

The tax gap: why HMRC have to be wrong

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I wrote [this blog last September](#) but it remains just as relevant now, so I will repeat it given that HMRC are continuing to massively and I suggest deliberately underestimating the tax gap to make their senior management look better than they are:

My work on the Tax Gap is, I note, receiving widespread publicity, and I'm aware that as a result of that work that this issue is now firmly fixed on the agenda for debate when it comes to how to manage the cuts. Unsurprisingly as a result there are those who would like to suggest that [I've got my](#) calculations wrong. This is an inevitable consequence of promoting ideas that suggest that there may be more tax to be collected from the economy. I'll deal with the politics of this in another blog. At this point I'll deal with the question as to whether it is reasonable to, as I have done, extrapolate the tax gap that HM Revenue & Customs admit to with regard to VAT across the whole economy. This I did [when calculating](#) that tax evasion might amount to £70 billion per annum in the UK.

This matter was [debated in parliament](#) on June 16. David Gauke MP rejected my argument on behalf of the Treasury. In response [I wrote](#):

The key question is, then, whether it is reasonable to extrapolate what is likely to be a tax evasion rate of 13.7% for VAT, calculated over seven years, over all direct taxes. The Minister says that is not the case, stating as noted above that such a ratio could not apply to payment systems such as PAYE where error rates are low.

Unfortunately the Minister makes a fundamental error in stating this to be the case. Of course it is true that once wages are declared by a company it is likely that PAYE will reduce the risk of error in declaration and computation occurring. That ignores that fact that tax evasion means that paid are simply never declared and as such go nowhere near the PAYE system and therefore are subject to a 100% tax calculation error rate irrespective of the efficiency of PAYE with regard to declared wages. The question is therefore whether the existence of a VAT gap suggests it is likely that an income tax gap on wages is likely to follow as a consequence (and a corporation tax gap on profits, etc.,) and not what the Minister claims.

Explaining how the VAT gap gives clear indication of the scale of this issue takes some effort but is worth doing. It is important in the context to understand the points in the revenue cycle at which major taxes hit revenue generating operations such as companies (and government departments, charities, self employed people and so on). This diagram of an income statement / profit and loss account might help explain that:

Income / expense category Tax charged

Income / sales VAT charged to customers

Overheads PAYE (made up of income tax and national insurance) on wages

VAT reclaimed on expenses incurred

Profit Corporation tax if a company / self employed income tax if not incorporated

It is important to note that revenue flows down the system i.e. sales have to be made to enable cash to be generated to ensure wages (and the tax on them) can be paid and in turn profit can be earned, again giving rise to tax due.

The VAT gap suggests that 13.7% of expected VAT is not paid to HMRC. Since VAT is eventually a tax on consumption this suggests in turn that 13.7% of turnover that should have been subject to VAT has not been reported for tax purposes.

In that case it is the contention of Tax Research LLP that the sales giving rise to that VAT liability are also not declared to HMRC when accounts are prepared (if at all) indicating profits earned. There is good reason for saying this: the most basic test a VAT inspector undertakes when looking at a company's records is to ensure that the sales recorded in the accounts are the same as the sales recorded on the business' VAT returns. In other words, given that this is widely known VAT evasion always gives rise to income suppression in accounts. Of course, in many cases it gives rise to no accounts being prepared or declared for tax purposes at all.

The latter case is, perhaps the best place to start the next stage of this explanation. It is very obvious that if someone runs a business where, to

avoid VAT they take all their sales income in cash and put none of it on a VAT return or in a set of accounts that they will not then declare any tax due on wage payments they make. These wage payments will instead be settled illicitly out of that illicit cash. They will therefore be part of the tax evasion gap.

Alternatively, if the illicit cash is not used to pay wages (and maybe other costs) then it will flow straight through to the bottom line i.e. it will be profit in the hands of the person who has committed the VAT fraud. This should also be subject to income tax (or, maybe corporation tax — but this is unlikely).

In other words, if there is VAT fraud at the top of the profit and loss account it has to flow down through that profit and loss account and in the process give rise to fraud with regard to income tax on wages and national insurance or tax evasion on profits with regard to income tax or corporation tax as well. This is the inevitable consequence of suppressing the income that was illicitly received to ensure VAT fraud took place.

It is important to note that the same pattern recurs if a business records part of its income and suppresses part of its top line sales records to ensure VAT fraud is not discovered. In that case either wages are paid in cash, and PAYE is not operated, or if wages are properly recorded in full then profit is seriously under-recorded and the direct tax fraud takes place there. But missing trader fraud apart (and that is now small — but does give rise to direct tax evasion on the proceeds of the crime, a fact that should not be ignored) in every case atop line VAT fraud gives rise to a direct tax fraud as well. The Minister is wrong to deny this.

And of course the Minister cannot suggest that the problem only exists in VAT registered businesses: why those business should suppress income to save tax but those that are not VAT registered do not is an argument no one should seek to make. Nor should they argue that the shadow economy does not extend to the state sector where it takes a different form in bribes and other payments made to officials, a problem little acknowledged but which is universal, and which also contributes to the tax gap

To put it another way then, the figure for VAT fraud does inevitably act as a proxy measure for the size of the “shadow” economy. In Tax Research UK’s work on the tax gap it is assumed that this ratio is 13.7% — the average for the VAT gap over 7 years, and have been cautious in extrapolation. The suggestion is, as a result, that this proportion of the total gross direct tax that should have been collected is lost as a result of the impact of the shadow economy (distinct from tax avoidance and late and non-payment of taxes declared to be due but not settled on time) just as this proportion of the total gross VAT that should have been collected is lost. As is shown above, one

conclusion flows from the other, inevitably.

The question to then ask is whether this is plausible. Work in estimating the shadow economy is always laden with the problem that people do, by definition, not wish to report their own tax fraud. However, an IMF estimate (admittedly relating to 1988 – 2000) suggests that the shadow economy in OECD states might be in the band 14 to 15% of GDP. The Revenue has acknowledged this in their own internal (but now published) memos on this issue^[ii]. Other literature in academic journals confirms that this might be the lower end of the expected range, but that the UK might also be at that lower end^[11]. However, what this confirms is that an estimate that the shadow economy might represent 13.7% of all economic activity within the UK is, on the basis of external studies, entirely reasonable. It follows that an estimate of this figure for the purposes of tax evasion is also reasonable.

In that case to assume that the VAT gap ratio applies to direct taxes as well is not only logical, it is the only rational assumption to make. To assume a substantially lower figure – of about 6% as HM Revenue & Customs have done – is outside the plausible expected range of outcomes and is therefore highly unlikely to be a correct figure for tax evasion.

[11] See for example, this paper which suggested 12.7%.
<http://www.dur.ac.uk/john.ashworth/EPICS/Papers/Schneider.pdf>

[ii] See bibliography regarding memos published February 2008

There seem two further issues to mention now.

The first is that the [World Bank have now suggested](#) the UK shadow economy is about 13.5% of GDP – a number so close to that I have used that the difference is immaterial. I count that as very powerful corroborating evidence for the assumption I have made – and which comes to a near enough identical estimate of the tax gap. I'm not sure how critics will dismiss this evidence when quite specifically the WB estimate is of shadow activity intended to result in tax evasion.

Second, critics like to suggest that the VAT gap relates largely to carousel fraud and say this cannot be extrapolated. However, carousel fraud is now of much reduced scale and less than 10% of the VAT gap. On the other hand the cash economy of small businesses is entirely outside the VAT net – these

businesses being too small to register, and this is almost certainly more important in proportionate terms than carousel fraud — and is not reflected in the VAT gap. In other words, if there is bias it is on my side.

I do therefore stand completely behind the plausibility of my estimate and continue to suggest that which HMRC offer is not just wrong, it's implausible.

The implausibility was obvious in the avoidance figures published at the same time where with respect to personal tax avoidance HM Revenue & Customs claimed that there was just £1.1 billion of tax avoidance for income tax, national insurance and capital gains tax combined and yet in his budget speech in June 2010 George Osborne straightforwardly contradicted that claim by saying that tax avoidance with regard to capital gains tax alone exceeded £1 billion, happening in the process to exactly confirm the estimate of avoidance with regard to that particular tax made by Tax Research UK for the TUC in The Missing Billions. This also meant that by implication there was no allowance left over at all for avoidance of income tax or national insurance — which is utterly implausible.

The HMRC methodology for calculating direct tax gaps is simply wrong. And as a result I suggest my data is, for the time being, the best there is.