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Shadow Economy in the context of Anti-Money Laundering Strategy in Latvia: Challenges and Solutions

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Shadow Economy in the context of Anti-Money Laundering Strategy in Latvia: Challenges and Solutions

Summary

Latvia grapples with the shadow economy, a substantial challenge to its economic and fiscal stability. Despite efforts to align with European economic standards, the shadow economy, comprising unreported income, under-the-table transactions, and unregistered activities, remains resilient. Estimates suggest it forms a significant part of the GDP, undermining tax revenue, fair competition, and public service provision. The analysis delves into Latvia's strategies against this issue, assessing government plans, legislative measures, and technological innovations against academic and financial sector insights. The shadow economy's persistence at 26.5% of GDP, with minimal year-on-year change, contrasts with trends in Estonia and Lithuania, underscoring the need for effective measures. The construction sector notably harbours the largest shadow economy share. Recommendations focus on improving the business environment, enhancing tax morale, and fostering inter-ministerial and data exchange coordination. The study underscores the significance of balancing regulatory enforcement with economic incentives to effectively address the shadow economy, offering insights for policy refinement and implementation.

Introduction

The shadow economy in Latvia represents a significant challenge to the country's economic development and fiscal stability. Characterized by unreported income, under-the-table transactions, and unregistered business activities, this segment of the economy evades the gaze of tax authorities and regulatory frameworks. Despite Latvia's continued efforts to integrate into the broader European economic space, the persistence of the shadow economy poses a substantial barrier to achieving equitable growth and fiscal health. For years, the scale of Latvia's shadow economy has remained alarmingly high, with estimates suggesting it constitutes a considerable portion of the Gross Domestic Product (GDP). This not only results in substantial tax revenue losses for the state but also undermines fair competition, discourages foreign investment, and hampers the provision of public services, thereby affecting the overall welfare and trust in the economic system. This article aims to delve into the complexities of combating the shadow economy in Latvia, exploring the multifaceted strategies employed and the challenges encountered. Through an examination of recent government plans, including legislative measures and technological innovations, alongside insights from academic research, financial sector studies, and expert recommendations, the analysis seeks to shed light on the efficacy of these approaches. The objective is to assess how Latvia navigates the intricate balance between regulatory enforcement and economic incentivization to curtail the shadow economy. By analysing the successes and shortcomings of these strategies, the article intends to contribute to the broader discourse on effective measures against economic informality, offering lessons that could inform both policy formulation and implementation within Latvia and beyond.

The Results of the Study on the Shadow Economy Index in the Baltic States

In 2022, the shadow economy in Latvia remained nearly unchanged from the previous year, accounting for 26.5% of the Gross Domestic Product (GDP), with only a slight reduction of 0.1 percentage points. This contrasts with significant reductions in Estonia and an observed increase in Lithuania, according to the annual Shadow Economy Index for the Baltic States by the Stockholm School of Economics in Riga (SSE Riga).

For a considerable period, the shadow economy in Latvia has been on the rise, experiencing a minimal decline in the reported year to 26.5% of GDP. The construction sector has the highest share of shadow economy, which increased last year. Meanwhile, Estonia saw a more substantial decrease, and Lithuania experienced growth in its shadow economy. Notably, the amount of undeclared wages in Latvia has reached its highest level since 2013, while the average share of income hidden from the state decreased to 16.3%. The overall level of bribery in 2022 increased to 9.4%.

Businesses across the Baltic States generally express satisfaction with the performance of the revenue services. Suggestions for improving the situation have been offered by Arnis Sauka, the study's author. The shadow economy in Latvia has shown a growing trend since 2016, with the highest levels observed in the Riga region and Vidzeme in 2022. The construction industry remains the sector with the highest share of the shadow economy.

In the Baltic States, Estonia saw a notable decrease in its shadow economy in 2022, down 1.0 percentage point from the previous year to 18% of GDP. Lithuania, however, saw an increase of 2.7 percentage points, reaching 25.8% of GDP, marking the highest level of shadow economy since the study began in 2009. The latest research indicates that Lithuania's shadow economy is nearing Latvia's levels, while Estonia's remains significantly lower.

The study highlights "envelope wages" as a significant component of the shadow economy in 2022, constituting 46.7% in Latvia and 44.5% in Estonia. Unreported income in Latvia for 2022 constituted 29% of the total shadow economy, with unreported employees making up 24.3%. In Estonia, unreported employees accounted for 28% of the shadow economy, with unreported income at 27.5%. Lithuania's main shadow economy components were unreported income (36.5%), followed by envelope wages (34.0%) and unreported employees (29.5%).

The percentage of wages hidden from the state, or "envelope wages," increased in Latvia in 2022 compared to 2021, reaching 25%. This is the highest level since 2013. Lithuania saw an even more significant increase in envelope wages, while Estonia experienced a slight decrease.

Regarding unreported income, there was a decrease in both Latvia and Estonia compared to the previous year, with Latvia reporting a hidden income share of 16.3% in 2022. Lithuania saw an increase in unreported income, reaching 19.7% in 2022.

The study also addressed unregistered businesses and bribery, estimating that the volume of goods or services provided by unregistered businesses in Latvia, Lithuania, and Estonia in 2022 was 8.5%, 9.5%, and 6.3%, respectively. The overall level of bribery decreased in Lithuania and Estonia but increased slightly in Latvia to 9.4%.

Satisfaction with the performance of the revenue services among businesses in the Baltic States remains relatively high. The "SSE Riga" study on the Shadow Economy Index in the Baltic States is conducted annually, based on surveys of Baltic entrepreneurs. To calculate the size of the shadow economy as a percentage of GDP, the index includes calculations on undeclared business income, unregistered or hidden employees, and undeclared "envelope" wages.

Businesses' satisfaction with tax policies and the quality of business legislation has increased across all Baltic States from 2021 to 2022. However, satisfaction with government support for businesses remained the same in Latvia, increased in Estonia, and slightly decreased in Lithuania.

The study suggests that while newer and smaller businesses proportionately engage more in shadow activities, the overall contribution to the shadow economy is primarily from larger businesses. This is directly related to the fact that larger businesses, though proportionally less involved in the shadow economy, circulate much larger financial resources.

To address the persistent issue of the shadow economy, Sauka recommends not focusing solely on specific industries but on improving the business environment and entrepreneurs' tax morale. Strengthening the state's administrative capacity and fostering a willingness among entrepreneurs to voluntarily pay taxes are seen as vital steps. Additionally, Sauka highlights the need for coordination between various ministries and agencies, data exchange and compatibility, and the development of more modern solutions to combat the shadow economy.

Government Strategies and Legislative Measures

The Latvian government's strategic plan for 2024-2027 aims to mitigate the shadow economy through a blend of horizontal and targeted interventions within specific economic sectors, emphasizing collaboration with sector ministries and non-governmental organizations. This middle-term policy planning document highlights the government's commitment to reducing the shadow economy over the next four years.

Three priority sectors have been identified for focused efforts to curb the shadow economy: construction, healthcare and social care, and wholesale and retail trade, particularly regarding the use of cash in transactions and the availability of information to, and its publication by, state institutions. The governance model established by the order ensures that each sector's ministry is responsible for the development, implementation, and oversight of the plan's measures within its purview.

To formulate proposals for the 2024-2027 plan, four working groups were established, focusing on the use of cash in transactions, information and data exchange between state institutions, policy and legal regulation in the construction sector, and policy and legal regulation in the healthcare sector, including cosmetic services. These groups, comprising representatives from various ministries, the State Revenue Service (VID), professional associations, and the anti-corruption office, among others, developed over 50 measures, laying out key action directions and expected outcomes.

The plan's measures aim to minimize the risk of the shadow economy within specific sectors and estimate the potential fiscal impact on the state budget. Initially, the plan was conceived for a three-year term but was later aligned with the Tax Policy Guidelines to cover a four-year period, underlining the interconnection between an attractive business environment and the mitigation of the shadow economy.

The plan was thoroughly discussed and agreed upon with sector ministries, the VID, and industry associations, including unique measures to reduce shadow economy risks that do not overlap with tasks included in other strategic documents or the VID's operational and supervisory activities.

Furthermore, the plan includes initiatives aimed at reforming sector policies and legal frameworks to limit the shadow economy, improve the business environment, and encourage voluntary compliance with tax obligations. These include using taxpayer ratings in public procurements, restricting cash circulation, promoting non-cash transactions, exploring the enhancement of resident income declarations, strengthening data analytics, and improving information and data exchange in construction, health, and beauty sectors, among other measures to enhance business competitiveness.

The Results of the Study on Opportunities for Increasing the Competitiveness of the Latvia Financial Sector

Research conducted by assoc. prof., Dr. Nina Linde, Director of the Institute of Economics of the Latvian Academy of Sciences in 2024 outlines significant insights into the Latvian financial sector's regulatory environment, focusing on the challenges and impacts of Anti-Money Laundering and Counter-Terrorist Financing (AML/CTF) measures on the sector's operations and the broader economy. A critical aspect highlighted is the excessive regulatory demands and increased bureaucracy, notably in AML/CTF risk control and management. These measures have led to increased customer service costs, directly impacting clients and making the account opening process both resource and time-intensive for potential clients, especially new entrepreneurs, and financial institutions themselves.

The study revealed that banks are increasingly focusing on serving Latvian residents due to the financially unfeasible nature of serving non-residents, attributed to stringent AML/CTF requirements. This shift has negatively affected Latvia's financial sector's attractiveness to foreign investors. Account opening costs, evaluated in terms of time and human resource consumption, vary significantly, with legal entities facing fees ranging from €100 to €150 for Latvian residents. For non-residents, these fees can skyrocket, reaching between €300 to €1,000 or even higher, reflecting the extensive and costly due diligence process required by banks.

The refusal rate for account openings varies across institutions, with reasons for denial including the failure to submit requested information, high AML/CTF or sanctions risks, unclear account usage purposes, and inadequate communication from the client regarding AML/CTF risks. Banks face challenges in balancing regulatory requirements with efficient customer service, often leading to situations where clients (consumers) feel held "hostage" by the bank's discretionary practices, including the risk of existing account closures without clear justification.

Despite the so-called "capital overhaul" improving banks' AML policies and their implementation, challenges persist, including the lack of practical execution standards and a common understanding of AML/CTF regulatory compliance among financial market participants. Furthermore, the "capital overhaul" has not yielded expected outcomes, such as reducing the shadow economy level in Latvia. Instead, it has negatively influenced economic growth, foreign investment attraction, and the competitiveness of the financial market.

The banking sector's perspective on stringent regulations is nuanced. On one hand, there's recognition of the need for robust AML/CTF measures. On the other, the complexity and cost of compliance have posed significant operational challenges. New businesses, in particular, risk being driven into the shadow economy due to the difficulties in opening accounts and starting commercial activities in Latvia. Moreover, the emphasis on regulatory compliance has diverted substantial financial and human resources from business development towards meeting the technical and procedural demands of AML/CTF measures, impacting the sector's ability to foster growth and innovation.

In summary, while efforts to strengthen the financial and capital market systems in Latvia were intended to combat money laundering and terrorist financing, the resultant regulatory framework has placed a considerable strain on the banking sector. This has not only increased operational costs but also potentially stifled economic innovation and reduced the attractiveness of Latvia as a destination for foreign investment. The challenge lies in finding a balance between enforcing necessary regulatory measures and maintaining a business-friendly environment conducive to growth and international cooperation.

The Importance of Integrating Research Findings into the Policy Agenda

The disconnect between policy formulation and the integration of academic research recommendations in Latvia's shadow economy reduction efforts highlights a critical gap in effectively leveraging expert insights for policymaking. Despite the existence of comprehensive research and expert recommendations on combating the shadow economy, there seems to be a persistent challenge in translating these insights into actionable and integrated policy measures. This gap not only undermines the potential efficacy of strategies aimed at reducing the shadow economy but also raises questions about the alignment of policy objectives with evidence-based research.

Experts and researchers have long emphasized the importance of adopting a holistic approach that encompasses not only regulatory and enforcement measures but also initiatives aimed at promoting voluntary compliance and enhancing the overall business environment. Recommendations often include the implementation of educational campaigns to raise awareness about the benefits of full tax compliance and the risks associated with partial compliance, the use of taxpayer ratings in public procurement to incentivize good tax behavior, the introduction of electronic invoicing to streamline tax reporting and reduce opportunities for underreporting, and the shift towards digital payments to reduce cash transactions that are harder to trace.

However, the successful incorporation of these recommendations into national policy and practice requires a concerted effort to bridge the gap between academic insights and policy execution. This entails fostering closer collaboration between policymakers, regulatory authorities, and the research community to ensure that policy decisions are informed by the latest findings and best practices in the field of shadow economy mitigation.

One of the key suggestions for improvement is the establishment of formal mechanisms for ongoing dialogue and knowledge exchange between researchers and policymakers. This could involve the creation of advisory panels comprising experts from academia, industry, and government to review and provide input on policy proposals related to the shadow economy.

Additionally, there should be a structured process for evaluating the impact of implemented policies and adjusting them based on empirical evidence and expert feedback.

Investing in technology and data analytics is another critical area for improvement. The implementation of data sharing and management platforms, as outlined in the proposal for a Data Distribution and Management Platform (DAGR), exemplifies how technology can facilitate better information exchange among government agencies, enhance transparency, and support more informed decision-making processes. Such platforms can enable more accurate monitoring of the shadow economy and the effectiveness of policies designed to mitigate it.

Furthermore, promoting taxpayer education and leveraging technology to improve tax compliance and administration efficiency can play a significant role in reducing the shadow economy. Informative campaigns aimed at improving tax morale, along with the adoption of digital solutions for tax reporting and payment, can significantly impact voluntary compliance rates.

In summary, addressing the disconnect between policy and research in Latvia's efforts to reduce the shadow economy requires a multifaceted approach that includes enhancing collaboration between researchers and policymakers, leveraging technology for better data management and policy evaluation, and focusing on initiatives that promote voluntary compliance and improve the business environment. By aligning policy initiatives with expert recommendations and evidence-based strategies, Latvia can make significant strides in mitigating the shadow economy and fostering a more transparent and fair economic landscape.

Conclusions

The analysis of Latvia's multifaceted strategies to combat the shadow economy reveals a landscape marked by significant efforts and challenges. The persistence of the shadow economy, constituting a substantial portion of the GDP, highlights the complexity of the issue and its implications for equitable growth and fiscal stability. Despite the slight reduction in the shadow economy's scale to 26.5% of the GDP, Latvia faces a pressing need to refine and sustain its strategies against this economic informality.

The government's strategic plan for 2024-2027, emphasizing collaboration with sector ministries and leveraging both horizontal and targeted interventions, showcases a commitment to addressing the shadow economy comprehensively. However, the effectiveness of these measures depends on their execution and the ability to adapt based on ongoing assessments. The focus on sectors like construction, healthcare, and retail, known for their susceptibility to shadow activities, is a step in the right direction. Yet, the success of these efforts requires rigorous implementation and continuous evaluation to ensure they meet the intended

Financial sector regulations, particularly those related to AML/CTF, highlight a critical tension between stringent compliance demands and the operational realities of banks and financial institutions. While these regulations aim to curb illicit financial flows, they also impose significant burdens on the banking sector, potentially affecting customer relations and the sector's attractiveness to foreign investment. Future policies should seek a balance that maintains rigorous AML/CTF standards while also considering the operational and customer service implications for financial institutions.

The disconnect between policy formulation and the integration of academic and expert recommendations represents a missed opportunity for leveraging comprehensive insights into effective policy-making. Establishing mechanisms for ongoing dialogue and collaboration between policymakers, researchers, and industry stakeholders could bridge this gap. By incorporating evidence-based recommendations and continuously evaluating policy impacts, Latvia can enhance the effectiveness of its strategies against the shadow economy.

For businesses, the current landscape underscores the importance of compliance and active engagement with policy developments. Companies must navigate the regulatory environment carefully while advocating for policies that support a fair and competitive business landscape. For the presented plans to be sustainable, there must be a concerted effort to address the underlying factors contributing to the shadow economy, such as tax morale, regulatory complexity, and the need for a transparent and efficient administrative process.

In conclusion, Latvia's fight against the shadow economy is an ongoing challenge requiring a nuanced, multi-stakeholder approach. Recommendations for future policies include focusing on enhancing tax morale through education and transparent communication, simplifying regulatory frameworks to reduce the burden on businesses, and fostering collaboration between the government, the financial sector, and academic researchers. Such a holistic approach can contribute to a more effective combat against the shadow economy, ultimately fostering a more transparent, fair, and thriving economic environment in Latvia.

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