VAT Gap: Frequently asked questions

See also IP/19/5511

What is VAT?

Value Added Tax (VAT) is a consumption tax, charged on most goods and services traded in the EU. The tax is levied on the 'value added' to the product at each stage of production and distribution. This means that VAT is charged when VAT-registered businesses sell to other businesses (B-2-B) or to the final consumer (B-2-C). VAT is intended to be 'neutral', in that businesses are able to reclaim any VAT that they pay on goods or services. Ultimately, the final consumer should be the only one who is actually taxed. Businesses are given a VAT identification number and have to show the VAT charged to customers on their invoices. The VAT system in the EU is governed by a common legal framework.

What is the VAT Gap?

The VAT Gap is the overall difference between the expected VAT revenue and the amount actually collected. The VAT Gap is defined as the difference between the amount of VAT amount actually collected and the VAT Total Tax Liability (VTTL), in absolute or percentage terms. The VTTL is an estimated amount of VAT that is theoretically collectable based on the VAT legislation and ancillary regulations.

The VAT Gap measures the effectiveness of VAT enforcement and compliance measures in each Member State, as it provides an estimate of revenue loss due to fraud and evasion, tax avoidance, bankruptcies, financial insolvencies as well as miscalculations.

What are the main findings of the 2017 Report on the VAT Gap?

During 2017, the overall VAT Total Tax Liability (VTTL) for the EU Member States increased by 2.9%, whereas VAT revenue increased by 4.1%. As a result, the overall VAT Gap in the EU Member States fell from €145.4 billion in 2016 to €137.5 billion in 2017. In relative terms, the EU-wide gap dropped to 11.2%, down from 12.2% in 2016.

In 2017, Member States' estimated VAT Gaps ranged from 0.6% in Cyprus, to 35.5% in Romania. Overall, the VAT Gap decreased in the majority of Member States, with the largest improvements noted in Malta, Poland, Cyprus, Slovenia, Italy, Luxembourg, Slovakia, Portugal, Czechia and France and increased in three: Greece, Latvia and marginally in Germany.

Member State	VAT Gap %	VAT Gap (Revenues in €mn)	Member State	VAT Gap %	VAT Gap (Revenues in €mn)

Belgium	12%	3996	Lithuania	25%	1119
Bulgaria	12%	625	Luxembourg	1%	23
Czechia	12%	2082	Hungary	14%	1893
Denmark	7%	2235	Malta	2%	13
Germany	10%	25016	The Netherlands	5%	2744
Estonia	5%	122	Austria	8%	2444
Ireland	13%	1938	Poland	14%	5764
Greece	34%	7399	Portugal	10%	1929
Spain	2%	1806	Romania	36%	6413
France	7%	12030	Slovenia	4%	128
Croatia	7%	459	Slovakia	23%	1791
Italy	24%	33629	Finland	7%	1622
Cyprus	1%	11	Sweden	1%	654
Latvia	15%	385	United Kingdom	11%	19199

What is being done at EU level to improve VAT collection?

Much progress has been achieved since the beginning of the Juncker Commission mandate to strengthen the ability of Member States to administer and collect VAT in their countries:

- New rules for sales of e-services online came into force in 2015 which allows Member States to collect VAT where the consumer is based – an underlying basic principle of the tax. This is made possible through a 'One Stop Shop' which allows traders to take care of all their VAT obligations using one online portal.
- In 2017 Member States have also now agreed to extend this new system to sales of goods online, delivering another boost for VAT collection in the EU and helping authorities to recoup the current estimated €5 billion of VAT lost on online sales every year. For the first time, online marketplaces will also be made responsible for ensuring VAT is collected on sales on their platforms made by companies in non-EU countries to EU consumers.
- In 2018 the EU has also agreed on a ground-breaking new framework to exchange more information and boost cooperation between national tax authorities and law enforcement authorities. Once in force, Member States will be able to exchange more relevant information and to cooperate more closely in the fight against criminal organisations, including terrorists.

That said, Member States should now move forward and agree as soon as possible on the much broader reform to cut down on VAT fraud in the EU's system, as proposed in 2017 year by the Commission. VAT fraud results from weaknesses in the current VAT system and the way in which tax administrations manage VAT collection. As VAT is a major revenue source for Member States, VAT losses, including those due to VAT fraud, have a big impact on the State budget. The new rules would help to make the VAT system much more fraud-resilient and easy to use for business, while bringing in much needed revenues for Member States.

What methodology was used to calculate the VAT Gap?

The study derives the VTTL for each country from national accounts by mapping information on different VAT rates (standard, reduced and exemptions) onto data available on final and intermediate consumption, along with other information provided by Member States. This means that the quality of the VAT Gap estimates depends on the accuracy and completeness of national accounts data.

When national accounts figures are reliable, the methodology is precise enough to estimate the VAT Gap. The main limitation of the methodology is the quality of the national accounts: collecting better data and relying less on estimations. Moreover, Member States use different methodology to estimate the informal economy and to reflect it in their national accounts, thus indirectly affecting the VAT Gap figures.

What causes such differences in the VAT Gap between the Member States?

Variations in the VAT Gap reflect the differences in Member States in terms of tax compliance, fraud, avoidance, bankruptcies, insolvencies and tax administration. The estimates also reflect structural differences in national economies and other variables. Indirect circumstances such as the organisation of national statistics could also have an impact on the size of the VAT Gap.

What is the Policy Gap?

The Policy Gap is an indicator of the additional VAT revenue that a Member State could theoretically collect if it applied a uniform VAT rate on all consumption of goods and services supplied for consideration.

The Policy Gap as defined above can in turn be broken down into the Rate Gap and the Exemption Gap. As the terminology suggests, the Rate Gap represents the potential revenue loss due to the existence of reduced rates, whereas the Exemptions Gap represents the potential revenue loss due to the existence of exempted supplies of goods and services.

The Exemption Gap, or the average share of 'ideal revenue' lost due to various exemptions is normally the larger of the two and is at 35% in the EU on average. Member States with the highest Exemption Gap are Spain (46.4%) and UK (44.3%), whereas the lowest value of the Exemption Gap was observed in Cyprus (15.9%) and in six other countries (Bulgaria, Croatia, Lithuania, Luxembourg, Malta, and Romania), the Exemption Gap was below 30%. The Exemption Gap in Spain is relatively high due to the application of other than VAT indirect taxes in the Canary Islands, Ceuta, and Melilla. The largest part of Exemption Gap is composed of exemptions on services that cannot be taxed in principle, such as imputed rents, the provision of public goods by the government, or financial services. The remaining level of so-called 'actionable' Exemption Gap is about 3.4% on average.

The Rate Gap, on the other hand, ranges from a low of under 1% in the case of

Denmark, to a high of 29.6% in Cyprus. The average is 9.6%.

The results moderate views about the relative importance of reduced rates and exemptions in decreasing the potential VAT revenue, and suggest that better enforcement remains a key component of any strategy to improve the functioning of the VAT system.

What is the Fast Estimate?

The methodology used to estimate the VTTL for 2018 differs markedly from the one used to estimate the VTTL for 2013-2017. The main simplifications and assumptions include:

- Structure of household final consumption does not change with respect to 2017. In fact, due to unavailability of up-to-date figures, it relies in most of the cases on a three-year lagged series.
- Non-deductible Gross Fixed Capital Formation (GFCF) liability changes in line with the year-over-year change in government GFCF published by the AMECO database.
- In the vast majority of cases where there are no significant changes in the statutory rates, net adjustments and intermediate consumption liability are rescaled from 2017 using growth rates for the entire tax base.
- The main limitation of this simplified method is a potentially large estimation error that could happen due to some important component of the country-specific adjustments. In this case, fast estimates for the Member State(s) concerned are not possible.

Fast estimates indicate that the VAT Gap will likely continue its downward trend and fall below €130 billion and 10% of the VTTL in 2018.