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AMNESTY FOR STATE TAX EVADERS: LESSONS FROM THE CALIFORNIA EXPERIENCE*

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I. Introduction

Following the favorable response to the Massachusetts Tax Amnesty Program, a significant number of states have offered their own versions of amnesty. Each state has usually produced one or more reports reviewing its program and summarizing the results. More recently, several surveys [7,8] have compared the various characteristics of the different amnesty programs.

From these and other analyses of amnesty some general conclusions have emerged. One is that the primary motivations for offering amnesty appears to have been 1) to raise revenue in the short run both by collecting taxes that otherwise would not have been paid and by accelerating the collection of receivables, 2) to raise revenue in the long run by getting new taxpayers onto the tax rolls and keeping them there, 3) to serve as a politically acceptable way of moving toward stronger enforcement, and 4) to obtain information that could be used to improve overall tax compliance. While debate continues over the probable success of amnesty programs in generating revenues, there seems to be general agreement that the latter two objectives should be attainable.

A review of amnesty program summaries suggests that, at least on paper, the stronger enforcement objectives have already been met. Many states have increased penalties, added resources to the compliance function, and/or introduced new reporting requirements. However, time must pass and follow-up studies must be conducted before the full effects of these reforms are known.

Progress toward obtaining information to improve the compliance effort has been slower. One reason is that detailed data on amnesty participants have not been generally available. Confidentiality and legal restrictions are partly responsible. However, it also appears that tax administrators in some states have been unable or unwilling to provide data to outside analysts. In fact, some states have destroyed all detailed records pertaining to their amnesty filers. Fortunately, this is beginning to change, as several states have generated carefully designed samples from the data in their amnesty files, and are making them available for further research.

In this paper, we provide information pertinent to the compliance effort by conducting a descriptive analysis of a sample of participants in the California Tax Amnesty Program. In contrast to other studies, we concentrate on those filing amended tax returns under amnesty rather than the participants who had

not previously filed. We uncover several patterns in the data which we believe may be of use in improving compliance. In the process, we offer some suggestions for effective administration of an amnesty program which may be of interest to those who may be considering the introduction of amnesty.

II. BACKGROUND

Since California usually has been included in the various comparative survey articles on state tax amnesty programs, there is no need to repeat those comparisons. Rather, a brief review of some of the primary characteristics of the programs should be sufficient.

The California Tax Amnesty Program ran over the ninety days from December 10, 1984 to March 15, 1985. It was narrower in scope than many programs since it applied only to the personal income and the sales and use taxes. Yet within this scope it was very broadly structured. Those eligible for amnesty included individuals who, for 1983 or an earlier tax year, had failed to file returns, had filed inaccurate returns, or were delinquent in paying their tax liabilities. Thus, California allowed taxpayers on its current accounts receivable to participate. In fact, special notices were sent to these individuals encouraging them to file under amnesty. On the other hand, amnesty was not available to those already subject to criminal investigation.

Under the amnesty provisions qualified participants were forgiven unpaid penalties and criminal prosecution. However, accrued taxes and interest charges were not dismissed. These terms were sufficiently attractive that over 145,000 amnesty returns were filed by 85,701 separate taxpayers. In total, the program generated $154 million in gross revenue. This is well above the experience of most other states. Of course, much of this can be attributed to the size of California's population and the fact that accounts receivable collections were included. Nevertheless, according to California Tax Franchise Board (CTFB), amnesty produced $34.5 million more revenue than would have been collected through traditional enforcement programs.[1]

Revenue generation was only one objective of the amnesty program, however. The program "was also expected to provide valuable information on characteristics of tax evaders and the methods used to evade taxes." ([2], p. 5). Toward this end, the CTFB selected a stratified random sample of 1,204 amnesty returns covering the tax years 1981–1983. Of these, 1,018 were by individuals who had not filed an income tax return in the year for which they claimed amnesty, and 186 were by those who amended their original returns under the program. The data set also included relevant information taken from the original returns of those taxpayers who filed an amended return.

In creating this sample, the CTFB excluded returns filed by individuals who were either already known to the CTFB or would have been detected through normal enforcement procedures. To ascertain the characteristics of these individuals, the CTFB commissioned Sheffrin [9] to conduct a descriptive study of these data. In doing so, Sheffrin developed profiles of three separate groups of individuals: the nonfilers for whom the CTFB had no records; the nonfilers for whom there were records in some year other than the year for which they claimed amnesty; and those individuals who amended their state tax returns under the program.

Because amnesty participants were primarily nonfilers, Sheffrin devoted most of his attention to these individuals. One of his most interesting findings was that there appeared to be a noticeable difference between the two types of nonfilers. The first group, those for whom no records existed, possessed charcteristics generally representative of the California taxpaying population. In contrast, the profile of the second group was more consistent with the Internal Revenue Service's view that nonfilers are typically low income individuals with limited education. Sheffrin also noted that the third group of taxpayers, those filing an amended return, tended to have higher levels of income relative to the State's population.

Upon completion of Sheffrin's study, the CTFB furnished us with the same data set. To date, we have focused our attention primarily on the data for amended return filers. This may seem unusual given that this group represents only 4 percent of the amnesty returns and only 15 percent of the net revenue generated. We believe there are several reasons for focusing on the amended returns, however. First, part of the compliance effort involves selecting returns for audits, which by definition means choosing among returns that have been filed. Thus, any information that can be obtained about individuals who file inaccurate returns may be of use in devising auditing selection rules. Second, these amended return filers can be used as a new source of data for conducting econometric analysis which can complement existing theoretical work on income tax evasion. In what follows, we present what we believe are interesting descriptive statistics which profile the nonfilers and briefly summarize the findings of our previous econometric work using these data.

III. ANALYSIS OF AMENDED RETURNS

Prior to conducting any analysis, we carefully reviewed the data on the original and amended returns for the 186 amended return filers in the CTFB sample. Our objectives were to check the internal con-

sistency of the data and to establish that these individuals could reasonably be viewed as evaders. The primary step in this review was recalculating the tax bill on both the original and amended returns of each individual in the sample. In the process, we detected a number of problems. These included missing data, obvious taxpayer or data entry errors, and data inconsistencies which prevented duplication of the tax calculations. We also encountered a few cases where there was no change or a drop in total tax liability, which suggested that the individuals in question may not have been evaders.

Observations with one or more of these problems were removed from our sample, so that our sample was limited to 123 amended return filers. We see no reason to suspect these omissions bias the sample. In fact, if anything, removing these "problem observations" should improve the accuracy of the profiles and improve the efficiency of any subsequent econometric estimators.

A. Descriptive Profile

We use two approaches to profile the amended return filers. First we compare average figures from the original returns of the amnesty participants with the corresponding figures for California taxpayers as a whole. The objective is to check for unusual values that might serve as identifying characteristics. Next, we compare the amended returns with the original returns. This is done to determine the relative magnitude of noncompliance, and to get some indication of the form it took. We also compare the average figures on the amended returns with the corresponding averages for California as a whole. All of the relevant figures are provided in Table 1.

We begin with the comparisons of the average figures on the original returns of the amnesty filers to those of the returns of all California taxpayers. We use 1983 data for all taxpayers as our benchmark.[2] The first thing that is apparent is that amended filers do have much higher average incomes.[3] In fact, they originally reported almost twice the Total and Adjusted Gross Income, and even more Taxable Income than the taxpaying population as a whole. Part of this may be due to the greater percentage of joint returns in the amnesty sample. But this higher income pattern holds even when filing status is taken into account.

The higher income on the amnesty returns came from various sources, most of which exceeded

TABLE 1
AVERAGE TAX RETURN FIGURES: AMNESTY RETURNS vs ALL CALIFORNIA

	All 1983 California Returns	Amended Return Amnesty Filers		
		Original Return	Amended Return	Amount of Misstatement
A. Summary Tax Calculations				
Total Income	22788	45434	48705	3271
Adjustments	481	1192	454	738
AGI[1]	22306	44242	48251	4010
Deductions	5313	4005	3749	256
Taxable Income	17246	40237	44503	4266
Net Tax	864	2278	2693	415
Tax Liability[2]	769	2590	2933	343
B. Selected Sources of Income				
Wages	17972	30690	n/a	n/a
Interest	1776	4246	n/a	n/a
Dividend	588	1010	n/a	n/a
Net Business	836	420	n/a	n/a
Net Capital Gains	950	7526	n/a	n/a
Net Pensions	815	2247	n/a	n/a
Net Rents	−204	−1221	n/a	n/a
Net Other Income	237	48	n/a	n/a
C. Selected Other Characteristics				
% Itemized Ded.	39	54	39	n/a
% Standard Ded.	61	46	61	n/a
% Single Filers	43	28	43	n/a
% Joint Filers	45	66	45	n/a
% Schedule C	14	14	14	n/a

[1]Includes negative incomes, causing a discrepancy with Taxable Income
[2]Net of Additional Taxes and Credits

the California averages. This was particularly true of the interest, capital gain, and pension income categories. On the other hand, amnesty filers originally reported less net business income and "other" income, and greater rental losses.

Several other interesting observations can be made as well. For example, the amnesty filers tended to claim considerably more adjustments in moving from Total Income to AGI. On the other hand, their average deductions are well below the state averages. This occurs despite the fact that a much greater percentage of the amended filers claimed itemized deductions. Somewhat surprisingly, the percentage of Schedule C filers (i.e., those with business income) in the amnesty sample is in line with that population as a whole.

Next we compared the original amnesty returns with the amended returns. Assuming the amended returns represent the "truth," the difference between values reported on these two returns indicates the extent of evasion. Since evasion can take place in a number of ways, we make several comparisons.

Perhaps most interesting is the comparison of the tax liabilities. This is not only the broadest measure in that it reflects all types of evasion, but it is also indicative of the direct revenue loss due to noncompliance. In our sample, the average tax liability was understated by $343. This is about 12 percent of the true tax bill and over 40 percent of the average overall state tax liability.

The sources of tax underpayment can be identified by calculating several income-based evasion measures. We do this by comparing the Total, Adjusted Gross, and Taxable Income figures on the original and amended returns. From the figures in Table 1 it is clear that the majority of the underpayment is due to the fact that true total income was understated by an average of $3,271 or 10 percent. This represents pure underreporting of income. Comparing the AGI and Taxable Income figures means adding in overstatement of adjustments and deductions, respectively. Clearly, after pure income underreporting, the next most important form of noncompliance was the overstatement of adjustments by an average of $738. The much smaller average overstatement of deductions accounts for most of the remainder of the noncompliance.

This pattern also emerges from a comparison of the amended returns to all California returns. Of course, income reported on amended returns exceeds that on original returns. Thus the amended figures exceed the benchmark values by an even greater amount. By the same reasoning, the deductions on the amended returns are even lower relative to the benchmark values than were those on the original returns. On the other hand, the adjustments figures are now in line with the benchmark rather than overstated, suggesting that high income levels and large adjustments may be good flags for audit purposes.

Given these patterns, we explored the nature of the noncompliance behavior in a bit more detail. We first tallied the individuals who underreported income as opposed to overstating adjustments or deductions. These are shown in Part A of Table 2. This tally indicates that people tended to evade by using only one general approach, and that by far the most popular approach was underreporting of true total income. Indeed, over 50 percent of our sample used pure income underreporting as the sole type of noncompliance. A little more than 34 percent of the other filers made use of overstatements of adjustments alone. In contrast, less than 2 percent overstated only their deductions and less than 14 percent evaded in some combination of these approaches.

To investigate this further, we examined the self-reported descriptions of the misstatements on the original return. A summary is provided in Parts B and C of Table 2. Based on these responses we found that, for those who gave reasons, on average, 1.1 detailed items had been misstated. In fact, over 80% reported only one type of detailed activity and almost 14 percent misstated only two items. Among the most frequently cited forms of understated income were: wages, other interest income, other income, and capital gains. The most popular deductions overstated were the medical and dental category.

To see if any of this noncompliance was likely to have been detected in the absence of an amnesty program, we asked the CTFB to give us an idea of the likelihood of audit under normal procedures. The Board did this by categorizing each return in the sample as having had a high, medium, or low probability of audit, based upon the information on the original return and the audit selection criteria in use at the time of filing. This exercise indicated that two thirds of the sample had a low probability of audit, 31 percent had a medium chance, and only 2 percent had a relatively high probability of being audited. While this may be due to the fact that audit rates in general were quite low, it does suggest that, in addition to the net new revenue which was produced, the amnesty program has also generated some new information on the activities of those evaders who file inaccurate returns.

B. Econometric Analysis

Elsewhere [6] we present econometric analysis using these data. Our objectives were to demonstrate how amnesty data could be used for empirical analysis of tax evasion, and to provide insight into the nature of the relationship between evasion and tax rates. Details such as the theoretical underpinnings of our model and the advantages and disadvantages of our evasion measures can be found in that paper. Here we summarize the major findings.

TABLE 2
APPROACHES TO EVASION

Item	Number Reporting
A. Broad Categories	
Income Underreporting Only	62
Overstated Adjustments Only	42
Overstated Deductions Only	2
Misstated Income & Deductions	8
Misstated Adjustments & Deductions	7
All Items Misstated	2
B. Detailed Income Categories	
Other Interest Income	29
Other Income	27
Wages	14
Capital Gains	9
Dividends	6
Pensions	4
Partnerships	4
Rents	3
Tips	1
C. Detailed Deduction & Credit Categories	
Medical/Dental	7
Other	2
Contributions	2
Other Deductions	2
Interest	1
Other Credits	34

The econometric work involved multiple regression analysis in which four measures of evasion were each regressed on the level of true income and the marginal tax rate, along with controls for such factors as the probability of detection, occupation, and marital status. The evasion measures were calculated by taking the difference between 1) the tax liabilities, 2) Taxable Income, 3) Adjusted Gross Income, and 4) Total Income as reported on the original and amended returns. True income was taken to be the total income figure on the amended return, and the marginal tax rate was determined using the Taxable Income on that return and the appropriate tax table. Based on the comparative static results of standard theoretical evasion models, we expected income to have a statistically significant positive effect on evasion, while the sign for the tax rate, was a priori indeterminate.[4]

The regression results indicated that income has the expected positive effect on evasion, a result consistent with previous empirical evasion studies using other sources of data. This also offers some support for the popular use of income as a factor in making audit selections. Perhaps of more interest is the fact that the marginal tax rate variable was positively and statistically significantly related to evasion in all four equations.

We find the positive link between evasion and marginal tax rates quite interesting. It is consistent with an important previous empirical finding [4], and it is intuitively appealing. Most casual observers expect higher tax rates to lead to increased evasion. In addition, the positive link is consistent with the usual microtheoretic prediction that the substitution effect of a relative price change normally outweighs the income effect. Our finding does run counter to a view held within the IRS, however [5].

To determine the relative magnitude of the effects of income and tax rates on evasion, we converted the corresponding parameter estimates into elasticities using mean values. This revealed a notable difference. The various measures of evasion proved to be more responsive to changes in marginal tax rates than to changes in true income. In fact, the tax rate response was consistently elastic, ranging from 1.31 to 2.25, while the income elasticities were between 0.19 and 0.28, which is well in the inelastic range.

The finding that income tax evasion is sensitive to marginal tax rate changes has implications for budget and compliance policy. From a budgetary perspective, this result provides some support for the "supply-side" argument that cutting marginal tax rates can be partially self-funding in that it will induce some income hidden in the "underground" economy to become part of the tax base. From a compliance perspective, the positive link between tax rates and evasion suggests that enforcement efforts may need to be adjusted as tax rates are altered by the legislatures.

IV. SOME LESSONS

We conclude by suggesting some possible lessons which may be learned from our work with the California Tax Amnesty Data. These include insights into evasion activity, issues to consider in improving compliance policy, and suggestions for administering an amnesty program. We note, however, that some of these observations have been made previously by Sheffrin [9].

First, Sheffrin's analysis of nonfilers tends to confirm several widely held beliefs about evasion. For example, there is evidence that some nonfilers are low income individuals who drift in and out of the system. There is also evidence that the self-employed are likely to be involved. Yet there are also a few surprises. For example, wage, interest, and dividend income figured prominently on the amnesty returns. In addition, many nonfilers had significant incomes and had filed returns in previous years. This suggests that states already have some information at their disposal which could be used more effectively to track down this group of evaders.

Some of these insights are confirmed by our analysis of the amended return filers. For example, a significant amount of evasion took place on filed tax returns, and that this was usually done by misstating one item. The most common item was true income, although significant overstatements of adjustments also occurred. As with the nonfilers, wages and interest income was frequently a part of the noncompliance. We also found evidence that evasion was responsive to changes in marginal tax rates.

These findings lead to several suggestions for improving compliance efforts. Most obvious is that a careful matching of tax return figures with the information provided by banks, employers, etc., would be a worthwhile undertaking. Further, given the number of nonfilers who had filed in a previous year, a careful follow-up on individuals that apparently drop out of the system would be warranted.

Analysis of the amended filers indicates that several return characteristics may be useful in identifying returns containing inaccurate information. In particular, returns with high total income and adjustments, unusually large interest, capital gains, and pension income, and/or low business or "other" income would seem to be good candidates for an audit. Of course, more analysis is needed to determine the effectiveness of these items in flagging noncompliant returns.

From an administrative perspective, the California experience suggests that short-run net new revenue can be generated from a carefully designed and well-publicized amnesty program. A strong publicity effort appears to be critical for revenue generation. The experiences of other states which had more limited promotional expenditures were much less favorable.

As for achieving success in obtaining useful information for compliance purposes, it is clear that advance planning and adequate resources are needed. There is the potential for a good deal of information to be obtained. But this requires thought as to what information is to be requested on amnesty returns, as well as to what supplemental figures should be collected from the original returns. It also requires that there be sufficient funding and staff so that the returns can be accurately processed, and that the amnesty returns be isolated for subsequent analysis (if this is legally permissible).

California appears to be one of few states which have taken this approach. Conversations with authorities from other states led us to believe that some could not have created a useful amnesty data set even if they were legally permitted to and were interested in doing so. In our opinion, it is truly unfortunate that some potentially useful information has been lost.

A final administrative recommendation is that amnesty returns should be as detailed as possible. The "other" category appeared a bit too frequently in our tallies. In particular, we found other income, other interest income, and other credits to be important sources of noncompliance. A related matter is that care should be taken to be sure the forms are filled out completely and the data transcribed correctly to machine-readable form. We found that missing information, inconsistent information, and data entry errors greatly complicated the task of extracting useful information from the data.

As a final thought, we would like to offer several suggestions for further research in this area. The most obvious is to replicate this type of descriptive and econometric analysis for other states in order to see if similar patterns are obtained. Another potentially informative activity would be to carefully match state amnesty returns with the associated federal returns. The IRS is convinced that there is little new information for them in the state amnesty programs. However, we believe this view is premature in that it is based on a review of only three of the earlier programs. In any case, even if the IRS view is substantiated, such a finding would offer the states some evidence that the matching of federal and state returns could be a productive approach to detecting noncompliance at the state level.

FOOTNOTES

[1]The cost of administering and publicizing the program was $5.8 million. Thus amnesty generated almost $6 of new revenue that would not otherwise have been collected for every dollar spent. Of course, this should be compared with the marginal return to increases in traditional enforcement procedures to determine if amnesty is a preferable approach to improved compliance.

[2]These patterns generally follow for year-by-year comparisons as well.

[3]These mean figures may be biased upward somewhat for several reasons. First, there is substantial variation in the sample, with several large observations. Using medians produces similar results, but the differences are not nearly as large. Second, the benchmark averages are based on all returns filed. It might be preferable to use taxable returns only. Once again, this causes the difference in average income between the amended filers and the benchmark to be smaller, but once again this does not alter the basic conclusion.

[4]Theoretical models are ambiguous because a change in the tax rate produces an income and a substitution effect which may oppose one another. The outcome depends on the nature of risk aversion and the relative magnitudes of the two effects. For details see Allingham and Sandmo [1] and Yitzhaki [10].

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PARTICIPATION IN STATE TAX AMNESTIES: THE CASE OF BUSINESS TAXES*

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I. INTRODUCTION

At least one tax collected directly from businesses has been eligible in nearly every state tax amnesty program, and those taxes, especially sales and corporate income taxes, have accounted for a substantial amount of amnesty collections. Most of the discussion and research about tax amnesty, and tax evasion for that matter, has focused on individuals, although there are several reasons to believe that business participation in an amnesty might be fundamentally different than for individuals. Therefore, we report in this paper the results of a detailed study of business taxpayer participation in the Michigan amnesty