institutions and trust in the State.

In order to lower or eliminate certain effects, later in the report we present the foreign investors' suggestions for combating the shadow economy.

## 4.1. Public procurement process

«The amount of tax paid is not taken into account when choosing applicants or winners of tenders, only the lowest price.»

- **Finance and banking company**

«Not the public procurement process per se, but the motivation why something is procured and something is not – most of the time this is not clear and makes no sense.»

- **Pharmaceutical company**

«This is a very big issue for all companies. There are no equal terms for the tenderers, no transparency on how particular tenderers win.»

- **Real estate company**

«Most of the public scandals happen in this area. The press likes to take these examples. They make a lot of noise, but no one ever goes to jail.»

- **Transport, logistics and freight company**

«We have heard about Mr. 20% and similar cases in tenders, for example transportation, but we have not been directly involved in any public procurement processes.»

- **Wholesale and retail company**

«Overall, it is not a particular problem where we offer our own products. Problems arise when we offer something bigger and start cooperating with construction companies – it is difficult to find reliable partners and subcontractors.»

- **Manufacturing company**

«We have experienced that some municipalities often have some very specific requirements that possibly prevent or restrict competition.»

- **Energy company**

«Many people think that these regulations are written in a way that only particular companies can win these tenders.»

- **Real estate company**

«[Possibility of] subcontractors should not be allowed.»

- **Manufacturing company**

## 4.2. Low likelihood of getting caught

«There is a sense of impunity and low penalties.»

- **Manufacturers' association**

«Historically, there are only few people who have been caught actively involved in the shadow economy. This does not improve the situation, since so far no one has been punished for the involvement in a “big scale” shadow economy in Latvia.»

- **Manufacturing company**

«As long as nobody goes to jail for cheating on taxes, everybody thinks that no one will be caught.»

- **Transport, logistics and freight company**

«Companies are not afraid to cheat. They can easily go to off-shore countries.»

- **Service company**

«Since the risk of being caught is almost zero, there is no fear of breaking the law.»

- **Technology and IT company**

### 4.3. Low penalties

«It is important to set criteria for imposing penalties depending on the amount of losses caused. Penalties relative to the losses caused are surprisingly low, at least have been so far.»

- **Manufacturing company**

«Yes, financial fines are low, but the actual reason for the evasion is thinking that you will not get caught anyway.»

- **Transport, logistics and freight company**

«Penalties do not really affect the shadow economy. You will not get results with penalties, which is same as with children, penalties will not get you anywhere. You have to work with rules, laws, economy.»

- **Wholesale and retail company**

### 4.4. Work of controlling institutions

«No or little reaction to abuse or violations by the institutions. Lack of forensic investigation. There are no or little consequences involving the courts.»

- **Energy company**

«Focused and coordinated law enforcement activities are a very important factor in combating the shadow economy. However, this factor alone, especially considering the State Revenue Service's limited resources and capacity, will not be able to deliver the expected results, if other aspects are ignored. For example, frequent and deliberate tax increases create various obstacles for the legal business, thus giving the 'green light' for illegal activities.

The underfinanced and understaffed State Revenue Service is a significant risk for the legal market.»

- **Manufacturers' association**

«We were on the top of the list of the largest debtors in Vidzeme, with a 30 days delay. We pay all our tax liabilities, but sometimes we just need more time. Tax authorities seem to be more concerned about "doing their job" than thinking about the actual business. They leave the shadow economy to the fiscal police. But if we go bankrupt and they lose their largest tax payer it is not their problem, because then at least we will no longer be on their debtors' list...»

- **Service company**

«The State Revenue Service is not willing or not competent in fighting against the "big fish".

Small entrepreneurs can make huge losses or even lose their business because of a tiny mistake. For example, if you have a deficit of 5 EUR in the cash register, you might have to pay a penalty of many hundred euros. One needs to be exact and careful with cash matters but that has already become a stupid joke. That kind of action is not raising the respect of state authorities like the State Revenue Service. And as we have seen recently, they really should clean their own nest prior to getting "street credibility".

Additionally, it seems they are also too scared of high authorities, scared of stepping on toes of some people. This is a general problem in Latvia, "the fear of the lord". It is evident in many places.»

- **Energy company**

«Credibility is not high in general, very formalistic approach, no substantial control, acts like the police, when they should act more like consultants.»

- **Real estate company**

«The State Revenue Service is a deterrent – being involved in dealings with the SRS is a very bad thing, there is nothing worse than that. If sometimes we have doubts about an issue and we send an official letter to them, we receive a very formal and often a useless answer. There is no client orientation whatsoever in there! Sometimes it takes going to the court to get a clear answer to your questions. Additionally, nowadays the State Revenue Service itself is a symbol of corruption.»



## 4.5. Trust in the State

«For investors their reputation is more important than trust in the State, so this does not really affect them. But for local companies it is very important to feel support of the government, to feel that you can communicate with them and they will not fine you for every small misunderstanding or mistake. The State Revenue Service scandal regarding their employees reduces trust in the State. Currently, the distribution of the taxes paid does not improve trust in the State, either.»

- Finance and banking company

«Government decisions can be very short term and reactive to internal government problems; they externalise these and thus create the lack of trust.»

- Pharmaceutical company

«Government is not concerned with effective governing and forward thinking, but rather focused on reappointment and short term gain.»

- Energy company

«You need to trust in the State in order to pay taxes. You need to be convinced that the taxes will be used fairly and adequately and that the tax money will not go to employ even more civil servants who will produce even more regulations. The government has to listen to the opinion of the businesses and make decisions based on analysis rather than intuition.»

- Wholesale and retail company

«If there is no trust in the State there will be no long term investments raising the economic competitiveness of Latvia. Only short-term, speculative investments will take place.»

- Manufacturing company

«You pay taxes when you trust that in case something happens you will be supported by the State and get back what you have given, for example, medical insurance. Why pay taxes when the government wastes the revenue.»

- Energy company

## 4.6. Communication with authorities

«Very important. To reach good results in business you need to understand your partner, in order to find the best way for both parties involved. When I see the Employers organization and the State representatives discussing on TV they are completely opposite, not listening to each other or understanding.

Those working in the public sector don't seem to understand where the money is coming from, like who pays the salary of the State services. They seem to think of businesses as "bad thieves" - and when we think "bad state" we receive back the same attitude".»

- Service company

«Efficient and predictable communication is needed.»

- Real estate company

«Communication with the industry is important. It should not be the case that government bodies make decisions influencing industry without consulting the industry. Such situations happen quite often and the official comment for not inviting the industry is "They will always complain on raising taxes".»

- Manufacturing company

«This has a significant effect. If the State is helpful – it is very important, particularly for new companies. The more government explains and talks to companies and entrepreneurs the better result they will get.»

- Wholesale and retail company

## 4.7. Consistency and transparency of the tax system

«Need publicly available information on paid taxes – who has paid what and how much.»

- **Finance and banking company**

«Various interpretations/inconsistency of the tax system may serve as an incentive to turn to illegal activities/use various schemes to avoid taxes or reduce the tax burden.»

- **Manufacturers' association**

«I believe that the system in place is complicated – besides the main taxes there are several others, for example, company car usage tax, solidarity tax on private income etc. The worst is that the tax system is changing regularly and the total amount of payments is growing.»

- **Manufacturing company**

«The tax system is far too complicated, even those who should apply it do not seem to have a solid knowledge; it may be the case that three employees of the State Revenue Service will give you three different opinions.»

- **Transport, logistics and freight company**

«Sometimes you can't understand anything without a consultant.»

- **Service company**

«No consistency and no transparency, especially for small and medium enterprises that often do not have enough resources to spare for understanding it.»

- **Technology and communications company**

«Transparency is there, but consistency is a different story. Now the State Revenue Service and the Ministry of Finance are showing signs of inconsistency, as for example, solidarity tax. There was a ceiling for social tax, which was later cancelled. And that had an immediate impact - sales went down in this market. After a few years again the ceiling was set for the social tax, but now solidarity tax has been invented. It is a message to the world - if we need additional income we can invent something else.»

- **Real estate company**

## 4.8. Tax rates

«Salary taxes are too high both for the employee and the employer. Unfair system, especially for low wages. In many other countries salary tax on lower wages is low percentagewise due to deductibles/tax allowances, which are practically non-existent in Latvia by comparison.»

- **Energy company**

«Taxes change too often, especially without a serious consideration, and not taking into account taxation system/rates in the neighboring countries, can easily foster the smuggling of cheaper goods from other countries. For instance, a very quick growth in the smuggling of cigarettes in Latvia began after a steep increase in the excise tax on tobacco in 2008, which was done without a proper evaluation/risk assessment – due to the low purchasing power, the demand for cheap cigarettes from third countries increased.»

- **Manufacturers' association**

«Should be more predictable (that is the key issue), taxes today are just invented for filling budgets.»

- **Real estate company**

«It is a bit too high on the employment side, salaries and social tax, but in general more or less neutral.»

- **Real estate company**

«No, does not play role. The tax burden in general is quite low compared to other countries. The problem is that not everyone is paying taxes.»

- **Finance and banking company**

«Tax rates are not particularly high and I don't think that they contribute to the scale of Latvia's shadow economy relative to other countries.»

- **Manufacturing company**

## 4.9. Legislation

«Legislation is not that bad. But there are some aspects of the system that lower this grading.»

- **Finance and banking company**

«The laws are probably appropriate, but there is a lack of willingness to go after offenders. There is no political will to properly address the problems, nor the will of the public agencies to properly enforce the law and regulations.»

- **Energy company**

«As it was demonstrated by journalists in “Fricis” café case, it is almost impossible to establish and operate a legal business abiding all laws.»

- **Finance and banking company**

«Legislation is not the problem, the problem is the enforcement and the collecting system.»

- **Real estate company**

«In general, there are no big differences among the EU member states, but the law enforcement is the problem.»

- **Finance and banking company**



Part B:  
Effectiveness of  
the initiatives  
against the shadow  
economy

# Evaluation of previous activities to decrease the shadow economy in Latvia

In this section of the interviews, foreign investors were asked to evaluate previous and current activities to reduce the shadow economy in Latvia.

As indicated in the previous sections, foreign investors are not satisfied with the work done by the government to reduce the shadow economy. Foreign investors indicate that the work current done by the government only slightly touches on the main problems of the shadow economy and concentrates only on short term PR goals. In the opinion of foreign investors, the loudest cases are active for some time and then left without a punishment.

Foreign investors believe that the public administration is ineffective in mutual cooperation, which in many cases translates in losses either for the State or companies and people.

How would you assess how efficient has been the fight against the shadow economy in Latvia in previous 3-5 years?



«If there is a police office next to the Central Market and you can still easily buy illegal cigarettes on the market, this is just not acceptable. We have heard so many cases and for a long time.»

- Wholesale and retail company

«Inefficient – we have not seen any numbers that the shadow economy has gone down. They are trying to build PR around some big cases, but these cases are not changing the system.»

- Real estate company

«The government has been very inefficient.»

- Manufacturing company

«The government is doing a lot of things for public relations. But in terms of principles – nothing important. We have no evidence that something is changing. What happened to the guy from Latvenergo? What is happening with the case of oligarchs? They try to show they do something, but in reality there is no real outcome from what they do.

The government has low motivation – they think until next elections. Politicians are not used to think as a business – that they have outcomes, results, inputs should match outputs, etc.

It is often the case in Latvia that you have too many generals and no soldiers.»

- Service company

# Combating the shadow economy in Latvia

The main reasons why combatting the shadow economy is perceived to be ineffective include: the lack of continuity for initiatives, lack of motivation from the government, low support for effective enforcement, corruption and political cronyism.

«The initiatives have been good, but the momentum in many cases has been lost and there has been no continuation of the initiatives. The state has to continue the initiatives to combat the shadow economy and devise new solutions as well.»

**- Finance and banking company**

«There is too much populism in how the tax system is devised in Latvia. And it should not be the case. Businesses and people have to understand and feel what the government wants to achieve with the tax policy. The tax system should be consistent.»

**- Finance and banking company**

«Unwillingness to investigate and change things. Many investigations are started only after external pressure to do so.»

**- Energy company**

«1. Insufficient focus on strengthening the external EU border for smuggled goods.  
2. Insufficient technical support to law enforcement in customs and border control by not fully utilising the EU funding and cooperation possibilities.»

**- Manufacturers' association**

«I do not see anyone too much interested in "putting their neck on the line", taking responsibility.»

**- Finance and banking company**

«I do not see that government would have done anything. In fact there is this fluidity, everyone knows each other, no one has an interest in making a difference. This does not mean everyone is benefiting, but they have no interest in fighting it.»

**- Finance and banking company**

«There are good ideas, but to implement a good idea there is a new stupid idea that ruins the result. There are no brave decision makers, who could really do something without being scared about their own position or political future.»

**- Energy company**

«Corruption – nothing has been done, we have Corruption Prevention and Combating Bureau who is doing nobody knows what. The State's attitude – never ending changes in legislation, and the administrative burden.

Nobody has tried saying: "Let's live for a moment without any changes." The problem is that there always are extra needs for the national budget and at that moment nobody thinks about companies and entrepreneurs.»

**- Manufacturing company**

«The punitive function still dominates their [controlling institutions] minds. They still want to catch big fish without changing their mind, but the real problem is the corrosive effect on the society caused by thousands of people cheating day to day.»

**- Real estate company**

«Sometimes you get a feeling that someone dictates to the State Revenue Service whom they can touch and whom they can not.»

**- Real estate company**

«The direction is wrong. The government should focus more on collection of employment taxes.»

**- Real estate company**

# Effectiveness of the “White list” initiative in the fight against the shadow economy

After considering the current status of the shadow economy in Latvia, foreign investors were asked to evaluate the effectiveness of the most recent initiative that had been started in Latvia to combat the shadow economy.

## “White list” initiative

The initiative of the in-depth cooperation program is run by the State Revenue Service, which, based on criteria such as law abidance, reputation, social responsibility, timely payment of taxes, and others, includes companies in a list, based on which they are regarded as safer partners of the Service and thus are subject to less frequent tax audits.

1/4 of the foreign investors indicated that they had not heard about the initiative.

Those who had heard about the initiative or even were on the list did not presume any actual benefits from being on the list, which is evident by the low mark on the effectiveness of the initiative.

Those who have, on average gave the initiative a rather low mark.

How would you assess how efficient has the “White list” initiative been?



«We participated in the beginning but I did not like the attitude. [...]in my opinion the purpose of the “White list” was not to reduce the shadow economy, but to free resources, so the Service could concentrate on other companies.»

- **Service company**

«Our clients have not received any tangible benefit from taking part in the activity.»

- **Professional assurance and advisory services company**

«We have heard about it and thought about participating but decided not to. It is quite a business for consultants to get all the documents ready. Not sure about the benefits.»

- **Energy company**

«I do not see sufficient reasons for a company to be on the list and to make an effort to prepare documents for it.»

- **Technology and communications company**

«I have not had time to go into the details of this idea, but maybe it is a right way. One of many. Only one thing, participants need to be sure it will not be possible to buy a place in that list.»

- **Energy company**

«A year ago I would have said inefficient, but because of the transition period introduced for cash machines I will be slightly more positive. Overall, I think it does not work. There are many requests that are formal and that come every year.»

- **Wholesale and retail company**

«They should allow companies from more industries to take part in the program. Previously we were not admitted because the State Revenue Service did not understand how we calculate our turnover due to the industry specifics.»

**- Finance and banking company**

«The program considers only the size of the company. Small clean companies are not invited to join.»

**- Service company**

«Criteria should be reworked completely.»

**- Manufacturing company**

«The criteria are vague – what does it even mean to be above the average country level? What if there are only three companies of the industry in the country? How do you measure the average level then?»

**- Wholesale and retail company**

«Not much tangible benefits for us to be on the list. It is more about prestige.»

**- Pharmaceutical company**

«[...]every year we need to write a letter about liquidity. Already four years in a row. We made a risk management system, but it is a formality and it looks artificial.»

**- Manufacturing company**

«The idea is very good, but the criteria and the benefits should be reviewed. There should be some tangible benefits, not just obligations.

Often there are initiatives that we do not understand – a member of our group, for example, received a thank you letter from the SRS but we did not. Not sure why. We have the same systems, exactly the same accountancy etc.»

**- Wholesale and retail company**

«It is targeted towards big companies and the problem often does not lie with the big ones. There is no stimuli to apply and be on the list. You need to do a lot of paper work, so I do not see any reason for being there at the moment.»

**- Technology and communications company**

## Participation in “White list” initiative

According to foreign investors, only half of those who were aware of the program, considered the admission criteria for the program were fair. The vagueness of criteria and incomprehensible reasons for admission were the most frequent reasons for companies not to take part in the program.

Additionally, foreign investors noted that there had not been any notable benefits for taking part in the program, since participants were required to maintain equally high level compliance even after being admitted.

## Additional benefits

Foreign investors indicate that additional benefits might encourage more companies to join such initiatives. One of such benefits could include an individual tax consultant who could give professional tax advice. Additionally, it was noted by some foreign investors that only companies that comply with all the requirements of the program should be allowed to participate in public procurement.



# Success stories

## Initiatives and activities that have been successful from the viewpoint of foreign investors

«The State Revenue Service audit of car repair shops and dentist offices.»

- **Finance and banking company**

«Zero declaration for income tax is a good thing.»

- **Service company**

«Communication with the State Revenue Service has improved.»

- **Wholesale and retail company**

«The Customs have improved their communication.»

- **Wholesale and retail company**

«Creation of microenterprises.»

- **Wholesale and retail company**

«Public tender conditions requiring certain tax status for companies participating in public tenders, for example, not allowing to qualify companies with debts in any of taxes.»

- **Real estate company**

«White list - we have finally experienced the importance of being on the White list – thanks to that we are allowed to introduce the new cash machines three years later. But this is the only positive reason.»

- **Real estate company**

«Micro tax would have been a good idea if it was not again distorted by various restrictions. It had to be easier, more going towards the sole entrepreneurs..»

- **Manufacturing company**

«The idea to publish the amounts of tax paid is excellent and I think more information should be made available to the public.»

- **Finance and banking company**

«In construction the reverse value added tax is something they did well.»

- **Energy company**

«The Gan Bei case was very well done, well publicly discussed.»

- **Asset management company**



Part C:

Suggestions for  
reducing the  
shadow economy  
in Latvia

# Suggestions for reducing the shadow economy in Latvia

In this section we present the suggestions made by foreign investors that are proposed to be implemented in the short and long term. These suggestions can be grouped in the ten core areas:

## 1. Focus tax reviews on the black list and increase punishment for working in the shadow economy.

Foreign investors recommend publicly discussing and punishing companies that are evading tax payments to improve tax enforcement. They suggest that punishment should include not only higher fines but also jail time depending on the extent of non-compliance.

In addition to avoidance of tax payments general non-compliance with regulations, including product quality and specifications, restrictions on weight or time controls would also have to be tackled by relevant authorities.

## 2. Improve enforcement by increasing professional qualification of public officials.

Foreign investors suggest that public officials including the State Revenue Service staff should be provided with clear operational KPIs linked to the key objectives of the respective institution.

The key objective in the eyes of foreign investors should be to work with the companies on the black list rather than looking for minor mistakes at the large taxpayers.

Some suggest that the State Revenue Service should reduce its staff number, eventually having less staff, but who are more qualified and keeping high professional standards. It is suggested that the State Revenue Service work on the reputation of its staff in order make them top class professionals who perform their job effectively.

«Identification of priorities and stop wasting resources fighting small violations of tax payments e.g. hairdressers or shoemakers.»

- **Manufacturing company**

«Prioritise business areas that are to be audited by the State Revenue Service according to the fiscal effect they would create, if they were to come out of the shadow economy.»

- **Wholesale and retail company**

«Prepare and audit a list of companies that pay the minimum wage in the riskiest industries.»

- **Manufacturing company**

«Invest whatever money is necessary in the number of people and their qualification needed to do their job of control and consulting in the State Revenue Service.»

- **Transport, logistics and freight company**

«Immediately stop negative publicity of the State Revenue Service by getting rid of dishonest employees and improving the service.»

- **Manufacturing company**

«Implement a service standard in the State Revenue Service whereby every public servant is considered to be a service provider and is required to act accordingly. There are some good examples like CSDD.»

- **Finance and banking company**

«Replace all the State employees. You need people with high morality running the country, not some oligarchs. Then a real change could happen. If you get the same people - they will keep doing the same thing and nothing will change.»

- **Finance and banking company**

«[...]there is an optimal tax rate according to some studies that would ensure that people pay the taxes – it is 19% (all taxes together). This feels right and that is the direction Latvia should go.»

- **Construction company**

«[...]we lack the systemic aspect – we always come up with some ad hoc decisions.»

- **Manufacturing company**

«The government should clearly communicate the strategy to fight the shadow economy.»

- **Professional and assurance and advisory services company**

«Have long term vision for taxes.»

- **Finance and banking company**

«Consider not only putting fines and punishing, but also creating incentives for people and companies to be honest, create disadvantages for acting in the shadow economy. Define the shadow and white economy. If there is no incremental approach to unlawful behaviour, then you cannot change anything.»

- **Pharmaceutical company**

«The State Revenue Service and Corruption Prevention and Combating Bureau should run a naming and shaming campaign of companies and people who do not pay taxes – they could go by industry and government sector.»

- **Finance and banking company**

# Suggestions for reducing the shadow economy in Latvia

**3. The state should agree on the core principles of the tax system and stay consistent.**

Foreign investors suggest that the government, the State Revenue Service as well as other institutions should collectively agree on the key terms as to how the tax system should work and must not change it too often.

Personnel taxes are often quoted as examples of taxes that change too often, in fact causing a potential increase in the shadow economy with persons deciding not to disclose their actual income (the latest example is solidarity tax).

It is also recommended to evaluate the actual effect on collected taxes from the changes introduced in the tax system as compared with the planned effect.

It is emphasized by foreign investors that combatting the shadow economy should be a topic for the whole government which would require joint strategy and collaboration between the ministries and regulatory bodies.

# Suggestions for reducing the shadow economy in Latvia

## 4. Lower the tax burden on labour force and the proportion of taxes paid by low income earners.

Foreign investors suggest that increasing the minimum base from which the tax is not paid would reduce the proportion of the shadow economy. Higher allowances for low tax payers would create a lower overall tax burden for low income earners.

## 5. Simplify the tax burden for small and micro companies.

Foreign investors recommend that smaller companies should have the possibility to pay simple and straightforward taxes without complex reporting that is found to be difficult to implement and maintain for smaller companies in the country.

In addition, it is proposed to simplify the calculation of taxes for smaller businesses. One example would be setting a fixed tax rate depending on the business that would be applied on an annual or a seasonal basis, which would be easy to understand, and feasible for small business to pay.

«Review payroll taxes and try to reduce them together with a massive campaign containing message “They are lower, but you must pay them”.»

- Real estate company

«Revise the tax burden. Shift it from labour to real estate, for example, as real estate tax is easier to collect and make sure not to put an extra burden on other areas; do it thoughtfully, so that it does not limit competition.»

- Wholesale and retail company

«In the long run, gradually decrease payroll taxes, allowing businesses to move from the shadow economy to the white economy.»

- Real estate company

«Lower the administrative burden for small entities, but as this creates an opportunity for the shadow economy in the small and medium sector, prosecution of the small companies should also be improved.»

- Professional assurance and advisory company

«Improve benefits of 'clear white' business.»  
- **Energy company**

«Older generation – they receive miserable pensions, their children see it and are not very motivated to pay any taxes and decide better to save themselves.»

- **Technology and communications company**

«Great progress would be achieved if there was less stealing and cheating in the government sector itself.»

- **Technology and communications company**

«In public procurement, the average salary paid by the company should be taken into account when choosing the winner, not just the price they offer.»

- **Finance and banking company**

«Design the public procurement process so that it would combat the shadow economy. Introduce additional tender requirements, so that the winners would not be selected based solely on the lowest price.»

- **Professional and assurance and advisory services company**

«Incentivise natural persons to register checks in the State Revenue Service database for services received in risky industries, such as restaurants, beauty saloons, hairdressers and others.»

- **Real estate company**

«Introduction of good standing certificates, which would allow to participate in the big public tenders.»

- **Construction company**

«More electronic solutions should be considered - how you pay taxes, report to financial institutions. The more automatic, the better it is, because it means you can also detect problems more easily.»

- **Finance and banking company**

# Suggestions for reducing the shadow economy in Latvia

## 6. The State should create incentives to pay taxes.

The majority of the interviewed foreign investors noted that those not paying taxes did not see any incentive to do that, as currently there is no difference between those who pay and those who do not.

A number of suggestions were formulated around the possibility to participate in public procurement only for the companies paying taxes in excess of a certain minimum, or including in tender evaluation criteria the total amount of taxes paid by the supplier. The same could apply to natural persons by introducing priority of public services rendered to those persons who pay social taxes over those who evade tax payments (for example by a priority queue in medical institutions).

## 7. Increase the use of electronic documents between tax payers and public institutions.

Foreign investors believe that increasing the use of e-systems in the public sector would promote transparency and reduce the shadow economy. E-systems should be implemented across all public institutions involving the health system, customs, education with the possibility to exchange information electronically between those systems. It would lead to simplified reporting and increased transparency, especially if all public sector systems are interconnected.

In addition, it is suggested to allow electronic invoicing to increase system transparency.

# Suggestions for reducing the shadow economy in Latvia

## 8. Improve education of youth.

Emphasis on educating the new generation is made by a number of foreign investors. The objective is to educate the youth with respect to the necessity to pay taxes in order to change the mind set in the longer term.

The suggestions have been to start with schools (some schools reportedly start including tax education in their curricula) and even kindergartens, so that payment of taxes becomes a natural behaviour of the growing generation.

## 9. Improve the quality of PR campaigns on paying taxes

It is noted that the general public knows too little about the way the tax money is spent. The suggestions are to regularly report details on tax spending in key areas (the number of hospitals receiving new equipment or infrastructure improvements, the volume of public services rendered and so on). In addition, the campaigns should address the question of how future taxes would be spent and what additional or improved public services could be provided should the level of tax collection increase.

Apart from public campaigns aimed at reporting to the public on tax expenditure, a separate area of PR campaigning should be run to show the route from the shadow economy into becoming an honest taxpayer. Such campaigns should provide a simple and straightforward explanation on how to start paying taxes, which would be understandable to any person.

«Improve education of the youth in terms of taxes and their role in the economy.»

- **Energy company**

«Tackle the moral issues. Look at different levels of the society from different perspectives. Consider age, gender, education, nationality.»

- **Finance and banking company**

«Educate people about the principles and have a common understanding. If you pay – you will receive public services. For example in healthcare, those who do not pay taxes would be last in the queue, just to show consequences.»

- **Service company**

«Make information on taxes paid available to the public – biggest payers, industries, etc.»

- **Finance and banking company**

«Increase transparency of public spending. The government has to explain where the money goes and why, give a rationale for that. Declare the purpose and it will be easier to make decisions.»

- **Pharmaceutical company**

«Work on the public opinion and understanding: make the public believe that the tax administration is going in the right direction.»

- **Finance and banking company**

«The State Revenue Service and the Ministry of Finance should communicate, as in a campaign, that salary “X” shows that the company works in the shadow economy and that if companies raise the salaries to a level, which is not considered shadow economy, the State Revenue Service will not go after them.»

- **Wholesale and retail company**

«Remove cash from the system and you will solve the grey economy.»

- **Real estate company**

«Overall tax policy – there should be a vision, a macro plan. Start with a plan and then go to specific tax issues.»

- **Wholesale and retail company**

«Change the message from the government. Currently the government's message is destructive: they only talk about problems, what is not working. I haven't seen a vision, only barriers.»

- **Pharmaceutical company**

« ...we would be happy to emphasize that we are a 'white' company. We would also agree to audit our biggest suppliers and see if they are clean and have no reputation damage. We want our suppliers to be responsible.»

- **Manufacturing company**

# Suggestions for reducing the shadow economy in Latvia

## 10. Take cash out of system.

Finally, foreign investors strongly believe that taking *cash* out of the system would altogether reduce the extent of shadow economy.

Furthermore, the majority of foreign investors show willingness to engage in combating the shadow economy in Latvia. They are ready to engage in different activities, participating either directly or by helping already existing initiatives set up by non-governmental organizations.

Summing it all up, the suggestions provided by the foreign investors can be seen as a joint set of activities that would require involvement of all Governmental authorities in the areas ranging from a predictable tax system, educating society, to incentives for taxpayers and an overall simplification of the tax system and legislation governing the business environment. Part of these solutions already exist and just need to be fully deployed: for example, making the various electronic databases across different governmental institutions compatible and putting to good use the information that can be shared via electronic means. After all, the movement towards more use of electronic systems should be straightforward in our country with a highly developed IT industry.



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## KPMG

We in KPMG represent one of the largest global networks of professional firms providing audit, tax and advisory services. We operate in 155 countries and have more than 174,000 professionals working in member firms around the world. We cooperate with the world's leading companies that rely upon KPMG member firms to provide them with high-quality professional services. Through our worldwide network we are able to offer our clients the benefits of a wide pool of skills and experience, while also utilising an in-depth understanding of each national market. As the business world changes in response to new political and economic situations, so does KPMG. As a professional services firm, we provide comprehensive, tailored and industry specific services to meet clients' needs, whether they are local or multinational.

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## Stockholm School of Economics in Riga

Located in Riga, Latvia, and founded in 1994, Stockholm School of Economics in Riga offers one of the best business and economic education programs in Northern Europe. The School is keen to promote a debate in topics that are of relevance to the Latvian economy as well as the two other Baltic countries.

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