United Nations University
World Institute for Development Economics Research

Introduction to Tax Gap estimation

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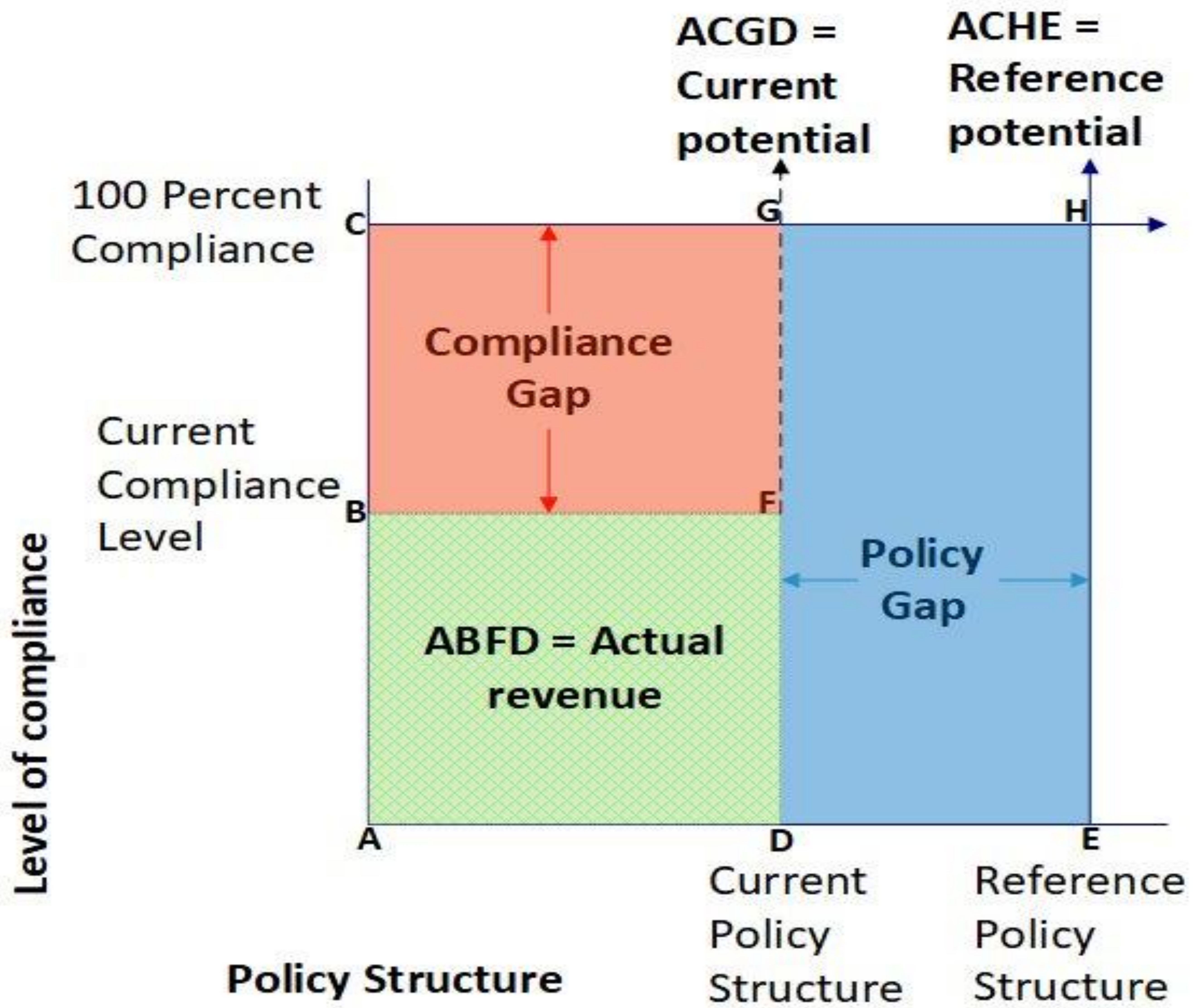
A few definitions

The tax gap is the difference between the *actual* and *potential* tax collected under full compliance with the tax code.

Terminology:

- From a policy perspective: distinguish between the **compliance gap** and the **policy gap**
  - Compliance gap: additional revenues raised if tax legislation perfectly enforced.
  - Policy gap: revenue that could be obtained (assuming perfect enforcement) if the base were taxed at the current standard (basic, average) tax rate.
- From a collection perspective: distinguish between gross gap and net gap
  - Non-filing, underreporting and underpayment



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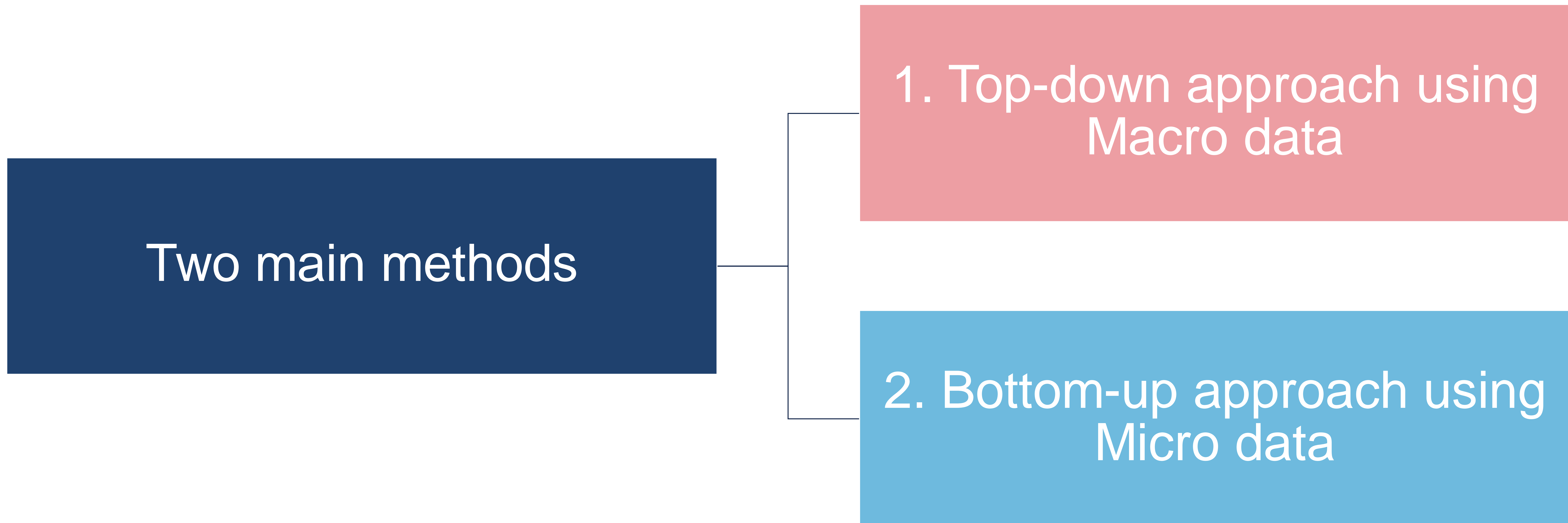
Important considerations

- Estimates of tax gaps are *rough* indicators of revenue loss.
- Usefulness of tax gap estimates depends on the methodology and the **data** used to estimate the gaps.
- **Caution** in interpretation needed –tax gap estimates are imprecise. It is, therefore, best to emphasise *trends* in the estimated results instead of focusing on absolute numbers.
- Differences in tax systems and tax gap methods mean that comparisons between countries are limited.
- Many of the factors driving changes in the tax gap are outside of the control of the tax administration

Methodology

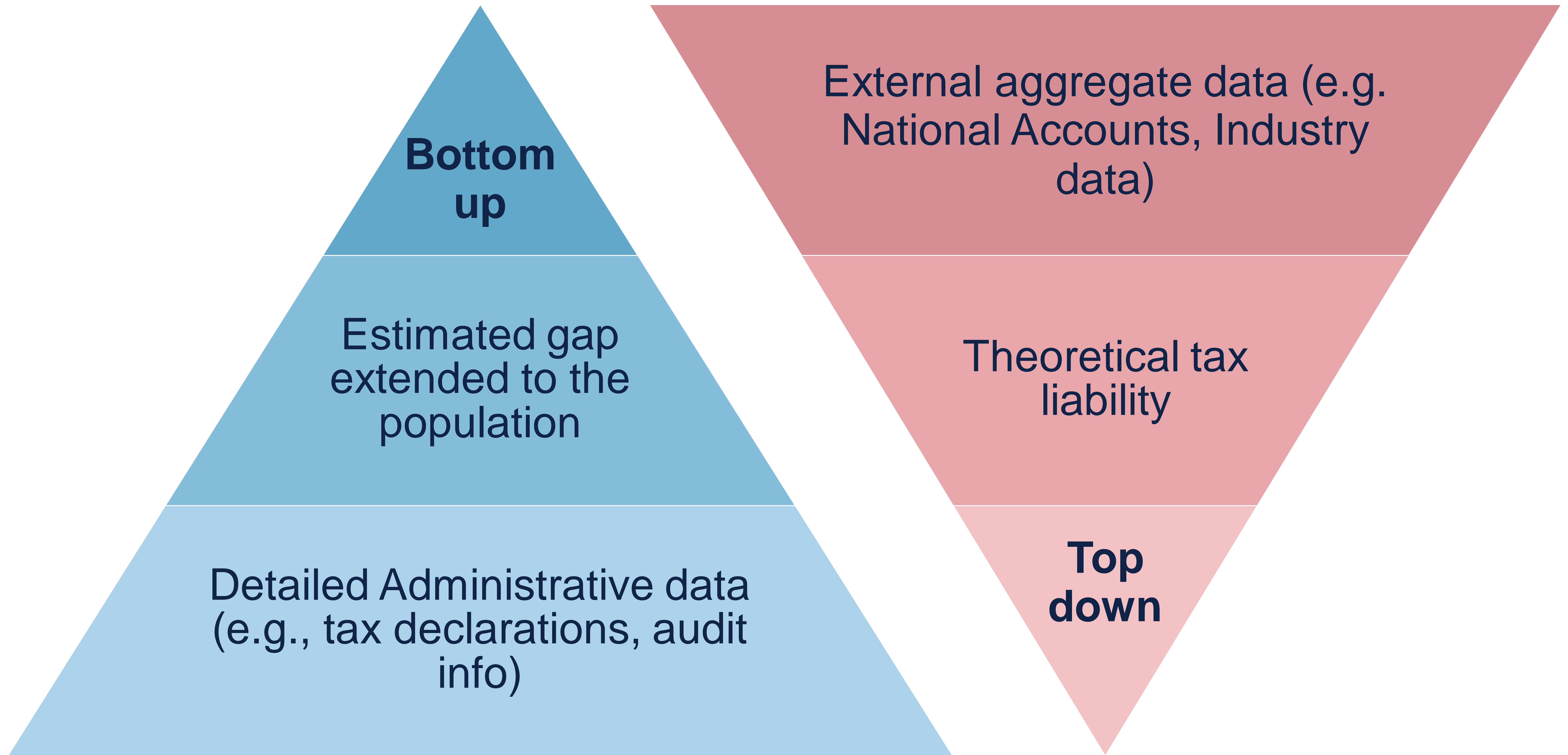


Which method to choose?

Considerations for suitability of method:

1. The structure of the tax system
2. Potential areas of compliance risks
3. Available data and resources

- For quality assurance, attempt multiple approaches (i.e. a top-down approach and a bottom-up approach)



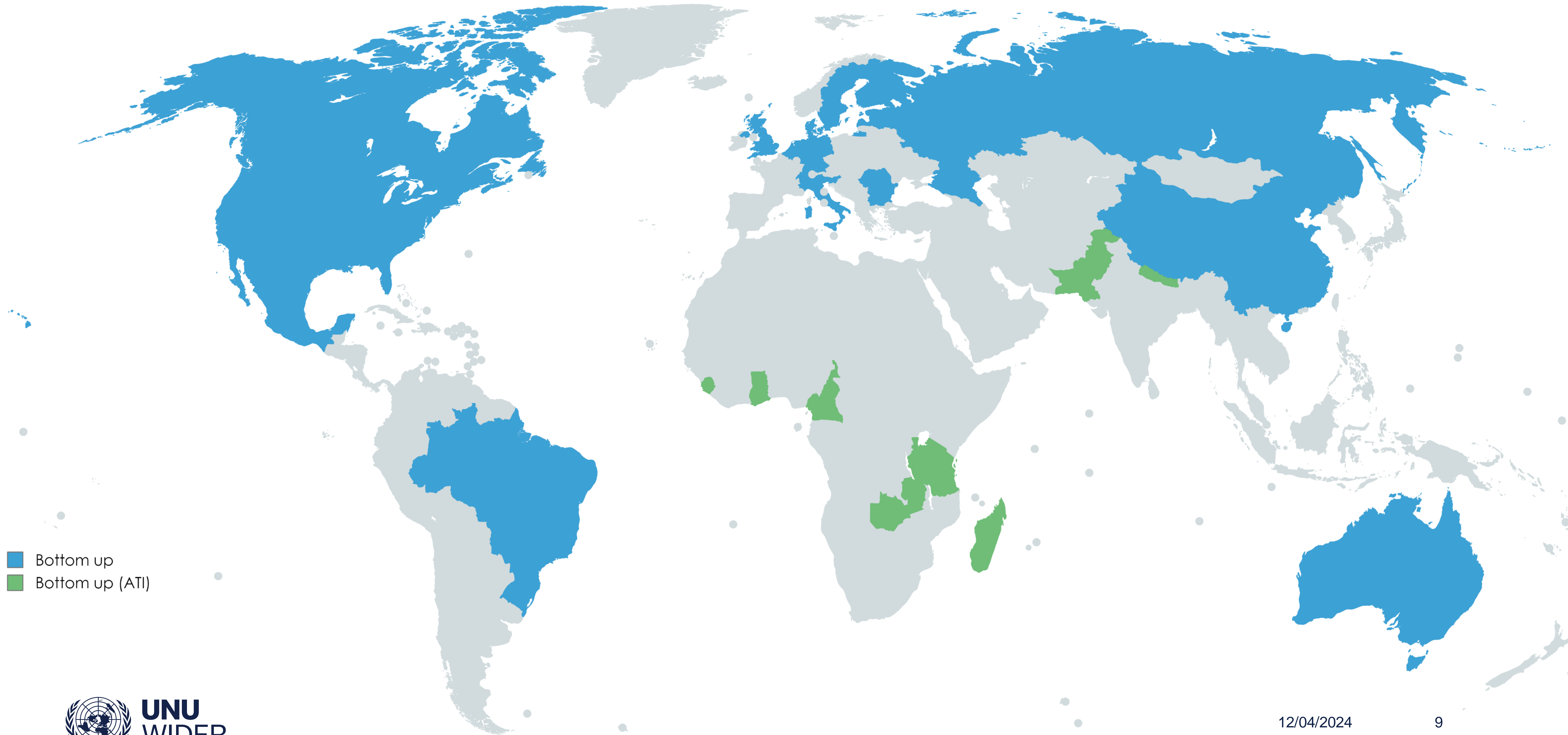
Source: Australian Tax Office

Benefits and Limitations of the Bottom-Up approach

- Tax gap components are estimated separately for different taxpayer groups as well as types of non-compliance
  - For example: small, medium or large firms, Mining sector etc.
- Uses tax administrative data that is usually more comprehensive and based on individual cases
- Few assumptions to estimate the tax base.

- Concealed activities may be excluded
- Data intensive
- Audit selection process complex to model, and estimates sensitive to modelling assumptions

Reality? Map of countries using bottom-up approach



Complementing the Top-down approach -

- Greater interest & attempts at **estimating tax gaps** in the developing world
  - Determine the tax gap in total and by sector
  - Formulate *tax policy* proposals to narrow the tax gap
    - to provide greater insights into individual components by taxpayer group and type of income evaded
  - Implement tax administrative measures to narrow the tax gap

- Combining the top-down and bottom-up approaches provides a more **complete** and **reliable** picture of the tax gap
  - Useful to inform decision-making and resource allocation.
  - Bottom-up approach can identify tax gap by taxpayer segments, income sources, or compliance risks

What about the rest of the economy?

- Both methods have *limitations* when estimating the gap that stems from the informal sector.
- This is important as developing countries can have large informal economies.
- Surveys can measure the **tax base** and **potential revenue** from the firms outside the tax net.

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