Grey economy and corruption in Latvia: causes and effects

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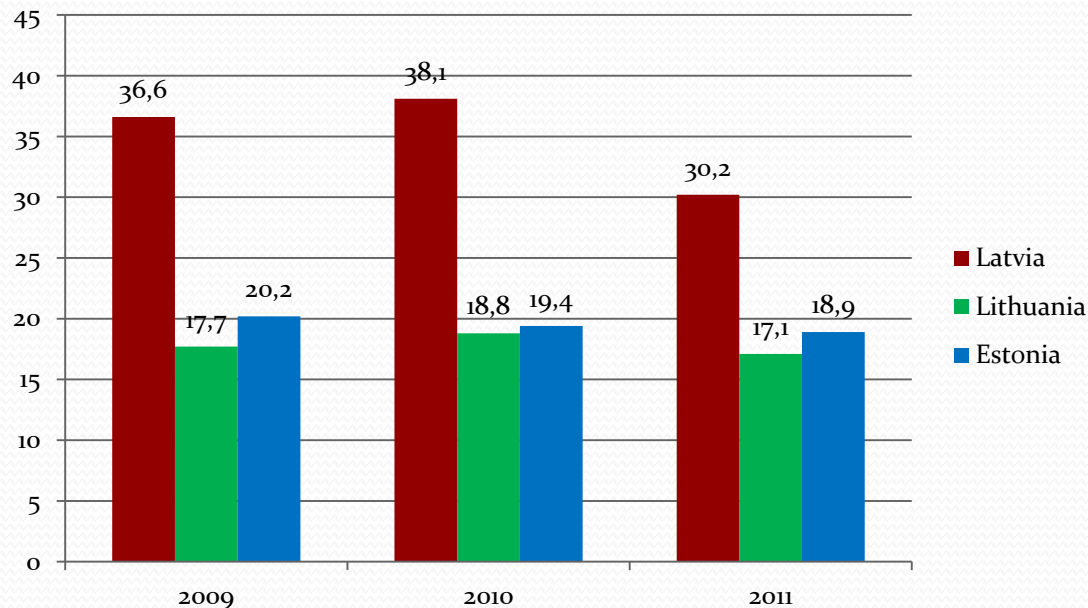
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Current and historical size of the grey economy in Latvia and in the Baltic States
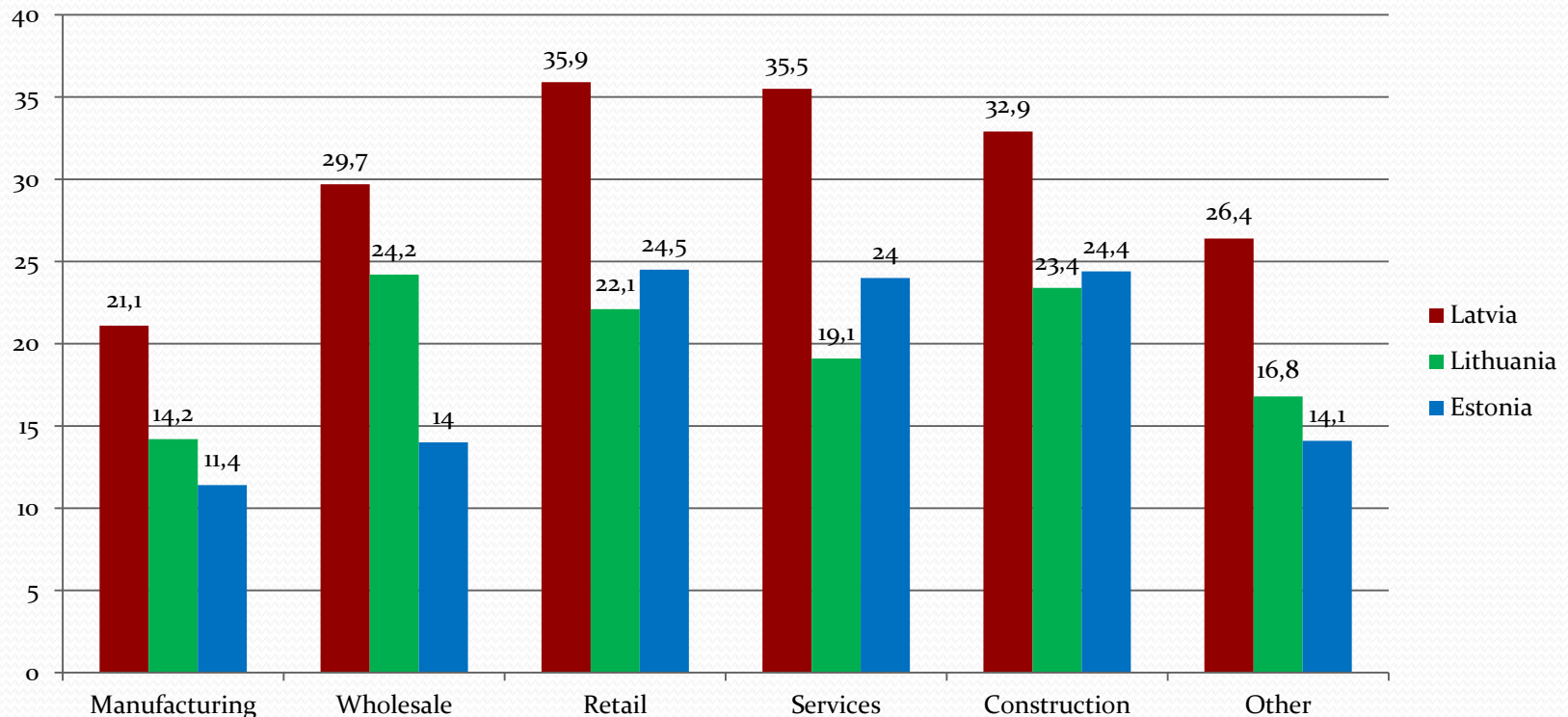
- For very well known reasons there is no official statistics on grey economy
- Statistical data in this presentation is based on an annual study done by two professors at the Stockholm School of Economics in Riga: Arnis Sauka and Talis Putnins
- The study is based on surveys of entrepreneurs in the Baltic States, the newest study was presented in May of 2012
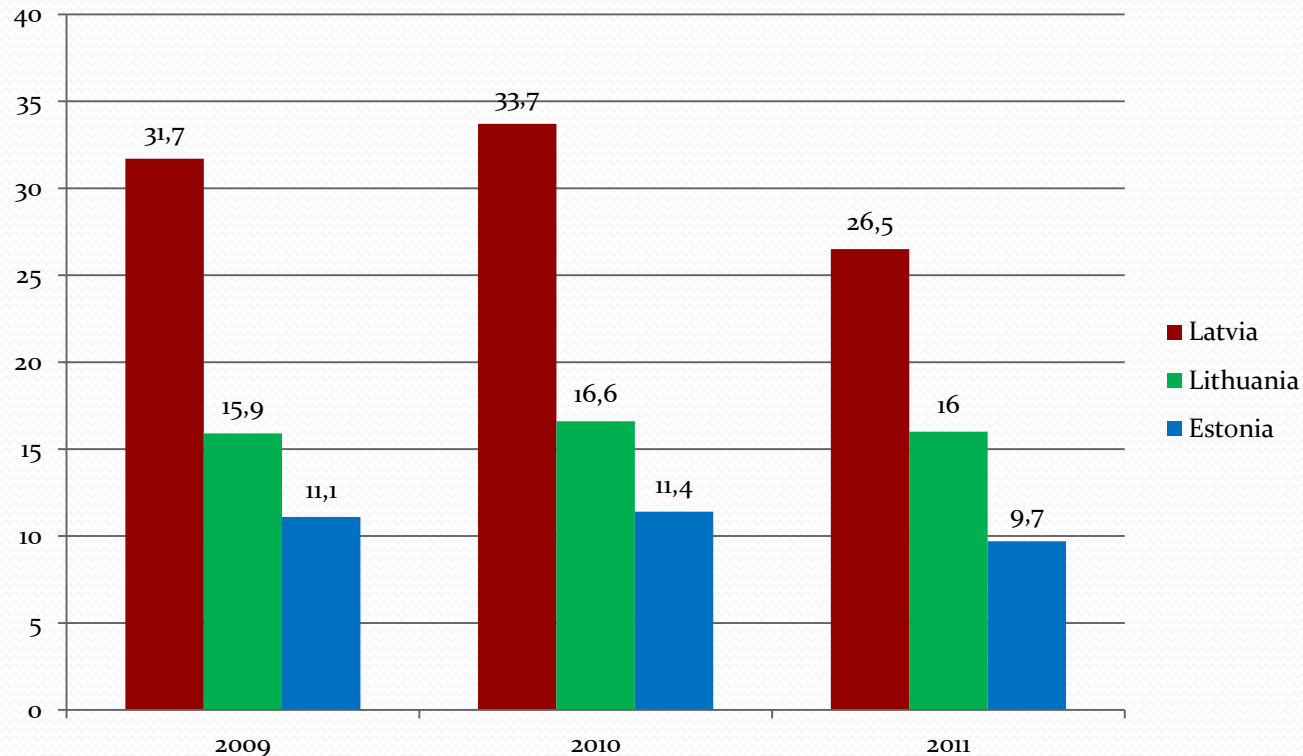
Size of the grey economy as % of GDP

Year	Latvia	Lithuania	Estonia
2009	36,6	17,7	20,2
2010	38,1	18,8	19,4
2011	30,2	17,1	18,9

Size of the grey economy in Latvia and in the Baltic States
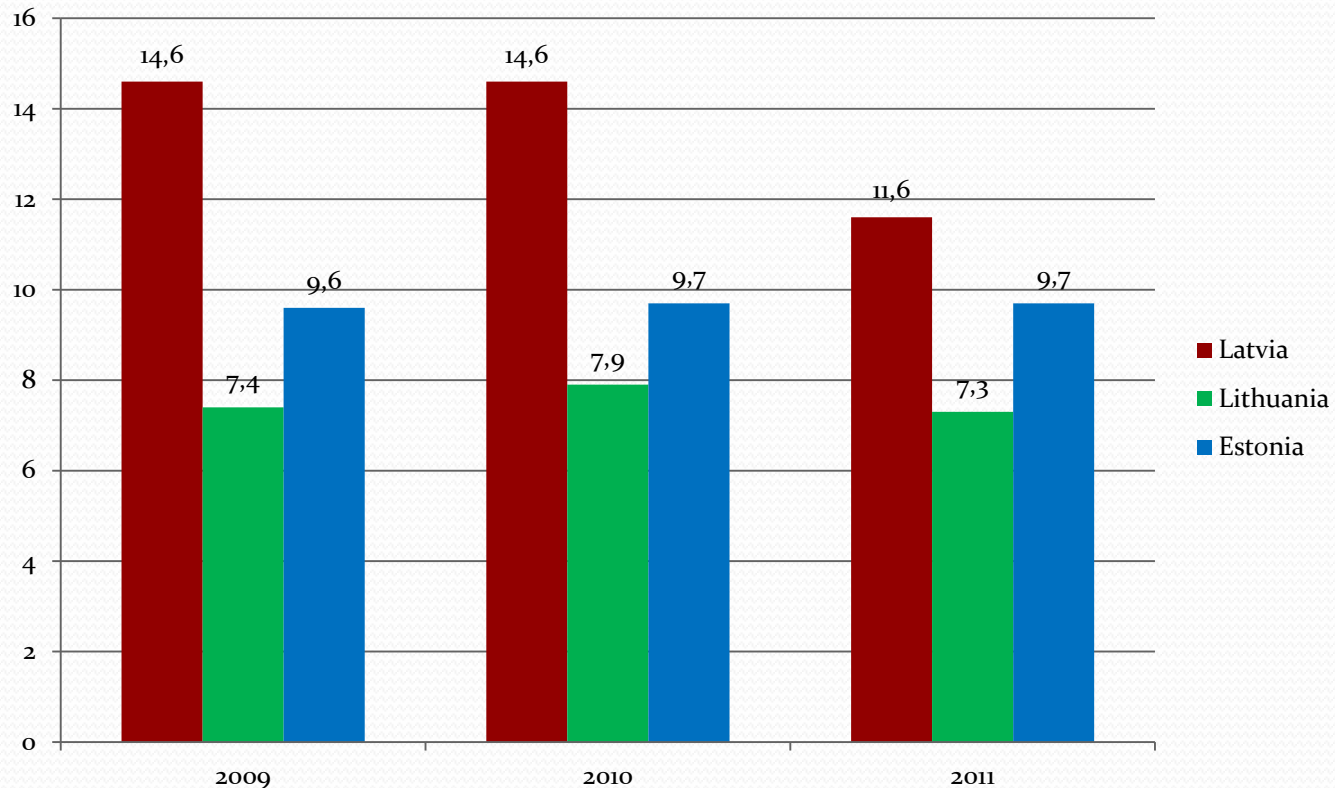
Size of the grey economy by sector (% of GDP in 2011)

Main characteristics of the grey economy: Underreporting of company's income

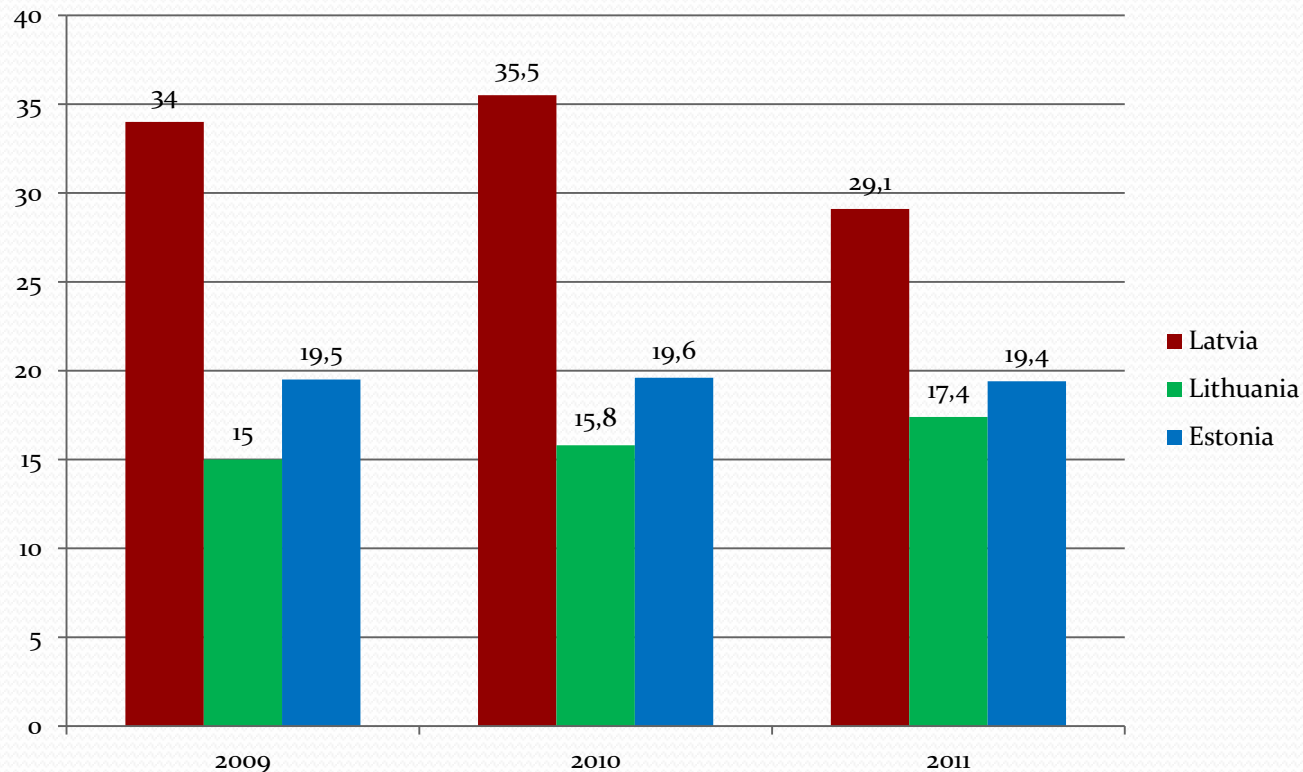**Level of underreporting company's income**
(% of actual profits)

Main characteristics of the grey economy: Underreporting of the number of employees

**Level of underreporting the number of employees
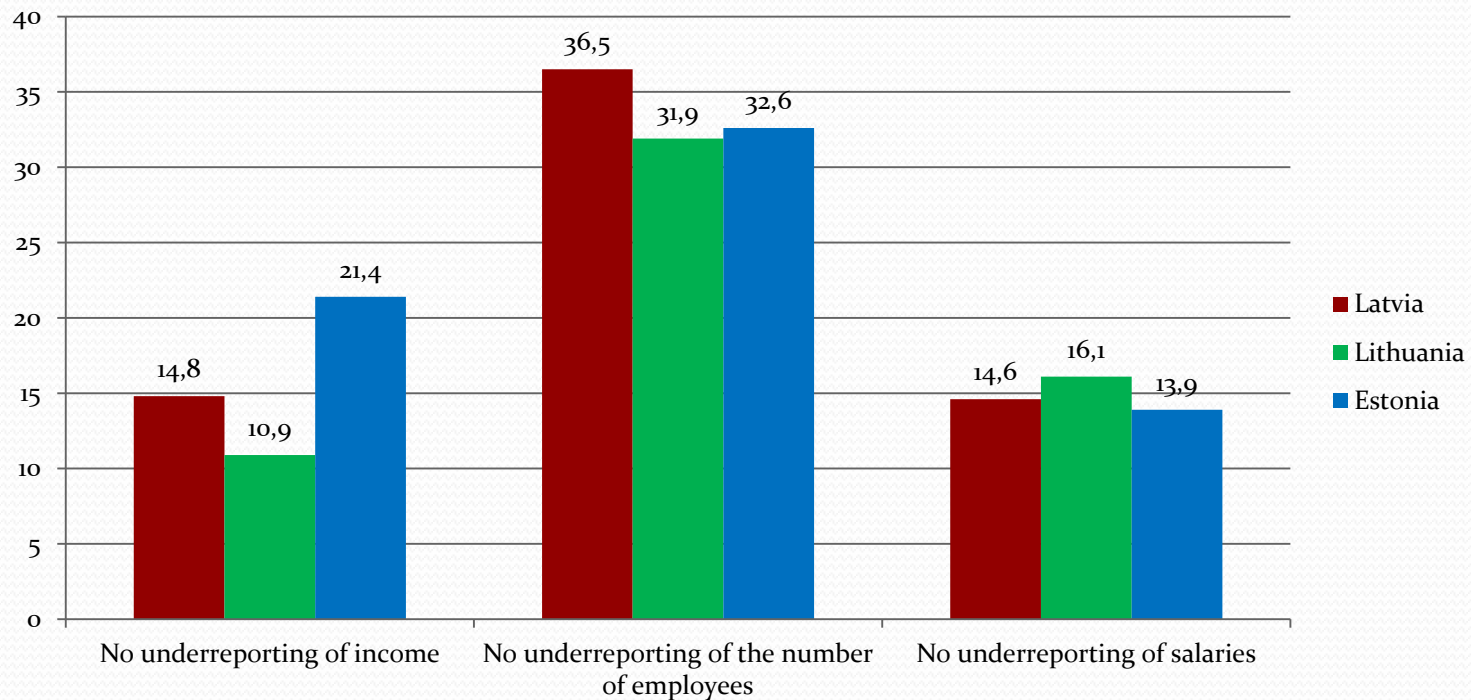(% of the actual number of employees)**

Main characteristics of the grey economy: Underreporting of salaries

Level of underreporting of salaries
(% of actual salaries)

Main characteristics of the grey economy: Percentage of "clean" enterprises

Percentage of enterprises, which <u>were not</u> involved in grey economy in 2011
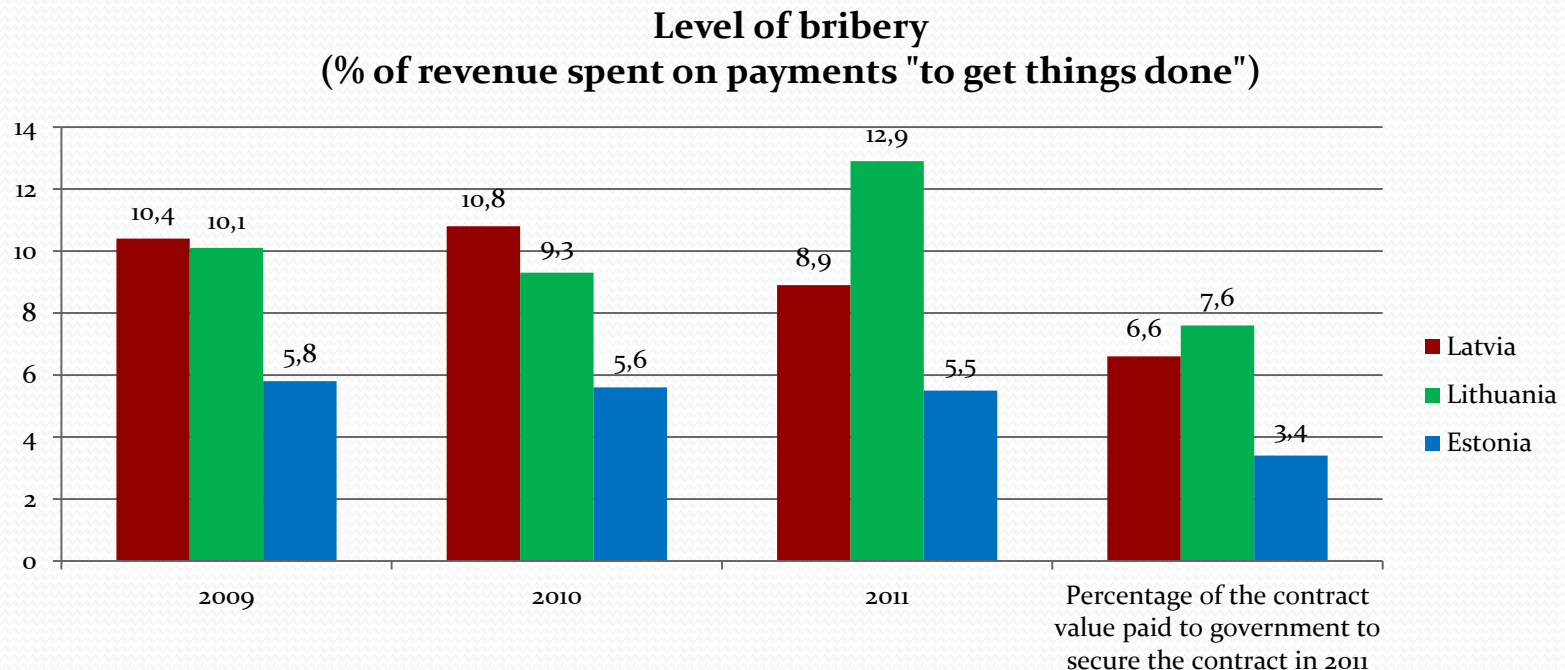
Corruption in Latvia

- According to Corruption Perceptions Index (CPI), in 2012 Latvia is ranked 54th below Lithuania (48th) and Estonia (32nd)

- In 2010 and 2011 Latvia's position in CPI world ranking was accordingly 59. and 61.

- In 2002 a special state institution was established in Latvia, which was responsible for corruption combating : The Corruption Prevention and Combating Bureau (KNAB), in October of this year it celebrated its 10th anniversary

- During these 10 years KNAS has penalized more than 700 state officials and accused of corruption more than 400 civilians

- There have been several attempts from some political parties and influential persons to decrease the capacity of KNAB, but luckily for the most of the part these attempts have failed

- The official reports of KNAB say that the number of corruption cases, where state representatives are involved, have slightly decreased during the last years, while the situation in the health care sector is still unsatisfactory

Corruption in Latvia (2)

- In November of 2011 KNAB ordered a public poll on corruption in the health care sector, and the results of the poll showed the following:
  - 33% of all inhabitants of Latvia, who had undergone a medical cure in ambulances or hospitals during the last 2 years, had made unofficial payments (7%), used private contacts (16%) or presented some gifts (21%) to the medical personal
  - Gifts and unofficial payments were made mainly by people with moderate and high income employed in the public sector
  - However, it looks like the situation is slightly improving year by year, because in 2005 the Corruption index in the health care sector was 41%, in 2007 – 34%, and in 2011 – 33%.
- In 2011 there was another poll targeted to Latvian enterpreneurs, which had the following results:
  - 67% answered "No" to the question: "Would you offer a bribe to a state's official, if it helped solve a problem for your enterprise?", 30% answered "yes" and 3% refrained from the answer
  - When asked "What could be a reason for you to offer a bribe to a state's official?", the most popular (33%) answer was "The issue/problem is reviewed faster"

Corruption in Latvia and in the Baltic States

- In the framework of their study professors of SSE in Riga have also analyzed the occurrence of bribery in private business, which plays a very important role in corruption:

Level of bribery
(% of revenue spent on payments "to get things done")

Legend:
- Latvia
- Lithuania
- Estonia

2009: Latvia 10,4; Lithuania 10,1; Estonia 5,8
2010: Latvia 10,8; Lithuania 9,3; Estonia 5,6
2011: Latvia 8,9; Lithuania 12,9; Estonia 5,5
Percentage of the contract value paid to government to secure the contract in 2011: Latvia 6,6; Lithuania 7,6; Estonia 3,4
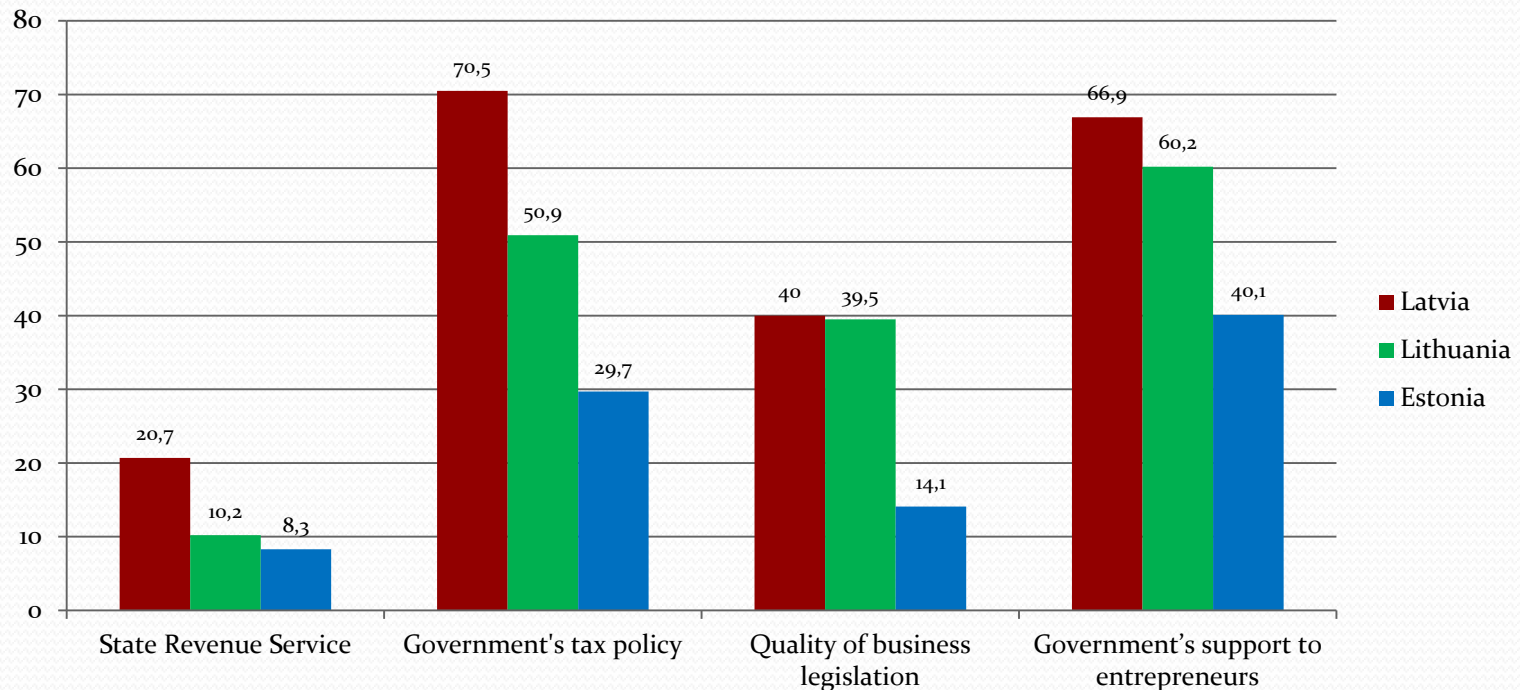
Grey economy and corruption in Latvia: main causes

- The literature on tax evasion identifies two main groups of factors that affect the decision to evade taxes and participate in the grey economy:

  1) the first set emerges from rational choice models of the decision to evade taxes. In such models individuals or firms weigh up **the benefits of evasion** in the form of tax savings against the probability of being caught and the penalties that they expect to receive if caught. The study of Latvian professors shows that almost a half of Estonian respondents report that there is a 0% **probability of being caught** for tax evasion and bribing. In contrast, approximately 1/3 of entrepreneurs in Latvia and Lithuania reported that this probability is in the range of 76%-100%. At the same time Latvian entrepreneurs perceive **the potential consequences for being caught** as being more severe than the consequences perceived by Estonian and Lithuanian entrepreneurs: 32.6% of Latvian respondents stated that being caught for deliberate underreporting will result in either a serious fine or closure of the business.

  2) **attitudes and social norms**: perceived justice of the tax system (tax burden and administration), attitude about how appropriately taxes are spent, level of trust in government, ethical values, moral convictions, a fear of feelings of guilt and social stigmatisation if caught.

Grey economy and corruption in Latvia: main causes (2)

Levels of dissatisfaction with government's policy, SRS and legislation in 2011, %

Grey economy and corruption in Latvia: main causes (3)

Indicator	Latvia	Lithuania	Estonia
Personal income tax rate (flat)	25%	15%	21%
Non-taxable amount (tax exempt), EUR/month	64	Regressive, starting from 136 EUR/month	144
Statutory minimum wage, EUR/month	285	232	278
Social insurance tax rate	35.09% (11% paid by employees)	39.8% (9% paid by employees)	37.2% (2.8% paid by employees)
Corporate income tax rate	15%	15%	0% for undistributed profit, 21% for distributed
VAT rate	22%	21%	20%
Tax wedge (in 2010)	43.5	38.8	38.6

The given tax rates and sums correspond with the situation in 2011

Grey economy and corruption in Latvia: main causes (4)

- Few more conclusions from the study:
- the overall pattern suggests that on average Latvian firms are the least tolerant of tax evasion and bribery, followed closely by Estonian firms, with Lithuanian firms appearing to be the most tolerant. This result may seem somewhat surprising given the relatively high levels of shadow activity and bribery in Latvia.
- Social norms are unlikely to explain the differences in the size of the shadow economies across the three countries, and therefore reinforces that attitudes towards the tax system and government are key determinants of shadow activity in the Baltic countries.
- The effect of detection penalties in particular stands out as being a particularly strong deterrent of shadow activity.
- The results suggest that Latvian companies are more inclined to emphasize tax evasion as a possible tool to ensure competitiveness (and survival) of the firm.
- More Latvian entrepreneurs, compared to Lithuanian and Estonian, tend to agree with the statement that evading taxes helps increase profits.

Grey economy and corruption in Latvia: main effects

- Small, insufficient tax revenues:
  - Endangered social insurance system (especially pensions)
  - Insufficient public investments in public infrustructure (e.g., roads) and services (health care, education, etc.)
  - Weak legal economy
  - To keep financing the system, government is inclined to increase taxes for those, who <u>are</u> still paying taxes
- Dead circle: dissatisfied tax payers → grey economy → small public investments, low quality public services → even more dissatisfied tax payers → etc.
- Difficulties to receive financing from banks and other legal credit institutions
- Distorted official statistics on country's economy, which shows high income inequality - Gini coefficient in 2011 was 35.2 in Latvia (1st place), 32.9 in Lithuania, 31.9 in Estonia
- Minimal trust in the government and other state institutions

Grey economy and corruption in Latvia: main effects (2)

- Although the grey economy generally weakens the legal economy, it has some positive influence, too – people can get some job (precarious, though) and income to spend it in the legal economy, the goverment can get VAT revenues from this consumption, GDP is increased as well – *this is not to support the grey economy* ☺

- People, who act in the grey economy, has less time and willingness to participate in public protest actions, there can be no trade unions and strikes – this factor can seem very attractive to some governments...

- Society is not as united as it should be, with different interests, trade unions have huge difficulties to get heard and to achieve their goals

Some proposals to improve the situation

- Strong and sustainable growth should serve as a basis for further reduction of the grey economy and corruption
- The government should improve its capacity in tax administration, workforce inspection and corruption combating (State Revenue Service, State Labour Inspectorate, KNAB)
- Revise/increase the severity of penalties for being caught
- Take specific measures to combat grey economy in different sectors (there should be a precise plan of measures)
- Reduce tax burden on low wage earners
- Regularly explain people the necessity to pay taxes ("cause and effect" principle)
- Raise people's trust in the government by ensuring fair and sustainable tax policy and by combating corruption inside the government's structures

Additional information

- More detailed information on the grey economy and corruption in the Baltic States (Latvia, Lithuania, Estonia) you can find on a home page of *Stockholm School of Economics in Riga*: http://www.sseriga.edu/en/research/centre-for-sustainable-business/shadow/

Thank you!