BRIEFING

EU policies – Insights

Addressing the VAT gap in the EU

SUMMARY

Among indirect taxes, value added tax (VAT) has the highest share in the Member States' indirect taxation revenues and is an important source of income for the EU budget too. Therefore, estimations and actions to narrow the difference between expected and actual VAT revenues – the VAT gap – are important. According to the European Commission, the EU VAT gap stood at €140 billion in 2018 and could fall below €130 billion in 2019. However, Covid-19-related containment measures have hurt Member States' economies and eroded the VAT base. As a result, the VAT gap may reach over €164 billion in 2020.

A broad VAT gap requires urgent action for improving voluntary compliance, achieving better administrative cooperation and enhancing the performance of national tax administrations. Recent EU legislative initiatives have addressed these needs, while also seeking to adapt the VAT system to the challenges of the modern economy. The VAT e-commerce package applicable from 2021 is a good example of these efforts. Another is the adoption in July 2020 of a tax package aimed to combat tax fraud. The package includes a Tax action plan, a communication on 'Good Tax Governance' and a proposal to amend Directive 2011/16/EU on administrative cooperation in the field of taxation.

The European Union is a global leader in the digitalisation of VAT compliance, and its work on drawing up the legislative framework for applying VAT in the digital economy spans a number of years. Noteworthy is the requirement for non-EU businesses providing digital services to private consumers in the EU Member States to register for VAT and charge VAT based on destination, which set an example to emulate by other non-EU countries.

In this Briefing

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Author: Miroslava Karaboytcheva

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Introduction

Value added tax (VAT) is a general consumption tax. It is paid with the purchase of the final goods or services by the end consumer and applies to almost all goods and services that are bought and sold for use or consumption. It is collected via a structure of partial payments, where taxable persons[1] deduct from the collected VAT the amount of tax they have paid to other taxable persons on purchases for their business activities. It is an indirect tax because the seller pays the collected VAT to the tax authorities, but it is the customer who pays it because it is built into the price.

VAT generates the highest share of revenue among the indirect taxes. In 2018, VAT revenue accounted for about 52.4 % of the total taxes on production and imports in the EU-28. A 2020 study published by the Commission estimates the difference between expected and actual VAT revenues. By definition, the VAT gap is the difference between the amount of VAT collected and the VAT Total Tax Liability (VTTL) over the same period. To compute the VTTL, the researchers conducting the study used a top-down 'consumption-side' approach by deriving the expected VAT liability from the observed national accounts data, such as supply and use tables (SUT). For this reason, the methodology they used relied on the availability and quality of SUT data, which varied from country to country.[2] According to the results, the smallest gaps in the EU-28 observed in 2018 were 0.7 % in Sweden, 3.5 % in Croatia, and 3.6 % in Finland. The largest gaps were in Romania (33.8 %), Greece (30.1 %) and Lithuania (25.9 %). The study suggests that the VAT gap could be interrelated with the values of risky imports of goods, pointing out the importance of fraud in driving the overall share of the VAT gap.

During the ongoing pandemic, which is having a huge impact on the EU economies, lost resources, including the VAT gap (forecast to increase in 2020), are even more problematic for Member States' revenues. Yet today, having secure tax revenues is of crucial importance for providing support to the people and businesses most in need.

VAT revenues and VAT gap in the EU

In 2018, VAT revenue accounted for 7.1 % of EU GDP; its highest share in the individual EU economies' GDP was in Croatia (13.5 %) and the lowest in Ireland (4.4 %). Income from VAT represented 18.2 % of the tax revenues in 2018. Hungary had the highest VAT rate (27 %) and Luxembourg the lowest (17 %). Worth mentioning is that VAT is an important source of income for both national governments and for the EU budget[3] and is the tax with the highest share in the Member States' indirect taxation revenues. In this regard, not only does VAT fraud have effects on the financial interests of the Member States and the EU but it also harms honest businesses by making them less competitive, especially in the sectors most affected by VAT fraud.

Estimating the VAT gap is important for the forecast of VAT receipts. The gap can be a useful indicator for tax administrations and governments to evaluate the magnitude of taxpayers' non-compliance and the need for further tax policy and tax administration initiatives.

A 2019 study concludes that the lack of knowledge on regional differences is a major limitation for measuring the VAT gap even though many Member States make considerable efforts to eliminate the revenue costs of fraud. If Member States are obliged to produce regional VAT gap measurements publicly, this could help identify where fraud is more significant within a country and to what extent this is caused by regional disparities.

There are different methodologies for estimating the VAT gap. A Commission report reviews these methodologies, stating that each has its advantages but also its limitations and shortcomings that should be taken into account when interpreting the estimates.

Fraud and evasion are the main causes of the VAT gap; other less significant causes include insolvencies, bankruptcies, administrative errors and legal tax optimisation (legally optimising and reducing the tax burden for business and personal finances).

Figure 1 – What causes the VAT gap?

Source: European Commission.

While factors such as the effectiveness of the tax system, the macroeconomic conditions and the quality of institutions, all affect the size of the VAT gap, fraud remains its leading cause. Cross-border transactions are a main source of VAT fraud, more specifically the missing trader intra-community (MTIC) fraud. This type of fraud is estimated at about €60 billion per year.
Some of the most significant sources that contribute to the VAT gap are:

- MTIC fraud and 'carousel' fraud: in the case of the first type of fraud, a supplier established in one Member State exports goods, charging no VAT on them, to a second company (the 'missing trader')[4] established in another Member State. The missing trader takes advantage of the VAT-exempt goods supplied to them and resells the goods on the second Member State's domestic market at competitive prices. Such an operation may take place numerous times between more than two Member States using the same VAT rules and advantages. The goods can also go back to a company in the first Member State; because this can be done a number of times, it is called 'carousel' fraud;
- e-commerce and import fraud: businesses selling online may fail to register properly for VAT or may fail to declare and pay the proper amount of VAT. Additionally, there could be insufficient information exchange on cross-border online supplies;
- VAT fraud related to cars: this is enabled by the fact that cars are subject to a different VAT regime depending on whether they are new or not;
- reduced-rates fraud: this is linked to the sale of certain commodities and services available in most Member States. Sellers may intentionally categorise their supplies erroneously in order to benefit from a reduced rate and be able to sell these supplies at a lower price.

Over time, the anti-VAT fraud regulatory framework has become quite comprehensive; nevertheless, the EU Member States are losing billions of euros annually due to fraud. Even though the EU VAT system is improving, it is relevant to consider how effective it is. To a certain degree, the estimates of the VAT gap and its evolution are a gauge for this effectiveness. As shown in Table 1 below, the VAT gap is most significant in Romania (33.8 %) and Greece (30.1 %), and is above 20 % in Italy and Lithuania. In nominal terms, the largest VAT gap is observed in Italy (€35.4 billion). A Commission study suggests that countries with very transparent public institutions have a smaller VAT gap.

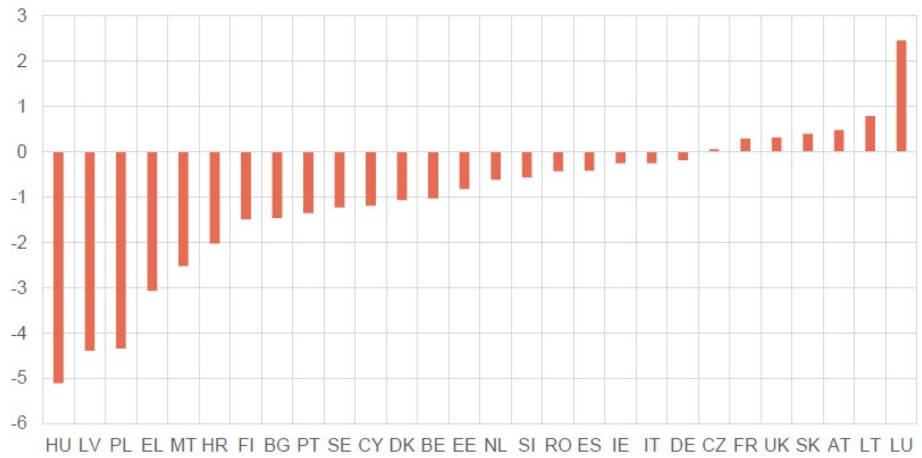
Table 1 – VAT gap as a percentage of the VTTL in the EU-28, 2018 (€ millions)

Member State	VAT revenues, €	VTTL, €	VAT gap, €	VAT gap (% of VTTL)
BE	31 053	34 670	3 617	10.4 %
BG	5 097	5 711	614	10.8 %
CZ	16 075	18 261	2 187	12.0 %
DK	29 121	31 369	2 248	7.2 %
DE	235 130	257 207	22 077	8.6 %
EE	2 331	2 458	127	5.2 %
IE	14 175	15 857	1 682	10.6 %
EL	15 288	21 858	6 570	30.1 %
ES	77 561	82 470	4 909	6.0 %
FR	167 618	180 406	12 788	7.1 %
HR	6 946	7 198	252	3.5 %
IT	109 333	144 772	35 439	24.5 %
CY	1 951	2 028	77	3.8 %
LV	2 449	2 705	256	9.5 %
LT	3 522	4 754	1 232	25.9 %
LU	3 729	3 928	199	5.1 %
HU	12 950	14 140	1 190	8.4 %
MT	920	1 084	164	15.1 %
NL	52 619	54 897	2 278	4.2 %
AT	29 323	32 231	2 908	9.0 %
PL	40 411	44 862	4 451	9.9 %
PT	17 865	19 754	1 889	9.6 %
RO	12 890	19 485	6 595	33.8 %
SI	3 765	3 913	148	3.8 %
SK	6 319	7 899	1 579	20.0 %
FI	21 364	22 171	807	3.6 %
SE	43 433	43 739	306	0.7 %
UK	168 674	192 126	23 452	12.2 %
Total EU-28	**1 131 912**	**1 271 953**	**140 042**	**11.0 %**

Source: Study and Reports on the VAT Gap in the EU-28 Member States (see p. 20)

In 2018, the VAT gap narrowed in 21 EU countries compared to 2017 (Figure 2 below). The biggest decrease was in Hungary (-5.1 percentage points), Latvia (-4.4 percentage points) and Poland (-4.3 percentage points). On the contrary, some Members States experienced an increase: Luxembourg (+2.5 percentage points), Lithuania (+0.8 percentage points), and Austria (+0.5 percentage points).

Figure 2 – Percentage point change in the VAT gap, EU-28, 2018 over 2017



Source: Study and Reports on the VAT Gap in the EU-28 Member States (p. 18).

However, according to estimates, the VAT gap for 25 Member States in 2006[5] was €106.5 billion, which means that it has increased over the past decade. According to Table 1 above, the VAT gap for the EU-28 in 2018 was €140 billion.

An increase in VAT non-compliance or a decrease in the base may reduce VAT revenues in 2020 and 2021. Based on the interrelations between the VAT gap, the macroeconomic indicators and the Commission's spring macroeconomic forecasts, the VAT gap is estimated to reach over €164 billion in 2020 due to the narrowing of the VAT base. Even though the EU economies are expected to partially recover in 2021 and to be supported by stimulus measures, all EU countries' GDPs would be below 2019 levels in nominal terms, and their general government imbalances could worsen in comparison with 2019. In this situation, even though the VAT gap is supposed to be lower in 2019 in relative terms compared to 2020, it is difficult to assume that it will reach the 9.6 % forecast for 2019.

Legal framework

The EU Treaties[6] have provisions aimed at harmonising the application of the VAT and other indirect taxes across the EU in order to protect the single market against possible distorting effects. More precisely, Articles 110 to 113 of the Treaty on the Functioning of the European Union (TFEU), specify that the legislation on indirect taxation has to be harmonised in order to create conditions for the proper functioning of the internal market and to avoid the distortion of competition. Harmonisation of the key aspects of the VAT system started in 1967, when the Council of the EU assumed the legal and political commitment to introduce a VAT system adapted to the single market.

The current framework is referred to as a transitional VAT system and is currently under review.[7] It rests on the principle that indirect taxes on consumption are paid in the country where the goods or services are consumed. The transitional VAT system is complex and compliance costs are high. The main challenge for advancing in the process leading to a definitive VAT system[8] consists in the fact that this could trigger concerns for some Member States, as they will depend on other Member States for their VAT collection.

Worth mentioning is that taxation policy is mainly a prerogative of the Member States, with the EU having only limited competences. The Council, through a special legislative procedure, adopts EU indirect tax legislation by a unanimous vote after consulting with the European Parliament[9] and the European Economic and Social Committee (Article 113 TFEU).

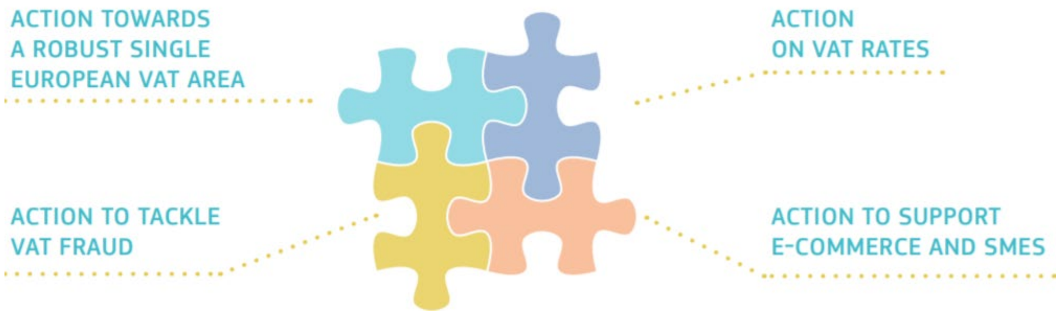
At the beginning of 2019, the Commission presented a communication on shifting to the ordinary legislative procedure when deciding on tax policy, which would simplify the task of reaching a compromise as compared to the current procedure. A main element of the communication is the transition to qualified majority voting, to avoid the actual blocking effect of the unanimity vote.

The current framework is based on Directive 2006/112/EC (the VAT Directive), on Implementing Regulation 282/2011 ensuring the uniform application of the VAT Directive, and on Council Regulation (EU) No 904/2010 on administrative cooperation and combating fraud in the field of value added tax.

Evolution of VAT legislation

In 2016, the Commission adopted an Action plan on VAT that had as its aim to help EU countries to advance to a single EU VAT area, to enhance the functioning of the single market, to boost trade and increase competitiveness and investment. It also sought to simplify the system, to tax the sales of goods and services among Member States as domestic sales and to narrow the VAT gap.

Figure 3 – The gist of the 2016 Action plan on VAT



Source: European Commission.

Toward a definitive tax system

According to the action plan, the establishment of a definitive EU VAT system for cross-border trade would be decisive in reducing opportunities for fraud. In November 2016, the European Parliament, through its resolution on 'Towards a definitive VAT system and fighting VAT fraud', called for modernising the VAT system, strengthening cooperation in the fight against VAT fraud and reducing the VAT gap.

The definitive VAT system package for business-to-business transactions (B2B) includes two legislative stages: the first concerning goods and the second services. The stages will be assessed one after the other. The first stage includes two sub-stages: a single-VAT-area package adopted in October 2017 and a proposal on detailed technical measures for the definitive VAT system adopted in May 2018. The aim is to remove the tax exemption on intra-Community supplies in order to reduce the VAT gap and make compliance easier. The Commission also introduced four quick fixes to apply until the definitive VAT system is launched. In February 2019, the Parliament adopted a position on the proposal.

According to the main principles of the prospective definitive VAT system for cross-border trade: i) intra-EU goods supplies will be taxed at the destination; and ii) the supplier will be responsible for charging and collecting the VAT within the Member State of destination. However, whenever the buyer is an eligible certified taxable person,[10] he or she will be responsible for paying the VAT due through a reverse charge mechanism.[11]

VAT e-commerce package

To facilitate cross-border trade, combat VAT fraud and ensure fair competition for EU businesses, the Council adopted the VAT e-commerce package in 2017. This resulted in the lifting of a very big barrier before small businesses engaged in cross-border trade. Furthermore, it made it possible for sellers of goods to consumers online to deal with their VAT obligations in the EU comfortably in their own language through an online portal. The package, which will become applicable from July 2021, includes Council Directive (EU) 2017/2455, amending the VAT Directive, and Council Regulation (EU) 2017/2454, amending the VAT Administrative Cooperation Regulation. Some changes in this regard, such as the harmonisation of the required proof of intra-EU transport of goods and the simplification of the VAT treatment regarding chain supplies, came into force already in 2019. In November 2019, the Council adopted the implementing measures for the VAT e-commerce package: Council Directive (EU) 2019/1995 and Council Implementing Regulation (EU) 2019/2026.

The e-commerce package regulates the VAT regime for transactions of goods or services aimed at final consumers (B2C).[12] Some of the major changes it introduced are as follows:

- It reinforced the principle of applying VAT to goods deliveries at the destination. Entrepreneurs who sell more than €10 000 per year to another Member State must start paying taxes at the destination.

- For electronic services, VAT will be payable at the destination where the consumer is located, through an electronic window, the Mini One Stop Shop (MOSS) online portal for e-services.[13] The current window used only for electronic services has been extended to the rest of the operations aimed at final consumers, even in the field of imports. In fact, three electronic windows will become available depending on the type of operation at hand (imports, delivery of goods or provision of services), and also depending on whether the seller is established in the EU. Their use is voluntary, and the seller could choose to identify him/herself in the Member State of destination where the operation is taxed and fulfil his/her obligations there.

Strengthened cooperation

The adopted rules amend the VAT Directive concerning the requirements towards payment service providers for keeping records of e-commerce cross-border payments. They also amend the Regulation on administrative cooperation in the area of VAT. Details of how national tax authorities will cooperate to detect VAT fraud and control compliance with VAT obligations are also included. To ensure compliance with VAT rules and to tackle VAT e-commerce fraud, it is essential to identify the online businesses that supply goods and services to customers in other Member States.

Recent amendments to Regulation (EU) No 904/2010, such as Regulation 2018/1541 and Regulation 2018/1909, aim to increase cooperation between Member States, as well as between tax authorities and law enforcement institutions, by introducing additional measures to tackle the main types of cross-border fraud. Furthermore, the Council adopted in February 2020 a set of rules on the exchange of VAT payment data to facilitate detection of tax fraud in cross-border e-commerce transactions, which will become applicable from 1 January 2024.[14] The measures will enable Member States to collect records made electronically available by payment service providers (PSM). Furthermore, a new central electronic system will be established to enable the storage of the payment information and its further analysis by the national anti-fraud authorities.

Administrative cooperation instruments in the area of VAT have also been strengthened: on its initiative, the Member States' anti-fraud experts' network (Eurofisc)[15] can now cooperate and exchange information with the European Anti-Fraud Office (OLAF)[16] and Europol. Tax authorities can exchange information with customs authorities on imports subject to VAT that lend themselves to customs fraud, and organise joint audits with the active participation of foreign tax officials in administrative enquiries.

Looking ahead

Noticeably, VAT legislation has been evolving to address the growing complexity of transactions of goods and services with ever-increasing digital content and virtual consumption. Yet, the digital economy continues to present new challenges to the tax administrations. At national level, tax authorities have limited resources to exploit the massive volumes of data that they collect through the implementation of measures. At global level, the European Union has had a leading role, as its work on preparing the legislative framework for VAT taxation in the digital economy dates a number of years back. Noteworthy is the requirement for non-EU businesses providing digital services to private consumers in the EU Member States to register for VAT and charge VAT based on destination, which even set an example for other, non-EU countries, to emulate.

On 15 July 2020, the Commission adopted a tax package. With a view to improving the use of technology, enhancing information sharing between Member States, and strengthening Eurofisc, the Commission envisages to prepare new proposals that would step up the fight against VAT fraud and ease compliant businesses. It is also ready to assist Member States to improve their tax collection and capacity for inspection. After analysing the VAT gaps and fraud schemes in Member States that need assistance, deep reform programmes could be carried out quickly. In this regard, the Commission may provide financial support and expertise to national tax administrations. The tax package has the following components:

- A legislative proposal to revise the Directive on administrative cooperation in the field of taxation, which will introduce an automatic exchange of information between Member States' tax administrations for income/revenues generated by sellers on digital platforms and will strengthen administrative cooperation through the clarification of existing rules.
- A communication on 'Tax good governance in the EU and beyond' aimed to review progress made in enhancing tax good governance in the EU, but also externally, and to suggest areas for improvement.
- An action plan for a fair and simple taxation supporting the recovery strategy and presenting a number of upcoming initiatives in the field of direct and indirect taxation. Worth mentioning are some of the envisaged initiatives, such as:
    - for the period 2020/2021: The European Parliament initiated the launch and financed an EU Tax Observatory as a preparatory action, which can last for up to three consecutive years. The tasks of the EU Tax Observatory will be to monitor and quantify trends in the level and scope of tax abuse and contribute to evidence-based policy-making.
    - in 2022/2023, the Commission plans to present a legislative proposal for modernising VAT reporting obligations. The aim is to ensure a quicker and more detailed exchange of information on VAT intra-EU transactions possibly in real-time, and to streamline the mechanisms that can be applied to domestic transactions. Furthermore, the Commission will explore how to switch from a manual exchange to an automated sharing of data through electronic information exchange systems or warnings between Member States. New technologies at the Member States' disposal would make cross-border transactions easier for honest businesses that want to be compliant with VAT rules. Tax authorities would focus their control more extensively on non-compliant taxpayers and honest taxpayers would enjoy more uninterrupted operation. In this regard, the Commission will also look at possible ways of increasing these cross-border investigations. It also envisages to propose an amendment to the VAT Directive to further expand the scope of the VAT One Stop Shop (OSS) for the declaration and payment of VAT on telecommunications, broadcasting & electronic services (TBE), which should be extended in 2021 by the VAT e-commerce package to distance sales of goods and services other than TBE services.[17]

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ENDNOTES

1 Such as VAT-registered businesses.

2 See the Study and Reports on the VAT Gap in the EU-28 Member States, p. 10.

3 See Table 7, 'Summary of financing (12) of the general budget by type of own resource and by Member State'.

4 A missing trader could be a new company with no real seat or activity.

5 Excluding Cyprus. Bulgaria and Romania joined the EU in 2007.

6 As well as previously the Economic European Community and the Treaty and the European Community.

7 A cross-border transaction of goods and services between taxable persons includes a supply of goods and services in the Member State of departure that is exempt of VAT and an acquisition of goods and services subject to VAT in the Member State of destination.

8 Transactions executed within the European Union as if they were carried out in a single country.

9 Except on budgetary-related issues, for which it is a co-legislator.

10 This refers to taxpayers considered reliable. Only taxable persons would be eligible for such a status, and they would have access to certain simplification rules in transactions involving a greater risk of fraud. Introducing this concept will be the basis of a gradual transition to the definitive VAT system.

11 The possibility to make the buyer liable to pay the VAT remains an option for Member States in the case of services, the supplier of which is not established in their territory.

12 A process for selling products directly to consumers.

13 With the goal that businesses could deal with their cross-border VAT liabilities in their own country and language.

14 Council Regulation amending Regulation (EU) No 904/2010 as regards measures to strengthen administrative cooperation in order to combat VAT fraud.

15 A network for analysis of targeted information on cross-border fraud between Member States, for the swift exchange and coordination of follow-up actions.

16 It mostly focuses on customs fraud and import-related VAT fraud.

17 Aimed at all of the remaining business to consumer (B2C) transactions that are not yet covered.

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