

## THE ROLE OF THE SHADOW ECONOMY AND UNACCOUNTED GDP IN THE REGIONAL ECONOMY OF LATVIA

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### Abstract

*The shadow economy is one of the most relevant problems of the modern economy. It is difficult to overestimate the influence of the shadow sector on the economy, but this influence is far from always negative. In some cases, the shadow economy brings positive changes to the development of the region. The article proposes to highlight new types of the shadow economy. In addition to the shadow economy, the author proposes to separately highlight unaccounted GDP and evaluate its impact on the region.*

**Keywords:** shadow economy, regional economy, unaccounted GDP.

### 1. The role of the shadow economy and unaccounted GDP in the regional economy of Latvia

The most important element in the development of any region is the economy. Not only the current level of well-being of the population depends on the economic well-being of the region, but also the prospects for the development of the region through attractiveness for investment, which in turn will lead to an increase in the number of highly qualified specialists in various fields and the development of infrastructure in the region.

However, with the growth of the economy, in most cases, the volume of the shadow economy is growing. Even in the case when the percentage of the shadow business is maintained, with the growth of the economy the opportunities for the development of the shadow sector also grow.

As a rule, the growth of the shadow economy is caused by a poor tax system, insufficiently effective work of control bodies and insignificant punishment for illegal actions related to the shadow business. We can say that the shadow economy is a compensation for inefficiency, injustice in public administration and a tool for survival for a certain segment of the population.

The shadow economy causes significant damage to the region by slowing down

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its pace of development, increasing the criminal situation and increasing the level of corruption.

Many experts around the world are looking for the answer to the question of how to limit the shadow economy (Elgar, E., 2008). There are many opinions and tools, but no one has managed to develop a viable formula for the economy without a shadow component. Based on this, we can conclude that there is an optimal level of the shadow economy, which will vary depending on the region and the specific time period.

According to one version, the basis of the shadow economy is cash (Khabibulin, A., Anischenko, V. and Anischenko, E., 2018). Many countries, including world leaders, have plans to completely abandon the use of cash in the short term. For example, countries such as Sweden and Norway have already announced plans to completely abandon the use of cash in the near future. In action, the implementation of such plans can be seen in the annual reduction in the ability to use cash in payments and the stimulation of the use of non-cash payment methods. Two countries in the world have already almost completely abandoned the use of cash - this is Sweden and South Africa. A detailed report on the use of cash in the world (World cash report, 2018) suggests that in all countries of the world except Canada and Oceania, there has been a significant decrease in cash turnover and an increase in non-cash transactions.

And so, the turnover of cash transactions in the world is falling, but the shadow economy is not. Does it follow from this that the version about the predominant use of cash in the shadow economy is wrong? No, because all reports deal only with registered transactions.

Refusal of cash certainly works against the shadow economy, but, according to the author, this will not bring significant results in the limiting of the shadow economy. Shadow cash operations, in the past, were by far the most convenient way to avoid taxes, but changes in state laws and technological development leads to the development of the shadow economy.

The world is improving and illegal business participants often go a few steps ahead of the legal business. Well-known numerous tax evasion schemes, for example, non-registration of transactions, virtual movement of goods between countries with VAT written off at each stage, salaries in envelopes and much more are gradually becoming a thing of the past, giving way to new forms of the shadow economy. It is no secret that a large number of illegal operations are carried out in cryptocurrency nowadays. The possibilities of using

cryptocurrency in the shadow economy are very great. Settlement for illegal activity in a currency accepted throughout the world, which is not taxable and whose movement is not monitored by the control authorities, leads to a significant reduction in transaction risk and an increase in business profitability. Moreover, most countries do not have legislation regulating the cryptocurrency market. But, despite the absence of legislation, measures are being taken to limit the calculation of the shadow business using cryptocurrencies. For example, the Supreme Court of the Russian Federation recognized cryptocurrency as one of the means of money laundering (Supreme Court of the Russian Federation, 2019). In Latvia, legislation governing the entire digital economy is under development.

Calculation in cryptocurrency is not taxed and is mainly not controlled by the state, which provides excellent opportunities for the prosperity of business, including shadow business.

The development of tax-free business in the region leads to the growth of prospects in the region, attracting additional investments and specialists, who in turn raise the standard of living in the region by means of living expenses and higher requirements for the quality of products and services.

It turns out that the shadow economy has a positive effect on the development of the region? Yes, but only in the short term at the stage of development of the region. The more developed the region, the more negative is the influence of the shadow economy. This is due to the fact that tax evasion, like labour emigration, is no longer a key factor in the survival of business and the population in the region.

The positive or negative effect of the shadow economy effect is also affected by its specific form.

For example, in Latvia, the shadow economy through tax evasion, which is one of the main forms of the shadow economy in the region, has a strong negative impact on the country's economy (Schneider, F., 2002). But at the same time, crypto transactions attract capital through the content of projects based in the region, which, in turn, positively affects the region's economy by increasing the total cash flow in the region and increasing per capita income.

It is important to understand that the share of the shadow economy is considered relative to the region's GDP, and crypto transactions are not taken into account in calculating the GDP. In fact, shadow transactions in cryptocurrency increase the real volume of GDP, but do not create a direct tax flow for the region. From this we can conclude that transactions in cryptocurrency increase the volume of the shadow economy, but do not increase the official volume of the region's GDP. Accordingly, the volume of real

(unofficial) GDP is growing, which favourably affects the development of the region.

There are many options for classifying the shadow economy, for example, the division into white-collar, grey and black (Table 1).

Table 1. Classification of the shadow economy

Criterion	«White-collar» shadow economy	«Gray» shadow economy	«Black» shadow economy
Subjects	Managers of the official («white») sector of the economy	Unofficially working people	Professional criminals
Objects	Redistribution of income without production	Production of ordinary goods and services	Production of prohibited and scarce goods and services
Relations with the “White” economy	Inseparable from “White”	Relatively independent	Autonomous

Source: <http://www.grandars.ru/student/nac-ekonomika/vidy-tenevoy-ekonomiki.html>

According to the author, the shadow economy can be divided into two fundamentally different types (Fig. 1). This division is innovative and takes into account current trends in the development of the shadow economy:

#### 1 Classical shadow economy

This includes all the classic forms:

- Non-payment of taxes of all types and forms
- Corruption, subject to cash settlement
- Sale of fakes
- Physical production of money
- etc.

#### 2 The shadow economy of the new generation, let's call it the innovative shadow economy.

This is a relatively new type of shadow business, based on the use of

cryptocurrency or tokens in the calculations.

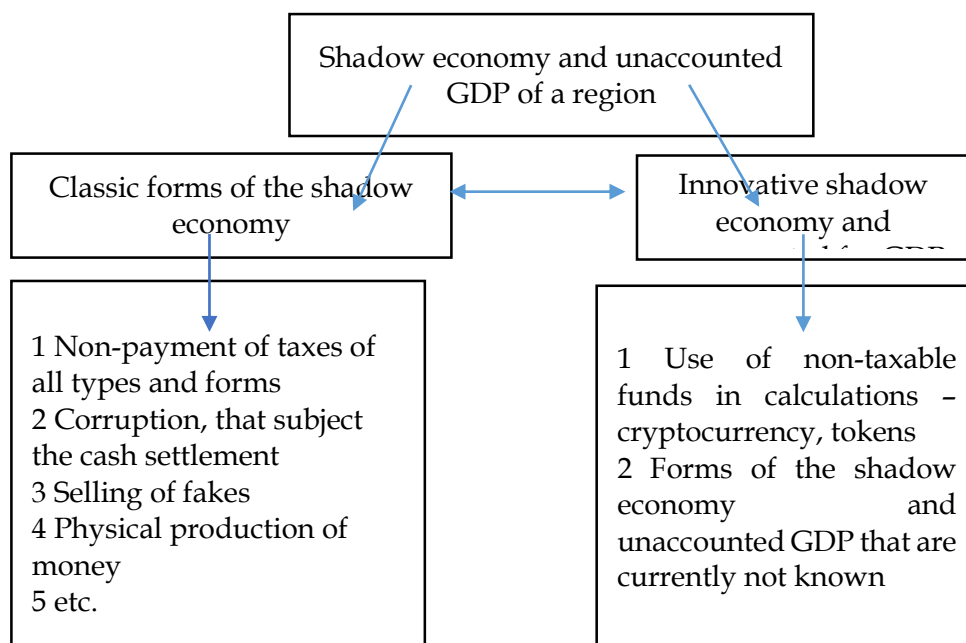


Figure 1: Shadow economy and unaccounted GDP of the region

Classical types of the shadow economy are mainly amenable to relative measurement and are limited by law.

It is currently not possible to count or limit new types of shadow economy due to the lack of digital legislation and, as a result, assessment and impact tools.

## 2. The influence of the shadow economy on the Latvian economy

Let's consider how the region, the territory of Latvia. According to Arnis Sauki, the share of the shadow economy in% of GDP in Latvia, in 2018, is 24.2% (Table 2).

Table 2. Index of the shadow economy in the Baltic countries (% of GDP)

Year	Latvia	Lithuania	Estonia
2018-2017	+2.2%	+0.5%	-1.5%
2018	24.2%	18.7%	16.7%
2017	22.0%	18.2%	18.2%
2016	20.3%	16.5%	15.4%

2015	21.3%	15.0%	14.9%
2014	23,5%	12.5%	13.2%
2013	23.8%	15.3%	15.7%
2012	21.1%	18.2%	19.2%
2011	30.2%	17.1%	18.9%
2010	38.1%	18.8%	19.4%

According to the author, even if we evaluate the classical shadow economy, the data of Arnis Sauki are doubtful, but, in the context of this article, we will rely on these data.

In a review of the global shadow economy, authors Leonardo Medina and Friedrich Schneider provide statistics on the level of the shadow economy in 31 countries, including Latvia (papers.ssrn., 2019) According to the data provided by Medina and Schneider, the share of the Latvian shadow economy relative to GDP in 2017 amounted to 21.3 percent. With this indicator, Latvia, according to the estimates of the above authors, ranks 13th in Europe in terms of the share of the shadow economy. It is noteworthy that in both Lithuania and Estonia the share of the shadow economy is higher, 23.6 and 23.8, respectively (Fig. 2).

It is not difficult to calculate, mathematically, that with the share of the shadow economy calculated by Arnis Sauka and GDP at 26851.1 million euros (Central Statistical Bureau, 2019), the amount of taxes not received by the state is 5907 million euros. Obviously, this is a significant damage to the state.

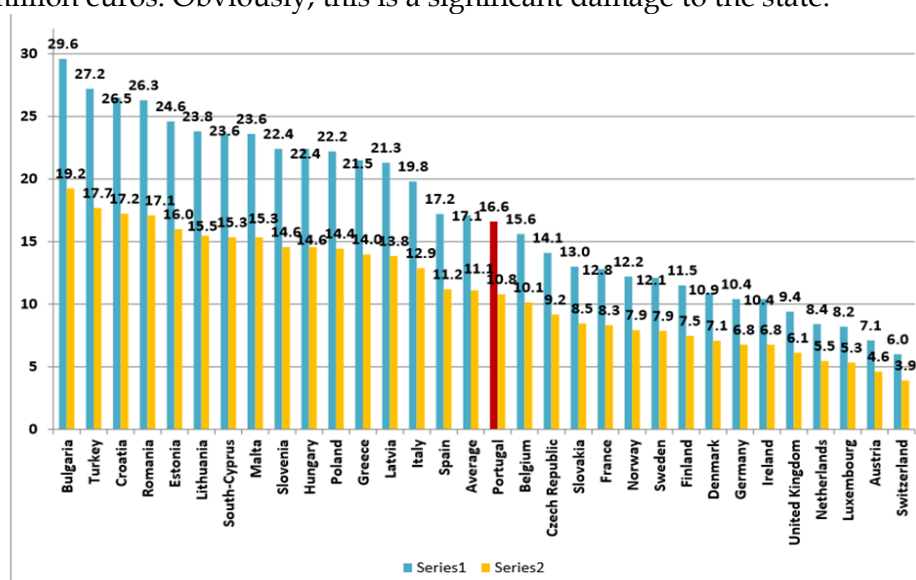


Fig. 2 The share of the shadow economy in 31 European countries.

First: by increasing the budget by this amount, the state could close many of the gaps in life support or reduce the credit part of the budget. Secondly: in connection with the activities of the shadow business, part of the legal business loses its position right up to forced bankruptcy or going into the shadows, which in turn further reduces tax revenues to the state budget.

Interestingly, despite the obvious importance of the issue, which was reflected in the national development plan of Latvia for the period 2014–2020 (Database, 2019) the topic of fighting the shadow economy is mentioned in paragraph 157 of “Radical actions to curb the shadow economy”, which envisaged the improvement of cooperation between controlling institutions, including in the field of public procurement, strengthening capacities and operational actions to detect and prevent new risks of the shadow economy, raising public awareness about the impact of the shadow economy on the quality of life.

But, except for the declaration of the existence of the problem, no specific areas and instruments of action are given.

The Sustainable Development Strategy of Latvia until 2030 also does not provide directions and tools to fight the shadow economy (Interdepartmental Coordination Center, 2019).

The shadow economy of a new generation in Latvia is not regulated by law and is not evaluated. Existing legislation does not evaluate the entire innovative economy, respectively, and does not provide tools to regulate this area.

Due to the lack of official assessment tools, it is difficult to determine the size of such an economy in the region, but it is obvious that the innovative form in the near future will become an integral component of both the shadow economy and legal business.

When assessing the new generation shadow economy, it is worth paying attention to the increase in the number of start-ups working on cryptocurrencies or own tokens, as well as on the emergence in the region of opportunities to pay with cryptocurrency for completely household items. For example, there is already a cafe where, along with classic money, you can pay with cryptocurrency. Also, in Latvia, there was an attempt to sell the property for cryptocurrency. Of course, these are just the first steps of the crypto business into the real world of Latvia, but these steps already create an additional circulation of goods and services (mainly services) and this turnover is not taxed. Is the given example a shadow economy? A moot point. Can it be considered illegal that is not prescribed by law? This example rather shows the evidence of the development of a new, promising direction and as a result of the growth of unaccounted GDP in the region.

So, a cryptocurrency start-up creates a certain turnover, generates a profit also

expressed in cryptocurrency. Obviously, this is GDP, but not taken into account. Of course, much can be attributed to unaccounted-for GDP, for example, the work of housewives, but the growth in turnover in the crypto industry is so great that in the near future it will significantly exceed all known forms of unaccounted-for GDP combined. It is not a problem to cash out cryptocurrency; accordingly, the profit is converted into real money, which further creates a real turnover on the regional market.

Does it affect the development of the region? Obviously yes, and positively. Is this a shadow economy? More likely not, due to the lack of legislation governing this area. In Latvia, legislation governing the entire digital economy is under development and will probably be published in the near future.

Given the significant growth in the popularity of cryptocurrency startups, the growth of unaccounted for GDP is growing rapidly, which leads to an increase in tax-free turnover.

### **3. Discussion and conclusions**

In this article, along with the classical classification of the shadow economy, is being considered innovative shadow economy and unaccounted GDP. The author introduced a new term - the shadow economy of a new generation. An important topic was touched upon - the creation of a new, rapidly growing segment of unaccounted GDP, through the development of reckoning in cryptocurrency and tokens.

The results of monitoring the situation will lead to an understanding of the need to create a digital legislation governing reckoning in cryptocurrency and tokens.

1 Classical forms of the shadow economy mainly negatively affect the development of the region.

2 The influence of new forms of the shadow economy and unaccounted-for GDP mainly positively affects the development of the region.

3 Considering the rapid growth of reckonings in cryptocurrency and tokens, there is a need to create a digital legislation. The goal is to transfer reckonings in cryptocurrency and tokens from unaccounted GDP into accounted for with the subsequent expansion of tax legislation on transactions in which payment is made in cryptocurrency or tokens.

4 The reduction of the share of classical shadow economy is very important for the researched region.

### **4. Suggestions**

1 Optimize the current tax legislation in order to create a favourable legal business environment, which in turn will reduce the share of the shadow



economy.

2 Shift the focus of control services from small and medium-sized businesses to large players.

3 Create legislation governing the crypto market, but take into account the interests of startups and provide them with a tax-free starting period.

4 Create tools to control the new economy.

5 Create a structure for the development of the state with a focus on new global economic trends.

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