

Prof. Dr. DDr.h.c. Friedrich Schneider

October 2018

E-mail: friedrich.schneider@jku.at

<http://www.econ.jku.at>

SHADOW ECONOMY IN LITHUANIA AND REFORM EFFORTS OF THE GOVERNMENT: LATEST RESULTS

1. INTRODUCTION

- (1) There are many political statements in Lithuania that tax evasion and the shadow economy are important and cause severe damage on the official economy and on public (tax) revenues.
- (2) Hence, the goal of this short lecture is *twofold*:
 - (i) To present the size and development of the shadow economy and of tax evasion in Lithuania and the two other Baltic countries.
 - (ii) To present and evaluate brand new policy measures to reduce the shadow economy.

1. INTRODUCTION

- **A *shadow economy*** has many names, like cash, underground, grey or sometimes dark economy. There is no convention what the „correct“ name is.
- **A *shadow economy*** is *more or less* a *parallel economy* meaning, that quite often additional activities are captured like: neighbors or friends help, do-it-yourself activities or family production.
- Hence, the consequence is, that using macro-methodes quite often a too *“large” shadow economy* is measured.

2. THEORETICAL CONSIDERATIONS

2.1 DEFINITIONS

- (1) The *shadow economy* includes all legal production and provision of goods and services that are deliberately concealed from public authorities for the following four reasons:
- (i) to avoid payment of income, value added or other taxes;
 - (ii) to avoid payment of social security contributions;
 - (iii) to avoid having to meet certain legal standards such as minimum wages, maximum working hours, etc.; and
 - (iv) to avoid complying with certain administrative procedures.

2. THEORETICAL CONSIDERATIONS

2.1 DEFINITIONS

- (2) *Underground activities* are all *illegal* actions that fit the characteristics of classical crime activities like *smuggling*, burglary, drug dealing, etc.
- (3) *Informal household and do-it-yourself* activities are household actions that are not registered officially under various specific forms of national legislation.

These two activities should not be included in the shadow economy activities, but to some extent they are.

- (4) *Tax evasion* is under- (or not) reporting capital and/or labor income, domestic or abroad.

3. ESTIMATION METHODS AND RESULTS

THREE ESTIMATION PROCEDURES

- (1) Direct procedures using the micro level and aiming at determining the size of the shadow economy. Quite often this method is done by surveys and by “calculating” discrepancies in National Accounts.
- (2) Indirect procedures that make use of macroeconomic indicators proxying the development of the shadow economy over time; e.g. the currency demand approach.
- (3) Statistical models that use statistical tools to estimate the shadow economy as an “unobserved” or “latent” variable; e.g. the MIMIC (Multiple Indicator, Multiple Causes) Method.

4. ESTIMATION RESULTS OF SIZE OF THE SHADOW ECONOMY

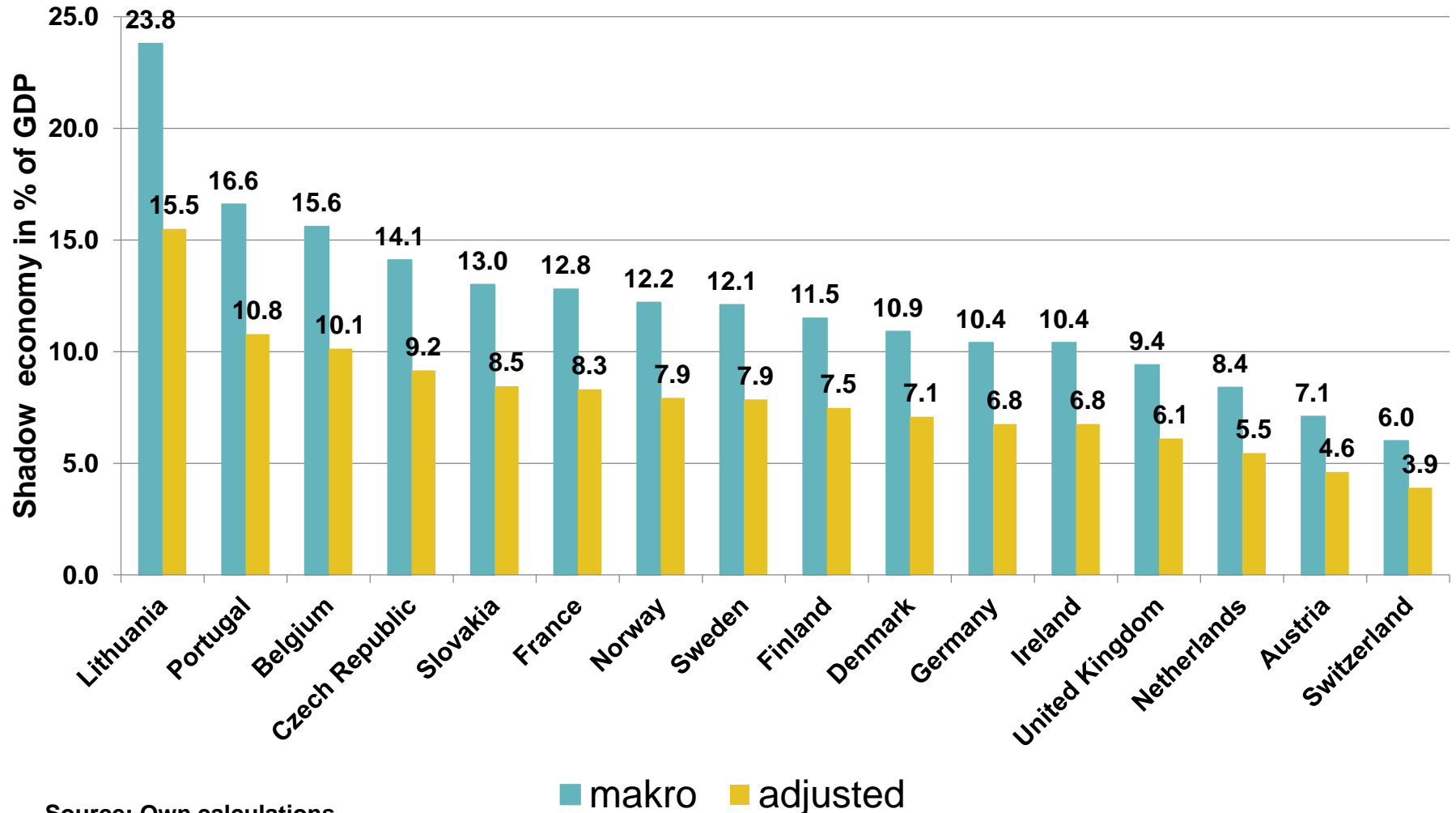
Table 4.1: Decomposition of the shadow economy activities in Lithuania and Germany

Kinds of shadow economy activities (rough estimates!)	Lithuania		Germany	
	Size in % of official GDP average 2009-2015	Proportion of total shadow economy	Size in % of official GDP average 2009-2015	Proportion of total shadow economy
(1) Total (macro) shadow economy (estimated by the MIMIC and calibrated by the currency demand procedures)	28.5	100%	16.2	100%
(2) Legally bought material for shadow economy and DIY-activities	6.0	20.3%	3.1	19.1%
(3) Illegal activities (smuggling etc.)	2.5	8.4%	1.2	7.4%
(4) Do-it-yourself activities and neighbors help ¹⁾	2.0	7%	1.5	9.2%
(5) Sum (2) and (4)	10.5	35.7%	5.8	35.7%
(6) “Corrected” or “adjusted” shadow economy, but legal activities (position (1) minus position (5))	18.0	64.3%	10.4	64.2%
¹⁾ Without legally bought material which is included in (2)				

Source: Own calculations, Linz, September 2016.

4. ESTIMATION RESULTS OF SIZE OF THE SHADOW ECONOMY - EMPIRICAL RESULTS

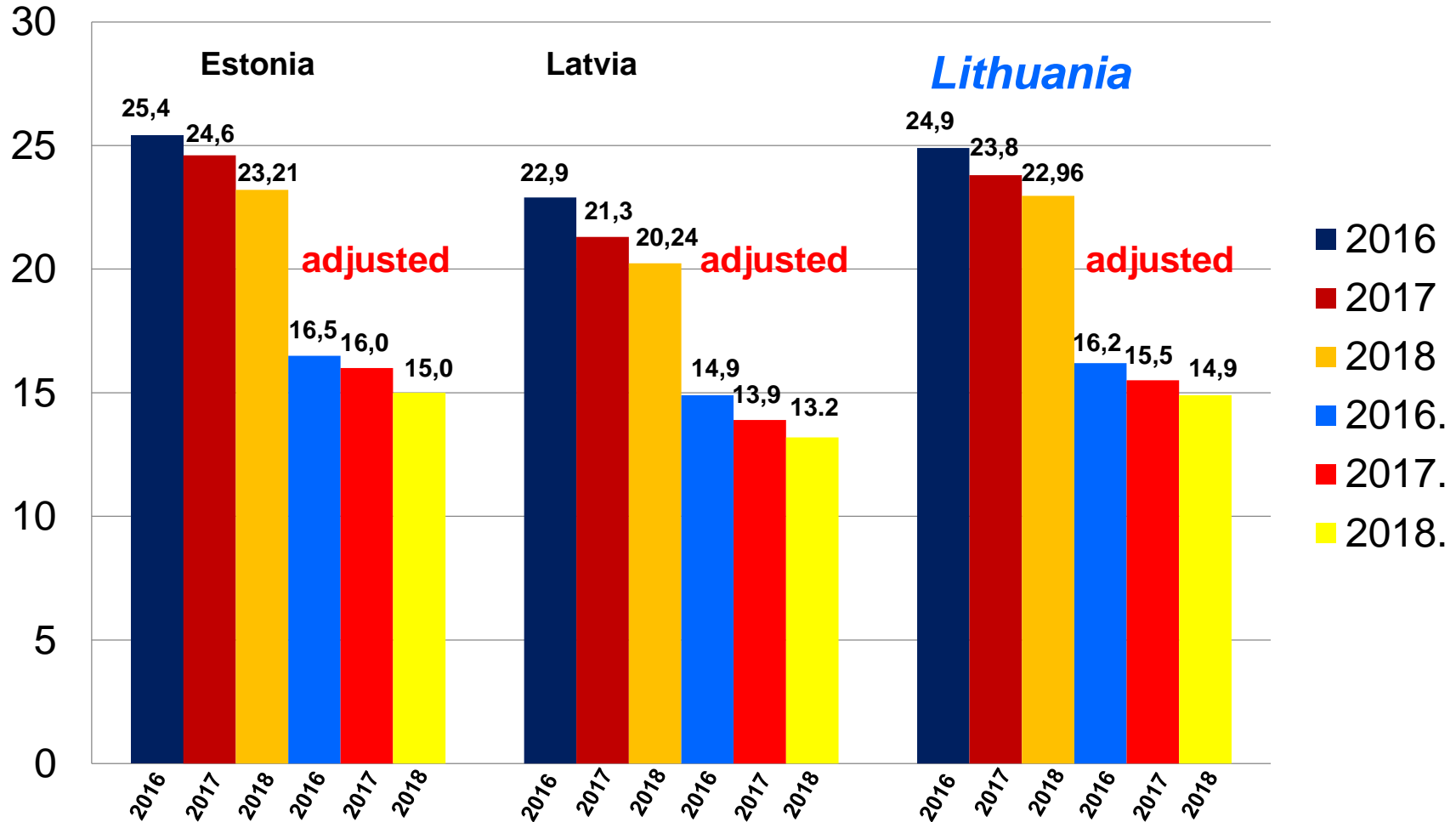
Figure 4.1: Size of the Shadow Economy of 16 European Countries in 2017– macro and adjusted



Source: Own calculations.

4. ESTIMATION RESULTS OF SIZE OF THE SHADOW ECONOMY - EMPIRICAL RESULTS

Figure 4.2: The development of the shadow economy (in % of GDP) of the *Baltic countries* over 2016 to 2018 applying macro-mimic and adjusted mimic method.



4. ESTIMATION RESULTS OF SIZE OF THE SHADOW ECONOMY - TAX EVASION FIGURES

Table 4.2: Size of tax evasion in % of GDP of some developed European Union countries in 2017

Country	Tax evasion	Tax Evasion Adj.
Bulgaria	3.8	2.5
Turkey	3.5	2.3
Croatia	3.4	2.2
Romania	3.4	2.2
South-Cyprus	3.1	2.0
Malta	3.1	2.0
Slovenia	2.9	1.9
Hungary	2.9	1.9
Poland	2.9	1.9
Greece	2.9	1.9
Estonia	2.8	1.8
Lithuania	2.6	1.7
Latvia	2.5	1.6

Source: Own calculations.

5. PLANNED POLICY MEASURES TO REDUCE THE SHADOW ECONOMY BY THE LITHUANIAN GOVERNMENT

- (1) In 2019, people will have a one-time possibility of paying their „forgotten“ taxes free of any penalty or interest. There will be a 6-month period for a voluntarily declaration and payment of these taxes.**
- (2) The government will encourage the public to use only officially registered household services, such as car repairs, housing repairs, child nanny services. As of 2019, citizens will be able to reduce their taxable income by the expenses incurred, i.e. they will be able to recover part of the paid personal income taxes (PIT)**
- (3) Beneficiaries of unemployment benefits will no longer be motivated to hide income: the payment of social benefits will continue another 12 months following the date of employment.**

5. PLANNED POLICY MEASURES TO REDUCE THE SHADOW ECONOMY BY THE LITHUANIAN GOVERNMENT

(4) “White finances” to tackle the shadow. Facilitation of official operations. Conversely, companies that pose risk in terms of tax payment will be banned from public procurement competitions.

(5) The liability for tax breaches will be more proportionate. Penalties for tax-related administrative offences will be increased by 30 %. The inevitability of the liability for tax evasion will be ensured through state-of-the-art information technologies.

(6) The State Tax Inspectorate (VMI) will facilitate the procedure of tax calculation and payment through an accounting service and a virtual cash register. Access to these services will significantly reduce the administrative burden.

6. CONCLUDING REMARKS. FIRST EVALUATION

These brand new measures are innovative and encouraging, because

- (i) they are a balanced mixture of more punishment for shadow economy activities and incentive orientated instruments to reduce it,**
- (ii) the tax amnesty provides a strong incentive to legalize shadow activities, and**
- (iii) the citizens directly profit from this measures through tax deductions and increased tax revenues.**

My evaluation: I strongly recommend to implement all of them!

**THANK YOU VERY
MUCH FOR YOUR
ATTENTION!**

