

## Forgiveness is Divine, But is it Good Tax Policy?



**Justin M. Ross**  
Assistant Professor  
School of Public and Environmental Affairs  
justross@indiana.edu

*The views expressed are solely those of the author and do not imply endorsement by Indiana University or the School of Public and Environmental Affairs.*

### Summary

Forgiving tax evaders and delinquents through sporadic offerings of “amnesty” has become an increasingly common practice among state governments in the U.S. Although these programs initially were part of important tax reforms, they have advanced in popularity in a misguided effort to serve as a panacea to revenue shortfalls. Tax amnesties can be good policy, however, if they can be reformed as permanent complements to the existing tax system.

### Introduction

The practice of forgiving tax evaders and delinquents has become an increasingly common feature of state government. A traditional tax amnesty program is one in which previously unknown taxpayers can reveal themselves to the authorities in exchange for a reduced punishment. The allure of tax amnesty programs is easily observed, in that they represent a potential windfall of cash and a stock of newly compliant taxpayers. The concern is that the programs are unfair to the honest taxpayers who have remained compliant on their own volition, and may well encourage future evasion on the expectation that, eventually, all will be forgiven. For this reason, amnesties are almost always marketed as a “one-time-only” event. Single offerings have proven difficult, however, as few states have been able to restrain themselves from engaging in polyamnesty, as they collectively executed 117 iterations between 1981 and 2011. Combined, they have recovered \$10.7 billion, with the median amnesty recovery yielding near \$28 million.

### Amnesty in the Beginning

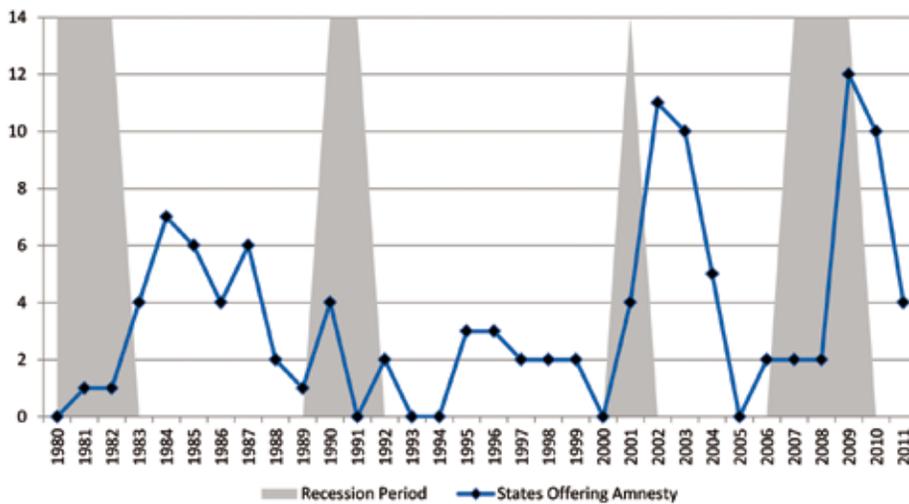
The details of the oldest known tax amnesty program dates to Egypt circa 200 B.C., and this program’s record remains one of the British Museum’s most famous attractions by virtue of its inscription upon the Rosetta Stone. Tax amnesty in the American states, however, did not begin until the 1980s, as can be seen in Figure 1. Observers in the early part of the decade were not particularly enthusiastic to see this use of tax amnesty, which many considered to be a “European” program, for countries with cultures of entrenched tax evasion. There was also concern that amnesty program recoveries would reveal that evading taxation is a much more successful enterprise than most people generally seem to believe.

By the latter half of the 1980s, several comprehensive studies of tax amnesty programs had emerged with the view of these programs as being integral components of broader reforms of the tax administrative system.<sup>1</sup> During this time

*Peer Reviewers:*  
*James Alm, Professor and Chair,*  
*Department of Economics, Tulane*  
*University; Russell Sobel, Visiting Scholar*  
*in Entrepreneurship, School of Business*  
*Administration, The Citadel; and*  
*Mehmet Tosun, Associate Professor,*  
*Department of Economics,*  
*University of Nevada, Reno*

<sup>1</sup> Studies include Mikesell (1986) and Parle and Hirlinger (1986).

**Figure 1. Number of State Amnesties by Year, 1980-2011**



Source: Mikesell and Ross (2012) and the National Bureau of Economic Research.

states made tax fraud a felony, increased the penalties and interest on delinquent liabilities, and often used the amnesty proceeds to invest in auditing personnel and computer systems for state revenue departments. The emphasis during this period was one whereby tax amnesties afforded a segue into an era of higher enforcement efforts and penalties by allowing those accustomed to the “old ways” to come clean with the state. A concurrent reduction in enforcement efforts by the federal government, via a reduced audit rate, meant states needed to invest in their own enforcement efforts to compensate.<sup>2</sup> Bundled with these efforts, administrators typically emphasized these amnesties to be a “one-time-only” event.

This emphasis on a higher post-“amnesty this time only” enforcement period seems to have been a well-advised counterbalance to the early concerns that rewarding tax evasion with amnesty would only encourage more evasion. In an experimental setting, subjects were randomly awarded incomes over multiple rounds, with each round ending in an opportunity to self-report income while knowing there existed some probability of a penalty that mimicked a tax audit. In trials where amnesty was offered half-way through the experiment, the share of self-reported income measurably declined, *except* in cases where the amnesty was bundled with a promise to never repeat and/or if penalty rates for detected evasion were increased. Although these experiments supported the possibility of amnesties working according to the intentions of state tax administrators, it is unclear whether or not state efforts in the real world have manifested similar responses among taxpayers. A comprehensive study of long-run tax revenue collections across states revealed

<sup>2</sup> See Durbin et al. (1992).

that the post-amnesty periods actually had *lower* revenue collections after executing an amnesty. Although the results do not settle the matter entirely, it is certainly not encouraging since the amnesties were presumably successful in the short-run in terms of returning delinquent taxpayers and discovering new ones.

### **One-Time-Only, Again (and Again and Again)**

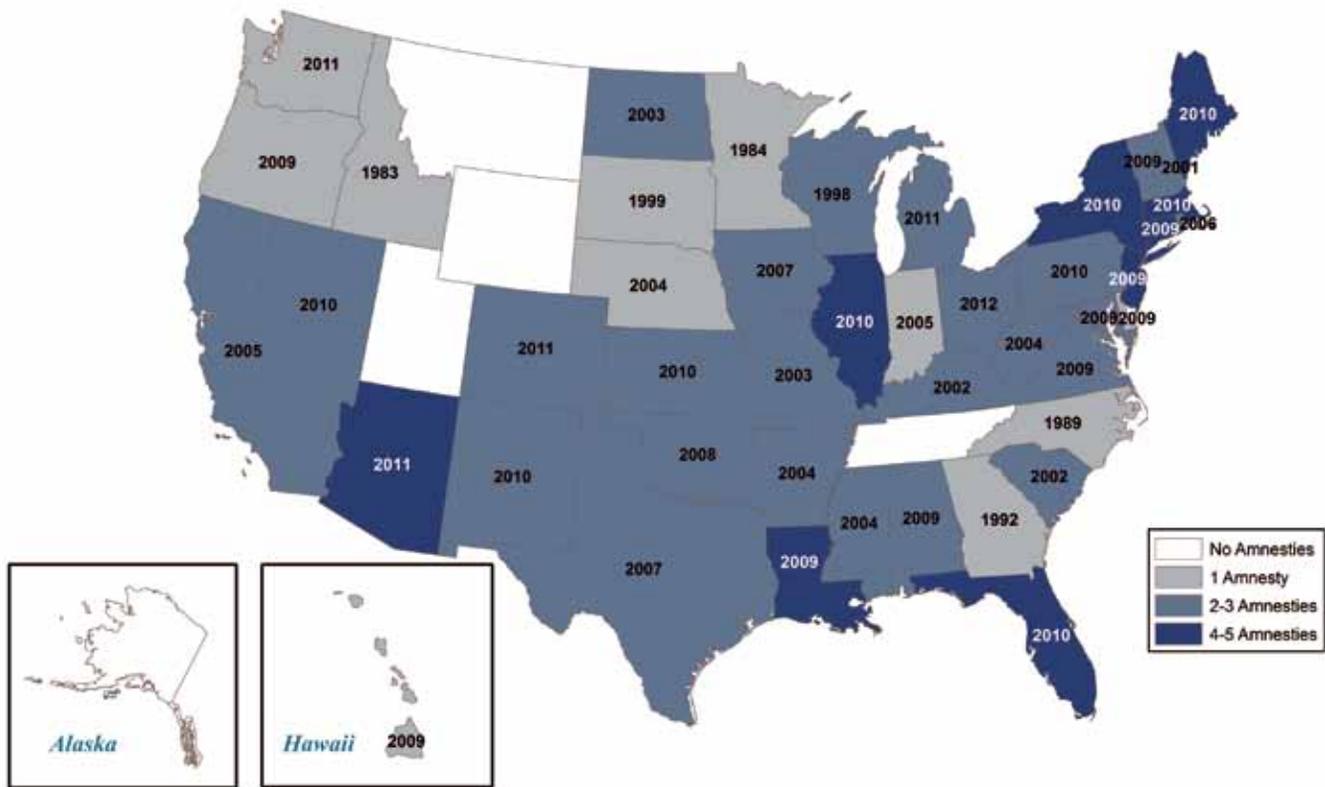
After the surge in the 1980s, amnesties mostly disappeared, with only a handful occurring in the 1990s. As can be seen in Figure 1, a renaissance of amnesty occurrences quickly followed the

tech-bubble recession that marked the beginning of the millennium decade, and another one at the book-end of the decade to accompany the Great Recession. By the 2000s, almost all of the amnesties were conducted in states that had offered at least one amnesty previously. In fact, there were more amnesty programs from 2000 to 2010 than there were American states. As Figure 2 demonstrates, of the 46 states (including DC) that have run an amnesty program, 35 have undertaken multiple offerings, with four states running as many as five iterations. If forgiveness “is not an occasional act” but “a constant attitude” as Martin Luther King Jr. suggested, then it would seem that state tax administrators have mastered this mantra under the banner of tax amnesty programs.

Most of the state level reforms of the 1980s and early-'90s had already picked what low-hanging fruit there was to be enjoyed in tax administrative reform (e.g., raising penalties and interest, reclassifying tax evasion as a felony rather than a misdemeanor), so any attempts at engaging in further reform would likely have exhausted diminishing returns. Combining the proximity of the amnesties to the recessions with the slim opportunities for reform would suggest that the focus of amnesties had shifted toward revenue recovery.

This view receives further support from a study of all state tax amnesty program features through 2011. The study concluded that the features of the most recent amnesty programs demonstrated an emphasis of amnesty purpose shifting toward revenue generation and acceleration. For example, only 26 of 58 programs studied in the 2000s were accompanied by any type of post-amnesty program, and just 14 of the programs actually demonstrated some interest in improving compliance. Furthermore, the 12 post-amnesty programs not emphasizing compliance actually included programs that attempted to increase recovery by targeting

**Figure 2: Year of Most Recent Tax Amnesty Program and Number of Amnesties by State**



selected currently eligible tax delinquents, rather than by aiming at a comprehensive emphasis for the population at large that would have represented broader interest in administrative reform. States also became more generous with their waivers of penalties and interest, likely because they had few other mechanisms for incentivizing participation.

Another example comes from the expansion of amnesty offers from “unknown” tax evaders to include “known” tax delinquents. While these “known” tax delinquents were eligible in less than half of the programs in the 1980s, 48 of the subsequent 66 programs since 2000 have made them eligible.

When it comes to factors that affect the total reported recovery, the above mentioned attributes are the ones most under the amnesty administrators’ control. Perhaps this is an acceptable strategy in periods of fiscal stress, but just how effective is an amnesty in helping states weather the storm?

### **Amnesty as a Revenue Generator**

Although amnesties almost universally conclude with celebratory headline-grabbing recovery levels, these gross recovery levels are probably unrepresentative of what the amnesty truly recovered. While amnesties have high absolute levels of collections, they rarely represent anything more than just a fraction of annual tax collections. On average, an amnesty recovers just 0.70 percent of the tax revenue collected in the previous year. The largest amnesty recovery on record is

the 2009 program in New Jersey, which yielded \$725 million, but even this abnormally large recovery represented just 2.7 percent of the state’s tax collections in the previous year. Even the most “successful” amnesty programs are unlikely to resolve any serious fiscal issues confronting the state, especially if the stress is a result of fundamental structural problems.

The true net recovery of an amnesty would represent a figure that excludes revenue that would be collected in the absence of the amnesty as well as program administration costs. Although program administration costs are likely small, they are usually underestimated by states.<sup>3</sup> Oftentimes states report the program costs as zero, but this simply means that there was no special appropriation in the budget for the amnesty program. Amnesty program costs ideally would be measured to include both new expenses incurred to execute the program, as well as the forgone value of resources (such as personnel) that were redirected to the amnesty program in lieu of their regular duties. Another cost that goes unaccounted for is the forgone collection of penalties and interest waived *in excess* of what was necessary to induce taxpayer participation. Although this cost is not easily estimable, it certainly exists and implies that recoveries are not as large as they are reported.

<sup>3</sup> See Parle and Hirlinger (1986) and Mikesell (1986) for estimates of amnesty administration cost.

Of more concern than the underreporting of program costs is the overstatement of revenues collected and attributed to the amnesty. Amnesties have the highest true revenue potential to the state when they incentivize the self-reporting of otherwise-unknown taxpayers. As described previously, states have increasingly declared “known” delinquent taxpayers who have entered into accounts receivable to be eligible for amnesty. Since states have a large arsenal of methods for collecting delinquent taxpayers on accounts receivable, it is likely the state could recoup its funds from anyone capable of participating in amnesty. Research has repeatedly shown this eligibility of known delinquents to be the most significant defining feature of the largest amnesty recoveries. As a result, taxpayers in accounts receivable who are granted amnesty represent “soft” revenues that likely would be recovered eventually without the amnesty, and likely represent a loss to the state given that they forgive penalties and interest.

Some of the recoveries are also likely just representative of a shift in the timing of some tax payments. For example, one study estimated that about 12 to 17 percent of an average amnesty’s tax revenues are “strategically delayed” payments. In other words, after tax amnesties are authorized and marketing to the public begins, some taxpayers become temporarily delinquent – holding onto their money until the amnesty is put into action, effectively treating the state as a short-term loan officer.

Finally, amnesties appear to carry no positive long-run return in the form of higher tax revenue collections. In fact, the best existing empirical research has found the long-term revenue worsened with each repeated offering of amnesty. As such, the best available evidence suggests that amnesties are lousy revenue generators. The most favorable interpretation of the empirical evidence is that they provide a very nominal short-run boost with no long-run benefit, and at worst they provide almost no short-run boost with some long-run compliance problems.

## Can Amnesty Be Good Policy?

The amnesty programs described thus far are temporary special deals offered on a sporadic basis. By so doing, states tend to undermine their own tax collection system at arbitrary

points in time. Many states have adopted a separate amnesty program that operates on a permanent basis, more popularly known as a “voluntary disclosure program.” From an efficiency perspective, this program generates some benefits in that it provides all households the option to delay a tax payment (increasing current consumption) in exchange for paying a slightly higher tax bill that includes penalties in the future. Thus, without increasing administrative efforts, the permanent amnesty can increase tax revenue collections and give households greater flexibility in the timing of their consumption without requiring administrative investments to offset “this-time-only” compliance deviations.<sup>4</sup> In fact, one might argue that this type of amnesty program is a form of social insurance, where those fearful of some immediate income shock might evade as a hedge against this risk.

## Summary and Conclusions

Once a segue to improving tax compliance and administration, recent fiscal stress in state budgets has caused policymakers to turn to sporadic offerings of tax amnesty to boost their coffers without raising taxes. Most of these revenue recoveries, however, have been illusionary and likely result in further long-run revenue losses – and often come at the expense of compromising the existing enforcement efforts. A more efficient and equitable approach would be to institute a permanent program for forgiving tax delinquents that complements existing administrative systems.

## Suggestions for Further Reading

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<sup>4</sup> The example provided here is a simplified version of the model provided by Andreoni (1991).