The Tax Gap. Definition and Essentials

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Table of Contents

Table of Contents ............................................................................................................................................. 2
What is the Tax Gap and Why is it so Important? ............................................................................................... 3
Methods to Identify and Eliminate the Tax Gap .................................................................................................. 4
Gross and Net Tax Gap ....................................................................................................................................... 6
  Voluntary compliance rate (VCR) .................................................................................................................. 6
  Net compliance rate (NCR) ............................................................................................................................ 6
The Scale of the Tax Gap in the Modern World .................................................................................................. 7
  EU Member States ......................................................................................................................................... 8
  USA ............................................................................................................................................................... 9
  United Kingdom .......................................................................................................................................... 10
  Australia ...................................................................................................................................................... 10
What is the Tax Gap and Why is it so Important?

“Taxes are how we pool our money for public health and safety, infrastructure, research, and services—from the development of vaccines and the Internet to public schools and universities, transportation, courts, police, parks, and safe drinking water.”

—Holly Sklar, New York, Political Analyst and Strategist

According to World Bank experts, tax revenues exceeding 4% of a country’s gross domestic product (GDP) are a key factor in economic growth and poverty reduction.

Countries are trying to achieve such growth not by raising taxes, but by improving their collection and reducing the tax gap. Imagine that the taxpayer made a mistake when filing a tax return, which led to an underestimation of the amount of taxes payable. If the tax office does not notice this error, then the taxpayer will inadvertently pay fewer taxes.

Here is another situation—a car repair shop conceals part of the profit in the tax return to reduce its tax liability. If the tax administration cannot prove the fact of tax fraud as a deliberate understatement of the amount of tax payable, then the company will also pay fewer taxes than it should.

The reason for a tax gap may be accidental errors and ignorance of one’s tax obligations, or deliberate understatement and non-payment of the accrued amount. The latter qualifies as an illegal business activity or tax fraud. Regardless of the cause of a tax gap, all the factors described contribute to the loss of national budget funds.

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1. 130 Inspirational Quotes About Taxes. Inc. URL: https://www.inc.com/geoffrey-james/130-inspirational-quotes-about-taxes.html

The difference between the amount of taxes due and the amount collected is the tax gap.

For example, the VAT tax gap in EU countries amounted to EUR 134 billion in 2019.\(^3\)

<table>
<thead>
<tr>
<th>EUR 134 billion</th>
<th>13</th>
<th>4000 EUR</th>
</tr>
</thead>
<tbody>
<tr>
<td>of VAT income</td>
<td>Years</td>
<td>of VAT income</td>
</tr>
<tr>
<td>Lost annually in EU member states</td>
<td>Needed to eliminate the existing VAT gap</td>
<td>Lost every second in EU member states</td>
</tr>
</tbody>
</table>

Below is a visual representation of what the EU can build with these funds.

<table>
<thead>
<tr>
<th>250</th>
<th>1</th>
<th>2,500</th>
</tr>
</thead>
<tbody>
<tr>
<td>modern hospitals</td>
<td>rehabilitation center</td>
<td>kilometers</td>
</tr>
<tr>
<td>Every year</td>
<td>Every 3 years</td>
<td>High-speed railroad from Porto to Tallinn</td>
</tr>
</tbody>
</table>

Methods to Identify and Eliminate the Tax Gap

In most countries, after the collecting tax returns and the expiration of the deadline for fulfillment of tax obligations by taxpayers, tax authorities conduct an audit, which helps to identify random errors, inconsistencies in returns, and past due payments. If the taxpayer inadvertently made a mistake in the declaration, the tax office will ask for clarification, and the taxpayer will correct the mistake and pay the additional amount of taxes. The amount of collected taxes will increase, the tax gap will decrease.

Thus, two sets of data influence upon tax collection:

> Data on primary tax returns, the volume of voluntarily and timely paid taxes.
> Data on revised tax returns, the amount of recovery after the audit.

Consequently, two primary definitions exist in the concept of the tax gap:

> **The Gross Tax Gap** is the difference between the actual tax liability for a given tax period and the amount paid voluntarily and on time.

> **The Net Tax Gap** is the gross tax gap less taxes that taxpayers subsequently will pay,
either voluntarily or because of the tax office’s administrative and enforcement activities.

Gross and Net Tax Gap

The gross tax gap appears in the event of:

> Failure to submit a tax return by taxpayers.
> Understating the amount of tax in a tax return that taxpayers must pay.
> Timely filing of tax returns, but late fulfillment of tax obligations.

According to several tax authorities, the cause for the main share of the gap is understating the amount of tax (for example, in the USA and Australia).

In determining the size of the tax gap, it is important to consider indicators of compliance with tax requirements:

Voluntary compliance rate (VCR)

The amount of “tax paid voluntarily and timely” divided by “total true tax”, expressed as a percentage.4

Net compliance rate (NCR)

The net compliance rate (NCR) is the sum of all timely and enforced and past due payments divided by total true tax, expressed as a percentage.5

Let us take an example. Suppose the amount of "true tax" should be $15 million. When filing primary tax returns, the amount of tax payable is $10

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million. Taxpayers paid the entire amount on time and voluntarily. After an audit conducted by tax authorities, they accrued an additional $2 million in tax, and collected it later in full.

According to the definitions:

> **Gross Tax Gap** = $15 million "true tax" − $10 million taxes paid voluntarily and on time = $5 million.

> **Net Tax Gap** = $15 million "true tax" − $10 million taxes paid voluntarily and on time − $2 million post-audit recovery = $3 million.

> **VCR** = $10 million taxes paid voluntarily and on time / $15 million "true tax" * 100% = 66.7%.

> **NCR** = ($10 million taxes paid voluntarily and on time + $2 million levied after audit) / $15 million "true tax" * 100% = 80%.

We see that the higher the VCR is, the higher is the level of voluntary compliance by taxpayers with their tax obligations. The difference between NCR and VCR demonstrates the quality of work by tax authorities.

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**The Scale of the Tax Gap in the Modern World**

Estimating the tax gap is not a simple task. The United States have not yet found a way to calculate the volume of unfiled corporate income tax returns. In the EU countries, only Estonia, Germany, Italy, and Latvia conduct the assessment of the tax gap for corporate income tax and personal income tax (according to data published for 2016). ⁶

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The reasons are related to the lack of resources and the complexity of the assessment methodology itself. Analyzing the data published in the public domain, we can suppose that global tax losses amount to a trillion US dollars a year.

Let us reflect in detail the countries that, according to the World Bank, make up about 8% of the global GDP, but are not major exporters of oil, gas, and other natural resources—the USA, the EU, the UK, and Australia.

### EU Member States

Not all countries use an estimate of the tax gap for personal income tax or corporate income tax. According to a 2019 study by the University of London, in 9 EU countries lost between €2015 billion and €750 billion in lost tax revenue, representing between 900% and 5% of total EU’s GDP.

If we look at the VAT gap for 2019 in all EU countries, we will see a positive trend and a decrease in the gap by 2.5% over the past 4 years. This is because of an increase in the volume of tax collection, the digital transformation of the national tax systems and an improvement in the quality of work of tax authorities.

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The share of the tax gap in terms of VAT in relation to the countries' GDP varies from 1% in Croatia to 34.9% in Romania. However, in general, in 2019, the share of the VAT deficit decreased in 18 EU Member States compared to 2018.

**USA**

According to tax authorities, the gross tax gap in 2019 was close to 600 billion US dollars, the net tax gap is about 584 billion US dollars, which is 15.2% of tax revenues. The amount looks enormous, but the US GDP for 2019 was $21.43 trillion and the net tax gap is less than 3% of GDP.

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United Kingdom

Tax gap for the period of 2020–2021 is about 32 billion pounds sterling (about 41 billion US dollars), which is 5.1% of tax revenues or less than 1.2% of GDP.\(^\text{11}\) In 2008, the UK launched a gap assessment program for all major taxes and was among the first states to address this issue.

Australia

The tax gap for the 2018–2019 exceeded US$33.5 billion, representing 7.1% of tax revenue or 2.4% of GDP.\(^\text{12}\) Australia's data–matching and tax gap assessment programs are extensive, with multiple estimation methods and external sources often used for each type of tax to produce the most accurate result. Additionally, they examine and enhance estimates from prior years because of the improvement of methodologies.

As we can see, developed countries are concerned about the minimizing the tax gap and are aware of the importance of solving this problem. The implementation of information technology and digitalization of tax administration simplifies the assessment of the tax gap and allows the enforcement of effective control measures to bring businesses out of the shadow sector and boost the volume of revenues to the budget of the count.


ABOUT DTT

Digital Tax Technologies — is an international expert in tax gap minimization, a trusted global digital transformation advisor & solution provider for national tax administrations.

We help tax administrations around the world to reduce the tax gap, improve tax revenue collection and reduce the share of the shadow economy.

Our mission is to increase global fiscal transparency, improve tax compliance and administration, and ensuring fair competition and welfare.

Our team consists of experts with experience in digital tax administration advisory and implementation in various European, CIS, Middle East and African countries.

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