An Overview over Value Added Tax Gap in the European Union

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Abstract

Value Added Tax (VAT) is a common tax to European Union Member States and is one of their main sources of revenue. Currently, in the European Union, the analysis and measurement of the Value Added Tax gap (VAT gap) has become necessary for fiscal administrations as a consequence of the increase in Value Added Tax evasion. In our paper the aim is to briefly present the features of Value Added Tax, the main objective being to analyze the VAT gap at European Union level and within Member States. The debate on the VAT gap is complex because of the impact of fiscal revenue collection on the economy and society. Other objectives are to present the factors influencing the VAT gap, the VAT rates applied in member countries and to examine the impact of the number and level of reduced rates on the VAT gap.

Key words: Value Added Tax, Value Added Tax gap, tax evasion
J.E.L. classification: H24, H25, H29

1. Introduction

The interest in this research topic arises both from the frequent approach of the subject in specialized literature and from the role of Value Added Tax in the formation of the public budgets of the Member States and the European Union budget.

The research undertaken is placed in the current context of the European Union's fiscal policy, where taxation is considered essential for the functioning of the single market. The Treaty on the Functioning of the European Union, at Article 113, provides the harmonization of legislation regarding excise duties, turnover taxes and other indirect taxes. Such harmonization is necessary to ensure the functioning of the single market. One of the directives with a significant impact on European Value Added Tax regulations is Directive 2006/112/EC on the common system of Value Added Tax in the European Union, with subsequent amendments and additions, which has been transposed into Title VII of the Romanian Fiscal Code (Teodorescu et al, 2017, p. 177).

To achieve the mentioned objectives, the following research hypothesis has been developed: a higher number of reduced Value Added Tax rates and a high level of their value lead to an increase in the Value Added Tax gap.

The paper is based on the bibliographical documentation of various regulations and studies on Value Added Tax, the theoretical research being supported by a study on the Value Added Tax gap in the European Union. The study is based on a European Union report published in 2023 by the Center for Social and Economic Research. The report is based on statistical data from 2017-2021. The report also provides estimates for 2022, but only for a few Member States.

2. Theoretical background

Value Added Tax represent an indirect tax, levied on services and goods in direct proportion to their price, regardless of the number of operations in the economic circuit. This means that the real tax burden is visible at every stage of the production and distribution chain.

Value Added Tax is an important source of revenue for Member States' budgets, but it also has the role of strengthening competitiveness at the European Union level (Teodorescu, 2017). As a sales tax with fairly high rates, it is often criticized on both equity and efficiency grounds (Ulbrich, 2011, pp. 228-238).

Characteristics of Value Added Tax

- *It is a consumption tax* levied on most traded goods and services;
- *It is levied on the 'value added' of the goods/services* at each stage of production and distribution, being charged when companies registered for Value Added Tax purposes sell the goods to other companies (Business to Business B-2-B) or to the final consumer (Business to Consumer B-2-C) (McCullough, 2019);
- It is a tax that influences the cash-flow for Value Added Tax paying companies, while for a non-Value Added Tax paying company it is a cost item.
- As an indirect tax, the Value Added Tax is subject to the phenomenon of repercussion, which occurs when the legal taxpayer enters into economic relations with other taxpayers, on whom the tax burden is shifted.

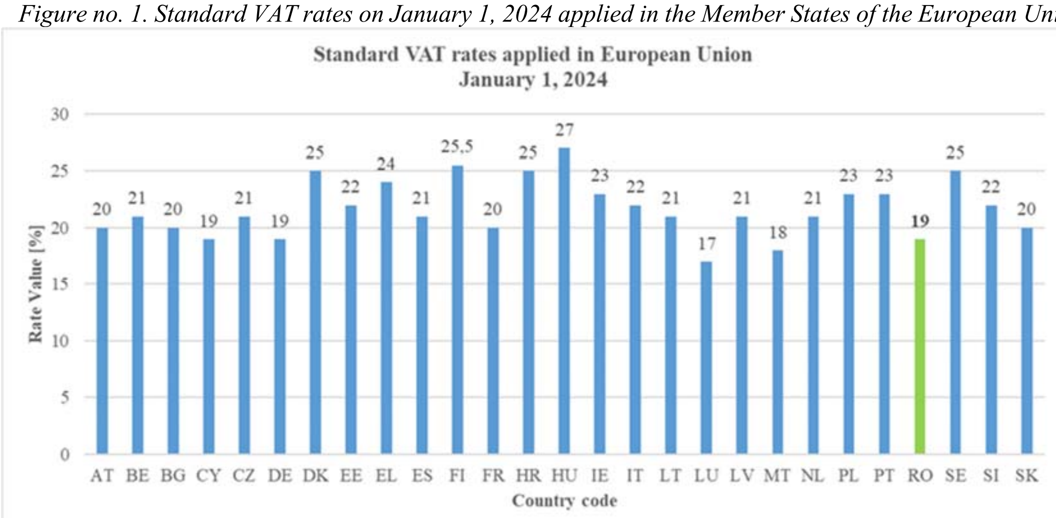
Advantages of Value Added Tax

- *It is a slightly adaptable tax*, which can be decreased/increased according to the needs of the state budget by changing the tax rate (Cernușca, 2021);
- *It is a tax with a high fiscal yield* (Costea, 2018, p.104) due to the fact that it is applied to a large number of goods and services and is paid by all persons who carry out taxable transactions, without involving high collection costs;
- *It ensures fiscal neutrality in intra-Community trade*, as equal fiscal treatment is applied to both domestically produced goods and goods purchased from other Member States (Teodorescu, 2017).

Disadvantages of Value Added Tax

- *It affects the real incomes of final consumers*, due to the decrease in their purchasing power, as the real burden of Value Added Tax is on the final consumer;
- *It has a regressive character*, mainly affecting people with low incomes;
- *It creates fiscal unfairness* by not taking into account the payer's personal situation, wealth or income.

Figure no. 1. Standard VAT rates on January 1, 2024 applied in the Member States of the European Union



Source: (***Your Europe, 2024)

Value Added Tax rates in the Member States

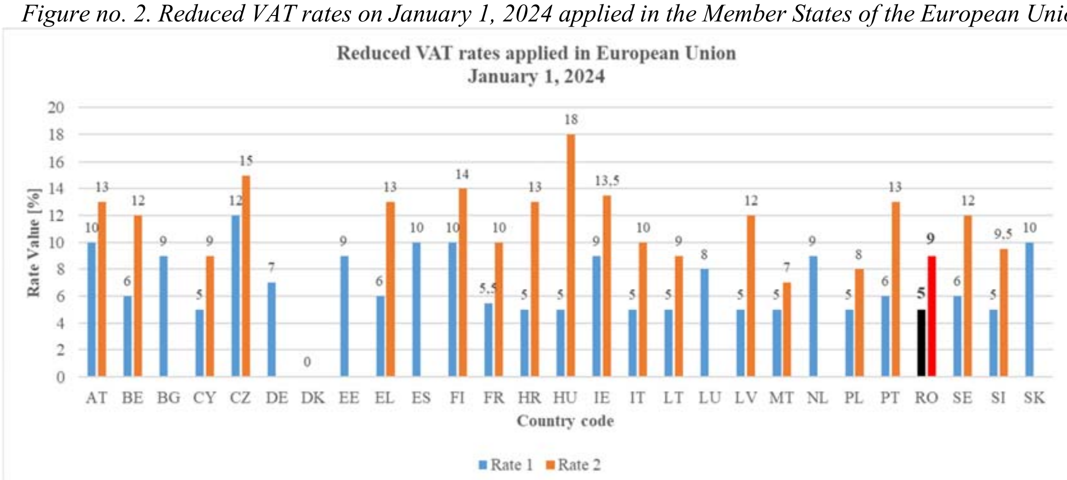
Each Member State of the European Union has a standard rate. This must be greater than or equal to 15% (Figure no. 1) and applies to most services and goods.

In addition there may be one or two reduced rates which may be applied to supplies of specific services and goods and which must be greater than or equal to 5% (Figure no. 2).

Increasing the standard VAT rate has been one of the main ways of meeting increased revenue needs in Member States since the start of the economic crisis in 2008 (Keen, 2013).

Even though successive regulations have established a common system applicable to Value Added Tax, at the level of the Member States, there are still significant differences at the lavel of tax rates (Figure no. 1 and Figure no. 2). In this regard, it can be argued that the desire for tax harmonization up to the level of closeness or unification of tax rates has not been achieved, the impact of the number of reduced rates and a standard rate influence the efficiency of VAT collection (Kowal et al, 2021).

Figure no. 2. Reduced VAT rates on January 1, 2024 applied in the Member States of the European Union



Source: (***Your Europe, 2024)

In the case of the reduced rate with a value of zero (Denmark - Figure no. 2) the buyer does not pay Value Added Tax. However, the seller is entitled to deduct the Value Added Tax he has paid on purchases strictly related to that sale.

Some Member States are allowed to apply super-low VAT rates of less than 5% for certain goods and services (France: 2.1%, Italy: 4%, Luxembourg: 3%), while others apply intermediary rates for certain supplies of services and goods not included in Annex III of Directive 2006/112/EC (parking rates). For these supplies, countries such as Austria (13%), Belgium (12%), Luxembourg (14%), Malta (12%) and Portugal (13%) continue to apply reduced VAT rates, but no lower than 12%.

The analysis of the data related to Figures no. 1 and no. 2 reveals that although Value Added Tax is the most widely harmonized tax in the European Union, the current Value Added Tax system is a transitional system, still fragmented and complex, as it has not been possible to establish a definitive system that would work in the union in the same way as it would work in a single country (Teodorescu, 2017)

Methods of Value Added Tax fraud at European Union level

Tax evasion, as a phenomenon, occurs both internationally and nationally.

The most common methods of Value Added Tax fraud at European Union level are:

- Missing trader intra-community fraud (MTIC) involving a ghost company. The MTIC fraud pattern is based on sophisticated activities aimed at exploiting differences in the fiscal treatment of Value Added Tax in different Member States.
- The carousel method can involve several firms located in different European Union countries trading the same goods successively, sometimes the goods get to return to the original supplier, the scheme repeating itself.

The VAT gap concept and its influencing factors

The VAT gap concept

The VAT gap is calculated as the difference between the amount of Value Added Tax actually collected and the VAT Total Tax Liability (VTTL) in a situation of full fiscal compliance (Trandafir, 2016).

The VAT gap provides an estimate of the loss of Value Added Tax receipts due to tax evasion, insolvencies, fraudulent bankruptcies and miscalculations. Other circumstances with a significant impact on the size of the Value Added Tax deficit include economic developments, government support measures and the quality of national statistics (Poniatowski et al, 2023).

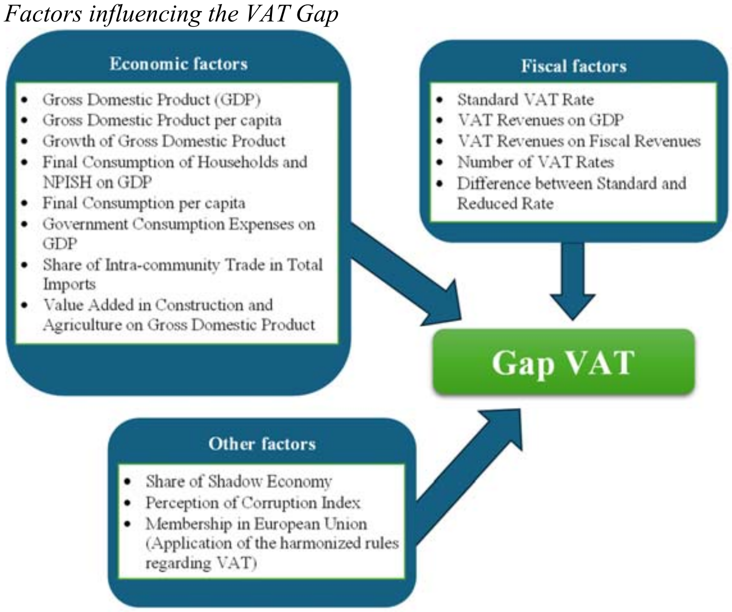
Value Added Tax revenue losses have a negative impact on the expenditure that governments allocate to public goods and services (Ciobanu et al, 2022, p. 34).

Influencing factors of the VAT gap

Understanding the influencing factors of the VAT gap (Figure no. 3) can help reduce the VAT gap by adjusting the Value Added Tax policy (Ciobanu et al, 2022, p. 34).

The determinants of the VAT gap range from legal exploitation of flaws in tax systems to large-scale organized tax evasion.

Figure no. 3. Factors influencing the VAT Gap



Source: (Zídková et al, 2016)

Note: *Adapted from What Causes the VAT Gap?. ** NPISH - Non-Profit Institutions Serving Households.

3. Research methodology

For the assessment of the VAT gap the study uses a scenario based on three working hypotheses: no tax evasion; no reduced VAT rates; no exemptions.

The study takes as its starting point a European Union report on VAT gap and is based on a comparative analysis of VAT gap in the European Union member countries.

Concepts used in the case study

VAT Total Tax Liability (VTTL) – represents the theoretical Value Added Tax revenue in a situation of full fiscal compliance.

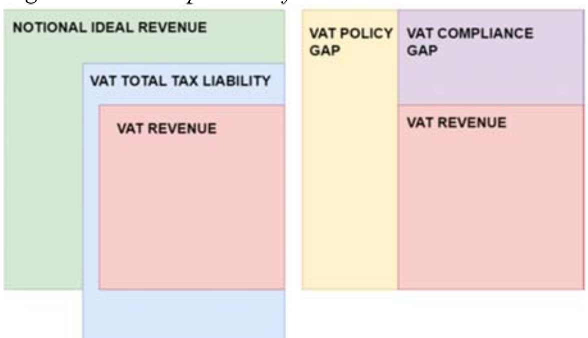
VAT compliance gap - measures overall Value Added Tax non-compliance which includes in addition to Value Added Tax losses due to tax evasion, losses due to insolvencies, bankruptcies, administrative errors and legal fiscal optimization.

Value Added Tax Revenue – represents the amount actually collected to the budget from Value Added Tax.

Notional Ideal Revenue (Figure no. 4) – represent the Value Added Tax revenue that Member States can collect under ideal conditions by applying the standard VAT rate to all goods and services, disregarding reduced VAT rates; it assumes that Value Added Tax is levied on all final consumption of households, government and non-governmental organizations, considering the standard VAT rate.

VAT Policy Gap - is an indicator that measures the additional Value Added Tax revenues that could theoretically be achieved (assuming perfect fiscal compliance in the absence of reduced rates and by applying a uniform VAT rate).

Figure no. 4. Components of the Notional Ideal Revenue



Source: (Poniatowski et al, 2023)

In the methodology used Value Added Tax revenue is the actual revenue received which is compared with a Value Added Tax revenue calculated in the ideal way.

The VAT gap is the estimated overall difference between the theoretical revenue expected to be collected and the amount actually collected. The estimated amount of Value Added Tax that can be theoretical collected is calculated based on the Value Added Tax legislation.

VAT gap = VTTL – VAT revenue

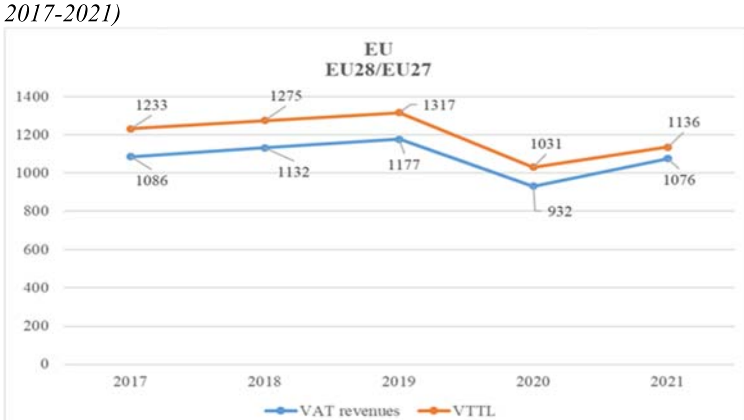
VAT gap (%) = $\frac{VTTL - VAT\ revenue}{VTTL}\ x\ 100$

The revenues included in the calculations are based on the European System of Accounts (ESA 2010) and are recorded on an accrual basis.

4. Findings

As shown in Figure no. 5, total revenues from Value Added Tax and VAT Total Tax Liability (VTTL) revenues increased in all years of the period under analysis, except in 2020, when both fell below the levels recorded in 2017 (-14.2%, -16.4%).

Figure no. 5. Evolution of VAT Total Tax Liability (VTTL) and VAT revenues in the EU (EUR billion, 2017-2021)



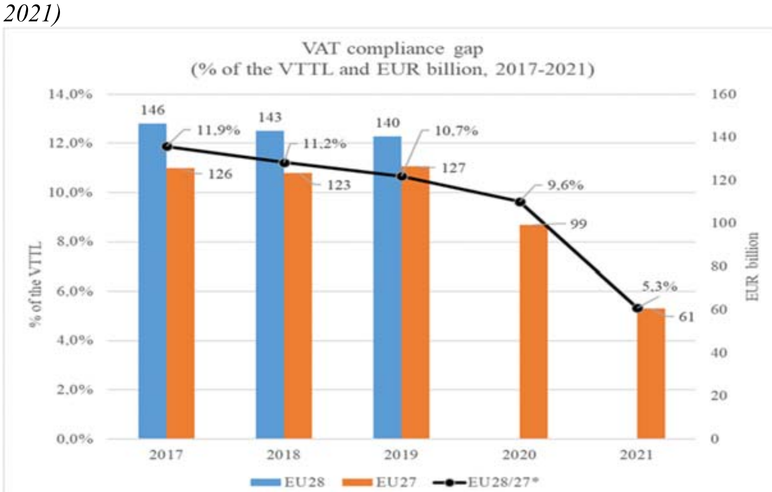
Source: (Poniatowski et al, 2023).

In the 2017-2019 period % of the VTTL has been calculated for EU28 and in the 2020-2021 period for EU27.

In 2021, total Value Added Tax revenues and VAT Total Tax Liability (VTTL) revenues recovered the decline and exceeded the values recorded before the COVID-19 pandemic (+15.5%, +10.2%).

Value Added Tax compliance gap refers to voluntary Value Added Tax compliance and the degree of compliance. If compliance conditions were uniform, the Value Added Tax compliance gap would not exist.

Figure no. 6. VAT compliance gap - evolution in the EU-27/ EU-28 (% of the VTTL and EUR billion, 2017-2021)



Source: (Poniatowski et al, 2023)

In the 2017-2019 period % of the VTTL has been calculated for EU28 and in the 2020-2021 period for EU27.

The VAT gap recorded at the level of European Union Member States has a very high degree of dispersion, with a downward trend from 11.9% in 2017 to 5.3% in 2021 (Figure no. 6).

Table no. 1. VAT compliance gap as a percent of the VTTL in EU-27 Member States (2020 and 2021)

	2020				2021				VAT gap change (pp)
Member State	VTTL (EUR mln)	VAT Revenues (EUR mln)	VAT gap (EUR mln)	VAT gap (%)	VTTL (EUR mln)	VAT Revenues (EUR mln)	VAT gap (EUR mln)	VAT gap (%)	
BE	33 898	29 282	4 616	13.6	36 834	34 304	2 530	6.9	-6.7
BG	6 076	5 635	442	7.3	7 018	6 671	347	4.9	-2.4
CZ	18 236	16 022	2 214	12.1	19 440	18 078	1 362	7.0	-5.1
DK	32 475	31 073	1 402	4.3	35 398	33 618	1 780	5.0	0.7
DE	234 602	221 562	13 040	5.6	266 845	259 385	7 460	2.8	-2.8
EE	2 599	2 469	130	5.0	2 887	2 847	40	1.4	-3.6
IE	15 770	13 765	2 005	12.7	16 708	15 592	1 116	6.7	-6.0
EL	16 351	12 925	3 426	21.0	18 173	14 942	3 231	17.8	-3.2
ES	73 447	69 435	4 012	5.5	82 912	82 250	662	0.8	-4.7
FR	176 449	161 537	14 912	8.5	194 283	184 731	9 552	4.9	-3.6
HR	6 710	6 322	388	5.8	8 108	7 647	461	5.7	-0.1
IT	126 968	99 669	27 299	21.5	135 580	120 980	14 600	10.8	-10.7
CY	2 164	1 786	378	17.5	2 378	2 182	196	8.3	-9.2
LV	2 790	2 541	251	9.0	3 079	2 854	225	7.3	-1.7
LT	4 929	4 009	920	18.7	5 482	4 688	794	14.5	-4.2

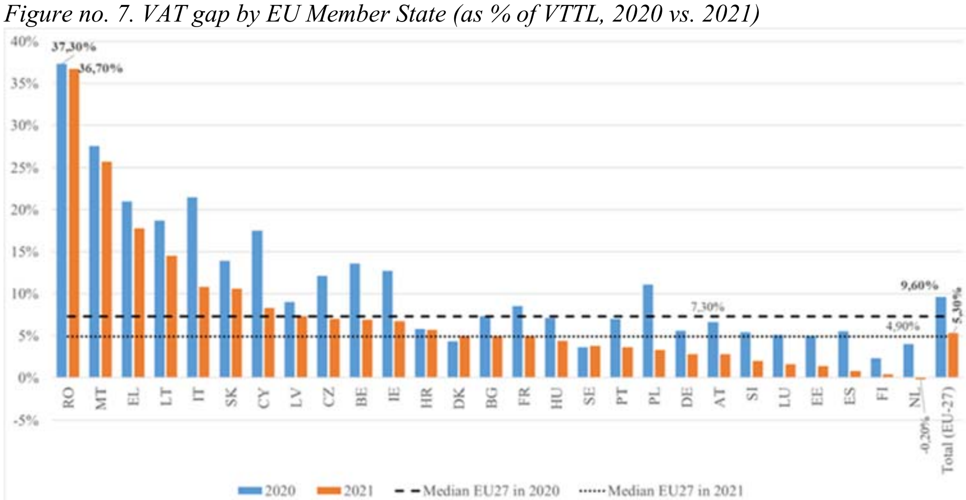
	2020				2021				VAT gap change (pp)
Member State	**VTTL (EUR mln)**	**VAT Revenues (EUR mln)**	**VAT gap (EUR mln)**	**VAT gap (%)**	**VTTL (EUR mln)**	**VAT Revenues (EUR mln)**	**VAT gap (EUR mln)**	**VAT gap (%)**	
LU	3 941	3 741	200	5.1	4 414	4 344	70	1.6	-3.5
HU	14 460	13 429	1 031	7.1	15 938	15 230	708	4.4	-2.7
MT	1 171	849	322	27.5	1 346	1 001	345	25.7	-1.8
NL	61 407	58 971	2 436	4.0	65 254	65 400	- 146	-0.2	-4.2
AT	30 133	28 136	1 997	6.6	31 551	30 668	883	2.8	-3.8
PL	47 085	41 856	5 229	11.1	51 010	49 317	1 693	3.3	-7.8
PT	18 071	16 804	1 267	7.0	19 821	19 108	713	3.6	-3.4
RO	21 304	13 368	7 936	37.3	24 507	15 511	8 996	36.7	-0.6
SI	3 754	3 553	201	5.4	4 386	4 299	87	2.0	-3.4
SK	7 925	6 820	1 105	13.9	8 236	7 366	870	10.6	-3.3
FI	22 527	22 005	522	2.3	23 641	23 551	90	0.4	-1.9
SE	45 625	43 981	1 644	3.6	51 151	49 215	1 936	3.8	0.2
Total (EU-27)	**1 030 868**	**931 545**	**99 323**	**9.6**	**1 136 381**	**1 075 778**	**60 603**	**5.3**	**-4.3**
Median (EU-27)				**7.30**				**4.90**	

Source: (Poniatowski et al, 2023)

A country-by-country analysis of the VAT gap over the period 2020-2021 shows that the VAT gap has decreased in all European Union countries except Sweden (0.2 pp) and Denmark (0.7 pp), where it has increased. The biggest decreases were seen in Cyprus (-9.2 pp), Italy (-10.7 pp), Belgium (-6.7 pp), Ireland (-6.0 pp) and Poland (-7.8 pp). The changes in the VAT gap for most Member States ranged between 0 and 10 percent of VTTL (Table 1).

In 2021 the highest value of the VAT gap was seen in Romania (36.7%), followed by Malta (25.7%), Greece (17.8%) and Lithuania (14.5%), while the lowest values were recorded in the Netherlands (-0.2%), Finland (0.4%), Spain (0.8%), all below 1% (Table no. 1).

Figure no. 7. VAT gap by EU Member State (as % of VTTL, 2020 vs. 2021)



Source: (Poniatowski et al, 2023)

Data for the graphical representation has been taken from Table 1.

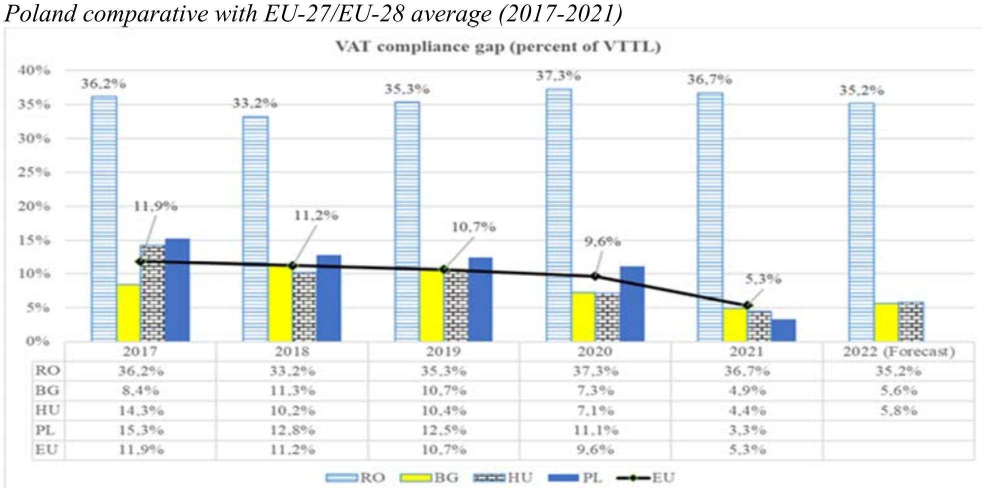
At the European Union level, the share of the VAT gap in VTTL decreased from 9.6% in 2020 to 5.3% in 2021, with the European Union median reaching 4.9% in 2021 from 7.3% in 2020 (Figure no. 7).

The median Value Added Tax-gap value of 4.9% in 2021 is closer to the VAT gap share in VTTL (5.3%) at EU 27 level, showing some degree of convergence of Member States with larger differences in Value Added Tax compliance.

Comparative analysis of VAT gap (as a share of VTTL) in Romania, Bulgaria, Hungary and Poland, in the period 2017-2022

The data presented in Figure no. 8 shows that at the European Union level the VAT gap trend has been downward, from 11.9% in 2017 to 5.3% in 2021. The same trend was recorded in Poland, from 15.3% in 2017 to 3.33% in 2021 (Figure no. 8). In Hungary and Bulgaria the trend has been random, with decreasing trends starting from 2018 in the case of Bulgaria and 2019 in the case of Hungary, with the mention that in the 2019-2021 period, both countries have recorded VAT gap values lower or equal to the European Union average. Estimated data for 2022 show an increase in the VAT gap for both Hungary and Bulgaria.

Figure no. 8. Evolution of the VAT compliance gap (% of the VTTL) in Romania, Bulgaria, Hungary, Poland comparative with EU-27/EU-28 average (2017-2021)



	2017	2018	2019	2020	2021	2022 (Forecast)
RO	36.2%	33.2%	35.3%	37.3%	36.7%	35.2%
BG	8.4%	11.3%	10.7%	7.3%	4.9%	5.6%
HU	14.3%	10.2%	10.4%	7.1%	4.4%	5.8%
PL	15.3%	12.8%	12.5%	11.1%	3.3%	
EU	11.9%	11.2%	10.7%	9.6%	5.3%	

Source: (Poniatowski et al, 2023)

Note: * In the 2017-2019 period % of the VTTL has been calculated for EU28 and in the 2020-2022 period for EU27. ** Data for 2022 is partial and estimated.

Policy gap in European Union

In order to understand how the different elements of the fiscal system contribute to the loss of Value Added Tax revenues, the VAT gap can be broken down into several components: the VAT rate gap and the VAT exemption gap. This breakdown makes it possible to determine the influence of the application of reduced VAT rates and their level, as well as the impact of exemptions or exclusion of a part of the final consumption from the tax base on Value Added Tax revenue.

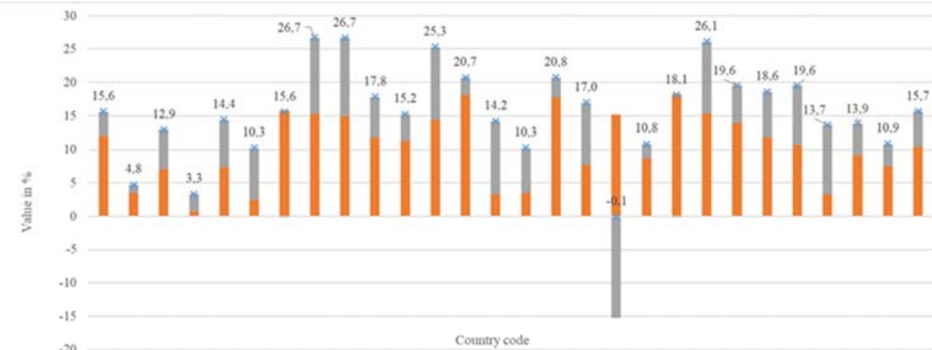
The assessment of the impact of reduced rates, their levels and exemptions on Value Added Tax revenue losses is based on a comparison of the VTTL (VAT Total Tax Liability) and the potential revenue that could be collected in a ideal VAT system with a uniform rate and the widest possible tax base (Notional Ideal Revenue). This VAT policy difference catch the effects of applying multiple tax rates, exclusions and exemptions on the revenue determinated theoretical that could be collected under a given Value Added Tax system (Figure no. 9).

Certain exemptions and exclusions apply to goods and services which are difficult to tax (such as goods and services which are not offered at market prices - public services), or for which it is difficult to define the taxable base (insurance and financial services) and the place of supply (in the case of international transport).

The impact of reduced VAT rates is lower in countries that rely either on a single reduced rate, e.g. Slovakia (3.2%), Estonia (2.5%), Bulgaria (3.5%), Denmark (0.7%), or on lower rates, e.g. Lithuania (3.5%) and Latvia (3.4%).

The multiple reduced rates (Figure no. 9) have led to significant losses of Value Added Tax revenue in countries such as Austria (18.3%), Cyprus (18.0%), Ireland (15.8%), Poland (15.4%), Greece (15.3%), Malta (15.2%), Romania (11.8%). But there are also countries where the existence of several reduced rates has not led to significant revenue losses, such as the Czech Republic (7.1%), Sweden (7.5%), Finland (9.2%).

Figure no. 9 Actionable policy gap split into the actionable exemption gap and VAT rate gap and the in European Union member states - 2021



	BE	BG	CZ	DK	DE	EE	IE	EL	ES	FR	HR	IT	CY	LV	LT	LU	HU	MT	NL	AT	PL	PT	RO	SI	SK	FI	SE	EU-27
Actionable exemption gap	3,6	1,3	5,9	2,7	7,1	7,8	-0,2	11,5	11,8	6,0	3,9	10,9	2,7	10,8	6,7	3,0	9,3	-15,3	2,2	-0,2	10,7	5,6	6,8	8,9	10,4	4,7	3,4	5,3
Rate gap	12,0	3,5	7,1	0,7	7,3	2,5	15,8	15,3	14,9	11,8	11,3	14,4	18,0	3,4	3,5	17,7	7,7	15,2	8,6	18,3	15,4	13,9	11,8	10,6	3,2	9,2	7,5	10,4
Actionable policy gap	15,6	4,8	12,9	3,3	14,4	10,3	15,6	26,7	26,7	17,8	15,2	25,3	20,7	14,2	10,3	20,8	17,0	-0,1	10,8	18,1	26,1	19,6	18,6	19,6	13,7	13,9	10,9	15,7

Source: (Poniatowski et al, 2023).

At European Union Member State level, there were significant losses of Value Added Tax revenue due to exemptions (Figure no. 9) in countries such as Spain (11.8%), Greece (11.5%), Italy (10.9%), Latvia (10.8%), Poland (10.7%), Slovakia (10.4%).

5. Conclusions

Value Added Tax gap monitoring is very important because:

- Value Added Tax not only contributes to national budgets, it is also a source of revenue for the European Union budget.
- It serves as an indicator of national fiscal administrations' performance in collecting Value Added Tax.
- The lost revenue from Value Added Tax has a negative impact on government expenditure.
- Estimating the size of the Value Added Tax shortfall contributes to the development of measures to improve Value Added Tax collection.

Among the factors with a major influence on the VAT gap, the most important is related to the fiscal features of the Value Added Tax system. Starting from the fact that both reduced rates and exemptions are important fiscal policy instruments that encourage certain areas of activity and protect vulnerable social groups, it is recommended to implement them carefully in terms of their impact on the VAT gap.

The VAT gap is highly dispersed across Member States. Studies show that the positive changes in VAT compliance have been mainly due to the digitization of fiscal administrations, the implementation of e-invoicing and the reduction in the frequency of bankruptcies.

Although there have been significant losses of Value Added Tax revenue in countries such as Austria, Ireland, Cyprus, Poland, Greece, due to the multiple reduced rates, there are also countries where the existence of multiple reduced rates has not led to a significant loss of revenue, for example Sweden and the Czech Republic. The impact of rates on the VAT gap is lower in countries that rely on lower reduced rates less, e.g. Latvia, Lithuania. In this regard, it can be stated that the research hypothesis has been confirmed only in some European countries.

Romania remains at the top of the ranking of countries with a high VAT gap, which highlights a high level of non-compliance and tax evasion. Romania's compliance gap recorded high values over the 2017-2021 period, being the highest in the European Union. The highest value can be seen in 2021, at 37.3%, the highest level in the European Union and significantly above the EU27 average.

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