The Limitations of the VAT Gap Measurement

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New VAT Foundations

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The VAT Gap in the European Union

The difference between theoretical VAT revenues and the amount of VAT collected

The VAT Gap in the EU is approximately 160 billion euros

(average 12.3%)

In 2016, in the EU-28, the VAT Gap share decreased in 22 countries and increased in 6

Luxembourg has the smallest VAT Gap with 0.85%

Romania has the largest Gap with 35.88%

Significance of the VAT Gap Measurement

Reflection of Revenues

- Tax revenues the primary source of funding
- Concerns on VAT Gap increase as the VAT system is a revenue generator with limited impact on economic growth
- In theory, one of the most efficient and neutral systems of taxation

VAT Fraud

- Captures VAT fraud which causes massive revenue losses
- Administrative and compliance costs for tax administrations and bona fide businesses
- Distortions in competition and taxpayer inequality

Limitations of the VAT Gap

Revenues vs Fraud

Reflection of the revenues lost and not necessarily a reduction in fraud levels

The primary goal is to recover the revenue losses arising from such activities and not eliminate fraud itself

Negative long-term effect on revenues and welfare

Limitations of the VAT Gap

Inaccuracy

- The complexity of tax law
- The variation between tax revenues on an origin basis and the collected revenues in a given period of time
- Inconsistent territorial scope of VAT law

No classification of business sectors or types more prone to VAT fraud

Disregards taxpayers’ behavioural response

Captures other defects in the tax system (the efficiency and effectiveness of tax authorities)

Small-Medium Enterprises

Small-Medium Enterprises (SMEs)

- Main employment provider for people
- They account approximately for 95% to 99% of the business population
- Defined by the number of staff headcount and their turnover or total balance sheet
- Relatively poor performance in complying with their tax obligations

Small-Medium Enterprises: Tax Compliance

Factors influencing negatively the tax behavior of SMEs

- Lack of resources and knowledge skills
- Absence of separation of ownership and control
- Absence of threat of the reputational damage on their corporations
- Risk of detection and punishment is presumed to be lower leading to low risk aversion

Regional Disparities

Studies in the area of TAX

- P. di Caro et al (2014), demonstrated using elasticities of evasion that personal income tax evasion is subject to regional structural factors
- A. Carfora et al (2018), demonstrated at regional level several, suggested factors to influence tax gap in Italy

Studies in the area of VAT

- M. Pinhanez (2008), highlighted disparities among states of Brazil within the same region with similar economic background
- A. Das-Gupta et al (2016), revealed for the VAT administration in India that improving the effectiveness of tax administration will have a different impact on the levels of VAT revenue collected amongst the states

The Influence of Geography on SMEs

SMEs in Rural Areas

One regional disparity is the possible tax incompliance tendency of SMEs in rural areas

More prone to evade VAT than firms located in urban areas

Two factors:

1. Culture in rural areas
2. Low probability of detection

Research on the VAT Gap Data in Cyprus

In 2015 the VAT Gap of Cyprus, estimated to be at 7%, which is approximately 122 million euros

There are 46,519 SMEs in Cyprus, (99.9% of all enterprises in the country) - they generate approximately 72% of total added value

Cyprus Statistical Service demonstrated that rural areas are dominated by SMEs with no large companies operating in such areas

The Cyprus Statistical Service and the European Commission provided only national data for the VAT Gap measurement with no VAT Gap regional data available to inform about disparities for VAT Gap of each region

This limitation is under-recognized - important factor when evaluating the effectiveness and accuracy of the measurement

Unexplored Limitation: Absence of Regional Disparities Data

The VAT Gap is only produced at national level and it is not influenced by regional evasion tendencies

New limitation of the VAT Gap which highlights the inaccuracy of the measurement and questions whether it can be used as an indicator of fraud

Considering regional disparities in the VAT Gap can lead to more effective anti-fraud policy, through targeted tax policy to address distinct features found within regions

Unexplored Limitation: Absence of Regional Disparities

Improving the quality and availability of national statistical is necessary to deliver a more comprehensive view on the general trend of VAT fraud

Identifying where fraud is more profound within a country and to what extent this is caused by regional disparities

How to address this limitation? Produce public regional VAT Gap measurements

The European Union to oblige the Member States to produce such data

THANK YOU!