

Tax gaps and double entry (wonkish)

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As some will have noticed, there have been those who have disputed my recent tax gap analysis, [published here](#). The first was a person called Jacqueline. I began by patiently explaining what I had done and why her logic was wrong. As quickly became apparent, she did not understand my logic, and had not read that of HMRC either, although she claimed she was defending their position. It also became clear fairly soon, using tests that I can apply to comments, that she was an experienced troll. This was not, then a serious challenge, but was instead the usual politically inspired nonsense.

The someone claiming to be an economist called Jordi appeared. I can say the use an academic email address from a university I know: who they actually are, I have no idea. But the obviously know some of the literature on tax gaps. And he or she (I know not which for sure) very clearly has a strong opinion that I am wrong, using what they think to be economic logic.

And they claim that my opinion is wrong, because most economists disagree with it. This is, of course, a situation I am familiar with. On MMT, the tax gap, tax havens, QE and much else I am wrong. Except I seem to continually be right and economists, with their intensely narrow minded and frankly unreal view of the world, are proved to be wrong. But, this one matters. And so I will defend it, boring as it is to have to do so.

Jordi said in [his / her latest comment](#), the following, and as it is the basis from which I will show that they are wrong, I will repeat their claim at length:

I can already see where you have made your mistakes. You now acknowledge VAT is a transactional tax at least.

“And if VAT is not charged when it should be there is unrecorded trade.”

Partly right. There will be some unrecorded trade. But you have simplified the problem, which leads to your first error.

Because VAT is charged at every level of a production cycle and then can be partly reclaimed, to analyse VAT properly you have to look at input AND output VAT. Not just

the last transaction in the chain.

The business not paying VAT on it's output will still have paid VAT on it's it's input in effect, so the whole of the VAT amount of the final transaction in a production chain is not lost. Only a marginal amount. Not only that, but VAT is charged and reclaimed throughout the chain on purpose partly because it makes it much harder for people to cheat. It's a tool tax authorities use heavily for VAT enforcement.

Your second problem comes when you say that unrecorded business means the top line of the business is understated. Unfortunately not paying VAT means nothing of the sort.

The top line of the business means nothing to the tax man. Business taxes are not levied on turnover. They are levied on profit, which is the bottom line. A businesses which has not paid VAT might not be making a profit, which means it might not be liable for any corporation taxes. You simply can't tell from VAT alone.

The same goes for income taxes. That business is going to be paying it's staff and owners, but not paying VAT gives you no evidence regarding any other taxes they may or may not be avoiding.

For your claim "once unrecorded for VAT then this income is unrecorded for all other taxes" to be true ALL of the economic activity of that supply chain would have to remain in the shadow economy. This is a horrible assumption which we know not to be true.

You have also claimed that your average tax rate should be higher because VAT is the top line tax. You allude to the claim here again "And that means it is not just the VAT that is lost — it is the income tax on the receipt of that unrecorded money that is lost, and the NIC that they owe."

As I have explained, this is simply wrong. Let's take a quick example using your logic, that VAT is a top line tax. This means all of the top line, or revenue must be counted for tax purposes.

A business sells something for £120. They evade paying the VAT (20%).

Of the remaining £100, £18 should go to CT, and for sake of argument £20 should got to income tax and £12 should go to NI.

According to you, because of the VAT evasion none of this gets paid. Top line, right! So the total tax loss is £70, or 58%! This is how you get to your wild claims that the average tax rate for the shadow economy should be higher.

Of course this is simply incorrect, because you need the input cost as well. How much profit did the company make on the transaction? How much VAT was really avoided?

Let's say the business bought the item they sold for £120 for £90.

Now let's see what that does to your numbers, factoring in the input costs.

VAT is value add, so all previous companies in the chain have paid VAT up to that £90. So HMRC are only missing revenue on the £30 markup, or as we call it "value add" — so only £6.

Businesses pay people out of net revenue, not gross. Even if there was evasion on all of the rest you now only have £5.4 of CT, £3.6 of NI and £6 of IT for a total of £21, or %17.5.

It is important to note that the VAT loss is also not at the headline 20% rate — it is going to be much smaller, because VAT is value added, and applies all the way through a production chain. For you to lose the full 20% every step of the chain would need to be evading.

Quite a difference, no? Even this is a gross simplification as CT, NI and IT are totally unrelated to the payment of VAT. CT might not be liable at all and the VAT tells you nothing about the levels for NI and IT. Like the sole trader who evades VAT but doesn't make enough profit to fall into IT thresholds, or conversely the trader who sells zero rated VAT products and evades no VAT but goes on to evade other taxes. The issue is highly devolved and complex. You can't simplify the problem in the way you have and expect it to be correct — which somehow in the fact of everything that goes on in the real world, you do.

In short, your methodology, logic and assumptions are wrong.

My apologies for the length of the quote. I would not have done it if I did not think it was necessary. And I apologise for the technicality of what follows: trust me again: I would not do this if it was not necessary. But it is because Jordi is hopelessly wrong. And that's because Jordi is missing some very basic but quite essential knowledge that should be at the core of all economics training, but is not in most. And that is double entry book-keeping. If Jordi had understood double entry he or she would not have dug themselves a pit quite as deep as they have.

Let me explain this. And let me make the example just a touch more realistic, because I suspect I have seen many thousand more sets of accounts than Jordi ever has.

Let's assume we have a business owned by a person who wants to take evade. The make sales of £100,000 (for example) a year and so are VAT registered. They only declare £90,000 of this. The scenario is common. The numbers could easily be very much bigger, but let's ignore that.

The business sells a product (unlikely at this scale in reality, but economists can't get their heads around services so let's pretend it does). The gross margin on this is 70%.

In other words they buy £30,000 of product to make their sales.

They pay just one person — the owner — a salary. Call it £50,000. There will be an employers NIC charge on that. It will be about £6,000. So the total declared cost of employment is £56,000. They are £4,000 of other overhead costs, excluding VAT. Total costs are then £60,000.

This means the declared profit and loss looks like this:

So, where is Jordi wrong? First he claims I do not understand that VAT is on the supply chain. Yes, I do. And that whole supply chain is in here — including the goods bought to support the unrecorded sales. The gross margin is just a bit deflated as a result — it's not 70% but is actually 66.6% - and so not so wildly out as to draw attention to the inappropriate claim.

And I stress tax is paid. The sums due are likely to be pretty much right, by the way. And I have rigged it so we do not have to worry about corporation tax. I could have allowed for that, but chose to just make things simpler.

Now let's suppose this business — which I have assumed is run in a limited company (and it always pays to ring fence dodgy business in a limited company because then the unpaid taxes and penalties very often are extinguished with it whilst the owner goes on to form another dodgy enterprise to perpetuate their activities) does have those undeclared sales of £10,000. Except, of course, they will not be £10,000 because the market expects a market price — and that includes VAT so the actual unrecorded sale will be £12,000.

Then we get this:

I have dumped all the data on you at once: I apologise.

Now let's be clear why we have to deem a salary of £10,545 due out of the £12,000 of unrecorded sales, on which VAT of £2,000 is evaded. There are two reasons.

One is double entry. That credit is missing from the books. It's not there. That's what evasion means. But that means that the debit cannot be either. That's a simple fact. There is no such thing as single entry book-keeping. In other words the debit has to be somewhere else too. And by definition that somewhere else has to be outside the business. And when transactions move outside a business a boundary is crossed and that is a transaction — and as a matter of fact all taxes — not just VAT — are transactional. And when the owner of a company takes cash out of it a boundary is crossed and that is a taxable boundary — PAYE is due. It is not a dividend — because

that has to be declared as such. It is pay. And so the tax on that pay is due. It cannot but be the case.

And that is true even if the money is (for reasons that defy imagine but which Jordi thinks possible and even likely) returned to the business from which it has just been stolen to meet business expenses. That, to avoid the credit which would give rise to that reinjection being treated as a sale — which would negate the whole exercise — would have to be treated as a loan or share capital from the owner. But to achieve this goal — which is utterly implausible in reality - the cash would have to still be treated as belonging to the owner — and to make it theirs tax would have had to be paid when they got it and by definition in this case it has not been meaning that the evasion has still taken place. And let me assure you, HMRC would have a field day with this — and the fact that it would show up on a balance sheet and look decidedly strange — would be a great reason for opening an investigation.

I say all this simply to prove that my claim that once VAT is evaded all other taxes due on the gross income are also evaded have to be evaded as well — which has to be true. The exception, it could be argued, is where the business is wholly illicit and then some input VAT would be suffered — but let's be clear that in that case that would then be swamped by the scale of other evasion.

So, are any of Jordi's accounting claims right? No, they're not. He can't even see that you only pay corporation tax on net profit. He gets just about everything wrong because he cannot do double entry.

I would add though that I do not prove my whole case with this simple example. It is an example. No more. The tax gap is not 33%. But then I only consider some taxes. Especially I ignore excise duties — which are commonly abused and massively compound the losses. I also ignore all illicit business, altogether — and that exists all around us. I saw two drug deals in my own little city yesterday. It also ignores the multiplier impact of tax evasion — which I only hint at in the example. That multiplier effect is big. But what it does show is that Jordi's claim is wrong.

And actually, so are most of the rest of his claims also nonsense for all practical purposes — and that is the reason tax gaps are estimated. For example, if GDP is wrong for this purpose, so what? It's wrong then for all purposes. But we use it nonetheless, because it's the best that we have got. To object to my use of it as if I am wrong to do so is facile in that case. It isn't wrong to use it. It's simply the best approximation for this issue — albeit one with errors in it.

And to say that I cannot compound the tax losses — well, I have shown above why I can.

But let's get to the final point. I never said my tax gap estimate was right. Or not in a range. I made both clear. And I never claimed we could get it all back. We can't. I didn't

even say that the shadow economy was the sole explanation for tax evasion — because I clearly included other figures for evasion as well and said they were not GDP based. These objections then are all made up. But so too is the claim that not recording VAT does not mean that other taxes are not evaded. That's just wrong and is at the core of one of my key estimates. And that claim is right. And I have shown why.