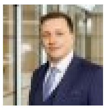
European Commission’s VAT findings 2/32/24



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In early July 2024, the European Commission (EC) published its annual report on tax policies across the EU. Value added tax (VAT) is one of the most important taxes in the EU accounting for about 7.5% of GDP and 18.6% of total EU tax revenue in 2022. This article explores the EC’s VAT findings.

Latvia is among the member states in which VAT revenue represents a significant percentage of total tax revenue. In 2022, Latvia’s VAT revenue stood at 31% (a 7% increase on 2013) – the second highest percentage in the EU and significantly higher than the EU average (18.6%), Lithuania (27%) and Estonia (28%). The lowest VAT revenue percentages were reported in Belgium (15%), Luxembourg (16%) and France (17%). This means the importance of VAT as a source of tax revenue varies from country to country.

The Latvian VAT rate of 21% is slightly lower than the EU average of 21.5%. In 2023 the highest rate was reported in Hungary (27%) and the lowest in Luxembourg (16%). Estonia has raised its standard rate of 20% to 22% this year and plans to bump it up to 24% in July 2025. Lithuania is considering raising its VAT rate of 21% to 22%.

To achieve its social, economic or environmental goals, Latvia applies reduced VAT rates on various goods and services, just like other member states. Reduced rates are important policy instruments, yet they cause a loss of VAT revenue and complicate tax administration. The EU VAT rate reform came into force in 2022. The member states can now apply no more than two reduced rates of at least 5% and within specified limits a reduced rate of below 5% (including an exemption with recovery). A reduced rate is only available on the goods and services listed in Annex III to the VAT directive. The reform takes account of Europe’s Green Deal by including it on the list of goods and services eligible for the reduced rate, such as solar panels, electrical bicycles and efficient low-emission heating systems (Latvia has not taken this option). The reduced rates will be phased out on fossil fuels (by 2030) and chemical pesticides (by 2032).

The EC estimates that the EU annual VAT revenue could rise 20% or by up to EUR 230 billion if reduced rates were not applied. The data for 2021 suggests that Latvia, Lithuania and Estonia were among the member states with the lowest loss of revenue due to reduced rates (3–4%). This means the Baltic States are applying reduced rates to a relatively small number of goods and services. The revenue lost because of reduced rates in countries such as Austria, Cyprus and Luxembourg is around 18%. This could be due to reduced rates being applied far more widely in these countries.

Failure to comply with VAT law causes a loss of VAT revenue known as a VAT gap. This is computed as the difference between the expected theoretical VAT revenue and the VAT actually collected. The VAT gap has various causes, including legal defects in legislation, tax evasion, fraud, administrative errors, and insolvency. The VAT gap caused by non-compliance with the law across the EU averaged 5.3% in 2021. The highest VAT gap is reported in Romania (36.7%), Malta (25.7%) and Greece (17.8%). The lowest VAT gap is reported in the Netherlands (–0.2%), Finland (0.4%), Spain (0.8%) and Estonia (1.4%). In Latvia, the VAT gap was 7.3% in 2021 (it was almost three times as high in 2012). Lithuania has the highest VAT gap of the Baltic States (14.5%).