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Tax Policy Analysis: The Introduction of a Russian Tax Amnesty

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1. INTRODUCTION

Governments of all kinds have frequently turned to tax amnesties as part of their fiscal programs. An amnesty typically allows individuals or firms to pay previously unpaid taxes without being subject to some or all of the financial and criminal penalties that the discovery of tax evasion normally brings. In the last twenty years, nearly forty states in the United States have enacted some form of tax amnesty, sometimes more than once. Many other countries have also used one or more amnesties. These countries include those in all parts of the world: in Europe (Belgium, France, Ireland, Italy, Switzerland), Latin America (Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Honduras, Mexico, Panama, Peru, Uruguay), Asia (India, Malaysia, Pakistan, Sri Lanka), and the Pacific (Australia, Indonesia, New Zealand, the Philippines).

Tax amnesties are a controversial revenue tool. The obvious purpose of a tax amnesty is to raise short-run revenue. This may or may not work, and it can bring about expectations of future amnesties thereby reducing taxpayer compliance after the amnesty. This paper discusses basic design features of an amnesty, evaluates the benefits and costs of an amnesty, examines the country experiences of several "typical" amnesties, and presents some conclusions and recommendations.

2. ENACTMENT OF A TAX AMNESTY

Prior to any final decision about the enactment of an amnesty, the authorities must assess the overall level of voluntary tax compliance, including the current quality of tax enforcement and any prospective changes in this enforcement. In particular, when considering an amnesty a government should first determine precisely what problems brought the tax system to its current state. If these problems are not addressed, it is likely that an amnesty will do more harm than good. Taxpayers will recognize that the problems of the tax system have not been solved and that since these problems have resulted in an amnesty once, they are likely to do so again. In Russia, for example, the simple fact that, by some estimates, 80% of transactions of large enterprises take place through a barter system means that there is no liquid cash available to pay taxes. An amnesty will not solve this problem, and may in fact perpetuate the barter system if expectations of future amnesties reduce taxpayer incentives to move away from barter and the accumulation of tax arrears.

Once a decision has been made to implement a tax amnesty several aspects of the amnesty must be specified: its eligibility, its coverage, its incentives, and its duration.

Eligibility: The amnesty must specify which taxpayers are eligible for participation in the amnesty. It is standard practice to allow any taxpayer with previously unpaid taxes to participate, as long as the taxpayer's unpaid tax liabilities are not known to the tax administration. These individuals include those who are already on the tax roles ("filers"), as well as those who are not on the roles ("nonfilers"). The treatment of those taxpayers with unpaid taxes who are already under investigation ("known delinquents" or "accounts receivable")

is more variable. Some amnesties allow taxpayers with known arrears to participate; other amnesties do not. Both domiciled and nondomiciled residents are usually allowed to participate. Similar comments apply to business enterprises.

Note that the decisions on eligibility have important effects on estimates of the true revenue impact of the amnesty. If agents already known to the tax administration as delinquents are allowed to participate, then any revenues collected by the government from these individuals during the amnesty would most likely have been received by the government even without the amnesty. Put differently, the revenue actually collected during an amnesty may overstate any additional revenues generated by the amnesty itself.

Note also that these decisions on eligibility send important signals to individuals about the tax administration's attitude toward evaders. Forgiving individuals or firms already known as delinquents to participate, even after some effort has been made to detect their evasion, suggests that the tax authority may not consider tax evasion a serious offense. The effects of this perception on tax compliance are almost certainly negative.

Coverage: The amnesty must specify which taxes are included in the amnesty. Many amnesties pertain to one specific tax source, such as the individual income tax, the corporate income tax, sales and use taxes, or property taxes. Limitations on the tax subject to the amnesty also necessarily limit the type of taxpayer who can participate. Other amnesties allow individuals and firms to pay the arrears of any tax for which they are liable, or any tax administered by the tax authority. Several countries have enacted tax amnesties in recent years largely to attract capital that citizens have illegally transferred abroad. These amnesties have typically reduced (or exempted from) taxes on all previously unreported income that is used for investment purposes (e.g., purchases of new equipment or plants, investments in financial instruments).

Incentives: "Amnesty" means "forgiveness", and the amnesty must specify the amount of the unpaid taxes, interest, and penalties that the tax administration will forgive. It is almost universal among tax amnesties to waive or to reduce any civil or criminal penalties on unpaid taxes. However, the treatment both of unpaid taxes and of the interest on these unpaid taxes varies considerably.

Nearly all tax amnesties require the individual or firm to pay all back taxes. However, some amnesties allow these back taxes to be calculated at tax rates that prevail at the time of the amnesty, rather than at the time of the original tax evasion. For example, in the recently completed amnesty in India, individuals reporting income in the amnesty were subject to a maximum income tax rate of 30 percent, based upon a February 1997 overall reduction in rates; these individuals could have been liable at a rate of 97.75 percent, which prevailed during some periods before the enactment of the amnesty.

The treatment of interest also varies significantly. Most American state amnesties have not waived accumulated interest on taxes declared in an amnesty; other states have waived or abated these interest charges. Amnesties in other countries also follow both approaches.

Amnesties sometimes allow agents to pay any declared amounts in installments; in this case, the tax administration must decide whether installment payments are also subject to interest charges.

Duration: An amnesty can be a one-time grace period of a pre-determined length, typically from 2 months up to a year in duration. The publicity surrounding such temporary amnesties typically emphasizes that delinquent taxpayers have only this single opportunity to declare all unpaid back taxes. However, it has been a common practice in some countries to enact multiple amnesties, even though each one separately is advertised as a one-time-only grace period. For example, India has offered six amnesties since the late 1970s, and countries as diverse as Argentina, Belgium, and the Philippines have also enacted multiple amnesties.

In contrast, several countries have in their tax systems a permanent, standing amnesty that allows agents to make restitution at any time. The United States had such a permanent amnesty in its income tax from 1919 to 1952, and Canada, Germany, the Netherlands, Norway, and Sweden have features in their tax systems that resemble a permanent amnesty.

3. THE BENEFITS AND COSTS OF A TAX AMNESTY

Benefits: Governments enact amnesties primarily for the obvious benefit of immediate, short run increases in tax revenues, and, as discussed later, some amnesties have in fact generated substantial amounts of revenues. An additional benefit is that a tax amnesty allows the tax authority to reduce its administrative backlog of paperwork and arrears, thereby saving some in administrative costs.

There are also other potential benefits of an amnesty. Advocates of amnesties argue that voluntary tax compliance may actually increase after an amnesty. They point out that an especially important source of increased compliance stems from getting individuals who previously had not paid taxes for one or more years back into the tax system and onto the tax rolls. These individuals may wish to correct their previous illegal actions but are afraid of the prosecution and penalties that normally accompany the discovery of tax evasion. By giving them the opportunity to correct their previous tax evasion and to enter or re-enter the system, a tax amnesty will increase voluntary compliance: these individuals no longer must conceal their tax evasion, their guilt is lessened, and the tax authority now has a record of their activities. Compliance will also increase if the amnesty is followed by greater enforcement efforts and by stronger civil and criminal penalties. In fact, for a government that wants to increase enforcement activities and do so in a manner that taxpayers perceive as fair, a one-time grace period before the enforcement increases may be an effective transition mechanism. Compliance may also improve if the amnesty is accompanied by more extensive taxpayer services and better education on taxpayer responsibilities, both of which make taxpayers more willing to pay their taxes.

Costs: There are also some serious potential costs of tax amnesties. Critics contend that the revenues from even the more productive amnesties are relatively small, and that even these

small numbers overstate the additional revenues from the amnesty if known delinquents are allowed to participate and if the administrative costs of the amnesty are not accurately considered.

More importantly, critics argue that the long run revenue impact of an amnesty is likely to be negative. This negative impact may occur for several reasons. First, honest taxpayers may view the amnesty as an unfair tax break for tax cheats, and will reduce their voluntary compliance in response. Second, and related, some individuals may pay taxes largely out of a feeling of guilt. If the amnesty lessens guilt as a motivating factor, post-amnesty compliance will suffer. Third, the mere announcement of the amnesty may make taxpayers aware of the widespread presence of noncompliance, something that was previously unknown to them. Fourth, the announcement of the amnesty may also make taxpayers aware of the ease of tax evasion; that is, taxpayers may have felt that tax evasion would be quickly detected and punished, but the amnesty sends a signal that the tax authority is unable to enforce the tax laws. Fifth, individuals may expect another amnesty to be given in the future, and again will decide to pay less taxes voluntarily in anticipation that this evasion will be forgiven at some point in the future. Expressions by the government that the amnesty will not be repeated may not be convincing if the government has little credibility. In short, post-amnesty compliance is likely to decline.

Summary: The benefits and costs of a tax amnesty can be summarized as follows. On the benefits side, amnesties can:

- generate an immediate increase in tax revenues
- reduce administrative costs
- improve post-amnesty voluntary compliance through better post-amnesty record keeping and monitoring of individuals who previously were not on the tax roles.
- improve post-amnesty voluntary compliance if the amnesty is part of a larger effort to reform the tax system with improved enforcement efforts, reasonable and equitable civil and criminal penalties, and better and more extensive taxpayer services and education.

On the Costs side, amnesties can:

- produce small and overstated amnesty revenues
- reduce post-amnesty voluntary compliance from previously honest taxpayers who view the amnesty as unfair, from individuals who are now less motivated by guilt to pay their taxes, from individuals who are now aware of the presence of noncompliance, from taxpayers who now realize that the government is unable to enforce the tax laws, and from taxpayers who anticipate that another amnesty may be given in the future.

4. SOME STATE AND COUNTRY EXPERIENCES

This section discusses the experiences of a small number of "typical" amnesties from countries around the world.

Argentina: Argentina enacted a tax amnesty in 1987 in order to stimulate the repatriation of capital that had illegally left the country. The amnesty exempted from taxes all previously unreported income used for investment purposes, and was open to both foreign and local investors. In particular, for every dollar of debt converted to equity, the investor was required to contribute (or match) an additional dollar in new funds, and these monies had to be used to purchase new equipment, build new plants, or improve the capacity of existing facilities. The government exempted any returned funds from any back taxes owed, and the government also promised that it would not investigate or prosecute delinquent taxpayers.

This amnesty generated virtually no revenues, and it was widely viewed as a failure. Individuals viewed the matching requirement as too burdensome. More importantly, Argentina had offered numerous previous tax amnesties, and the 1987 amnesty was not accompanied by any increase in enforcement efforts or any change in the underlying fiscal system. The clear lesson of the Argentina experience is that the introduction of a tax amnesty with no other structural adjustments is likely to fail.

India: Like Argentina, India has a history of frequent tax amnesties, most of which generated small and decreasing amounts of tax revenues. However, the experience of its 1997 amnesty was far different. This amnesty collected 100 billion rupees (or \$2.5 billion dollars) from over 350,000 individuals, nearly three times the cumulative amounts from all past amnesties. Although the individual income tax collects very little in India (or less than 2 percent of gross domestic product), these revenues were significant, and amounted to roughly one-half of those collected from the income tax. The bulk of these collections occurred in the last days of the amnesty. In Delhi alone, nearly 12,000 people rushed to pay back taxes on the last day of the amnesty.

India's amnesty ran for 214 days, from July through December 1997. Individuals could report previously unreported income, and pay taxes at the current tax rates, not those prevailing at the time of the evasion. Under the current income tax rate schedule, the maximum rate is 30 percent; with previous maximum tax rates sometimes reaching as high as 97.75 percent, the amnesty presented a large element of tax forgiveness to evaders. The amnesty also allowed individuals to declare taxable assets bought in previous years at the original value, not the current value; with the high rates of inflation that have prevailed in India, this element further lowered the effective tax rate on income declared in the amnesty. The amnesty was accompanied by an extensive media blitz on radio, television, billboards, and newspapers, using film stars, sports figures, and other celebrities. This campaign first attempted to remove the traditional mental barrier against payment of taxes, then turned to emphasize the benefits that individuals could

expect to receive from payment, and finally changed to stress the significantly increased penalties following the amnesty. The finance ministry also said repeatedly that this amnesty would be the last of its kind. Overall, the government considered the Indian amnesty a tremendous success.

Ireland: In January 1988, the Irish government introduced an amnesty that allowed taxpayers ten months to pay overdue income taxes without incurring any interest or penalty charges or facing the risk of additional criminal or civil prosecutions. Simultaneously, the government increased the number of tax auditors, and it began publishing in national newspapers the names of delinquent taxpayers. The government also introduced a new tax system, effective at the conclusion of the tax amnesty, with increased interest and penalty rates and enhanced seizure powers for tax investigators.

The government expected amnesty revenues of \$50 million, but the revenues actually collected were \$750 million. This performance was attributed to several factors. The Irish government had not previously enacted any amnesty, and the government emphasized that the amnesty was the first and last opportunity for delinquent taxpayers to be forgiven. The increased post-amnesty enforcement also contributed strongly to the success of the program, especially in relation to the relative lack of pre-amnesty audits and penalties.

Colombia: The 1987 Colombian tax amnesty allowed individuals with previously unreported assets or over reported liabilities to correct their reports without penalty or prosecution. To be eligible, individuals had to declare income at least as great as reported income in the prior year, and known delinquents were allowed to participate. The Colombian government also changed many features of the tax system: it reduced income tax rates, it eliminated the double taxation of dividends, and it increased income tax withholding rates. The government also increased significantly enforcement efforts and penalties. The amnesty collected nearly \$100 million, or 0.3 percent of gross domestic product in 1987.

France: The 1986 French amnesty was designed to recoup income illegally transferred abroad. The government significantly reduced the tax rate on repatriated capital, and it abolished the wealth tax. This amnesty followed a similar amnesty enacted in 1982, which was also designed to attract capital held overseas. The program was not accompanied by increased enforcement efforts or greater penalties. The exact amount collected from the amnesty was not determined, but was believed to be small.

State of Colorado: The U.S. State of Colorado tax amnesty was similar to those in most other states in the United States. The amnesty was designed as a legislated, one-time opportunity for individuals and businesses to pay any unpaid back taxes without penalties or criminal prosecution. The program was signed into law on June 6, 1985, and was scheduled for two months in 1985, September 15 through November 15. The amnesty program was part of a larger Colorado tax program entitled "Colorado Fair Share," an on-going program aimed at detecting tax evasion and promoting voluntary compliance with the tax code.

Taxes eligible under the amnesty included individual income, corporate income, sales, use, gross ton mile, special fuel, cigarette, and liquor taxes; individual income taxes were by far the largest source of amnesty revenues, accounting for over 90 percent of the amnesty revenues. The program was designed to be as user-friendly as possible. All Department of Revenue district offices, located in ten cities throughout the state, had specially trained staff who could answer questions about the amnesty program as well as interpret the tax code. To encourage participation, the state allowed installment payments as a method to pay taxes and penalties in some cases. Taxpayers who had received notices or billings for back taxes from the federal Internal Revenue Service were eligible for the Colorado amnesty, but taxpayers who had been notified or had been billed by the Colorado tax authorities were not allowed to participate.

The amnesty program was advertised as a last chance for delinquent taxpayers to comply with the tax laws before civil and criminal penalties for noncompliance were increased. In all, the bill authorizing the amnesty contained 51 new or increased penalties. In addition, personnel and other resources devoted to tax law enforcement increased after the amnesty. The number of personnel in the "Colorado Fair Share" department increased from 6 to 36, and operations were computerized following the amnesty, which led to an increase from roughly 1500 per year to 90,000 per year in the number of tax notices mailed to taxpayers. The advertising budget for the amnesty program was \$145,000, and the program was publicized widely through virtually all forms of the media, from radio and television spots to placards on the sides of buses. All carried the same message -- "Don't Say We Didn't Warn You" -- and cautioned that the amnesty was a one-time opportunity to clear up any previous non-payment problems.

The program directors expected to collect amnesty revenues of \$5 million; actual collections slightly exceeded these expectations, at \$6.3 million.

5. SOME CONCLUSIONS AND RECOMMENDATIONS

General evidence from a large number of past tax amnesties suggests the following:

1 . Tax amnesties often generate only a small amount of additional tax revenue.

Revenues from a tax amnesty are generally small and, in any case, amnesty revenues are often overstated because they are from known delinquents and would have been collected anyway. This suggests that a tax amnesty should not be viewed as any kind of fiscal panacea. Multiple amnesties are even less successful in generating additional revenues, and they have perverse effects on voluntary compliance as taxpayers incorporate the expectation that future grace periods will occur.

Furthermore, most revenues collected in an amnesty generally come from those individuals with relatively small amounts of previously unreported taxes. Hard-core evaders, or those with large amounts of evasion, typically do not participate in an amnesty at very high rates. Consequently, the ability of an amnesty to get these hard-core evaders on the tax rolls seems

small, which is part of the reason that amnesties rarely generate significant amounts of additional revenue.

2. Individuals or firms are more likely to participate if a tax amnesty is accompanied by a significant change in the tax system.

Empirical evidence indicates that amnesty programs most effective in generating revenues are those that reduce taxes, interest, and penalties on items reported in the amnesty, that allow known delinquents to participate, and especially those that increase post-amnesty enforcement. Individuals will not voluntarily admit past tax evasion in a tax amnesty unless they believe that tax enforcement will be increased following the amnesty. An individual with unpaid tax liabilities has made the decision that the benefits of evasion (e.g., reduced taxes) exceed the costs (e.g., the risk of detection and punishment). If it was rational for the individual to evade taxes in the past, then in an unchanged environment it is rational for him to continue to evade taxes even if a tax amnesty is enacted. The individual will participate in an amnesty and report past evasion to the authorities only if he believes that audit and penalty rates will increase. A significant reduction in liabilities on previous evasion is also effective in encouraging participation; this reduction occurs by lowering tax rates, waiving penalties, and reducing interest charges.

Voluntary compliance generally falls somewhat after an amnesty that is unaccompanied by greater audit rates, penalty rates and taxpayer education programs. This decline is due to a variety of factors, notably taxpayer expectations of another future amnesty and taxpayer feelings of unfair treatment of evaders. An amnesty that is followed by an enhanced enforcement regime and improved taxpayer education generally increases or at least does not decrease voluntary tax compliance.

3. Citizens must believe that the amnesty is a one-time opportunity -- the government must have credibility.

To the extent that an amnesty is successful in raising revenues during and after the amnesty, citizens must believe that the amnesty is a one-time opportunity. An amnesty should not be used as an emergency-revenue measure this will only encourage further non-compliance in anticipation of the next revenue-emergency. In addition, citizens must believe and must eventually see that the amnesty is accompanied by enhanced enforcement.

At the very least an amnesty should be part of a major shift of the tax system and a reorganization of the tax administration. In fact, if increased enforcement and reorganization are already planned by the tax authorities, then a tax amnesty is an effective tool for easing the transition to a new, tougher tax regime. Such an amnesty offers several advantages: the amnesty generates some immediate tax revenue; individuals with past evasion are not locked into continued evasion; and the government both clears its ledgers of accounts receivables and adds the names of past evaders to its records. It is essential, however, that individuals believe that improved enforcement will occur: the government must have credibility.

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