China-CEE Institute
中国—中东欧研究院

ISSN: 2560-1601

Vol. 12, No. 2 (LT)

November 2018

Weekly Briefing

Lithuania Economy briefing:

Lithuania increases the efforts to fight the shadow economy to sustain the GDP growth

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Lithuania increases the efforts to fight the shadow economy to sustain the GDP growth

In October, the International Monetary Fund (IMF) re-assessed the forecast for the world economy growth and decreased the previous global growth estimations by 0.2% to 3.7% due to the ongoing tensions between the largest economies of the world (the United States and China). As part of this global forecast, IMF also provided the growth predictions for the Baltic countries, indicating that the growth in Lithuania in 2019 would be 2.9%, the slowest comparing to Estonia's and Latvia's (3.2% and 3.3% respectively). This contrasts with a growth outlook on Lithuania for this year, which IMF even raised by 0.2% to 3.5% in its forecast.

Though the growth figures for the Baltic countries are higher than for the rest of the euro zone, where the growth is still lower (estimated to reach 1.9% this year and 2% the following year), yet the Government and the financial sector in Lithuania are getting concerned. In order to converge with the advanced economies in the European Union, the EU 17 countries, which are also the advanced economies globally, Lithuania as well as other Central and Eastern European (CEE) EU Member States need to sustain growth at higher GDP rates. The European Central Bank has calculated recently that in order to achieve the 100% of convergence with the existing EU 28 average by 2030 (not mentioning that of EU 17) Lithuania needs to sustain a GDP per capita growth rate higher than 3% (Piotr Żuk and Li Savelin, „Real Convergence in Central, Eastern and South-Eastern Europe“, Occasional Paper Series, No. 212, European Central Bank, July 2018).

Thus, being wary of the prospects of facing the slowing or even decelerating economy growth and in view of the upcoming electoral year, the Government has announced this autumn a new comprehensive plan to increase the collection of taxes (which form 95% of the state budget) by tackling the shadow economy in a more systematic way. As of January next year, a three-year plan would come into force which would put into action a number of measures to fight the tax evasion on multiple fronts: from introducing the possibility of paying for the "forgotten taxes" to the possibility of tax deduction for a number of economic activities that would be applicable under the existing law. The underlying principle behind these new efforts to collect more taxes is to treat the economy actors as partners of the state rather than potential tax evaders and offer them a set of incentives in order to increase the compliance with the tax law.

The governmental efforts partially echo the insights and the conclusions from the major study carried out by the Lithuanian Free Market Institute (LFMI), a think-tank representing the corporate interests of its founding members, together with its partner organizations in several CEE countries (including Estonia, Latvia, Poland and Czech Republic). The study has aimed, for the first time, to explain the drivers and the motives for the persistence of the shadow economy in the analysed countries, including Lithuania (the policy report entitled "Shadow Economy: Understanding Drivers, Reducing Incentives" was publicly presented on 16 November).

The shadow economy is defined as economic activities (labour, goods produced, and services rendered) that are conducted in non-compliance with applicable laws for avoiding taxes or/and regulations. The concept of the shadow economy is primarily concerned with value creation and as such is the phenomenon, which is analysed in the study from the perspective of the participants of the shadow economy: the value creators (the companies and the individuals generating value) and from the consumers.

The approach to see the shadow economy as a stage in the free market development comes from the development studies, including the studies on the transitional economies of the CEE countries. The concept of the shadow economy has helped to measure the level of the development of the market economy. In 2004 a comprehensive analysis of the shadow economy of 110 countries, including developing, transition and developed OECD countries showed that in the years 1999-2000 the average share of the shadow economy as a proportion of the official GDP in developing countries stood at 41%, in transition countries – at 38 %, and in OECD countries – at 17%. (The results were published in Friedrich Schneider, "Shadow economies around the world: what do we really know?, *European Journal of Political Economy*, Sept. 2005, pp.598-642.)

This global study estimated that in 1999-2000 (at the time when the negotiations for Lithuania's accession to the EU started) the shadow economy in Lithuania stood at 30.3% from the official GDP. It was significantly lower than, for example, in Latvia (39.9 %) but higher than in Poland (27.6 %), and much higher than in the Czech Republic and the Slovak Republics which had the lowest share of the shadow economy among the CEE countries (19,1 and 18,9 % respectively). Since then various studies aimed to calculate more precisely the share of the shadow economy in Lithuania. Most recently, the report published by the Prime Minister's Office in 2016 referred to the estimates provided by an Austrian economist Friedrich Schneider from the Institute of Labour Economics at Johannes Kepler University, Austria, whose calculations indicated that the shadow economy in Lithuania in 2015 stood at 16-18% from GDP.

The 2018 population survey for LFMI study on the shadow economy (based on the target audience 18 to 75-year-old residents with a total sample size of 6,055 across the six countries) have showed that experiences with unaccounted purchases (the main form of engaging in the shadow economy) differ widely across the CEE countries. The highest incidence of people who reported purchasing from illicit sources (or those who do not declare their income) occurred in Lithuania, where 59% of respondents in Lithuania reported that during the last 12 months they had made a purchase from an official source, knowing or suspecting that the revenues remained undeclared for tax purposes. As many as 27% said they had done illicit purchases three to ten times or more. In Latvia the share of respondents having experience of purchases without a receipt from legitimate sources was slightly lower (52%). Notably, in Estonia this figure was much lower (36%), while the Czech Republic and Poland reported significantly lower incidences (29% and 27% respectively).

The main product categories bought through illicit purchases in Lithuania included food products (31% of the share of their total consumption in this category), clothes (28%), medicine, food supplements, drugs (17%), cigarettes (17%), cars and spare car parts (15%), wood logs, wood pellets, coal (13%), fuel (12%). The services that were unaccounted for taxes included auto repair services (23%), medical, beauty services, hairdressing and massages (25%), construction and home renovation (18%), sewing, clothing and show repairs (11%).

The type of products and services bought illicitly indicate that the shadow economy in Lithuania concerns mostly the economic activities that serve the basic consumer needs and are of most relevance to the inhabitants on lower incomes. The survey results confirm that; 89% respondents of the survey in Lithuania indicated that the high cost of legitimately bought goods and services is the main reason for illicit purchases of those goods and services.

That the effective taxation needs to take into consideration, the impact of taxes on the economic needs of population is an increasing argument in Europe. The European Commission in the recent report “Taxation Trends in the European Union” (2018) makes use of the implicit tax rate on consumption defined as the ratio of the revenue from all consumption taxes (VAT, excise taxes on tobacco, alcohol, energy and others) to a household’s total consumption expenditure. Presumably, the higher the rate the bigger incentive to decrease it through participation in the activities of the shadow economy. In a factsheet on undeclared work in Lithuania, the European Commission states that one of the main motivators for undeclared work in Lithuania is the high tax burden and low wages in the conditions of the overall low level of income and high tax wedge, people are more inclined to increase their income through undeclared work.

Thus, by pursuing a new initiative on increasing the tax collection the Government is trying to do an uneasy balancing act. On the one hand, the further tax evasion fighting measures will aim to cover the tax loopholes as regarding the economic activities with the highest share of illicit purchases (such as car repairs, construction and home repairs, the baby-sitting etc.). On the other hand, by emphasizing the possibility of using the existing tax exemptions by companies (tax exemptions for investments, tax exemptions for capital gains, tax exemption on tax on profits generated from the commercialization of inventions) the government will aim to increase the transparency in market. However, the impact of these and other measures aiming at decreasing the shadow economy would in the end depend on the economic wellbeing of the society-at-large.