



Is the national policy to curbing the shadow economy effective?

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Audit report

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Performance audit “Is the national policy to curbing the shadow economy effective?”

The audit was conducted based on audit schedule No 2.4.1-83/2024 of the Fourth Audit Department of the State Audit Office of Latvia of 16 September 2024.

The cover design includes an image generated on 11 September 2025 by using the artificial intelligence tool *Microsoft Copilot*.

Dear Readers,

The State Audit Office of Latvia has concluded a performance audit, which assessed the state's approach to curbing the shadow economy.

Studies show a correlation between gross domestic product and the size of the shadow economy, namely, as a country's economy develops and prosperity increases, a decrease in the shadow economy is also observed. Public trust in state power and state administration as well as confidence in the rational use of public resources plays a significant role in reducing the shadow economy.

Increased attention is being paid to the shadow economy in Latvia. The Ministry of Finance of Latvia has taken on a leading role in shadow economy issues and coordinating processes, where a separate structural unit has been established. In 2024, the implementation of the fourth shadow economy curbing plan was launched.

In the opinion of the State Audit Office of Latvia, the current state approach to reducing the shadow economy with a plan focusing on limiting the shadow economy is not the most effective because the planned and implemented measures are more focused on combating the consequences, rather than on the causes of its occurrence. Instead of focusing on creating a clear, predictable tax (fees, mandatory payments) policy, which is the most effective tool for eradicating the shadow economy according to researchers and practitioners, the plan focuses more on increasing control mechanisms and requirements. But the development of a future vision in tax policy has been neglected.

At a time when the country is making great efforts to identify and, as one expects, implement ways to reduce bureaucracy and administrative burdens, some of the measures in the plan to curb the shadow economy are directed in the opposite direction.

High-quality decision-making is based on true, reliable and comprehensive data. The shadow economy is an area in which the Ministry of Finance does not use official statistical data on the unreported or shadow economy for communication with decision-makers and the public.

After the audit, we expect that the decisions and communication of the Ministry of Finance on the shadow economy will be based on comprehensive data, and it will review the existing plan, activities and organization, including, by involving other state institutions and screening measures through the filter of reducing bureaucracy.

We would like to thank the audited entity, the Ministry of Finance, as well as the State Revenue Service of Latvia, the Ministry of Economics, the Saeima Subcommittee on Combating the Shadow Economy, the State Construction Control Bureau of Latvia, the Central Statistical Bureau of Latvia, the Bank of Latvia, the Financial Intelligence Service, Professor Arnis Sauka, the Ministry of Smart Administration and Regional Development, the Latvian Scientific Council, the University of Latvia, the Riga Technical University, the Latvian Chamber of Commerce and Industry, the Employers' Confederation of Latvia, the Foreign Investors' Council in Latvia, the Free Trade Unions Confederation of Latvia, the Latvian Construction Council and the Latvian Construction Association for the information and opinion provided and for cooperation in the audit.

Respectfully
Ms Inga Vilka
Department Director



Summary

In Latvia, the government pays great attention to the shadow economy.

In the opinion of the State Audit Office of Latvia, the current government approach to limiting the shadow economy is not the most effective because the planned and implemented measures are more focused on the consequences than on the causes of its occurrence, and the results of research are not sufficiently used. The data used for decision-making and communication with the public is not versatile, and official statistics on the economy not captured in reports, or the shadow economy, are not used. The State Audit Office of Latvia considers that the activities of the currently responsible institution, the Ministry of Finance of Latvia, are oriented towards the process, not the result. The established management model was not organized rationally for a long time, and the organizational changes made should be continued.

Main conclusions

The shadow economy exists in all democratic countries. The latest available estimates of the shadow economy in Latvia vary, and they show that the size of the shadow economy in the country can be estimated at less than 7 to slightly over 20% of the gross domestic product (hereinafter referred to as GDP).

Taking into account the large share of the shadow economy, the government has been developing plans for limiting the shadow economy for more than 15 years. A number of state institutions of different levels and degrees of influence are involved in the fight against the shadow economy. Including a relevant subcommittee established in the Saeima in 2023.

After summarising the experience of other European countries, one concluded that such great attention was not paid to the shadow economy elsewhere as in Latvia because the measures to limit the shadow economy were integrated into various policies in most countries.

In Latvia, the Plan 2024–2027 is already the fourth in a row, and both its development process and technical implementation have been improved to some extent when compared to the previous ones. However, it must be concluded that neither the findings of the national research program study nor the study commissioned by the Fiscal Committee of the European Parliament have been taken into account sufficiently to select the most effective and efficient set of measures to limit the shadow economy..

The State Audit Office of Latvia has drawn attention repeatedly to the fact that the state administration does not use data sufficiently and it does not contribute to data-based decision-making. Determining the spread of the shadow economy is complicated; its share is assessed by using various methods, and the results of various studies differ. For instance, regarding

Latvia both in terms of the share of the shadow economy and the direction of dynamics in individual years, and also Latvia's position among the Baltic States.

Although the Ministry of Finance uses data from the Central Statistical Bureau (hereinafter referred to as the CSB) for macroeconomic forecasts, it does not use calculations of the CSB on the share of the unreported or shadow economy in matters of the shadow economy. According to CSB data, the size of the shadow economy was 6.7% of GDP in Latvia in 2023. If official statistics are not used in policy planning, public trust in government policy may decrease.

The Ministry of Finance uses the comparatively higher shadow economy indicators for planning, informing decision-makers and the public, and assessing the results of activities and plans on the share of the shadow economy: data from two research groups led by Professor Arnis Sauka and Professor T. Putniņš (21.4% of GDP in 2023) and Professor Frīdrihs Šneiders (19.9% of GDP in 2022). The calculation of these data depends on the initiative of the researchers and available resources whereas their regularity and access to state institutions in the long term is not guaranteed. Also, the results of the calculations carried out by the combined methodology for determining the share of the shadow economy, developed under the state research program financed from the state budget and commissioned by the Ministry of Finance (25.7% of GDP in 2022), are not fully used.

To determine whether the chosen action of the government to limit the shadow economy is the most effective, the audit has assessed the efficacy of the 56 measures included in the Plan 2024–2027 to reduce the shadow economy and whether the measures increase bureaucracy and administrative burden, including the workload of state institutions. The assessment concludes that the government action to limit the shadow economy is not focused on influencing the causes that cause and contribute to the shadow economy in the country sufficiently. Most of the measures are focused on increasing control capabilities.

Researchers' findings indicate that taxes are the most effective driving force of the shadow economy. Although the Ministry of Finance has been working on tax policy guidelines, the Cabinet of Ministers has still not approved the national future vision in the field of tax development. When looking at the shadow economy separately from tax policy, a complicated vision of limiting the shadow economy is not formed in order to find the most effective solutions for curbing it. In the opinion of the State Audit Office of Latvia, a predictable tax policy is a prerequisite for the development of the economy and the business environment.

In addition to horizontal measures, the Plan 2024–2027 has set two priority sectors, that is, construction and healthcare sector. When assessing the validity of the choice of these sectors during the audit, the auditors concluded that the prevalence of the shadow economy in healthcare sector was relatively low. In their turn, sectors with a significantly higher shadow economy have remained outside the Plan 2024–2027.

In the construction sector, measures to reduce the shadow economy have been implemented for a long time and the share of the shadow economy in the sector has fallen, but it is still assessed

as high. The measures to limit the shadow economy provided for in the Plan 2024–2027 will not, in the auditors' opinion, reduce the causes of the shadow economy in construction.

Curbing the shadow economy is a horizontal area of state activity, in which many state institutions are involved, thus creating a complicated division of responsibility among state institutions for the implementation of the Plan 2024–2027. In a fragmented system of institutional responsibility, the approach to limiting the shadow economy is more process oriented.

The instruments at the disposal of the Ministry of Finance, as the responsible institution, for the implementation of the Plan 2024–2027 are limited and more suitable for collecting and circulating information, clarifying the progress of the implementation of measures and discussing them, and they do not guarantee the achievement of results.

The auditors consider that the expansion of the Ministry of Finance eight years ago with a new position of Deputy State Secretary and a department for coordinating the restriction of the shadow economy should be assessed as irrational and disproportionate. The creation of such a division did not ensure a unified development and management of tax and duty policy and policy in the field of the shadow economy. With the structural changes of April 2025, the Ministry of Finance returned to the previous unified responsibility for the management of taxes and the shadow economy assigned to the Deputy State Secretary. Thus, a step has been taken towards rationalization, which should be continued by finding a more effective and economical way to primarily promote economic development in the country with a transparent tax policy by limiting the shadow economy indirectly.

Recommendation

Based on the audit conclusions, one recommendation has been made to the Ministry of Finance of Latvia. One expects that the implementation of the recommendation will improve the approach and instruments for curbing the shadow economy, based on long-term available data, including official state statistics, to which access is guaranteed. It will contribute to the reduction of the shadow economy, bureaucracy and administrative burden, and the improvement of the environment for socially responsible entrepreneurship and economic activity.