

The tax gap and how to tackle it

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I am off to Beirut this morning to speak at a UN conference. The theme is tackling illicit financial flows. I will be talking the tax gap and illicit financial flows on Thursday. In the meantime this is the note I sent in advance, a few weeks ago. I will blush my slides on Thursday. In the meantime it's a day of travel. And with luck an hour or two to see the nplace, maybe, over the next couple of days.

The tax gap and how to tackle it

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1 What is the tax gap problem and what are its consequences?

Illicit Financial Flows (IFF) are a multifaceted problem. The flows in question range from the proceeds of numerous varieties of crime to illicit funds resulting from the evasion of numerous forms of regulation of which the most common is taxation. The problem is an issue at a number of micro, mezzo and macro levels.

At the micro level the issues are:

- * Identifying crime;
- * Tracking the proceeds of crime;
- * Delivering taxpayer compliance;
- * Enforcing regulation;
- * Preventing corruption;

- * Protecting those abused.

At the mezzo level, which has been too often ignored, the issues are:

- * Protecting communities impacted by IFFs and related activity;
- * Maintaining social cohesion in the face of the challenges of inequality that IFFs create;
- * Delivering free and competitive markets when IFFs create an environment where effective markets frequently cannot exist;
- * Preventing the development of criminogenic environments;
- * Ensuring that the agencies of law enforcement are not just effective but are not corrupted.

At the macro level the issues are:

- * The economic cost of the breakdown of trust in society;
- * The economic cost of crime;
- * The cost of all forms of enforcement;
- * The drain of the shadow economy and the cost of the interface between it and the recorded economy.

There are other issues to consider as well. In particular there is the loss of tax. This involves consideration of:

- * The loss of tax revenues;
- * The undermining of tax morale;
- * Lost government programmes resulting from increased government deficits curtailing scope for activity;
- * The cost of failed social and economic policy that is ineffectively delivered because the tax system is not fully functional.

There is also the cost of the loss of economic control to consider:

- * The loss of effective fiscal policy;
- * The cost of multiple currencies circulating in an economy, which usually happens when the shadow economy is large;
- * The loss of confidence in government itself.

This last point is often overlooked. IFFs undermine faith in the state, and impose a cost because of the limitation on its remit. Nothing is beyond corruption by IFFs.

2 How much is lost?

The scale of the tax losses requires us to estimate:

- * How much of GDP is recorded;
- * By corollary, how much of GDP is unrecorded;
- * What tax is lost because it relates to activity that would never have appeared in GDP e.g. because it relates to capital flows and not income, and therefore falls out of GDP based tax gap estimates;
- * What the effective tax rate might be on the income not recorded within GDP, which might be the prevailing tax rate but also might not be: tax rates might be lower, for example, if everyone did pay the tax that they owed;
- * Data on how much tax is actually paid, where my current research suggests that this is surprisingly hard to secure.

It is not apparent that all these questions can be answered. In many countries we are at present working at the limits of knowledge and any estimate offered is decidedly approximate. That said, there is some evidence that can be considered:

- * Although the bases of calculation are quite different MIMIC (multiple indicator; multiple cause) models of the shadow economy in the EU are at present producing estimates of the shadow economy quite similar in scale to those prepared using estimated VAT losses calculated for the European Commission;
- * Those losses are at present remarkably similar to the scale of loss I estimated [\[iii\]](#) for the EU in 2012.
- * **If that European estimate remains reasonable then I suggest that the worldwide data is also similar to that I presented [\[iv\]](#) in 2011. Then I estimated that total tax evasion amounted to 5.07% of worldwide GDP. If that is still the case then tax evasion worldwide might have cost US\$4 trillion in lost revenues in 2017 based on World Bank GDP estimates. Data from the IMF and others would suggest that corporate tax avoidance of maybe US\$500 million might be added to this sum, which indicates it is of a lesser scale of significance.**

3 What can be done about this issue?

The critical facts on which most would agree are that:

- * Whatever the weaknesses in the estimates the scale of the IFF and tax evasion problem is economically significant and has a serious impact on development;
- * The illegal activity that gives rise to these flows - which could amount to nearly 20% of world GDP - is deeply disruptive to well-being for billions of people around the world;
- * Sustainable development; stable and efficient markets; effective government, efficient fiscal policy, the rule of law and secure societies cannot be maintained if this problem persists.

What then can be done? First, we need to improve the quality of our data:

- * This requires better GDP data;
- * It also requires more official candour than we enjoy at present about the scale of the shadow economy that appropriate GDP data might reflect;
- * In turn that requires better estimation of the shadow economy itself because there is still little agreement on, and too little study of, this issue despite it being quite literally one of the biggest issues in economics.

Second, we need better tax data. My research is showing that we do not know enough about what is paid where, and that there are major inconsistencies between data from various agencies. These are hard to explain.

Third, we need more data on how many taxpayers there are: we simply do not know in too many cases.

Fourth, we need to improve tax gap methodologies. Most that we have are heavily microeconomically focused. This is of use if the aim is to measure the efficiency of particular jurisdictions tax authorities, but the goal of tax gap measurement is much bigger than that. We do therefore need to develop and refine macroeconomic measures of the tax gap.

Fifth, we also need to understand how much tax is given away by governments in the form of allowances, reliefs, concessions, special measures, and so on, all of which mean that the taxable capacity of countries is forgone without necessarily securing matching economic benefit in exchange. The approach to the tax gap has to be about creating optimal tax systems, and not just beating crime, however important that is.

Sixth, we need to think much more broadly about this issue. I still meet people who think that most tax evasion involves tax havens and that most tax loss is as a result of the activities of multinational corporations. Both are significant, and both are more significant to developing countries than they are to developed countries, but it is also true that around the world domestic tax evasion is a much bigger issue when we look at the total sum of illicit financial flows. I stress the point: IFFs do not need to flow across

international borders to be illicit, and the problems within domestic economies have to be identified as well as those that exist internationally. In other words, as important as country-by-country reporting; the automatic exchange of information from tax havens and registers of beneficial ownership of corporations throughout the world might be (and I stress that they are) they will not by themselves solve all the problems that create the tax gap.

Seventh, it remains the unfortunate case that tax evasion is not always considered a predicate offence for money laundering purposes, and that even when it is the standards used to determine whether prosecution is appropriate, or not, are inconsistent and inconsistently applied. Much more work is required in this area as long experience has indicated that prosecution for tax evasion is very often the easiest way in which those participating in criminal activity can be pursued.

4 Where to go from here?

I have already outlined some of the detailed tasks that need to be addressed if IFFs are to be appropriately tackled but there is one more issue to mention.

It is fair to note that the issue of tax justice has come a long way since I was one of the founders of the Tax Justice Network in 2003. Back then there were a tiny handful of us who thought that tax could be a significant issue for the development. I am delighted that so many now agree. But, in my opinion the time has come to identify the next big issues that we need to address if we are to make further progress in tackling tax injustice.

Campaigners concentrated on the low hanging fruit when we started work in this area. So, for example we looked at tax havens, corporate tax abuse, and the obvious problem of secrecy that has been so effectively highlighted by the Financial Secrecy Index over the years. However, that did mean that insufficient attention was given to domestic tax evasion. And in looking at international issues I would suggest that perhaps too much attention has, in retrospect, been focused on corporate taxation issues in particular when these taxes do not, even in developing countries, usually comprise more than 20% of taxation revenues.

What we now need to do is recognise the tax is a much broader issue, and so, therefore, is tax abuse. All countries suffer domestic tax losses. In addition, too many jurisdictions are tax aggressors, and look like tax havens. But most countries, even those that are tax havens, are also vulnerable to abuse from other tax havens. And there is no one tax that operates in isolation. So, for example, if someone evades a sales tax, they will also fail to declare their income or corporation taxes, and might well evade social security contributions as well, whether due by themselves, or by the staff that they employ. These statements are simple matters of accounting certainty. In that case the risks within tax systems are not bilateral i.e. from one country to another particular country, or solely between taxes of a similar type. There is instead a

significant risk of tax spillovers: that is, a weakness in one tax or one aspect of a tax administration system can impact on many other taxes and not only in a domestic jurisdiction, but beyond it.

It is, of course, the case that we need data to appraise just how big our losses are to international financial flows. But I now argue that it is no longer the case that addressing particular and isolated aspects of this problem is enough. What we now need is an international organisation, or a range of those organisations, to come together to undertake both quantitative and qualitative reviews of tax systems to properly identify the risks that exist between them and within them, and between particular aspects of individual taxes and aspects of tax administration in all potential scenarios.

I have been looking at developing an appraisal system to facilitate this task with my colleague Professor Andrew Baker of Sheffield University. We hope to publish academic research on this issue very shortly and would like to share it with you. Our goal in doing so is simple. In February this year the United Nations, the World Bank, the International Monetary Fund and the OECD all committed in a common statement to look at tax spillovers but did not say how they were going to do so. What we want is that those organisations work with those in civil society and academia who have long worked in this area to develop the necessary methodologies to appraise precisely where the tax risks are on a country-by country basis. The goal is to ensure that measures to identify and address illicit financial flows, wherever they might occur, can be put into effect with the greatest chance of yielding maximum return on the investment in this process so that people around the world can be convinced that the better societies, the better economies, and the better markets that might result are truly within their reach. This, in my opinion, is the way to achieve the Sustainable Development Goals and I am as a result delighted that this conference is looking at this issue.

[\[iii\]](#) Richard Murphy's work on the tax gap is undertaken as part of a European Commission Horizon Research and Innovation Action, 'Combatting Fiscal Fraud and Empowering Regulators' (COFFERS, grant #727145).

[\[iii\]](https://socialistsanddemocrats.eu/sites/default/files/Special%20report%20on%20tax%20gap%201%20trillion%20euro_130109.pdf) socialistsanddemocrats.eu/sites/default/files/Special report on tax gap 1 trillion euro_130109.pdf

[\[iv\]](#) <https://www.taxjustice.net/wp-content/uploads/2014/04/Cost-of-Tax-Abuse-TJN-2011.pdf>