

SHADOW ECONOMY AS AN OBSTACLE TO SUSTAINABLE ECONOMIC DEVELOPMENT

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Abstract. The article describes the research of the development of the shadow economy, defines its essence, discloses main reasons for its occurrence; describes its structure, Identifies factors that promote its development; evaluates the system of combating measures and reveals the results of controlling it. Policy implications are being suggested.

Keywords: shadow economy, economic development, Baltic countries

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1. Introduction

The shadow economy has an impact on all economic phenomena and processes of the society: formation and distribution of income (Baikovs, Zariņš 2013; Giriūnienė 2013; Garškaitė-Milvydienė 2014; Peker *et al.* 2014; Giriūnas, Mackevičius 2014; Šabaševičienė, Grybaitė 2014; Korsakienė, Tvaronavičienė 2014; Tvaronavičienė 2014), trade, investment (Dudzevičiūtė 2013; Laužikas, Krasauskas 2013; Korsakienė 2013; Wahl, Prause 2013; Figurska 2014), motivation of employees (Laužikas, Mokšėckienė 2013; Išoraitė 2013; Caurkubule, Rubanovskis 2014; Tarabkova 2014), approach towards entrepreneurship (Litvaj, Poniščiaková 2014; Moskvina 2013; Bileišis 2014; Dzemyda, Raudeliūnienė 2014; Raudeliūnienė *et al.* 2014), valuation of companies (Prause 2014; Peker *et al.* 2014) and economic growth and sustainable development in general (Plachciak 2010; Baikovs, Zariņš 2013; Tvaronavičienė 2014; Vasiliūnaitė 2014). Shadow

behavior is observed not only in economics but also in a variety of non-economic areas of the state: political system, law and law enforcing spheres, media, education, health, culture and science, etc.

Globalization in the world economy has not only opened up new possibilities for progressive economic development in the post-Soviet countries, but at the same time caused a number of qualitatively new global threats. Today the shadow economy has become one of such threats. The statistical analysis shows that to calculate the exact share of the shadow economy in the world GDP is extremely difficult. According to the representatives of the International Monetary Fund, the total amount of shady transactions in the world reaches up to 10-11 trillion dollars, which is comparable to the size of the total U.S. GDP.

The goal of the article is to define the essence and causes of the shadow economy, and to indicate measures required for its suppression in the economy in Latvia. **The objectives of the article are** to define the

nature of the shadow economy and its main causes, to analyze its structure and identify its components, to determine the factors contributing to the development of the shadow economy and to evaluate the system of measures which combat it, to identify practical mechanisms of control. The object of the study is a comparative analysis of the socio-economic development in the Baltic countries - Estonia, Latvia and Lithuania, the subject of the study is the analysis of existence of the shadow economy as a socio-economic phenomenon. The methods of the study were basic techniques of systemic and situational approach, structural and comparative analysis. This article describes the investigation of the shadow economy mainly at the macro level. The criminal shadow economy is not considered, especially its extreme variant - latent economy (in German "Latentwirtschaft", in French "Economie latente", in Russian "латентная экономика").

2. The essence of the shadow economy

With the development of the science of management, views on the shadow economy also develop. It is believed that the shadow economy emerged simultaneously with commodity and commodity-money relations. Prior to the formation of national legal systems a major restriction of unfair business practices was a tribal moral or religious morality. Ethical standards were formed mainly on the basis of religious principles (e.g., "Thou shalt not kill," "Thou shalt not steal").

It is possible to find in Plato and Aristotle, what developed the economic sense of a natural way of managing. For instance, Plato (428-348 BC) opposed the use of money in order to gain wealth and usury. Aristotle (384-322. BCE) is notable for his analysis of capital, as it existed in the ancient world of trade, in its monetary form. He singled out two forms of economic organization: he called the first one *chrematistics*, and there he included activities aimed at profit and the accumulation of wealth. He called the second one *the economy*, which meant activities aimed at the acquisition of goods for households and the state.

According to the ideology of Christianity the economic interests must be subordinated to the common good and genuine cause of life – the salvation of the soul. In medieval theory, there was no place for economic activity that was not associated with a moral purpose. The state has not always been a mod-

el. It often violated the rules itself, especially in the sphere of money circulation.

The period of the so-called primitive accumulation of the capital during XV-XVIII centuries is likely to be regarded as the end of the dominant influence of the ideas and practices of canon law. The leading states of that time (Spain, Portugal, the Netherlands, and England) were actively involved in the slave trade, in the export of precious metals from Latin America and in encouraging piracy. That period led to the emergence of a new social class - entrepreneurs. The evolution of attitudes towards entrepreneurship also represents a certain interest. It is well known that the term "entrepreneur" was introduced into scientific discourse by Richard Cantillon at the beginning of XVIII century. He considered business income as a payment for risk. The concept included not only traders but also people who organized military expeditions, and even thieves. It should be noted that the views on what constitutes fair and unfair business practices also changed over time. Thus, in the period of primitive capital accumulation, slave trade, sea piracy, confiscation of the native lands flourished abundantly. They were considered to be normal business practices.

One of the most paradoxical phenomena of economic science in XX century was that the shadow economy was increasingly growing within the market economy, changing shapes and scale, but economists continued to ignore the fact, considering it to be the subject of study of criminal law, criminology, etc. The problems of present day informal economy have attracted the attention of researchers in 1930s. In the late 70s there were a number of serious studies in this field. The work of P. Gutmann can be noted in this connection (USA) "The Subterranean Economy" (1977), where he strongly argued in favor of the inadmissibility of ignoring its scope and role (Gutmann 1977). Also the work V. Burov (Russia) should be mentioned "The shadow activities of small businesses" (2011), in which she explores the problem of shadow activities of MPs, tendencies of transformation and quantitative assessment of the scope and structure of these activities (Burov 2011).

In 1991, the Conference of European Statisticians took place in Geneva and it was devoted to the phenomenon of hidden and informal economy. The conference was guided by the latest publications on the statistics of the shadow economy in the countries

with a market economic system. In May 1996, at a joint meeting of Eurostat, the problem of assessing the scope of the shadow economy was considered and a special working group for its study was set up. Although the studies on the shadow economy have been going on for several decades, economists have still not formed a unified conceptual framework for its analysis. Most authors, who tried to assess the shadow economy, are still facing the difficulty of producing a precise definition of the phenomenon. (Alderslade *et al.* 2006; Brueck *et al.* 2006; Chen 2004; Flaming *et al.* 2005; Marcelli *et al.* 1999; Tafenu *et al.* 2010; Williams and Windebank 1998, 2001a, b). In trying to produce this definition different terms in different countries have been applied: in English-speaking countries it is called the “shadow”, «unsanctioned», «parallel», «hidden» economy, in French – “informal” (informelle), «underground» (souterraine), «informal» (inofficielle); in German – the “shadow economy” (Schattenökonomie).

However, in the economic and sociological literature there it may be noticed not only the absence of a single unified term that defines the phenomenon of the shadow economy, but there is absent a clear understanding of the phenomenon too. Even EU countries do not have a single principle of accounting, for example, of manpower and agricultural production. In the Netherlands only land owners are treated as producers, but direct services providers, such as workers of specialized cooperatives, are not. (They are considered service producers.) In Denmark, the owners of certain types of land and those who actually work in these lands are not counted as employed. On one fine Saturday in September, A. Rubanovskis had the honor of talking to burgomaster of Ærø island. (This island is about 16 x 4 sq. km, the village is divided into two settlements and there is just one police officer as he crime situation is very quiet there). A. Rubanovskis asked him, how many people were employed in the agricultural production on the island, as it was noticed that a lot of people worked in all fields. The burgomaster replied: “Nobody! This is hobby farming!” (They call these areas as home gardens, backyard farms, etc.). The owners of these farms - mostly retired, may be living even in Copenhagen. They are helped by children, grandsons and great-grandsons, and are not included in any special cooperatives, as in the Netherlands.

At the initial attempt undertaken by German re-

searchers to economically define this term, only secret financial transactions of various kinds were attributed to the underground economy. A number of German authors believe that the shadow economy primarily involves criminal activity, while others define it as a sector which involves all tax evading practices. Some others include here not only financial transactions, but also economic activities, which results in their opinion, should be included in the GDP. Here it is also worthwhile to mention the definition formulated by E. Feige (1990): “The informal economy includes economic activity which bypasses the (private) costs and eliminates the (social) benefits and rights prescribed by the laws and regulations governing the relations of property, commercial licensing, labor contracts, the relationship of financial credit and social insurance.”

The “Business Oxford Dictionary” gives the following definition of the shadow economy: “The underground economic activities, the discovery of which entails a taxation of income and even imprisonment of those who are engaged in them” (Business: The Oxford Dictionary 1995). Pass *et al.* (1995) define it in this way: “The shadow economy is an activity that is conducted within the framework of the economy, but not registered properly and therefore not reflected in the national income accounts.” According to one commonly used definition it comprises all currently unregistered economic activities that contribute to the officially calculated Gross National Product (Buehn *et al.* 2009; Feige 1989, 1994; Frey *et al.* 1984; Gołębiowski 2007; Karmann 1986, 1990; Schneider 1994, 2003, 2005). Smith (1994: 18) defines it as “market-based production of goods and services, whether legal or illegal, that escapes detection in the official estimates of GDP.” Put differently, one of the broadest definitions is: “...those economic activities and the income derived from them that circumvent or otherwise avoid government regulation, taxation or observation” (Dell’Anno 2003; Dell’Anno and Schneider 2003; Feige 1989; Feld *et al.* 2005; Fleming *et al.* 2000; Thomas 1999).

Such activities may include:

1. Working for a friend, which work may be performed as a favor without payment, also unpaid services of a spouse (with the development of household appliances and technologies, the cohabitants gladly help each other in the kitchen, by cleaning the property and so on.)
2. One person delivering to another person goods or

services in exchange for the equivalent without receiving payment in cash.

A Latvian scientist V. Roldugin (2005) gives the following definition of the underground economy: "It is the economy, which is not controlled by the state and it does not include the official state statistics."

In most cases, the shadow economy promotes the emergence of a crime situation in which subjects avoid taxes. There may be other reasons, when the economic subject does not want to report his economic activities to anybody. The UN specialists engaged in national accounting consider the shadow economy as three, partly overlapping, spheres of activity, but they are well-defined and distinct from other sets of phenomena. These spheres are:

- Legitimate activities connected with the production of goods by households and consumed by them not subjected to official registration and taxation ("informal"), for example, agricultural production on the private farms and for individual needs, is considered beneficial to the society.
- Legitimate activities which, in order to evade the payment of taxes, are hidden or minimized and/or carried out without the appropriate licenses ("hidden") This type of informal economic activity covers a significant share of the economy, ranging from large enterprises, firms, financial institutions and to the activities of small enterprises without legally employed workforce (e.g. temporary construction teams). It poses a threat to the economic safety of the country, first in the form of concealment of income and taxes, and secondly, in the form of the creation of criminal economic environment.
- Illegal activities representing production and distribution of goods and services forbidden by law (for example, the production and distribution of drugs, weapons, prostitution, smuggling), as well as the activities representing illegal obtaining of income not related to the production of goods and services (e.g., racket, fraud). These activities represent a direct threat to the security of individuals, society and the state. (Kovalev and Latov 2006).

In the light of all said above, it is evident, that the shadow economy is a part of the national economy, where certain business operations are conducted not according to the legally accepted business behavior. Because of the illegality of the shadow economy, its products are fully or partially concealed from the official record by economic agents (Kovalev and Latov

2006). In the most general form, the shadow economy is defined as a set of economic activities, which, for some reason are not taken into account by official statistics, are not covered by taxation and are not included in the GDP (Grjaznova and Dumnaja 2005.).

Summarizing all views on the shadow economy considered above, the authors propose the following definition: "The shadow economy is production, distribution, exchange and consumption of any commodity, material assets, money, services, uncontrollable by state and society and being hidden from the government and the public." The shadow economy covers the sphere of socioeconomic relationships between individuals, social groups, etc, by the use of state property for personal or group interests. The shadow economy includes all unaccounted, independent, other than those specified in the regulations and the rules of managing economic activities.

3. The scope and the structure of the shadow economy

There are many approaches to the study of the shadow economy. The peculiarity of the economic approach is related to its impact on the economic policy effectiveness, distribution and use of economic resources, the development of reliable methods of measurement and evaluation. This approach tends to explore the underground economy at its various levels. At the macro level, shadow economic activities are analyzed in terms of their impact on the structure of economy, production, distribution, redistribution and consumption of the GDP, employment, inflation, economic growth and other macroeconomic indicators. In this case a variety of methods are used to quantify the scale of the shadow economy (Burov 2011). As a result of application of different methods the following estimates of the shadow economy were produced (in% of GDP) for the countries that differ in a number of features from each other and at different periods of time: for Austria - from 4 to 9%, Belgium - from 2 to 20%, France - 6 to 9%, Germany - from 3 to 15%, UK - from 2 to 8%, U.S. - from 4 to 30%. A famous publication of the American economist Feige (1979) was scandalous: he calculated that the sector of irregular economy in the U.S. makes at least one third of the official GDP, i.e. about the same as the informal economy in the countries of the third world. Just how strong repercussions this article produced was evidenced by the fact that a special hear-

ing of the economic committee of the U.S. Congress was dedicated to its discussion. (The underground economy 1979) E. Feige’s colleagues unanimously reproached him in overestimating his figures several times (apparently, the author wrote his article specifically with an aim to produce an epatage). For example, P. Gutmann (1979.) estimated the size of the informal economy in the U.S. in 1978 only about 10% of officially registered GNP and V. Tanzi (1982) even cut it to 4.4%. While experts continue to argue about the extent of the phenomenon, the attention of the scientific community to this sector of the economy

of developed countries has been assured since then. In later years, special studies on informal economic activity began to be conducted not only in the U.S. but also in other developed countries. In Europe, the share of the shadow economy in 2012 decreased to 19% of gross domestic product (GDP). The research of scientists at Linz University included the countries of EU, together with Switzerland, Norway, Croatia and Turkey. In 2012, the shadow economy in these countries amounted to 2.175 trillion euro (1.5 trillion LVL). In 2011, the proportion of the shadow economy in Europe was 19.2% (Figure 1).

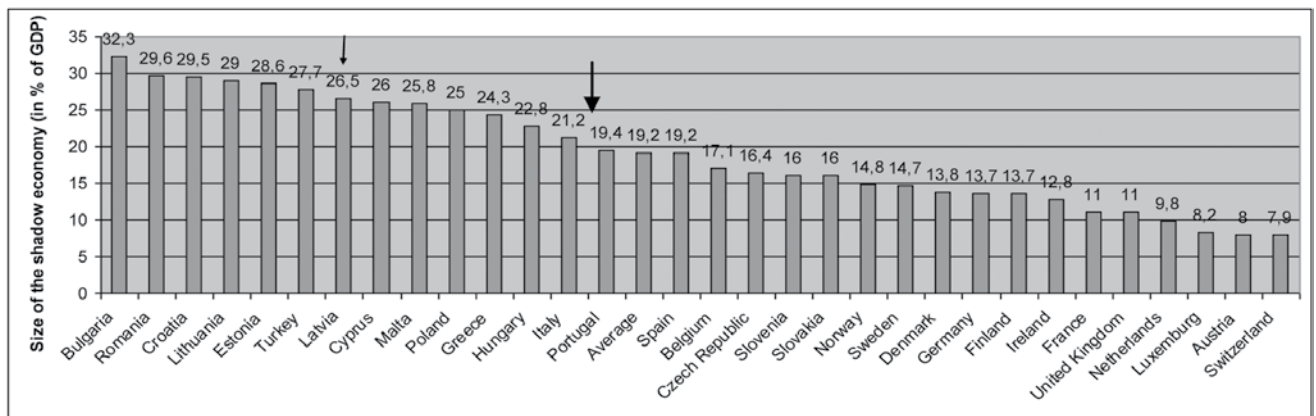


Fig.1. The scale of the shadow economy in EU in 2011

Source: Schneider 2013

As for Latvia, according to CSB LR, in 2011 the proportion of the shadow economy was 18%, according to preliminary estimates of professor Friedrich Schneider of the Linz University- 29% of the GDP (Latvian statistics 2014). At the end of the study, F. Schneider gives the final figure for 2011 - 26, 5% (Schneider and Buehn 2012), which is the fifth highest in all EU countries. According to the shadow economy dynamics, it can be seen that since 2010 the share of the shadow economy has reduced, but the level is still high. Figure 2 reflects the dynamics of the shadow economy scale in Latvia.

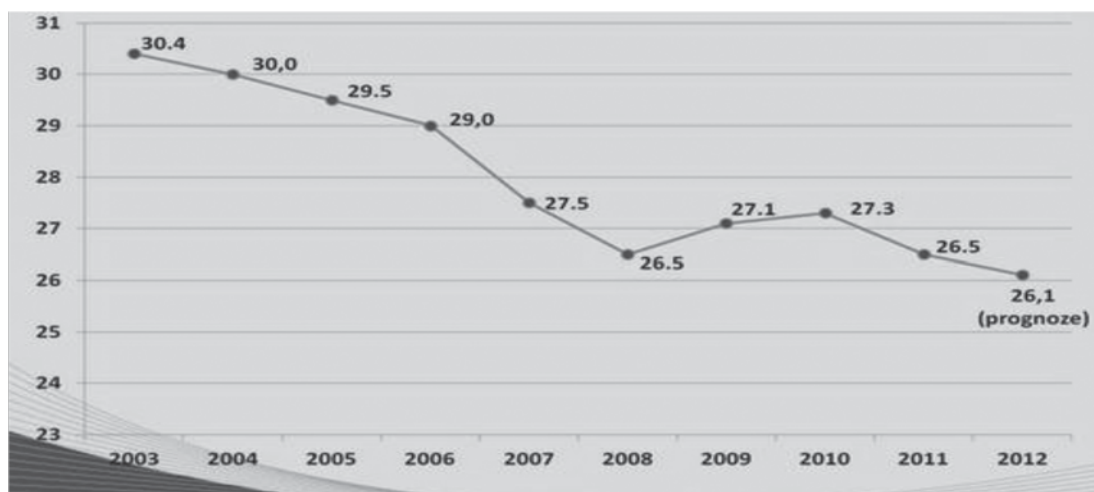


Fig.2. The scale of the shadow economy in Latvia 2003-2012.

Source: Schneider 2013

4. The links between the shadow economy and the economic progress in the Baltic states of Lithuania, Latvia and Estonia

Table 1 reflects the dynamics of growth for the shadow economy in the Baltic States:

Table 1. The growth rate of the shadow economy in the Baltic States (in % of the GDP)

Country	1989	1992	1995	2010	2011	2012
Estonia	12.0	22.4	12.8	19.4	28.6	19.2
Lithuania	12.0	39.2	21.6	18.8	29.0	18.2
Latvia	12.0	34.3	35.3	27.3	26.5	21.1

Source: the author's construction from (Does not indicate a reduction of the shadow economy 2012; Burov 2011; Sauka 2011)

The analysis of the data represented by Table 1 shows a trend of downward tendency in the level of the shadow economy of Latvia in the post-crisis period. However, in comparison to Estonia and Lithuania, in 2012 Latvia was the leader according to the scale of the shadow economy, which to some extent correlated to the economic development in these states.

In May 2011, TNS Latvia completed the study, which showed that 58% of the economically active people of Latvia were in some way connected with the phenomenon of the shadow economy. As for the structure of the shadow economy, the results of the study released on 15.05.2013 at a press conference in Riga Graduate School of Economics, showed that 42.9% of the shadow economy in Latvia are wages "in envelopes", 39.5% - concealed income and 17.6% - unofficially working people. In Lithuania, the structure of the shadow economy is similar - wages "in envelopes" make 39.3%, concealed profit - 42.7%, unofficially working people - 18%. In Estonia, the main proportion in the shadow economy structure is wages "in envelopes" - 52.3%, the share of not shown profits - 28.5%, unofficially working people - 19.2%. The proportion of the shadow economy is the highest in the wholesale and retail trade, which is respectively 28.7% and 26%. 23.2% of the sector of services is also in the "shadow". According to the conclusions of the authors of the cited study, mostly small businesses and micro-enterprises with the number of employees from 1 to 5 persons are involved in the shadow economy - 30.5%. The share of enterprises with number of employees from 6 to 10 is 26.2%. The lowest share of the shadow economy

is in the group of large enterprises employing more than 200 people - 17.3% (Sauka 2013). Table 2 reflects the rating of the Baltic States in relation to the GDP per capita and the average level in EU, which shows that Latvia has the lowest GDP per capita according to the EU average.

Table 2. Rating of the Baltic States in relation to the GDP per capita and the average level in the EU

Position	Country	2010	2009	Changes
21	Estonia	65	64	1
24	Lithuania	58	55	3
25	Latvia	52	52	0

Source: RIA "Analytics" (2011)

Eurostat data on labor productivity also show that the gross domestic product per working hour in Latvia in 2010 was only 15.6 euro, while in Lithuania - 18.5, and in Estonia - 20.6 euro. Lower than in Latvia, productivity indices were registered only in Bulgaria and Romania (Development of Latvia is slowed by shadow economy 2011). This is also evidenced by rating data on the share of food expenditure in overall consumer spending in 2009 (Table 3), although during the post crisis period the situation in Latvia did not change much.

Table 3. Ranking countries according to the share spent on food products in the overall amount of consumer expenditure (2009)

Position	Country	Food-stuff, %	Non-alcohol drinks, %	Alcohol, %	Catering, %
26	Estonia	20.9	1.4	5.8	4.4
32	Lithuania	23.3	1.9	4.7	1.9
25	Latvia	18.4	0.1	4.3	3.3

Source: RIA "Analytics" (2011)

The important factor in the growth of the shadow economy is the level of corruption in the state. The Old Greek philosopher Socrates (\approx 469 - 399 BCE) already specified the corruption of a state as an immoral phenomenon. In the ranking of countries in terms of corruption (Table 4), according to the study conducted by the international organization "Transparency International", Latvia looks the worst, in comparison with Estonia and Lithuania and among 182 countries, which was expected:

Table 4. Corruption Perception Index of the countries in 2012

Position	Country	Score
32	Estonia	64
48-49	Lithuania	54
54-57	Latvia	49

Source: The most corrupt countries in 2012

There are two different explanations of high interdependency between the shadow economy and corruption: the shadow economy is an attempt to eliminate corruption - the entrepreneur goes into hiding to avoid paying bribes, thus corruption generates additional growth of the shadow economy. According to some estimates, the increase in the corruption index by one point leads to the growth of the shadow economy by 7.6%. This is not consistent with the concept of the shadow economy as a way to bypass the corruption, but supports the concept of the shadow economy as a product of corruption. Table 5 was compiled on the basis of reports made in 2011, which covered 142 countries. The table shows that Estonia takes 35th place, Latvia – 43rd and Lithuania – 47th. According to the ratings of the Baltic States in the last 3 years, it can be concluded that Estonia is the leader among these countries in the field of social welfare, and its place is relatively stable over the last three years. Latvia worsened its position in the ranking of 2011 as compared with a rating of 2010 by 4 points, but in 2012 moved up by 8 points, ahead of Lithuania. It means that in 2011 (rating of 2012) social welfare in Latvia improved compared to 2010 (rating of 2011) (The 2012 legatum prosperity index table).

Table 5. Rating of the countries according to the index of prosperity

Year	Latvia	Estonia	Lithuania	Countries researched
2010	47	35	42	104
2011	51	33	44	110
2012	43	35	47	142

Source: The 2012 legatum prosperity index table

5. Factors influencing the development of the shadow economy

Several groups of causes affecting the development of the shadow economy may be identified:

1. Economic factors - the restructuring in the spheres of economic activity, which is not always focused on the development of legitimate business structures, the crisis of the financial system and the impact of its adverse effects on the economy as a whole; imperfect investigation of the privatization process; the operation of unregistered economic structures; problems of economic competition; low income level of the population; the rise in prices of basic food products; improperly balanced tax burden; shortcomings in the regulation of the labor market; the quality of social services and inadequate formal assessment of the current economic situation in the country.
2. Social factors - low standard of living, which contributes to the development of hidden economic activities; high level of unemployment and the general orientation of the population to earn income by any immediate means; the uneven distribution of the GDP; and low level of social protection.
3. Legal factors - inadequate functioning of law enforcement agencies due to the lack of necessary materials and technical resources; poor knowledge of people working in the system of law enforcement regarding the economic activities and conditions of the market economy; the overall low level of legal awareness and legal culture of the population; imperfect legislation.
4. Political factors - controversy in the political system. One of the fundamental questions here is about the relationship of power and big business.
5. Anthropological factors - these are connected to contradictory human nature. The aspiration to receive more at the expense of less effort is typical of a human being. Similar rationalism in case of absence or weakness of delimiters induces a person to engage in shadow activities.
6. Ethical factors - poor ethical foundation of entrepreneurship.
7. Social and cultural factors – it is essential to understand the basics of entrepreneurship and the features of the shadow economy in culturally different societies.

The analysis shows that to the already mentioned factors influencing the shadow economy development in Latvia, the low income of the main part of the Latvian population should be added - the minimum gross salary in Latvia is 200 LVL (net salary of about 146 LVL), which is significantly lower than the subsistence minimum established by the government (176 LVL). According to the LR Ministry of Welfare, the minimal wage in 2012 was received by

35.4% of the population, from 200,01 to 500 LVL – by 39,4%, from 500,01 to 800 LVL – by 15,3%, from 800.01 1000 LVL –by 3,9%, from 1000.01 to 2000 LVL –by 4,9%, over 2000 LVL – by 1,1% (Does not indicate a reduction of the shadow economy 2012). The increase of the minimum wage to 225 Ls from 01.01.2014 will not significantly improve the financial position of the majority of the population because of growing prices and inflation that will be the results of the transition to euro. The increase in the prices of basic food products and utilities will further lower the standard of living of the financially disadvantaged population. Because of the global financial crisis and recession of the economy, many Latvian companies went bankrupt, and those which remained “afloat” are still experiencing the effects of the global crisis. As the head of “COMPENSA Life” branch in Latvia V. Gustsons (2012) noted, this is the reason why many companies want to optimize their operations not excluding also illegal methods, trying to reduce costs, most of which are the salaries of employees; thus improving their financial position, but at the same time worsening the situation for the employees. Oftentimes, wages remain the same, but are paid “in envelopes”.

According to the World Bank, an important reason for the growth of the shadow economy is the excessive tax burden, and also, as the World Bank mentions in its report, imperfect regulation of the labor market, a poor quality of social services and incorrect formal assessment of the current economic situation in the country (Latvia - first in Europe in the shadow economy). Another important reason for the growth of the shadow economy is a low level of social protection. As it is seen in Table 6, one can conclude that expenditures on the social protection in Latvia are much less than in the EU. The figure for Latvia is not stable and has not yet reached 20%, which is the indicator of a normal development of a country according to the UN.

Table 6. Expenditures on social protection (by ESSPROS classification) in the EU countries for 2005-2010 (% of GDP)

	2005	2006	2007	2008	2009	2010
ES - 27	27,1	26,6	25,7	26,7	29,5	29,4
Latvia	12,8	12,7	11,3	12,7	16,9	17,8

Source: Eurostat (2013)

According to the CSB, in Latvia of 2011, the expenditures on social protection, as calculated according to the methodology of ESSPROS, were 15% of GDP, which is 2.8% less than in 2010 when they were 17.8% of GDP (Latvian statistics 2014). Latvia is still one of the poorest countries in the EU. The welfare of Latvian population is also lower than in neighboring Baltic countries. According to the study of Eurostat in 2008 the number of Latvian people who are at risk of poverty is steadily increasing. For example, in 2008 the proportion of the poor in the population was 33.8%, in 2009 it increased to 37.4%, and in 2010 it was already 38.1%, in 2011 - 40.1%. In numerical terms, back in 2010, 846,000 Latvians lived near the poverty line, and at the end of 2011 - already 900,000. Some economists, among them I. Feiferis (2011) believe that the shadow economy is one of the major components of the economy of Latvia, which allows people to survive on low incomes and so resist emigration to other more successful EU countries.

6. Measures of controlling over the underground economy

On 11.08.2010, the Government of Latvia supported the plan developed by the Ministry of Finance to control the underground economy, which purpose was to make shady financial transactions unprofitable for enterprises. The plan proposed a number of bonuses and benefits for businesses operating legally, the introduction of zero declaration and partial taxes amnesty from July 1, 2011. Entrepreneurs were offered the opportunity to legalize undeclared income by paying a certain tax. At the same time, the Ministry of Finance proposed to create a “white list” of companies that will have advantages in obtaining government contracts and easier access to the EU funds. Also the idea of possible differentiation of the minimum wage, depending on the scope of activities was supported. In total, the plan of the Ministry of Finance listed 60 proposals, most of which eventually acquired a repressive character. However, the international experience shows that the repressive measures are not effective mechanisms for solving the problem of eliminating or reducing the shadow economy. The best measures are considered to be the so-called “stimulating” instruments or incentives. Thus, according to V. Gustsons (2012) an important government decision may be a correct long-term program of fiscal discipline and strategy. Another very effective

“stimulating instrument” is the proposal of the Minister of Health to connect the actual tax payments with the right to receive planned healthcare services. The introduction of such a regulation will make those who are paid in envelopes think twice, whether it will not cause even greater losses in case of the need in medical assistance. V. Gustsons (2012) also considers being an important factor the government procurement orders and the procurement orders of local governments, which account for a significant part of the total purchase briefcase. In perspective there should be a system, when every entrepreneur who wants to receive a government contract will be assessed according to the tax payment criteria. In addition, the government should take measures to tax alignment with the entire Baltic region, as currently the tax burden on workers is the highest in Latvia in comparison with other neighboring countries.

7. Ways to reduce the shadow economy

To effectively combat the shadow economy, it is necessary to understand its causes, which are implied by the economic environment in Latvia. These include, above all, a low living standard of the majority of the population, and a fairly high level of tax burden on business. However, the actions of various government agencies, unfortunately, are insufficiently coordinated with each other and not systemic. In addition, the national legal system is not adapted to combat the laundering of funds, and a huge bureaucratic apparatus of public administration provides a good breeding ground for various corruption schemes at the level of government, especially municipal.

Restriction of the size of the shadow economy may happen only as a result of very serious efforts, including political ones. This should be a real progress towards democratization of all social and economic processes, the increase of accountability of the executive power, strengthening the judicial system and law enforcement system as a whole, and combating corruption of the government. In the light of the global interbanking transactions in the EU and worldwide, prevention of the activities of “laundering” money should conceptually be based on a common basis for all states. Each country is required to develop a strategy for such a struggle, taking into account national peculiarities and specific local conditions. Integrated measures should be based on international practice and should include the following points:

- constant monitoring of new schemes of “laundering” of money and exchange of the information received at the international level;
- monitoring the penetration of organized crime into the sphere of politics and government structures by way of using illegally obtained capital;
- monitoring processes of fusion of organized crime with legitimate criminal and financial institutions;
- continuous tightening of control over banks’ reporting on their work with clientele, and in case of violations applying such measures as criminal prosecution, fines, and withdrawal of licenses;
- strengthening of control over the activities of non-banking financial organizations and institutions, and over the functioning of non-profit organizations, if they create charitable foundations;
- the analysis of the impact of criminal activity related to the “laundering” of money on national law enforcement authorities and economic structures;
- continuous improvement of the performance of public and state structures involved in the prevention of the crime of “laundering” money.

In general, the restriction of the development of the shadow economy in Latvia would contribute to a further improvement of the economy and to the implementation of the governmental plan to control the shadow economy.

Conclusions and proposals

Shadow economic activities have always been neglected by the law. The development of the science of management promotes the development of views on the shadow economy. All sources of shadow economy are intertwined and cannot always be clearly differentiated. One of the most paradoxical phenomena of economic science in the XX century was that the shadow economy was increasingly growing within the boundaries of the market economy, changing in shape and scale, but economists continued to ignore it, considering it a subject of study by criminal law, criminology, etc. The shadow economy embraces the socioeconomic relations among individuals, social groups, etc. and uses the state property in personal or group interests. The shadow economy includes all unaccounted and independent economic activities, other than those specified in the regulations and the rules of managing. The shadow economy is a part of the national economy, where business operations are conducted outside the field of legality. At the macro

level, the shadow economic activities are analyzed in terms of their impact on the structure of economy and the spheres of production, distribution, redistribution and consumption of the GDP, employment, inflation, economic growth and other macroeconomic processes. The data analysis shows a tendency of downward trend in the level of the shadow economy in Latvia during the post-crisis period. However, in comparison with Estonia and Lithuania, in 2012 Latvia was the leader according to the proportions of the shadow economy, which, to some extent, correlated to the economic development of these states. As for the structure of the shadow economy, the results showed that 42.9% of the shadow economy in Latvia are wages “in envelopes”, 39.5% - hidden income and 17.6% - unofficially employed workers. There are two different explanations of high interdependency between the shadow economy and corruption: the shadow economy is an attempt to eliminate corruption - the entrepreneur goes into hiding to avoid paying bribes; in its turn, corruption generates additional growth of the shadow economy. The important factor in the growth of the shadow economy is the level of corruption in the state. The rise in prices of basic foodstuffs and especially utilities reduces the standard of living of the low income section of the population. The important reasons for the growth of the shadow economy are improper tax burden and a low level of social protection. The social protection in Latvia is significantly below than in most countries of EU. The level of social protection in Latvia is not stable and has not yet reached 20%, which % is the indicator of a normal development of a country according to the UN. Some economists believe that the shadow economy makes a major component of the economy of Latvia, and it allows people with low incomes to survive and thus resist emigration to more affluent EU countries. However, this is a short-term “aid” for which people will have to pay in a long-term period. On 11.08.2010, the Government of Latvia supported the plan developed by the Ministry of Finance to control the underground economy, which purpose was to make shady financial transactions unprofitable for business enterprises. The plan of the Ministry of Finance consisted of 60 proposals, most of which ultimately had a repressive character, although the international experience shows that repressive measures are not effective in solving the problem of the shadow economy. An important government decision may be a correct long-term program of fiscal discipline and strategy. First of all the

government should align taxes with the entire Baltic region, as currently in Latvia and in comparison with other neighboring countries, the tax burden on workers is the highest. In general, restriction of the shadow economy in Latvia would contribute to the further improvement of the economy and to the implementation of the national plan to control the shadow economy. The shadow economy is decelerating element in the development of the national economy.

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