

Mind the VAT gap: more effective consumption-tax collection could improve euro area's public finances

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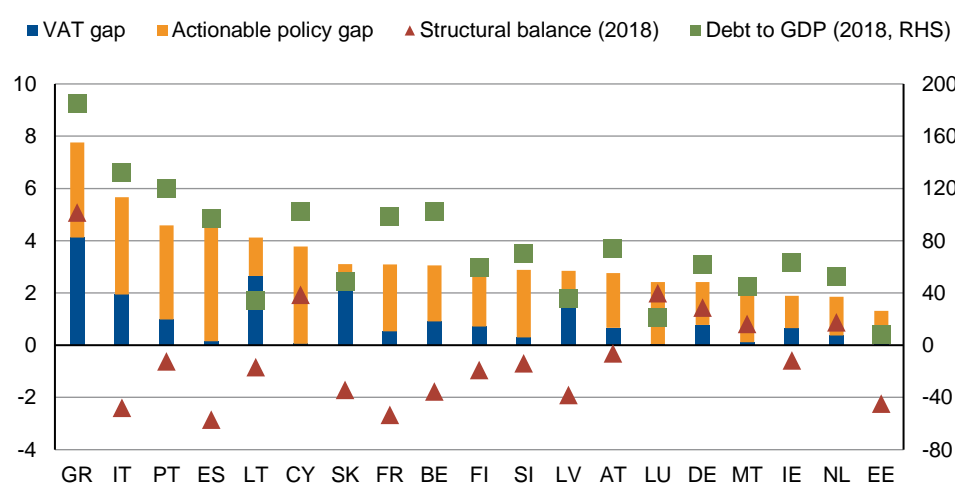
Improving the effectiveness of value-added-tax systems in the euro area would create extra fiscal space for heavily indebted euro area governments such as Greece, Italy and Spain and spur economic growth by reducing tax distortions.

Quantifying the degree of flexibility among euro area countries for improving VAT tax collection and/or reducing excessive exemptions or varying VAT rates reveals considerable room for many governments to enhance tax revenues. Implementing more effective VAT systems could raise fiscal space in highly indebted countries by up to 7.8% of GDP in Greece, 5.7% in Italy and 4.6% in Portugal and Spain.

We quantify the remaining tax potential of a country's VAT system as a share of GDP in two ways: i) the VAT gap, which captures inefficiencies in tax collection including fraud and tax evasion; and ii) the VAT-actionable policy gap, which measures tax revenue which might be recovered through higher, more homogenous VAT rates and fewer legal tax exemptions.

Improving tax receipts is particularly important for countries with structural deficits and limited flexibility to adjust expenditures. The sources and scale of the potential additional revenue are relevant for policymakers in: i) setting standard tax rates; ii) improving tax collection, for instance, by using more digital technology; and iii) shifting the tax burden toward consumption taxes from other sources such as labour and capital.

Figure 1: Potential additional VAT revenue (2017) in the context of euro area public finances, % of GDP



Source: "VAT Gap in the EU-28 Member States", CASE, IAV, EC, ECB, Scope Ratings GmbH

We present three major findings:

- Additional VAT revenue potential varies widely among euro area countries, from 1.3% in Estonia (A+/Stable) to 7.8% of GDP in Greece (BB/Positive).
- Countries with high debt-to-GDP ratios and/or structural fiscal deficits show the highest additional revenue potential, in particular Greece, Italy (BBB+/Stable), Portugal (BBB/Positive) and Spain (A-/Stable).
- Raising extra revenue from VAT depends on narrowing the VAT gap and/or the VAT-policy gap, thereby implying a different policy response depending on each country's fiscal circumstances.

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VAT is less distortive than taxes on labour and capital

Direct and indirect (potential) support to fiscal consolidation

VAT collection effectiveness and policy regimes

How can higher effectiveness in VAT systems support fiscal revenues?

Governments often face the challenge of fiscal consolidation in the context of low economic growth. When fiscal space is limited, enhancing the effectiveness of public budgets becomes key to support growth. VAT systems usually serve as the most important source of fiscal revenue (17% of total tax revenues in the EA-19) after income taxes (46.2%) but have a less distortionary impact on the economy and leave consumers' spending decisions over the life cycle unchanged¹. VAT is a constraint on domestic consumption, which becomes increasingly distortive when VAT rates differ across goods and services, whereas income taxes have a direct adverse impact on the productive inputs in an economy.

On average, VAT revenues account for around two thirds of revenues from consumption taxes, with the remaining share falling on so-called "sin taxes" such as levies on alcohol, tobacco and fossil fuels. The broader the scope of the VAT on goods and services, the larger the tax base and the lower the incentives for tax evasion.

Enhancing effectiveness in VAT systems can be a way to shift the tax burden from labour or capital² and provide some leeway for reducing standard tax rates, thereby incentivising compliance and lowering the tax burden on the economy. For the purpose of this report, we concentrate on the potential additional revenue from more effective VAT taxation while ignoring how governments might use those revenue gains to alter other taxes or tax rates.

There are two aspects to examining the effectiveness of euro area VAT systems (using data included in the VAT gap report prepared for the EU Commission³): i) inefficiencies in tax collection (i.e. the "VAT gap") and ii) exemptions or favourable VAT rates (i.e. VAT-policy gap or "actionable policy gap").

Implications of results

Figure 2: Summary of results by country

	VAT gap	Actionable policy gap	Tot: potential additional VAT revenue
GR	4.1	3.6	7.8
IT	1.9	3.7	5.7
PT	1.0	3.6	4.6
ES	0.2	4.4	4.6
LT	2.6	1.5	4.1
CY	0.1	3.7	3.8
SK	2.1	1.0	3.1
FR	0.5	2.6	3.1
BE	0.9	2.1	3.0
FI	0.7	2.3	3.0
SI	0.3	2.6	2.9
LV	1.4	1.4	2.8
AT	0.7	2.1	2.8
LU	0.0	2.4	2.4
DE	0.8	1.6	2.4
MT	0.1	2.2	2.3
IE	0.7	1.2	1.9
NL	0.4	1.5	1.9
EE	0.5	0.8	1.3
avg.	1.0	2.3	3.3

Source: "VAT Gap in the EU-28 Member States", CASE, IAV, EC, Scope Ratings GmbH

¹ ECB Economic Bulletin, Issue 5/2017, *The composition of public finances in the euro area*

² This could also entail potential trade-offs between income distribution and efficiency, if the shifts affect the progressivity of tax systems. OECD report to G-20 Finance Ministers and Central Bank Governors, *Tax policies for inclusive growth in a changing world*, July 2018

³ CASE, IAS, VAT Gap in the EU-28 Member States, September 2019

More effective VAT systems could raise tax revenues by 3% of GDP on average

Our analysis (**Figure 2**) shows significant differences in euro area countries' potential gains from narrowing the VAT gap, ranging from 1.3% of GDP in Estonia to 7.8% of GDP in Greece.

The absolute values for an individual country should be treated with some caution given the underlying assumptions, but the differences across countries provide interesting insights into the potential effectiveness gains from VAT collection.

Countries with the largest scope for greater VAT effectiveness are Greece, Italy, Portugal, Spain, Latvia and Cyprus, while the differences between the remaining countries are smaller, with Estonia, Netherlands and Ireland being the most effective VAT collectors.

A closer look at the two respective tax gaps shows scope for using revenue potential in the following countries:

- VAT gap: Greece, Lithuania, Slovakia, Italy, Latvia
- VAT-policy gap: Spain, Italy, Cyprus, Greece, Portugal, Slovenia, France

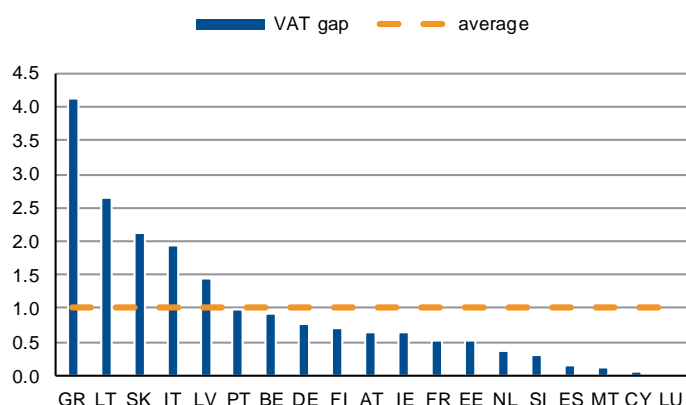
The VAT gap

Following the EC's approach, we examine the efficiency of tax collection through the "VAT gap", measured as the difference between expected VAT revenue (VAT total theoretical liability (VTTL)) and actual VAT revenue. The VAT gap captures revenue losses due to fraud and tax evasion as well as insolvencies and administrative errors.

EA countries lost on average 1% of GDP in revenues due to the VAT gap in 2017 (**Figure 3**), while countries at the upper end of the distribution such as Italy (2%) and especially Greece (4%) could raise additional revenue from narrowing the VAT gap. While the public discussion often concentrates on expenditure adjustment, this finding shows that at least part of the structural fiscal imbalance compared with other countries stems from insufficient revenue mobilisation.

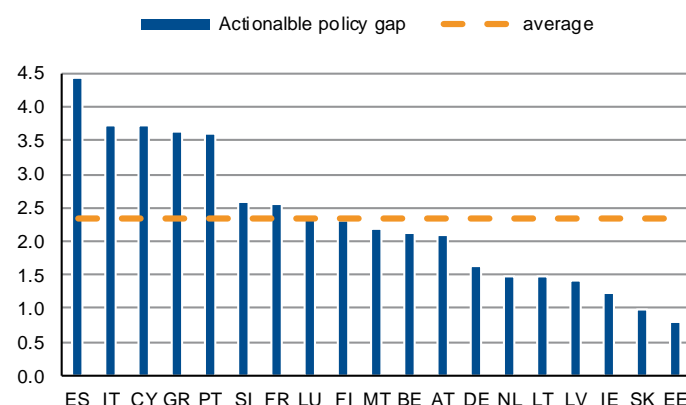
Reducing cash payments and/or introducing electronic invoicing are in general the preferred measures to close the VAT gap, ones which countries are likely to implement increasingly in the future with the growth of digital finance.

Figure 3: VAT gap, % GDP, 2017



Source: CASE, IAS, EC, Scope Ratings GmbH

Figure 4: VAT actionable policy gap, % GDP, 2017



Source: CASE, IAS, EC, Scope Ratings GmbH

The VAT actionable policy gap

Our second approach to assess the effectiveness of VAT systems is to examine a country's fiscal policy, or the so-called "actionable policy gap," by looking at revenue lost from VAT

exemptions and multiple different VAT rates, which we assume governments can adjust⁴. Any additional potential VAT revenue assumes a uniform VAT rate on all goods and services while the actual VAT revenue accounts include political decisions to exempt items or groups of goods and services. The VAT-policy gap is more abstract than the VAT gap given its assumptions on perfect tax compliance and on the degree of political freedom to adjust the exemptions.

Exemptions and/or favourable VAT rate regimes usually stem from policy choices regarding redistribution (i.e. reducing taxes on vital consumer goods such as food and medicine) though they may also be induced by partisan interests (rent-seeking behaviour). Not surprisingly, every government has some degree of a VAT-policy gap when it comes to maximising VAT collection, though we see significant cross-country differences (**Figure 4**), which point to sizeable revenue potential among those countries with a wide gap.

On average, the VAT-policy gap among euro area countries ranges between 2% and 2.5% of GDP, more than twice the average VAT gap and more importantly, with a range between 0.8% and 4.5% of GDP. Spain (4.5%), Italy, Cyprus, Greece and Portugal (all around 3.6%) have the largest unfulfilled VAT potential vis-à-vis their euro area peers, followed by Slovenia and France, where the VAT policy gap is slightly above 2.5% of GDP.

Concluding remarks

The data collected by the European Commission on VAT effectiveness show sizable differences across countries in revenue collection. These differences can explain a large part of the differences in euro area countries' structural deficits and show how governments can more sustainably consolidate public finances. More precisely, Italy, Portugal or Spain could reduce public debt without any spending adjustments on less than half of the revenue they could raise from narrowing the gap between current and potential VAT collection.

Countries with high VAT statutory rates and large VAT gaps such as Greece and Italy could even lower the statutory rate, thereby incentivizing collection, and at the same time diminish distortions on their economies, without sacrificing government revenues.

In France, Belgium, Greece and Italy – countries with the highest tax burden on labour in the euro area⁵ – additional revenue from VAT could be used to shift the tax burden away from taxes on labour and capital, which are detrimental for growth.

Any change to the effectiveness of tax collection or reduction of exemptions changes both the direct tax burden and tax incentives, which may lead to some unintended consequences such as lower overall consumption and tax revenue. However, in advanced and wealthy economies such as the euro area, the impact of broadening the tax base would usually more than offset the impact on tax revenues of any reduction in overall consumption.

Higher effectiveness in VAT systems could vastly improve consolidation

⁴ For a detailed analysis on non-controllable areas for VAT exemptions, see the study by Barbone, et al., *Study to quantify and analyse the VAT Gap in the EU27 Member States*, 2013.

⁵ European Commission, *Taxation trends in the European Union*, 2019: Greece, Italy, France and Belgium are the European countries with the highest implicit tax rate on labor.



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