



Dipartimento
delle Finanze

Ex-post assessment of the split payment and reverse charge provisions: preliminary results and methodological approaches

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Italian efforts to fight tax fraud and evasion: *split payment* and extension of *reverse charge*

- Italy's VAT compliance gap was estimated to be among the highest in the EU (32%) in 2012 and to have slightly increased compared to 2011.
- Low tax compliance and VAT fraud undermine tax revenues (VAT accounts for around one-third of total tax revenue), distort competition, and hinder the financing of public expenditure.
- The Stability Law 2015 introduced two measures to fight against VAT evasion and fraud:
 - The **split payment system** for goods and services supplied to Italian public bodies.
 - The **reverse charge mechanism** (previously available only for certain types of services in the real estate and construction sectors – Law 296/2006) extended to other services in the real estate and energy sectors:
 - ✓ cleaning, demolition, equipment installation and completion services in relation to immovable property;
 - ✓ for a period of four years, to the transfer of allowances to emit greenhouse gases and of gas and electricity certificates; supplies of gas and electricity to a taxable dealer.

Split Payment

- Recent analyses of cases of tax evasion in Italy provided evidence for unreported or unpaid VAT charged to the Public Administration bodies from their suppliers.
- Under the **split payment system**, suppliers continue to charge Italian VAT (where due, and unless the reverse-charge mechanism applies) on goods and services supplied to Italian public bodies.
- Public bodies “split” the payment of the invoice: they pay the taxable amount to the suppliers, and the VAT to a blocked VAT bank account of the Treasury.

Split Payment – Derogation from VAT directive provisions

- The implementation of this system required the authorization to apply a derogation under article 395 of Directive 2006/112/EC. Italy requested and obtained a priority treatment so to allow the entry into force the 1 January 2015.
- The Italian Republic requested authorization to derogate from Articles 206 and 226 of the VAT Directive.
- The measure derogates from Article 206 as it concerns collection of VAT and not whom is liable for it and from Article 226 in order to mention on the invoice that it is subject to the split payment.
- The system of split payment in question was designed in close connection with the system of mandatory electronic invoicing to the Public Administration, which has been implemented approximately at the same time in Italy.
- It is consequently possible for the Agenzia delle Entrate to monitor the VAT payments of public bodies and to take prompt action in case of irregularities.

Split Payment

- Under the split payment system suppliers may experience two main difficulties:
 - a liquidity reduction associated to the mechanism of VAT collection and payment system;
 - a constant VAT credit position.
- The Italian VAT refund system was recently modified by the Legislative Decree 175/2014: it is no longer mandatory to submit a bank guarantee for VAT refund claims (if claimants are not considered to be “risky”).
- In addition, two measures were introduced this year to mitigate liquidity problems for businesses:
 - The decree of the Ministry of Economy and Finance of 23 January 2015 granted a priority access to the refunds of the VAT on supplies where the split payment applies.
 - The priority access was granted to the suppliers also if the standard priority access criteria are not met (Decree of the Ministry of Economy and Finance of 20 February 2015).

Split Payment- *ex ante* and *ex-post* estimates

- The introduction of split payment was estimated to increase net VAT revenue by **988€ million annually**.
- In order to take into account the fact that the split payment mechanism is likely to result in an increase in the VAT credits, in the mid-year Budget review last June, the two components of the net revenue have been splitted:
 - 1€ billion has been added to the Government revenue and,
 - 1€ billion to the Government expenses (to account for the expected increase in VAT refund), confirming a net positive effect of 988€ million.

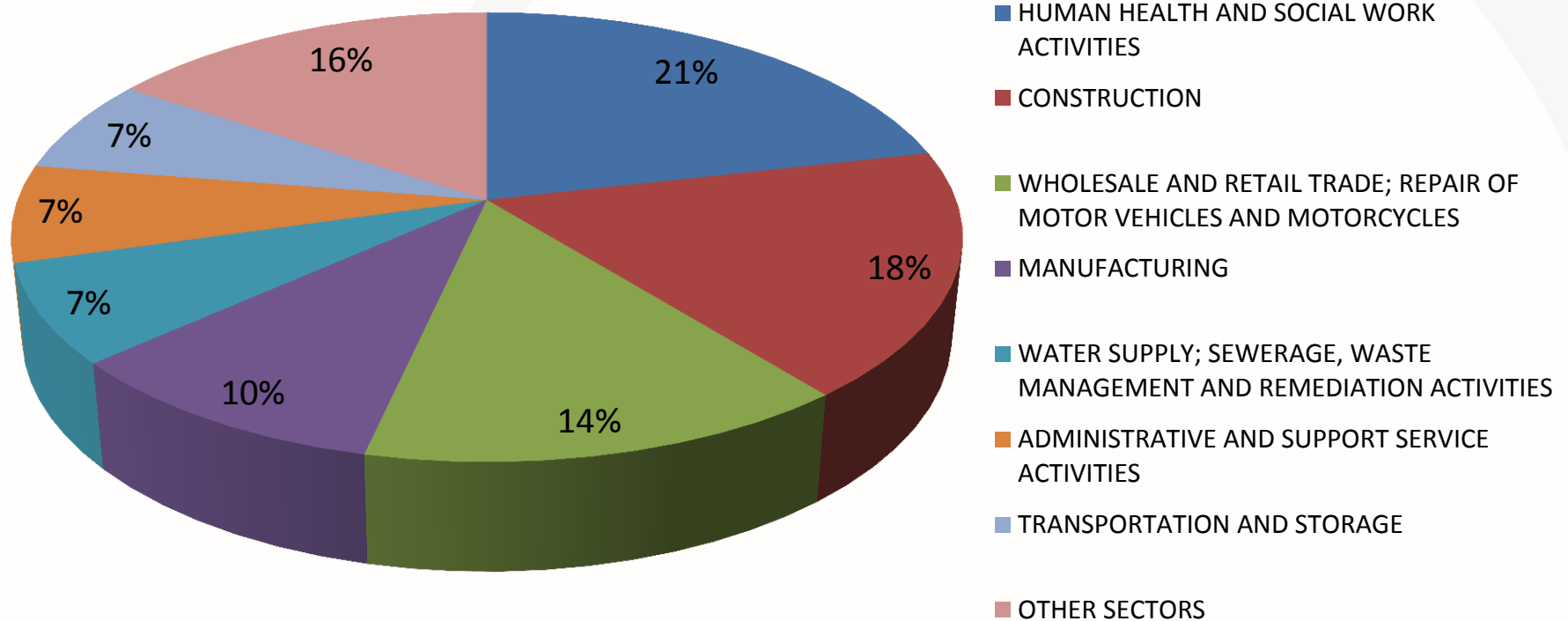
Split Payment- *ex ante* and *ex-post* estimates

January-August 2015 preliminary results - € million

	2014	2015	2015/2014 change	2015/2014 % change
Split payments VAT	0	3,410	3,410	100%
Domestic transactions VAT	60,951	59,636	-1,315	-2.16%
Total	60,951	63,046	2,095	3.44%

- In January-August 2015, the VAT paid by the Public Administration amounted to 3,410€ million.
- In the same period, total VAT on domestic transaction increased by 3.4% (+ 2.09€ billions) with respect to the same period last year.
- Taking into account the aggregate consumption dynamic, the VAT growth can be almost entirely explained by the reverse charge and the split payments measures.
- Ex-ante estimates suggest that the split payment accounts for 60% (1.3 € billion) and the reverse charge mechanism for 40% (0.7€ billion) of the total VAT increase.
- In the same period the increase in VAT refund amounted to around 300€ million.
- Therefore the net effect of the split payment is 1€ billion, in line with the *ex-ante* estimates.

Split Payments by Sector



- Preliminary results suggest that the 21% of the total split payments is collected on transactions with suppliers operating in the Health Sector, the 18% on transactions with suppliers operating in the Construction Sector, and the 14% on transactions with suppliers operating in the wholesale and retail trade Sector.

Reverse Charge

- Currently, the reverse charge mechanism can be implemented by the Member States in specific cases to tackle fraud in accordance with the following provisions of the VAT Directive:
 - Derogations granted on the basis of Article 395 of the VAT Directive (or on the basis of a standstill provision with reference to Article 394)
 - Options to apply a reverse charge mechanism to the goods and services enumerated by and under the conditions laid down by Article 199 and Article 199a of the VAT Directive.
- In Italy, the **reverse charge** was extended by the Stability Law to the following services in the real estate and energy sectors:
 - cleaning, demolition, equipment installation and completion services in relation to immovable property;
 - for a period of four years, to the transfer of allowances to emit greenhouse gases and of gas and electricity certificates; supplies of gas and electricity to a taxable dealer.
- This extension was implemented according to the categories listed in Articles 199 and 199a of the VAT Directive.

The *Reverse Charge* mechanism – *ex ante* estimation

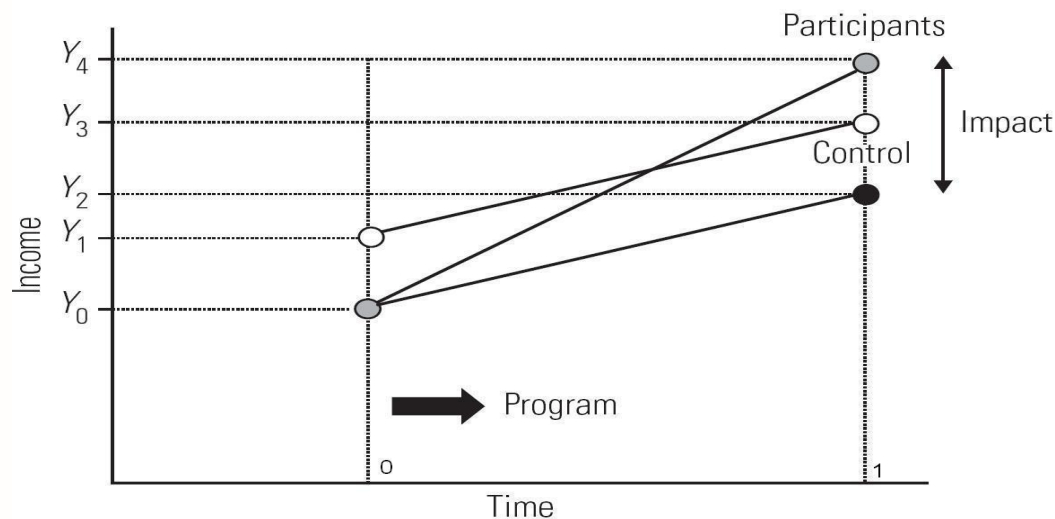
- In the following slides, the methodology and the results of the *ex-ante* estimates and the methodology to perform an *ex-post* analysis of the effects of the reverse-charge mechanism are briefly discussed.
- The extension of the reverse charge mechanism was estimated to **increase VAT revenue by 720€ million annually.**
- The estimation has been performed by comparing the total aggregate net value of VAT declaration, before and after the introduction of the reverse charge mechanism in 2007, among two groups of company:
 - Companies operating in the real estate sector affected by the introduction of the Reverse Charge provision for certain types of services in 2007.
 - Companies operating in the real estate sector that were not affected by the introduction of the Reverse Charge provision.
- The analysis shows that the reverse charge provision has increased the value of VAT declaration in by 40% between 2006 and 2007.
- As the VAT declared is not necessarily paid, the estimated increase in VAT revenue is corrected by accounting for the average propensity to pay declared VAT (which might differ among groups of companies).

The *Reverse Charge* mechanism – *ex post* estimation proposed methodology

- The Department of Finance and the Revenue Agency are planning to perform an ex-post estimate of the measure once the 2015 VAT return data will be available (as of February 2016).
- The difference-in-differences (DID) approach is one of the most robust methodologies to evaluate *ex-post* casual effects of a given policy.
- The basic idea is to compare individuals directly affected by the introduction of the policy (**treatment group**) with similar individuals that were not affected by the policy (**control group**) before and after the introduction of the policy.
- The **control group approximates** the counterfactual outcome (*i.e.* what would have been the outcome of the treatment group if the policy was not introduced).

The *Reverse Charge* mechanism – *ex post* estimation proposed methodology

- It is possible to correctly identify the effect of the provision only if it is reasonable to assume that the treatment group and the control group would have shared the same trends if the measure was not introduced (**common trend assumption**).
- The figure below (from the “Handbook on impact evaluation” – World Bank, 2010) provides an example of the importance of the common trend assumption.



Common Trend Assumption:
 $(Y_3 - Y_2) = (Y_1 - Y_0)$.

The *Reverse Charge* mechanism – *ex post* estimation proposed methodology

- To evaluate the effectiveness of the reverse charge mechanism it is possible to apply the methodology described before.
- The basic idea is to compare the actual VAT payments of each taxpayer operating under reverse charge with the counterfactual VAT payments (*i.e.* the amount of VAT that would have been paid by each taxpayer in the absence of the reverse charge provision).
- As the counterfactual cannot be directly observed, it must be approximated with reference to a **control group** that should include taxpayers that **do not operate under reverse charge but as similar as possible to those operating under the reverse charge mechanism** (e.g. taxpayers operating in real estate sector with comparable tax variables).

The *Reverse Charge* mechanism – *ex post* estimation proposed methodology

- More specifically, the proposed approach consists of estimating the following equation using 2014 and 2015 data:

$$Y_{it} = \beta_0 + \beta_1 T + \beta_2 d + \gamma dT + \delta X + \varepsilon_{it}$$

- where:
 - T is the treatment dummy (T = 1 if the taxpayer operates under reverse charge mechanism and T = 0 otherwise).
 - d is the time dummy (d=0 before the introduction of the reverse charge and d=1 after the introduction of the reverse charge).
 - Y_{it} is VAT payments of individual i at time t.
 - X is a set of control variables.

Concluding remarks

- Some measures have been taken to improve VAT compliance as part of the fiscal strategy in 2015 aimed at fighting tax fraud and evasion.
- Preliminary evidence suggests that split payment has been effective in countering VAT evasion; the impact on VAT revenue is in line with the *ex-ante* estimates.
- Data to conduct *ex-post* impact assessment of the reverse charge mechanism are not currently available.
- Once the data will be available, the Department of Finance and the Revenue Agency will conduct a policy evaluation analysis of the reverse charge mechanism using the methodological approach described earlier.

Thank you!

