CAPITAL ECONOMICS

Searching for lost tax in the wrong places: Measuring the OECD tax gap

Key points

- The under-payment of tax most often arises from domestic activity, such as plain errors and failure to take reasonable care, rather than from offshore evasion or avoidance
- The size of the shadow economy across all OECD nations was roughly $5.2 trillion in 2016. This implies a tax gap across these countries of roughly $940 billion: far outweighing any possible tax evasion or avoidance through offshore centres
- Focus should be put on onshore tax evasion, and focusing on IFCs distracts from this

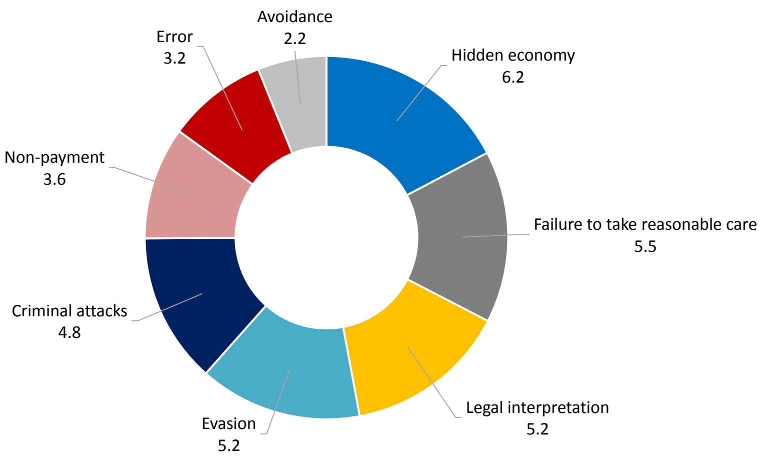
1. The under-payment of tax most often arises from domestic activity, rather than IFCs

There has been much focus on tax evasion and avoidance, with international finance centres (IFCs) often pointed to for this 'missing' tax. However, there is very little research that supports this claim.

The United Kingdom and the United States have attempted to measure their 'tax gaps': the difference between the amount of tax that should, in theory, be collected, and what is actually collected. The UK and US use different methodologies to calculate this, yet both analyses reveal that the under-payment of tax is predominantly an issue of domestic policy, rather than activities undertaken through IFCs.

Official analysis by the UK's tax authorities finds that most of its 'tax gap' arises from domestic activity, such as plain errors, failure to take reasonable care, pure non-payment, legal interpretation, criminal attacks, and the hidden economy, rather than from evasion or avoidance – and it is clear that only a fraction of these two categories have any potential to relate to offshore activity (see Figure 1).

Figure 1: Value of the United Kingdom tax gap by behaviour, 2014/15, £ billion



Sources: Capital Economics and HM Revenue and Customs

2. The tax lost through activities in developed economies' 'shadow economies' far outweigh any possible tax evasion or avoidance through offshore centres

Aside from the United Kingdom and the United States, there are few other official tax gap estimates. We attempt to estimate it for the OECD.

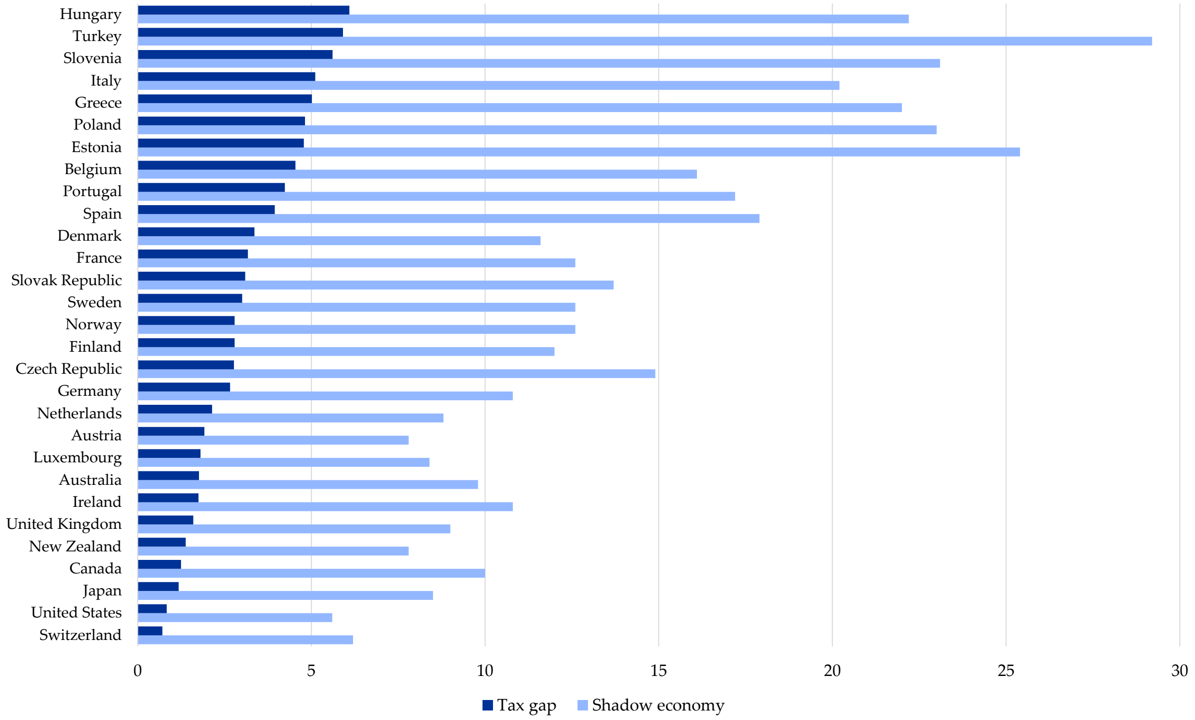
Measures of the shadow economy serve as a useful starting point for estimating the potential tax gap across OECD nations. The shadow economy includes all market-based legal production of goods and services that are deliberately concealed from public authorities and are therefore beyond the reach of tax collectors and regulators. Examples include unreported income from self-employment, fringe benefits, the barter of goods and services, and do-it-yourself work for a neighbour or friend.

There are few estimates of the shadow economy. But of those estimate that are publicly available, we see that the size of the shadow economy across all OECD nations was roughly $5.2 trillion in 2016: equivalent to 11% of its gross domestic product.[1] The shadow economy varies dramatically across countries, from almost 30% in Turkey to 6% in the United States.

Tax gap (as a share of GDP)	=	**Shadow economy** (as a share of GDP)	x	**Average tax rate**

From here, we can estimate the potential tax gap for OECD countries, using data on the size of their shadow economies as well as the average tax rate across these same countries (see Figure 2).

Figure 2: Size of shadow economy and tax gap from shadow economy for Organisation for Economic Co-operation and Development countries as a share of nominal gross domestic product, 2016, per cent



Sources: Capital Economics, Organisation for Economic Co-operation and Development, Friedrich Schneider and CESifo Group Munich

[1] This estimate includes all Organisation for Economic Co-operation and Development countries except for Latvia, for which sufficient information was not available.

Three revenue streams account for over 92% of all tax take in OECD countries: tax on income, profits and capital gains; taxes on goods and services; and social security contributions. We take the weighted average of each of these tax revenue streams by country as a share of total average OECD taxation.

We find that the tax gap for OECD nations as a whole was roughly $940 billion in 2016: equivalent to 2.0% of gross domestic product. There is much variation between countries, with Hungary and Turkey's tax gaps accounting for around 6% of their output and Switzerland's gap accounting for less than 1%.

3. Focus should be put on onshore tax evasion, and focusing on IFCs distracts from this

Our estimate of the OECD tax gap, close to US$1 trillion, is much larger than many of the headline-grabbing estimates of offshore tax evasion. For example, Gabriel Zucman contends that roughly $189 billion of tax revenues are lost through offshore centres.[2] Zucman's estimate for global tax evasion offshore is just 20% of the entire tax gap for OECD nations – and would be even smaller if the tax gap for countries in the rest of the world were included. As we show elsewhere, these estimates of supposed offshore tax losses are probably grossly overstated, being based on flawed data and analysis.

The focus on tax evasion through offshore jurisdictions is therefore misguided. It is clear that only a fraction of the OECD's tax gap relates to offshore activity. Matters of tax evasion and avoidance are predominantly issues for domestic policy.

2 Gabriel Zucman, The Hidden Wealth of Nations: The Scourge of Tax Havens (University of Chicago, Chicago) 2015.