

Tax Amnesties: The Case of Sticks and Carrots

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Abstract- Tax amnesties are an invitation to tax evaders to join the ranks of people who pay the due taxes. The popularity of amnesty programs over time and across countries is understandable as it produces both short- and medium-term benefits. However, cost benefit analysis shows that the costs exceed the benefits of the program. This paper weighs the advantages and disadvantages of tax amnesties, drawing on results from the theoretical literature, econometric evidence, and using Sri Lanka as a case study. The focal point of this research is to determine if a 'successful' tax amnesty is a norm or an exception to the norm. It is evident that tax amnesties have been devised to increase tax compliance. However, the low levels of tax compliance can be better addressed via improvements to the tax administration system. Thus, it leads to the question whether tax amnesties are only a plaster on a broken bone where an extensive surgery is required for full reparation i.e. an enhanced tax administration system. It must be understood that tax amnesties alone cannot increase tax compliance, as it is only an incentivizing mechanism and not the solution to the larger problem at hand. Most successful amnesty programs rely on improving the tax administration's enforcement capacity. Furthermore, given the potential drawbacks of tax amnesties, a few alternative measures are discussed which can be implemented to improve the enforcement capacity of tax administration system.

KEYWORDS: TAX AMNESTY, TAX ADMINISTRATION, COMPLIANCE, EVASION

I. INTRODUCTION

A tax amnesty provides a time bound window of opportunity for taxpayers to pay a defined amount, in exchange for forgiveness. The tax liability payable for the past tax period(s) including interest and penalties will be overlooked by a tax amnesty. A tax evader who makes use of an amnesty will not be criminally prosecuted for his past mistakes.

The American Bar Association in 1987 describes tax compliance to be the 'payment of taxes as required by the legislation' and 'the timely filling and reporting of required tax information, the correct self-assessment of the taxes...owed and the timely payment of those taxes without enforcement action'.

Process of compliance must ensure identification of taxpayers, assessment and collection of taxes due from them.

Tax compliance, simply put, is the extent to which a taxpayer agrees (or disagrees) with the tax rules of his country. Accordingly, a rise or fall in tax compliance refers to the number of taxpayers paying the due taxes, producing and submitting information to the tax authorities on time correctly in a given tax year. The mere submission of returns does not cater to all aspects of the elaborate definition(s) on tax compliance.

Reluctance to pay taxes has been observed worldwide amongst taxpayers. Direct taxes such as income tax and even indirect taxes on consumption such as Value Added Tax (VAT), Goods and Services Tax (GST) and other sales taxes are usually paid late often past their due dates. Delay in payments of course is when remittance to tax authorities is entirely unavoidable. The culture of reluctance is often due to reduction in resources and economic vigour i.e. taxes may take a sizeable cut off a person's income. This feeling of a taxpayer is usually influenced by socioeconomic and political factors present within the country. The aggregate effect of this rather global phenomenon is usually reflected in declining rates of compliance.

The causal nexus between amnesties and tax compliance has quite a roundabout way of unravelling itself. Theoretically, a tax amnesty by operation must increase tax compliance by enabling ex tax evaders to join the ranks of tax payers. However, in practise, this does not appear to be the case.

II. VITALITY OF TAX COMPLIANCE FOR TAX SYSTEMS AND TAX ADMINISTRATION

'Tax on income became a reality because of the concern of the government...that public expenditure should not exceed revenue.' (Gooneratne, 1992)

Any government in the world must generate revenue to fund itself. On the other side of the equation, a major share of government revenue is usually earned via taxes. In Sri Lanka, during the period of 2000, 2001 and 2002 tax revenue as a percentage of total government revenue was at 86%, 88% and 85% respectively.¹ (Note -For the purpose of this study, the period from 2000-2003 have

¹ As per Administration Reports of Commissioner General of Inland Revenue (CGIR)

been examined as a tax amnesty was last operated in Sri Lanka in 2003)

A. Tax administration

Bagchi, Bird and Das Gupta (1994) points out that the primary function of tax administration is to monitor compliance and apply sanctions (or otherwise) as prescribed in the statute against the offenders.

Compliance also effects other preliminary functions of tax administration i.e. assessment and collection.

Unsatisfactory compliance can cause delays and loss of momentum which in turn can jeopardize the whole tax system. However, achievement of overall compliance up to a greater percentage of all taxpayers makes a tax system very successful. A successful tax system paves way to implementation of tax policies by the tax administration. Thus, compliance is a vital requirement for tax administration as well as a tax system.

Compliance may vary from country to country, time to time and even amongst taxes depending on the context. Effectiveness of efforts by tax administration to enforce compliance and economic growth are the main factors affecting compliance.

According to Bahl and Bird low tax morale, unskilled and underpaid workforce, manual and outdated procedures are the attributes of poor tax administration. They attributed slow revenue growth not only to slow economic growth but also to narrow tax base and inefficient administration. Moreover, their position may be summarized by what they said in their research paper, "No tax is better than its administration, so tax administration matters -- a lot." (Asghar, n.d.)

B. The Sri Lankan experience

Non-compliance and lack of compliance, like a troublesome pair of non-identical twins, has wreaked havoc in the tax system time to time. The disease did not only plague the tax system but also affected the economic climate of the country when the government revenue dropped and debts sky rocketed.

Prosecuting and imposition of penalties on offenders, specifically on those who do not submit annual returns have been widely used to curb the problem of non-compliance in Sri Lanka. The other measures used to enhance compliance include auditing and investigations (In Denmark compliance rate is 95% due to effective audit (Asghar, n.d.)) collection of tax at source as in the case of Withholding Tax (WHT), use of information, field surveys and maintenance of taxpayer assistance centres etc.

During the last 50 years or so, a number of tax amnesties were introduced to the Sri Lankan tax system to enhance future compliance. Although repetitive enforcement of tax amnesties are not recommended, some countries have an unhealthy addiction towards the same i.e.

declaring repeated amnesties.² Sri Lanka too have employed 10 tax amnesties from 1964 to 2003. (Hapuarachchi, 2005)

Under most amnesties, pardon is granted only for penalty amounts. Prosecution and investigation rights of the tax authorities are not exercised against those declarants. In Sri Lanka, collecting tax amounts due by employing amnesties is a rare occurrence since only an increase in levels of compliance was expected in most instances. In all recent amnesties employed, full immunity have been granted where no back taxes were collected.

The amnesty of 2003 which brought the highest recorded number of declarations under an amnesty provided in Sri Lanka provided forgiveness and exoneration from all dues on all taxes concerned. Additionally, non-implementation of investigation and prosecution provisions of the tax statute was also guaranteed. The amnesty of 2003 is seen to be the 'most peculiar and beneficial' amnesty so far introduced in the history of amnesties as it provided protection from 26 statutes operating to raise government revenue in Sri Lanka via both direct and indirect taxes. (Hapuarachchi, 2005)

C. Purpose and objectives of this study

Tax amnesties are normally used as the last resort to enhance compliance. Although, a number of amnesties were declared with the hope that tax evaders will be captured by the tax system without the fear of being penalised, authorities believe that the potential tax revenue does not flow to the government coffers. Although the per capita GDP have been gradually increasing over decades, a wide disparity in income distribution prevails. Then the number of taxpayers should increase since majority of the income is earned by a section of the public which should be more than the existing number of taxpayers. However, the number of individual tax payers have always been less than 1% of the total population. Even in the existing tax files it is doubtful where correct amounts of taxes are being assessed. The ultimate consequence is always loss of government revenue.

In such a background, government seems to rely on tax amnesties as a tool to increase income tax compliance. Attraction towards tax amnesties are mainly because it generates short term revenue.

However, adequate studies have not been carried out to determine the effectiveness of tax amnesties on income tax compliance.

This study aims to establish effects of amnesties on income tax compliance within the status quo of the tax system and administration in Sri Lanka i.e. how an amnesty can affect the compliance trend.

² Repeated amnesties were also implemented in Argentina, Chile, Bolivia, Peru, Mexico, India, Pakistan and Philippines.

III. TAX AMNESTIES FOR COMPLIANCE ENFORCEMENT

In an ideal setting, firstly, a tax amnesty is an opportunity to pay previously unpaid taxes sans penalties. In some instances such taxes may be written off and/or disregarded completely when compliance is the primary motive of the amnesty in effect. An amnesty also provides the guarantee of non-prosecution and investigation, a sovereign act of forgiveness by a government to all citizens – which doubles the attractiveness of an amnesty.

Secondly, an amnesty is introduced to improve short term gains which can also be experienced in the long run when the new declarants files tax returns.

However, theoretical and empirical work on this area of study suggests otherwise revealing controversies on reaching objectives of tax amnesties.

A. Tax amnesties and money laundering

The sudden commercial boom worldwide has much to do with globalization. The evolving nature of business activities drove some of them underground far from the prying eyes of any authority. Immoral and/or illegal underground activities and even a portion of legitimate economic activities may be purposely hidden (i.e. not visible and taxable) via evasion, avoidance and tax planning. The only way to bring the untaxed income to the economy for routine circulation would be to coax them out of their hiding spots. A rational thinker may consider the auxiliary benefits of a tax amnesty and calculate how a tax amnesty fills the void in laundering black money.

An amnesty is an opportunity to declare such past income without paying taxes and enjoying immunity from punitive measures applicable against the offence of tax evasion.

For an instance, in an interview with tax advisors, it was revealed that 'high wealth individuals' in Australia who have accumulated non taxed income overseas by operating in tax havens were expecting an amnesty to declare their assets. (Braithwaite, 2003)

B. Objectives of 'declaring' a tax amnesty

The economic objective of declaring a tax amnesty is to contribute to the development of the country by increasing money in circulation and capital reserves. Introducing the large wealth amassed but not declared or invested in the formal economy of the country into the formal economy is an amnesties way of contributing a country's development.

From the tax administration's point of view, compliance and revenue enhancing tools such as tax amnesties are strategic measures adopted to bring tax evaders into the tax net voluntarily thereby enabling tax revenue to reach its potentiality. For this purpose, 'carrots' such as pardon for past evasions, non-implementation of legislative powers to investigate and prosecute are promised to declarants. Although tax amnesties are said to induce future compliance, studies have proven otherwise. Thus

leading to a loss-loss situation where neither back taxes due are collected nor future compliance have been achieved.

C. Costs v Benefits

As reiterated throughout the paper, benefits are mostly theoretical. Short term revenue gains, hike in voluntary tax compliance have been highlighted throughout. Additionally, citizens who become tax delinquents by mistake who would like to make amends can also make use of amnesties. (Zeckhauser and Leonard, 1986)

Costs also include but not limited to: relatively small revenue collection even from the most successful amnesties. (Alm, 1998) Secondly, dissatisfaction amongst law abiding taxpayers, who feel that offenders are being forgiven whilst the honest pay their dues, will affect the tax morale of the country which will in turn adversely affect compliance. Again, previous tax evaders cannot be trusted that they will not fall back onto their old habits and continue evading tax payments. Repetitive offenders are a reason for decline in post-amnesty compliance.

If the prevailing problems of a tax system are not addressed by an amnesty, it is likely to do more harm than good. (Alm, 1998) As official data on the performance of an amnesty is rare, empirical evidence on effects of an amnesty is also rare. However, Alm and Beck who analysed the effects of the Colorado tax amnesty of 1985, found that long run revenue impact of an amnesty is likely to be negative. Furthermore, the average level of compliance fell after an amnesty. (Alm and Beck, 1993) Das-Gupta and Mookherjee (1995) also supported the hypothesis of adverse compliance effects of amnesties or falling penalty collections overweighing direct gains of an amnesty. Only the 1975 amnesty amongst all amnesties introduced in India between 1965 and 1993 have had a positive impact on revenue. (Das-Gupta and Mookherjee, 1995)

According to Leonard and Zeckhauser, an amnesty is a political instrument and reduction of penalty must be coupled with a promise of more vigorous enforcement to win political approval of an amnesty program. A tax amnesty must not undermine the legitimacy of the tax system and the tax revenue that it collects. Public mistrust about the tax system and the government would lead to gradual decrease of compliance.

Some scholars have explored the relationship between tax amnesties and tax evasion. In theory, the cost of an amnesty must not exceed that of tax evasion. In other words, probability of detection should be high and tax amounts plus penalty payable if detected should exceed back taxes that have to be paid under (revenue collecting) amnesties. As a second factor, the costs side would be much heavier if psychic costs including stress over the probability of being caught and stigma are added. Thus amnesties seem to have lesser costs than evasion in any case concerning past fraudulent acts of non-compliers. In such circumstances, theoretically, tax evaders should be willing to come under amnesties. Based on this rationale, when back taxes are not collected under an amnesty

programme, such amnesty should be excessively successful in bringing evaders into tax net as the overall benefit for evaders is the aggregate of whole back taxes with penalties in monetary terms and relief from psychic costs in non-monetary terms. (Hapuarachchi, 2005)

IV. TAX AMNESTIES IN SRI LANKA

In the Sri Lankan context, tax amnesties have been a frequent occurrence during the last few decades with tax amnesties being declared in 1964, 1965, 1978, 1989, 1990, 1992, 1993, 1997, 1998 and the last one in 2003.

A. The 2003 Amnesty

As the legislature governing the enactment of the 2003 amnesty (i.e. the Inland Revenue Special Provisions Act No.10 of 2003) states, the objective of the amnesty was to secure future compliance of taxes in force. Any person in Sri Lanka or abroad having undeclared income earned or assets acquired prior to April 1st, 2002 could make a declaration of such income and assets as at April 1st, 2002, to the CGIR on or before August 31st, 2003.

Declarants were exonerated from their past acts of non-compliance and evasion. Pardon was granted for omitted payments that should have been made by those declarants under 26 enactments. Pardon for evasion of indirect taxes and wrongdoings against foreign exchange regulations and also import and export regulations were intrinsic to the 2003 amnesty. Levelled criticism prevailed over this aspect. The extraordinary coverage for unscrupulous acts and wrongdoings with regard to various types of taxes were argued to be to attract 'tax dodgers' who were unconvinced and not motivated to declare their acts of evasion under previous amnesties – which seems to have paid dividends when the number of declarations are taken into account. Queries, investigations and prosecution was not contemplated against the declarants and even actions already taken were waived off. The secrecy of the information received was strictly maintained.

Income tax liability for previously undisclosed income and assets up to the Year of Assessment (Y/A) 2001/2002 declared was pardoned. Where returns were filed by existing taxpayers, liabilities were finalised on the basis of such returns without any queries being raised. Appeals pending against any additional assessments, even before the judiciary, were settled amicably on the basis of income declared in returns. Existing taxpayers were able to declare previously undisclosed income and assets up to March 31st, 2002 without any burden whatsoever. From the Y/A 2002/2003, taxes must be paid under as one normally would.

For those without income tax files or with income tax files but no returns have been filed, all past undisclosed income and assets can be declared and taxes be paid from Y/A 2002/2003.

The 2003 amnesty persuaded 51,805 declarants with past evasions, to seek for forgiveness. This is a huge number compared to all previous amnesties under which the total declarants were less than 1000 as reported. Out of them,

the most number of declarations (at 575) were under the 1965 amnesty. (Hapuarachchi, 2005)

V. CONCLUSION

Tax compliance is a vital for a tax system as it simultaneously assists and determines the smooth functioning of other operations of tax administration, namely, assessment and collection. A variety of measures have been tried and tested by tax administrators worldwide in an attempt to facilitate and enforce compliance. One such measure is tax amnesties. The Sri Lankan government have often declared tax amnesties with the objective of persuading non-complying citizens towards compliance leading to the observation that the state authorities seem to rate amnesties as better equipment. The rating is in comparison to the already existing enforcement and facilitating measures within the tax system. The higher ranking of tax amnesties is a result of other compliance enhancing measures failing to achieve the assigned objective. However, a criticism is that most tax amnesties employed in the Sri Lankan context enhanced compliance at the cost of tax revenue. The supporting argument for the same is that a tax amnesty should ideally function as a window of opportunity for citizens with a history of tax evasion to pay the due taxes on such evasion without being subjected to penalization or prosecution, which is sadly not the case in Sri Lanka.

Healthier options to counter the problem of non-compliance include prosecution and imposition of penalties on offenders, especially on those who do not submit annual declarations. At least, the time value of money can be recovered via penalties unlike in the case of tax amnesties where the whole of tax revenue is often lost when the evader is pardoned and freed from the liability of having to pay taxes evaded. Other measurements include auditing and investigations, collection of taxes due at source (i.e. Withholding taxes), use of information, field surveys and by maintenance of a taxpayer assistance centre.

In conclusion, it is evident tax revenue and expected number of files i.e. compliance is unlikely to increase meaning amnesties could work against the very objective of introducing them, where the administration is weak. Thus, an amnesty will do more than good if not executed perfectly. Sri Lankan tax system must rid itself of the vicious cycle of continuing to implement tax amnesties and focus on remedying the root cause than to apply a band aid on visible wounds.

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