

Considerations in Using Tax Amnesty to Generate Revenue

Walter Marciniak
USA - IRS

The budget deficit has exceeded 200 billion, a figure which is approximately equal to some estimates of the size of the underground economy in the United States. The Service estimates that the voluntary compliance rate is 83.6% in 1986, and that the "tax gab", the difference between taxes owed and actually paid, is in excess of 98 billion dollars.¹ If the baselines envisioned in the Gramm-Rudman-Hollings Deficit Reduction Act of 1985 (Gramm-Rudman) are maintained, the budget deficit will be reduced. However, pressures are building to exempt various agencies and programs from Gramm-Rudman and to cut taxes. Can amnesty be used as a tool to tap the vast reservoir of funds that has thus far eluded the treasury? The stakes are very high indeed. But it is difficult to make a fully informed decision because relevant information is short supply, and is subject to the interpretations and assumptions of the beholder. Our knowledge is limited, and predictions are no better than guesses.²

A successful tax amnesty will achieve three goals, (1) A one time revenue windfall, (2) Increase future revenues by adding nonfilers to the tax rolls, (3) Improve the overall voluntary compliance rate. However, amnesty will have a negative impact upon voluntary compliance if viewed as unfair to honest taxpayers or seen as a desperate attempt by an inefficient taxing system to secure funds that

can not be collected in the usual course of business. The resulting erosion of voluntary compliance in the long run may eradicate any short term funds that may be collected as a result of the amnesty.

To avoid an undesirable impact upon voluntary compliance, a federal tax amnesty must be compatible with the purposes of an income tax system. These purposes include supplying adequate revenue, imposing equal taxes on equal incomes, assist in achieving economic stability, reduce economic inequality, avoid impairment of a market oriented economy, and enhance the harmony between the income tax and political order.³

Horizontal and vertical equity are tenets of our tax system, and therefore of voluntary compliance. Horizontal equity refers to fairness. It means that taxpayers with similar incomes are treated equally. Vertical equity refers to reduction of income inequality by taxing the rich more heavily than the poor.⁴ It is difficult to justify a federal tax amnesty in terms of horizontal or vertical equity. Therefore, there is a threat to voluntary compliance.

One of the cornerstones of "Compliance 2000" as envisioned by the Service is voluntary compliance. There is little empirical evidence regarding the effect a federal amnesty program may have upon voluntary compliance. However, at least 18 states and the District of Columbia have conducted amnesty programs.

1 Bonnie Ross, "Federal Tax Amnesty: Reflecting on the States' Experiences", 40 Tax Lawyer, 145. See also IRS Research Division, "Trend Analysis and Related Statistics", 1980 Update 27 (1988).

2 Leo P Martinez, "Federal Tax Amnesty: Crime and Punishment Revisited", 10 VA Tax Review, 535.

3 Sneed, "The Criteria of Federal Income Tax Policy", 17 Stab. Law Review. 567 (1965).

4 Zmarak Shalizi, "Reforming Tax Systems" 42 Tax Notes 219, at 229 (1/9/89).

But does this experience translate to the federal sector? Probably only to a limited extent. There are contrasts between the levels of enforcement of tax policies among state systems and between the state and federal systems. The level of enforcement is generally greater at the federal level. Therefore, federal noncompliers are more likely to have intentionally evaded paying taxes and are more willing to play the audit lottery.⁵ The types of taxes and the tax rates are not sufficiently similar to federal taxation. A substantial percentage of noncompliance at the state level involves sales taxes. The Congressional Research Service (CRS) reported that the states received most of their amnesty revenues from sales taxes and corporations. Yet approximately 90% of the federal tax gap involves individual income taxes.⁶ Because the income tax rate is lower for states than for the federal government, noncompliance taking advantage of a state amnesty program may be unwilling to pay the higher price of buying into a federal tax amnesty.

The following table is a summary of the most significant features of the amnesty program conducted by 18 states.⁷

⁵ Allen H. Lerman, "Tax Amnesty, The Federal Perspective" 39 *National Tax Journal* 325 (1986).

⁶ "Baucus Continues to Back Tax Amnesty; Skeptics Question Promises of IRS Expansion", *Tax Notes*, 1207, 3/24/86.

⁷ Source of Table: Mikesell, "Amnesties for State Tax Evaders: The Nature and Response to Recent Programs" 39 *National Tax Journal*, 507 (1986).

State	Program Length days	Eligible Taxes & Acc. Rec.	Nature of Amnesty	Amnesty Revenue Millions	Amnesty Budget Thousands	Add'l Audits
Alabama	91 Starting 1/20/84	All -	Waive all civil & criminal penalties	3.14	28	yes
Arizona	60 Starting 11/22/82	All -	Waive all criminal, & 2/3 civil penalties	6	15	yes
California	96 Starting 12/20/84	Individual income & sales (AR)	Waive all criminal, & civil penalties	145	2,800	yes
Idaho	105 Starting 5/20/83	Income -	Waive all civil & criminal	.3	-	yes
Illinois	73 (2) Starting 12/28/81 & 10/1/84	All (AR)	Waive all civil and criminal	152	2,000	yes
Kansas	92 Starting 7/1/84	Income, sales & Use -	Waive all civil and criminal	.6	25	yes
Louisiana	92 Starting 10/1/85	Alcohol, Corporate income, E&G, gas & use, etc. -	Waive 1/2 interest, 1/4 delinquency	1.2	40	no
Massachusetts	93 Starting 10/17/83	All (AR)	Waive all civil & criminal	84.6	1,300	yes
Michigan	52 Starting 5/12/86	All (AR)	Waive all civil & criminal	102	2,000	no
Minnesota	92 Starting 8/1/84	All (AR)	Waive all criminal & civil, for delinquents, reduce liability	12	250	no
Missouri	61 Starting 9/1/93	All -	Waive all civil and criminal	.8	-	no
New Mexico	91 Starting 8/15/85	All -	Waive all civil & criminal & interest	13.6	100	no
New York	92 Starting 11/1/85	Income, Hyway use, fuel, E&G, Business, & Misc. (AR)	Waive all civil & criminal	343.5	2,000	yes
North Dakota	91 Starting 9/1/83	All -	Waive all civil & criminal	.1	600	yes
Oklahoma	184 Starting 7/1/84	Income & Sales (AR)	Waive all civil and criminal	13.9	272	no
South Carolina	91 Starting 9/1/85	All (AR)	Waive all civil and criminal	8.8	-	no
Texas	29 Starting 2/1/84	All -	Waive civil and criminal	.4	-	yes
Wisconsin	69 Starting 9/15/85	Income, E&G, W/H, Sales, Use, etc. (AR)	Waive penalties, reduce interest, reduce liability.	25	inc.	no

The amount of amnesty revenue varied greatly between programs. Reasons for variation were: (1) The number of noncompliers in the state, (2) Restrictions on eligibility for the program, (3) Type of taxes involved in the program, (4) Whether tax compliance in the post amnesty period was substantially augmented, and (5) Promotion of the program.

The amnesty program in Massachusetts is frequently used as a model because it was one of the first states to conduct a successful amnesty program. Cornerstones were open eligibility, large scope, increased enforcement in the post amnesty period, and a generous budget allocated to the amnesty program. Programs conducted by states that failed to follow the Massachusetts model were not successful.

The amnesty program in Massachusetts is frequently used as a model because it was one of the first states to conduct a successful amnesty program. The model was used by several other states including New York, California, and Illinois. And officials from Massachusetts, including then Governor Michael Dukakis and Ira Jackson, Commissioner of the Revenue for the Commonwealth of Massachusetts, have been very vocal in explaining the benefits derived from their amnesty program. They maintain that a federal tax amnesty would be equally successful. Hallmarks of the program were open eligibility, extensive advertising, significantly increased penalties in the post amnesty period, and a 30% increase in the budget of the revenue department.

New York's amnesty program was the most successful, raising over 340 million dollars. As may be expected, New York had open eligibility, large scope, increased enforcement in the post amnesty period, and an amnesty budget in excess of 2 million dollars. However, half of the states raised less than 10 million dollars. In general, the amnesty programs conducted by states that failed to follow the Massachusetts model were not successful.

Illinois conducted two amnesty programs. The first program was open only to nonfilers who were unknown to the state tax rolls. The amnesty period

was only 12 days, and there were no additional funds appropriated for the program. Only \$80,000 in additional revenues were realized from the program. The second program followed the Massachusetts model and raised \$160 million in additional revenues.

Some states included accounts receivable in the amnesty program. These states are identified by an "AR" designation in the column "Eligible Taxes and Acc. Rec.". The inclusion of accounts receivable merits special attention. From a fiscal point of view, inclusion of accounts receivable in a federal amnesty makes excellent sense. After all, a primary goal of the program is to produce revenue.

However, waiving penalties for delinquent accounts may have a profound, negative impact upon voluntary compliance for two reasons. First, in an efficient system of tax administration, most delinquent payments would be secured in the normal course of business. Therefore, taxpayers may perceive the amnesty as an indication that current collection procedures are inefficient.

Second, much of the amounts owed to the federal government involve taxpayers engaged in a trade or business who diverted the amounts withheld from employees' salaries for use in the trade or business. Penalties should not be waived for taxpayers who misuse funds belonging to their employees and that have been entrusted to them for safekeeping and payment to the treasury. Therefore, while accounts receivable represent a significant source of funds, they may be ineligible for a federal amnesty because of the possible adverse effect upon voluntary compliance.

Officials in Massachusetts and other states that have conducted an amnesty based on that model have indicated that their amnesty program did not have an adverse impact upon voluntary compliance in the state, although they do acknowledge that if done wrong, an amnesty may have that effect.¹¹

¹¹ Ira A. Jackson, "Amnesty and Creative Tax Administration" 39 National Tax Journal, 317, at 320 (1986). See also "Is a Federal Tax Amnesty the Answer to our Deficit Problem?", 30 Tax Notes 711 (1986).

One generality that applies to states that have conducted a successful amnesty program is that only penalties were forgiven, both civil and criminal, but not the taxes themselves or interest.

To forgive interest, or change a below market interest rate would be to violate the horizontal equity among taxpayers.

Penalties are distinguishable from interest because they serve primarily as an administrative means of compelling taxpayers to comply with the system. If the penalty proves ineffective, it may be forgiven if that act produces the desired behavior. Further, it is widely known that penalties are now routinely waived for taxpayers who voluntarily disclose a tax problem, and this fact has not caused a disturbance in voluntary compliance.

The nature of the publicity surrounding an amnesty program affected the way the program was perceived by both honest taxpayers and noncompliers. State officials ensured that news articles included stories of enforcement efforts in the post amnesty period such as restaurant chains losing their licenses, and wealthy taxpayers losing their yachting and airpilots licenses.

Voluntary compliance was found to be unaffected if the amnesty program was effectively publicized as a means of adding taxpayers to the rolls, thereby reducing the tax burden for other taxpayers. After the Massachusetts amnesty, increased voluntary compliance was recorded. A jump in income tax filings was recorded that could not be explained by employment or population growth. Apparently, what offends honest taxpayers the most, and what most adversely affects voluntary compliance, is a neighbor who is not paying the full share of his or her taxes.¹²

History of the Federal Tax Amnesty

In 1945, the Service conducted a voluntary disclosure/amnesty program to collect tax owed by black marketeers who enjoyed illegal wartime profits. The program brought in \$500 million dollars. And from 1919, the Bureau of Internal

¹² Ibid.

Revenue had a voluntary disclosure policy by which immunity from criminal prosecution was routinely granted to noncompliers who voluntary disclosure the nature and amount of their tax liability. The programs officially ended in 1952.¹³ The program was corrupted by fraud and abuse. It was discontinued because it was deemed impossible to prevent its exploitation by racketeers.

The program failed because there were basic defects in its implementation. Individuals who consented to pay back taxes under an installment payment method were granted amnesty. It was unclear whether these individuals could later be prosecuted if they failed to make the installment payments. Also, there were no guidelines for eligibility in the program. Service officials applied the program according to local whims.¹⁴ A noncomplier who learned of a possible investigation, sometimes by leaked information, was able to thwart the investigation at any time merely by agreeing to participate in the amnesty. Records were backdated as needed to accomplish the amnesty.¹⁵

Alternatives to Tax Amnesty

A tax amnesty has been called a gamble in the national laboratory. However, there may be alternatives to raising revenue that may avoid some of the risk inherent in an amnesty program and yet achieve the desired goals.

One alternative is to increase the types of income subject to withholding. Amounts that are subject to withholding enjoy a 98% voluntary compliance rate.¹⁶

The Service has been forced to limit enforcement efforts in reaction to budgetary constraints. The aggregate examination coverage of income tax for individuals and corporations is as follows:¹⁷

¹³ Treasury Department Information Release S-2930 (1/10/52).

¹⁴ George Guttman "IRS Tax Amnesty", Tax Notes 1361 (3/26/84).

¹⁵ David R. Burton "The Tax Amnesty Issue Dictates Patience", Tax Notes 1369 (March 26, 1984).

¹⁶ George Guttman, "IRS Tax Amnesty", Tax Notes 1361, 3/26/84.

¹⁷ Internal Revenue Service Annual Reports, Table 7 and 8.

Year	1984	1985	1986	1987	1988	1989
Individuals	1.27	1.31	1.12	1.09	1.03	0.92
Corporations	2.66	2.39	2.25	1.58	1.33	2.02

The Service estimated that it was economically feasible to collect 28 billion of a 75 billion tax gap in 1981 if funds were provided for a fully effective enforcement program.¹⁸ Further, the Service returns \$14 in additional revenues for each dollar spent on enforcement efforts.¹⁹ The following yield-to-cost ratios are calculated by the Service Resource Allocation Model (ERAM) which is part of the budget decision making process of the Service. Using marginal analysis, the following yields have been computed for four major enforcement programs, Examination, Information Returns Matching Program (IRP), Delinquent Returns, and Accounts Receivable:²⁰

	Yield Billions	Yield to Cost Ratio	Marginal Cost to Yield Ratio
Examination	\$ 15.6	10.7	7.0
IRP	2.3	11.8	10.8
Delinquent Returns	4.9	28.4	26.9
Accounts Receivable	9.1	19.0	11.8
Total	\$ 31.9	\$ 13.9	N/A

Sufficient funding would also permit auditors to spend more time on each audit, enhancing the scope and quality of each audit. More computer matching initiatives could be launched such as cross checking state files for persons receiving business licenses to income is disclosed on the federal return.

Compliance 2000 envisions a system of "self-audits", and development of better systems to target for examination those returns having the highest probability of requiring attention in the program. This approach is also endorsed by the American Bar Association.²¹

Such initiatives are preferred alternatives to an amnesty program because they are compatible with the purposes of a federal tax system, maintain equity among taxpayers, and minimize the risk of adversely impacting voluntary compliance.

18 Internal Revenue Research Division, "Estimates of the Individual Tax Gap" (1985), as reported in American Bar Association, "Report and Recommendations on Taxpayer Compliance" 41 Tax Law 329, at 349 (1988).

19 Frank Malanga, "The Relationship Between IRS Enforcement and Tax Yield", National Tax Journal, Vol. 39 p. 333.

20 Frank Malanga, *Supra*.

21 American Bar Association, "Report and Recommendations on Taxpayer Compliance", 41 Tax Law.

Reasons for Low Voluntary Compliance

An amnesty is considered only when there is a perception that voluntary compliance is low, causing substantial amounts of revenue to escape the treasury. If voluntary compliance coupled with taxpayer outreach programs and a vigorous enforcement program are seen as inadequate mechanism to capture income, it then becomes desirable to justify taking risks to enhance tax collections. Therefore, it may be helpful to analyze reasons for low voluntary compliance.

Some reasons are:

- Economic reasons (Cheating on taxes is seen as getting something at a discount).
- The tax system is seen as unfair, therefore taxpayers have the right to correct the perceived inequities by cheating.
- It is unnecessarily burdensome to comply with the tax laws, which are too complex and constantly changing.
- There are moral defects in society.
- The governmental will merely waste our tax dollars anyway.
- There is a perception that enforcement of tax laws is ineffective.

Of these, the moral defects in a society may be the most compelling reason for low voluntary compliance.²⁵ Very few taxpayers report tax noncompliance even if known to them.

There is a general perception that the rich have access to avoidance schemes not available to the general public, and that, if caught, the penalties are less severe. Government handling of the banking crisis leading to losses of still uncounted millions is seen as an example of taxpayers forced to pay for the excesses of the rich and influential few in our society who go virtually unpunished. Other examples are the artful use of bankruptcy to avoid payment of taxes and penalties that may otherwise apply, and the use of off-shore financial institutions to shelter funds.

²⁵ American Bar Association, Commission on Taxpayer Compliance, "Report and Recommendations on Taxpayer Compliance", 41 Tax Law 329 (1988).

Parade Magazine on October 27, 1991, published a poll indicating that of the top ten issues facing the country, governmental misconduct and mismanagement is the second most critical issue. Only the faltering economy scored higher. The tax burden was number 6, with the explanation that downward mobility in America has been accompanied by upward taxes.²⁶

Americans now are expressing pessimism about government and even about the entire process that undergirds a democratic society. Seven in ten Americans think the country is off track. Seven in ten also believe the government is controlled by special interests, not by themselves, a view that was rejected by a similarly strong majority during the 1960s. Today, only three of ten believe that the government will do the right thing all or most of the time.²⁷

A Government Accounting Office (GAO) survey of 2,200 Service employees indicates that thirty four percent of those surveyed believed at least some upper-level managers engage in misconduct. Forty percent of those surveyed believe that at least some mid-level employees engage in misconduct, and forty seven percent believe staff personnel do so. Mr. Goldberg responded, in part, that "We will continue our efforts to ensure we treat taxpayers and our employees fairly and consistently In many respects, our job will never be finished".²⁸

However, every year millions of taxpayers, over 80%, do voluntarily comply with the tax laws, and determine themselves how much tax they owe. They are the great silent majority who honor their obligations as citizens in a democratic society. Tax related programs must be designed to nurture the behavior of the majority, and not detract from the commendable behavior of the U.S. taxpayer.

²⁶ Parade Magazine, "Intelligence Report" (October 27, 1991). The conclusions reported were made by the staff of Parade Magazine's Washington staff. The conclusions were the result on an analysis of topics raised in letters to the editor, radio talk shows, and Congressional mail.

²⁷ Washington Post, "A Tide of Pessimism and Political Powerlessness Rises", November 3, 1991, p. 1, col. 1.

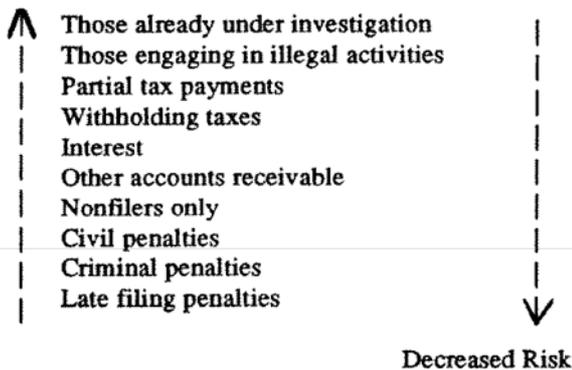
²⁸ Federal Times, "IRS Workers Vouch for Agency's Integrity" (August 5, 1991) p. 11.

Revenue Estimates from an Amnesty Program

One of the goals of an amnesty program is to raise revenue. Almost certainly, there will be an increase in revenue. However, there is a wide variation in estimates regarding the amount of revenues that may be raised by an amnesty program. Some tax specialists have determined amnesty will raise approximately \$1.2 billion²⁹, others have determined that amnesty will raise \$5 to \$10 billion.³⁰

Experience with state amnesty programs indicates that revenue will be maximized if all taxes and taxpayers are included in the program. However the risk to voluntary compliance increases as additional tiers become eligible for the program.

Increased Risk



²⁹ Estimate prepared by the Joint Committee on Taxation, reported in "Baucus Continues To Back Tax Amnesty; Skeptics Question Promise of IRS Expansion", Tax Notes 1207 March 24, 1986.

³⁰ George Guttman, "IRS Tax Amnesty", Tax Notes 1361, 3/26/84 and David Burton, "The Tax Amnesty Issue Dictates Patience", Tax Notes 1367 (3/26/84).

Before an amnesty program is defined, a marginal cost benefit analysis must be performed to weigh the revenue that may be generated by including additional types of tax in the amnesty program, against the possible risk to voluntary compliance and the resulting loss in revenue.

Conclusions

A federal tax amnesty is an effective tool that may be used by a tax system only under certain conditions. The conditions are:

- Taxpayers must be confident that the tax system is accomplishing the purposes of a tax system and that the government is ethical in conducting its operations.
 - Substantial revenues must be collected that would otherwise be lost.
 - The amnesty program must be effectively publicized.
 - Taxpayers must perceive a greater threat of being detected and punished in the post amnesty period.
5. The program must be perceived as a once-in-a-lifetime opportunity.

At this time, the above conditions are not satisfied to an extent justifying the expectation that a federal tax amnesty will be successful. And there are alternatives to amnesty that may achieve many of the goals of an amnesty program without the inherent risks to voluntary compliance.

However, the states' experience with amnesties indicate that with preparation, planning, and some old fashioned good luck, a successful federal amnesty program can be developed.