[VAT Gap: Frequently asked questions]

See also [IP/18/5787]

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 2016 Report on the VAT Gap?

During 2016, the overall VAT Total Tax Liability (VTTL) for the EU Member States stayed at the same level, while collected VAT revenues rose by 1.1 percent. As a result, the overall VAT Gap in the EU Member States saw a decrease in absolute values of about €10.5 billion, down to €147.1 billion. As a percentage, the overall VAT Gap decreased from 13.2% to 12.3 %.

In 2016, Member States' estimated VAT Gaps ranged from 0.85% in Luxembourg, to 35.9% in Romania. Overall, the VAT Gap decreased in the majority of Member States, with the largest improvements noted in Bulgaria, Latvia, Cyprus, and the Netherlands and increased in six – namely, Romania, Finland, the UK, Ireland, Estonia, and France.

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:

- Since 2015, new rules for sales of e-services online came into force 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.
- 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.
- The EU has also recently 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 last year by the Commission. VAT fraud results from weaknesses in the current VAT system and the way in which tax administrations manage VAT collection. A recent study suggests that on average 36% of the VAT Gap is due to VAT fraud. 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: better data-in, better estimations-out. 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 34.9 percent in the EU on average. Member States with the highest Exemption Gap are Spain (46.7%) and UK (44.7%), whereas the lowest value of the Exemption Gap was observed in Cyprus (16.8%) and Romania (24.9%). 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 “Actionable” Exemption Gap is about 6.5%, 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 27% in Cyprus. The average is just under 10%.

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.