A STUDY ON THE ROLE OF TAX AMNESTIES IN PERSONAL INCOME TAX COMPLIANCE IN SRI LANKA

By

R.M.Jayasinghe

THESIS

Submitted to
KDI School of Public Policy and Management
in partial fulfillment of the requirements
for the degree of

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Committee in charge:

Professor Younguck KANG, Supervisor ______

Professor Lee, Kun-Ho Kun-Ho Lee

Professor Jinsoo LEE Lee Jinsoo

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ABSTRACT

A STUDY ON THE ROLE OF TAX AMNESTIES IN PERSONAL INCOME TAX COMPLIANCE IN SRI LANKA

By

R.M.Jayasinghe

Tax compliance is a vital requirement for a tax system, since it assists and decisively determines success of the other functions of tax administration: assessment and collection. A wide range of different measures to facilitate and enforce compliance are implemented by tax administrations around the world. In Sri Lanka, for achieving this objective, more emphasis has been placed on punitive measures. In addition, tax amnesties have frequently been introduced as to allow wrong-doers to reveal their evasions without being subjected to tax liabilities, penalties and prosecutions. But still compliance is not satisfactory and paves the way for mass-scale evasions, in government's view. However, impact of tax amnesties on personal income tax compliance in Sri Lanka have not yet been studied, even amongst declaration of frequent amnesties. In this context, by using pre and post amnesty movements of tax revenue and number of files, this thesis attempts to fill that vacuum by checking the role played by tax amnesties in compliance enhancement. Emphasizing on tax amnesties granted in 2003 and 2009, it tries to establish impact of amnesties on compliance within the prevailing situation of tax system of Sri Lanka. Results of this study suggest that these amnesties do not seem to have effectively increased number of personal income taxpayers, tax revenue and thus short-run compliance of personal income tax within the status quo of Sri Lankan tax system.

Dedicated to all my teachers

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TABLE OF CONTENTS

LIST OF TABLES

CHAPTER ONE

INTRODUCTION

Public finance addresses both directly and indirectly the question of enhancing living standard of the public. Payouts of many governments consist of recurring expenditure in the caliber of education, health, welfare, security, maintenance of legal system etc. On the other hand, the governments are supposed to provide and maintain infrastructure for smooth functioning of the economy. Hence, a colossal sum of capital expenditure has to be incurred on non profit making projects and activities that do not attract investments from private sector organizations.

The major share of the government revenue, the other side of the equation, usually comes through numerous taxes, whether it is a developed or developing country. Generating revenue to finance the Government’s unavoidable or must do endeavors has become immensely necessary. The tax system of a country must be designed to collect the taxes in the most efficient and equitable way possible. In developing countries with emerging markets, especially in those that aim at becoming integrated with the international economy, tax policy must play a particularly sensitive role. This situation is common to Sri Lanka, which is facing budget deficit as a result of inadequate revenue streams. The overall budget deficit has been approximately 10% of the GDP for the last few years and it has been financed through both foreign and domestic means.

In Sri Lanka, tax revenue as a percentage of total revenue of the government was 89.37% and 88.08% in 2008 and 2009 respectively. Inland Revenue Department (IRD) which administers mainly income tax (IT) and value added tax (VAT) collected Sri Lankan Rupees 441.65 billion, which was 62.86% of the total government revenue in 2009. Income tax (both corporate income tax and personal income tax) contributed to Rs 139.55 billion being 31.59 % of the total collection of the IRD. Individual income tax (mostly referred as personal income tax in Sri Lanka) was responsible for Rs 65.32 billion in 2009. This amount, as seen by expert analysts, could have been more, had it been brought the potential revenue that might have been deprived by low compliance to the tax law by Sri Lankan citizens. Weak compliance is undoubtedly a reason to undermine tax revenue in Sri Lanka.

Prosecution and imposition of penalties on offenders especially those who do not submit annual tax declarations have been widely used for countering weak-compliance problem in Sri Lanka. The other measures include auditing, investigations, collection of tax at source (withholding tax), gathering information, field surveys and maintenance of taxpayer assistance centre etcetera. In addition, several *tax amnesties* have also been declared from time to time to enhance compliance. These amnesties have been used when other compliance enhancing measures fail to deliver the goods.

Although tax amnesties are not recommended to be introduced repeatedly by many writers, who have researched on them, some countries are having a practice of declaring repeated amnesties.[1] Confirming this scenario, Sri Lanka has employed 10 tax amnesties staring from 1964, whilst the latest was in 2009. The government seems to rate tax amnesties as better compliance enhancing equipment.

A typical tax amnesty is an opportunity for tax paying citizens to pay their taxes without penalty. The objective of introducing tax amnesty is to increase short term revenue. Thus under most of the amnesties, pardon is granted for penalty amounts. It means the tax defaulters are allowed to pay the past taxes without penalty before a specified date. But Sri Lankan experience on this aspect is rare as full immunity has been granted under all recent amnesties, without collecting any back taxes. They were focused to attract new tax payers to the tax net and to draw current tax payers' undisclosed sources of income to the tax net as well. Government's final aim was to enhance the tax payers' compliance and, thereby,

[1] The governments of many countries including Argentina. Chile, Bolivia, Peru, Mexico, India , Pakistan and the Philippines have also introduced several amnesties.

increase the Govermnment revenue. The amnesties of 2003 and 2009 provided forgiveness and exoneration for past dues concerning income tax whilst non-implementation of investigations and prosecution provisions of the tax statute was guaranteed.

Adequate studies as to ascertain the effectiveness of tax amnesties on income tax compliance in Sri Lanka, i.e. whether amnesties have enhanced compliance or not within the status quo of the tax system, have not been carried out as yet. Hence, my intension of this research is to try and fill this vacuum which will be helpful for arriving at recommendation for vital policy and strategic requirements for bettering the situation from its status quo.

This study aims and revolves around establishing effects of amnesties on income tax compliance in Sri Lanka. Short-run effects of 2003 and 2009 amnesties will be analyzed in the following ways[2].

- ❖ As the first objective, the personal income tax compliance of post amnesty period is checked in comparison to pre amnesty period and assess whether the amnesties seem to have enhanced compliance within the prevailing situation of the tax system. The pre and post amnesty figures of number of personal income tax files and revenue are analyzed for this purpose.
- ❖ Secondly, if the objective of the amnesties have not been achieved (i.e. income tax compliance has not been increased) I try to identify the actual circumstances behind such failures depending on the theoretical matters reviewed , and
- ❖ Lastly, to recommend necessary policy changes and specific strategies with measures for tax system and administration to enhance compliance, in the light of theoretical review and empirical results.

[2] Most of the amnesties introduced prior to 2003 did not attract tax dodges and only a few declarations received in many cases. No declaration was requested under the amnesty in 2008 but non filers were asked to get the tax files opened in the Department of Inland Revenue without paying past taxes . Details of performances are rare to be found in cases of these amnesties.

CHAPTER TWO

Issues Relating to Income Tax Compliance and Tax Amnesties

– A Theoretical Framework

A. Income Tax Compliance:-

Income tax compliance simply means “the payment of income taxes as required by the legislation”. American Bar Association (1987) defines *Income Tax Compliance* as “the timely filing and reporting of required tax information, the correct self assessment of taxes owed and the timely payment of those taxes without enforcement action”. Mere submission of income tax return does not fit for the whole requirements. Disclosing of correct income and in-time payments are also important. The primary function of tax administration would appear to be monitoring compliance and apply the sanctions prescribed in the statute against the offenders as pointed out by Bagchi, Bird and Das- Gupta (1994). If income tax compliance continues to be unsatisfactory, the major functions of tax administration- scrutinizing of tax returns, assessments & collections- are delayed and tend to lack momentum jeopardizing the government coffer.

Non compliance of income tax brings detrimental consequences to the economies by reducing the government revenue and, thereby, increasing government debts. Non compliance of income tax affects the government revenue in various ways.

- Non compliers do not pay the taxes to the government and it directly reduces the potential revenue of the government.
- Law-abiding taxpayers’ dissatisfy as to why they should pay tax, while others do not pay the taxes on their actual income. This feeling of discourage among the citizens creates tax evasion and it decreases the government revenue in the long run.

- When existing taxpayers are not compliant in providing correct information, it is difficult for the tax administration to know about their transactions with other parties and thus new taxpayers including those who engage in economic activities that do not come to the surface cannot be identified and taxed. This minimizes the government revenue.

Economic growth of a country is considerably affected by its citizens' tax compliance behavior. Serra (2003) points out that improving tax compliance, due to various programmes to increase enforcement and taxpayer services, had been responsible for rapid economic growth in Chile during 1990s.

Most tax administrations around the world adopt combined mechanisms of both facilitating approach and confronting approach to enhance tax compliance. Taxpayer services with consulting, guidance and tax education etc are provided in the former, whilst tax enforcement by way of investigations, imposition of penalties, prosecution is committed in the latter. Measures such as gathering of information and withholding tax etcetera are also used to enhance compliance as additional features of the latter.

Despite these measures a majority of taxpayers in developing countries, is reluctant to pay their taxes, especially direct taxes in the caliber of income tax since it reduces resources and economic vigor of the tax payers. This feeling of a taxpayer is inspired from various political, economic and social reasons. Moreover, level of compliance varies from country to country, time to time and among various taxes, depending on contexts including effectiveness of efforts by tax administration to enforce compliance.

B. Incidence and Prevalence of Tax Amnesties

When business activities and financial systems are greatly evolved with globalization, draining of a section of such activities without coming to the surface of tax jurisdiction is inevitable. The money or other assets accumulated through this way is generally called ***black money***. Such streams emerge within the borderlines of a country as a result of immoral attitude of the citizens or illegal nature of such economic activities.

A portion of legitimate activities may not be taxable due to *tax evasion* and *tax avoidance.* Deliberate non declaration or under-declaration of tax base, misuse of tax rates and creation of tax violating business arrangements are coming under the tax evasion. Tax avoidance means the planning of business structures and business transactions within the law so as to minimize the final composite amount of taxes. Evasion is illegal & immoral. But tax planning within the law (tax avoidance) is not illegal & immoral and does not form non-compliance, as accepted commonly. A need arises for bringing the undisclosed assets, made up using tax-evaded income, to the formal (in other way lawful and moral) tax net and ensuring future compliance of such citizens.

The other portion of the black money represents the proceeds of crime. Today, an emerging issue of concern to the economists throughout the world is ***Money Laundering***. "Money laundering", stripped of its technical connotation, refers to an attempt convert what is commonly referred to as "dirty money" into respectable assets. There are several technical definitions of "money laundering"; perhaps the simplest is the one that describes it as

> *"the process of converting cash, or other property which is derived from criminal activity, so as to give it the appearance of having been obtained from a legitimate source." (McDonell, 1997)*

The crimes discussed here are drug trafficking, human trafficking, prostitution, gambling, arms deals, smuggling, securities scam, pornography, fraud, bribe, corruption and so on. The noticeable attribute of these money launderers is that they extremely use the financial systems to convert their dirty money into white whereas they always try to be hidden from the tax authorities. They perceive the financial system as service-oriented while the tax authority as enforcement-oriented. Prevalence of underground economic activities that are not easy to be tackled by a tax administration with the limited resources or other restrictions may cause tax compliance problems, avoiding the reach of tax revenue to its potentiality. However, it is the tax authority's judgement that only a tiny part of crime proceeds is visible through tax files. The lion's share is out of the tax net. The subsequent generations of income of these funds (second income stream and so on) also tend to be hidden because of the fear of detection of the original crime. In the above context, coupled with economic point of view, it is rational to think that tax negation will bring such black money into tax files.

Moreover, if there are a huge number of citizens who engage in informal sector activities and occupations (unorganized economic activities), organized non-compliance and tax evasions could have amassed a huge stock of wealth which they do not invest in rightful activities as to avoid taxation problems. Investments in such rightful economic activities, however, are vital for the development of a country. If such citizens are given tax breaks and thereafter the specific fields and activities of investment are streamlined, the undisclosed wealth can be absorbed to the essential sectors, perhaps by repatriation. Thus the capital stock of the country can be increased.

Tax amnesty, which is advocated as compliance enhancing tool, is a strategic measure, widely used to tackle such low compliance situations. Bringing of tax evading citizens and non compliers into the tax net voluntarily is the main objective of tax amnesty. For this purpose, in many cases, penalty forgiveness for payment of past taxes is granted[3]. In rare number of cases, we can find full forgiveness for past taxes. Further "carrots" such as non-implementation of legislative powers related to investigation & prosecution are guaranteed for the declarants. It's a sovereign act of forgiveness by a government to all citizens.

[3] Generally, if the income tax is not paid in time, a penalty is added to the delayed tax payments on the basis of period of delay and both tax plus penalty is collected by the tax authorities.

C. Previous Findings on Tax Amnesties

Whilst approaching other important areas to build up our reasoning, it is worthwhile and necessary to review some of the previous work on amnesties. Table 2.1 indicates basic characteristics of amnesties implemented in some countries. As the official data relating to the performance of amnesties is scarce, mostly as a result of secrecy provisions attached to amnesties, empirical evidence on effects of amnesties is also rare. But we can come across more important findings even in that limited number of empirical works.

In many countries tax amnesties are introduced for compliance boom and short term revenue climb. Both these aspects of tax amnesties should be touched in a study of tax amnesties.

Most tax amnesties were designed to grant waiver of penalties. Back taxes could be payable without penalty. In most of these cases it was guaranteed a protection from prosecution and investigation too. These amnesties have raised short-run revenues on many occasions. For example Indian amnesty of 1997 and some state amnesties in the United States have been successful in raising short term revenues.

However, performance of an amnesty, in enhancing compliance and improving revenue depends on several factors including nature of the amnesty, probability of future replica, change of enforcement and credibility of guaranteed benefits etcetera. Theoretically, compliance patterns of pre amnesty period could change in post amnesty period as a result of the introduction of an amnesty. In some cases, such changes might be difficult to be seen in practice, as it depends on nature of the amnesty itself and several other factors.

Tax amnesties are justified as the last opportunity for evaders to pay taxes and legitimize their activities. This rationale is controversially identified to be based on the principle of equity. However, several kinds of benefits of tax amnesties from the part of the government can be identified.

Table 1 –Some Experiences around the world

Country and Amnesty	**Characteristics and Experience**
India – 1997	Revenue collecting amnesty Declared to the last amnesty in India Highly publicized Enforcement Strengthened Ended in tremendous success in revenue raising
Argentina – 1987	Introduced to repatriate capital Exempted from all taxes Not accompanied by increase of enforcement or changes to fiscal system Identified as a failure
Massachusetts – 1983-1984	Revenue collecting amnesty Highly publicized Combined with emphasis on enforcement Wildly successful
France - 1986	Revenue collecting amnesty Reduced tax rates on repatriated capital Not combined with increased enforcement or greater penalties Unsuccessful

Sources : Alm (1998)
Leonard and Zeckhauser (1986)

First is the collection of tax amounts at relatively low administrative and collection costs, which are difficult to be collected under prevailing situations. This is the mostly talked short term revenue goal and most governments enact amnesties in this perspective. Second is the increase of compliance with granting of an opportunity to correct past evasion from the part of previously non-compliant citizens. With an increased number of taxpayers submitting their tax returns, the voluntary compliance should increase. As pointed out by Leonard and Zeckhauser (1987) some citizens become tax delinquents by mistakes and would now like to become honest citizens. Amnesties help them to correct their errors and thus it also has a positive impact on compliance.

Except the benefits that have been reasoned out as controversial in line with previous research findings, there exist costs as well.

First is the relatively small revenue collection even from the most publicized amnesties, as pointed out by Alm (1998). Even for collecting such low amounts numerous benefits - surrendering the taxing rights concerning investigations and prosecutions - are granted to the declarants. In many amnesty programmes, existing taxpayers are also forgiven for past evasions. The tax administration has to give up all audit and investigation works that could collect some additional revenue.

Secondly and most importantly, dissatisfaction among law-abiding taxpayers (more broadly law-abiding citizens) with the feeling of unequal treatment might lead them not to comply with tax laws in the long-run. Feeling that “the offenders are being forgiven while the honest pay their dues” is the reason for this. Same way the feeling of “Even the honest evade taxes, they also can escape or enjoy pardon like the offenders do” will affect the tax morale of the country giving adverse effects on compliance process. “If the majority of citizens voluntarily comply with tax laws, the option of an amnesty for a small group of evaders can be understood by a majority as a violation of equity” according to Torgler and Schaltegger (2003). Moreover, amnesties reveal the existence of vast-spreading tax evasions in the society and the tender treatments of tax administration towards evaders. All such factors change the mindset of the public along with behavior and responsiveness. That is decisive for the long-run compliance and revenue.

On the other hand, some of the previous evaders who have been brought into the books after the amnesty, cannot be trusted that they will not go back to their beaten track and become repeated offenders, when there are no effective post monitoring and enforcement efforts or once they become sluggish due to various reasons. This can be a second reason to decline post-amnesty compliance.

As the most important area, the objective of an amnesty revolves around post-amnesty compliance. Although compliance depends on several factors, as we have already emphasized, had an amnesty been successful, it should have effectively increased post-amnesty compliance, ceteris paribus. Vigorous enforcement measures including prosecutions, investigations, tax audit and withholding provisions coupled with taxpayer services like consultation and tax education would play a decisive role to ensure compliance. Both new taxpayers and existing taxpayers who declare their correct income during and after the amnesty should be monitored and enforced properly. That is to avoid those with bad track records going back to their familiar situations and the honest becoming less compliant with dissatisfaction over the introduction of amnesties. Amnesties without proper post enforcement are found to be unsuccessful, as a decrease of ex-post level of compliance is most probable in such situations. This rationale establishes a scenario that amnesties are introduced only to identify evaders and evaded amounts which could have been approached without revenue, if tax administrations had been alert and strong enough to work for achieving its objectives. Nevertheless, counter-arguments that "introduction of an amnesty is necessary before strengthening compliance enforcement mechanism" also prevail.

In line with previous findings, law-abiding taxpayers become dissatisfied with amnesties and become knowledgeable of the prevalence of evasion when an amnesty is introduced. It should affect adversely on their compliance. Moreover, those who were afraid of the law and paid taxes because of the "sticks" are no more afraid as they can evade taxes and come under a future amnesty. If an amnesty lessen guilt as a motivating factor with its signals, post-amnesty compliance is likely to decline according to Alm (1998). Punishment is, however, one decisive factor for the behavior of taxpayers. This is in par with Becker's crime and punishment theory' (1968). Dependence of tax evasion on probability of detection and punishment is established by Allingham and Sandmo (1972), in early literature on tax evasion. Neither the probability of detection nor punishment pursues taxpayers towards unwilling compliance as a result of the guaranteed protection from an amnesty. Prevalence of possible replica of amnesties in the future, rather than anticipated thorough enforcement should further discourage compliance. As the introduction of amnesties certainly reduce costs of evasion, a drop of compliance level is unarguably probable from the part of those, who had previously been motivated by such sticks.

Amnesties might not enhance compliance, when inefficiencies of tax systems, shielding wrong doers and motivating the honest for wrong doing, continue to prevail. Furthermore, such weaknesses might prompt frequent amnesties in a vicious circle, when government's reliance on amnesties is high instead of enforcing and facilitating compliance.

According to Resnick, who analyzed effectiveness of state amnesties of the United States during 1982 – 2002. "Amnesty is not a strategy that can be overused since successive programmes will naturally yield smaller returns and may provide subtle incentives for tax evasion as taxpayers rely on the opportunity to pay back taxes penalty free". Amnesties, said to be the last opportunity for evaders, are mostly repeated by some countries in practice. Then citizens having tax evaded assets expect future amnesties that can be used to reveal their past evasions. Even the present compliers drop their compliance under these circumstances, since such income can be declared during future grace periods.

However, in an array of empirical studies on amnesties, developed hypotheses mostly reveal controversies on reaching objectives of amnesties.

First, the literature emphasizes that if compliance is unsatisfactory and an amnesty is intended to be introduced, the circumstances behind the status quo should be thoroughly studied. Alm(1998) points out, that if the prevailing problems of a tax system are not addressed by an amnesty, an amnesty is likely to do more harm than good. The authorities must assess the overall level of voluntary tax compliance, current quality of tax enforcement and prospective changes to it. Moreover, the long run revenue impact of an amnesty is likely to be negative according to him.

In an empirical work, Alm and Beck (1993), who analyzed the effects of Colorado tax amnesty of 1985, also found that the long run revenue impact of amnesty is likely to be negative. Moreover, Alm et at (1990) points out that average level of compliance falls after an amnesty, inter alia.

Empirical work by Das-Gupta and Mookherjee (1995) also supported the hypothesis of adverse compliance effects of amnesties and confirmed the falling penalty collections overwhelm the direct gains from an amnesty. Only 1975 amnesty from all amnesties introduced in India between 1965 and 1993 appeared to have had positive impact on revenue.

Another issue, theoretically arises, is relating to the legitimacy of tax provisions and the political nature of amnesties. According to Leonard and Zeckhauser (1987) “an amnesty is a political instrument”. They further emphasize that the reduction of penalty must be coupled with a promise of more vigorous future enforcement. According to them some elements of amnesty will support and other elements will undermine the legitimacy of the tax system and tax revenues that it collects. Given the salience of taxes in citizen’s interaction with the government, a tax amnesty may also affect the perceived overall legitimacy of government” according to them. When mistrust, from the part of the public, about the tax system and the government inspires based on this situation, the unavoidable result will be a gradual decrease of compliance.

CHPTER THREE

Income Tax Compliance and Tax Amnesties in Sri Lanka

A. Level of Individual Income Tax Compliance in Sri Lanka

In Sri Lanka the volume of economic activities started to expand since liberalizing the economy in 1977. Acquisition of private properties has been on the rise. Growth of population was around 1.5 during the past period while total population was 19.9 million approximately in 2009. However, the number of individual tax payers having with income tax files has always been less than 2 % of the total population. Even in the foresaid income tax files, it is doubtful whether the correct amounts of taxes are paid as reiteratively suspected by the government. The ultimate consequence of such a climate is a definite loss of revenue to the government.

Achievement of possible maximum compliance for taxes is the primary objective of any tax administration in the world. Being the main contributor to the government revenue of Sri Lanka, Inland Revenue Department (IRD), administers income tax and several other taxes. Various measures are implemented by the IRD to enhance individual income tax compliance.

Even among the tax payers already in the tax net, the compliance is not much good. The submission of income tax returns, measured as one month after the deadline has remained between 50% - 60% of the ***registered taxpayers*** (Table 3.1). Even though submission of returns reaches 75% or more after one year of the deadline, some returns are without financial statements and other necessary information and sometimes being mere “nil” returns. Then the overall tax compliance in these cases cannot be said to have been achieved since the mere submission of returns does not satisfy all conditions of compliance.

Table 2 – Income Tax Filling Compliance Rates in Sri Lanka

(Returns Field as a Percentage of Total Income Tax Files)

Year	*Measured at one month After the Statutory Deadline*	*After 13 months of the statutory deadline*
2006	**52%**	**81%**
2007	**59%**	**86%**
2008	**58%**	**82%**
2009	**50%**	*****

Source : Administration Reports of Commissioner General of Inland Revenue (CGIR)

Tax compliance is the ultimate outcome of different factors. As in any other country, effectiveness of the compliance enhancement efforts of tax administration is one of the main determinants of the compliance in Sri Lanka. Economic climate forms another decisive determinant. Furthermore, political and social climate that affects individual ideas should also contribute for the compliance level.

The mechanism adopted by the IRD to raise individual income tax compliance in Sri Lanka is two folded. First one is the measures for facilitation. Second is the enforcement measure.

Facilitating of taxpayers' compliance by giving instructions on their problems is performed through a taxpayer assistance centre. In addition, a 'Taxpayer Services Unit' was established to assist taxpayers in 2002 with the declaration of 2003 tax amnesty.

Enforcement approach consists of various measures. Inland Revenue Acts No 28 of 1979, No 38 of 2000 and No 10 of 2006, the legislation governing income tax in Sri Lanka, includes many provisions for deterring non-compliance and monitoring of taxpayer compliance. Quarterly self- assessed tax payments shall be made on prescribed dates prior to making the final payment. Penal provisions are implemented against breaches of this law. Commissioner General of Inland Revenue has the power to impose such penalties. Imposition of penalties on non – filers in the registered tax payers' list is the most commonly used tool for deterring non-compliance. Moreover, taxpayers are prosecuted before Magistrate Courts for failure to submit returns. Furthermore; the law provides necessary sanctions against submission of incorrect returns and information.

Secondly, as a necessary feature to enforce compliance, IRD has to ascertain the accuracy of income declared and tax paid. Information collected from external sources is used for this purpose, in addition to the financial statements, submitted with returns. A process of rapid audits is carried out and returns with problems are selected for detailed audits or field investigations. Thus, the motive of carrying out audit has two dimensions. First is to arrive at correct tax liability of taxpayers. Second is to enhance the compliance of others who engage in business dealings with them by collecting information relating such transactions.

Thirdly, withholding taxes are also used as stimuli to enhance compliance. Mechanism adopted for collection of tax at source comprises following streams.

(a) Withholding tax on interest: Banks and other financial institutions should deduct a withholding tax at 10% on the total interest payable to any person (Subject to certain provisions and exceptions) and remit it to the IRD, in accordance with the legislation.

(b) Pay –As-You-Earn scheme (on Profits from employment): Employees of private sector organizations are subjected for PAYE tax on the point of salary earnings.

(c) Withholding tax on dividends

(d) Withholding tax on specified fees. Certain receipts are subjected to withholding tax at the point of payment.

B. Tax Amnesties in Sri Lanka

Tax amnesties have frequently been introduced in Sri Lanka with the objective to increase compliance. Thus , tax amnesties have been declared in 1964, 1965, 1978, 1989, 1990, 1992, 1993, 1997, 1998, 2003 and the last being in 2009. The tax amnesties in 2003 and 2009, which are checked in this study, were introduced for both increase of short-term revenue and enhancement of compliance. Under both these tax amnesties back taxes were not collected and the declarants were totally exonerated.

(I) Mechanism of the 2003 Amnesty

Inland Revenue (Special Provisions) Act No. 7 of 2002 (legislation that was passed by the parliament to introduce the 2003 amnesty) granted the immunity for income tax on undeclared income. The low compliance situation may have persuaded the government to declare a broader amnesty incomparable with former ones. It was stated at the outset, that the said bill was not a premium on tax evasion but an opportunity for coming into the tax system without fear of being penalized. As the Act itself states, the objective of 2003 amnesty was to secure future compliance of taxes in force. Any person whether in Sri Lanka or abroad having income in Sri Lanka or having assets in Sri Lanka earned or acquired prior to April 1, 2002, could make a declaration of such income and assets to the Commissioner General of Inland Revenue on or before 31.08.2003. Following is excerpts from the title of Inland Revenue special Provisions Act NO. 07 of 2002.

> *"An act to enable persons who have not furnished a return of income and assets prior to march 31, 2002 to make a declaration in respect thereof: to make provision for the grant of certain concessions to declarants: to indemnify such persons against liability to pay certain taxes and against liability from investigations, prosecutions and penalties under specified statutes, with a view to securing the future compliance of such persons with the prevalent tax laws: and to provide for matters connected therewith or incidental thereto"*

Thus queries, investigations and prosecutions are not contemplated to income and assets, declared under amnesty whilst any burden, responsibility, duty and actions already taken were removed. Besides, secrecy of declarations received is strictly maintained in terms of the provisions of the Act. Thus, any information with regard to declarations and latter actions by tax administration was not published.

Firstly, with regard to an existing taxpayer who has filed tax returns up to 31st March 2002, he could make a declaration under the Amnesty Act to disclose undisclosed income and assets up to March 31, 2002 (the end date of the year of assessment 2001/2002). Then he could enjoy forgiveness without any burden whatsoever. But, from the year of assessment 2002/2003[4], he should pay tax as governed under normal legislation.

Secondly, if returns have not been filed even though income tax files were available or in case of those without files, they could declare all past undisclosed income and assets without paying any past liability. They could start paying taxes from year of assessment 2002/2003 onwards.

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

Prevalence of a great deal of pros and cons regarding the 2003 amnesty, it has significant features even at the time of enacting it. The extraordinary coverage for unscrupulous acts and wrong doings with regard to income tax could have been the reason for this. The argument behind such a wider coverage was to attracting tax dodger who was not convincingly motivated with previous amnesties to declare their acts of evasion.

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[4] Under the provisions of Inland Revenue Acts No 28 of 1979, 38 of 2000 and 10 of 2006 that govern income tax as a whole (including both personal and corporate income taxes) a year of assessment commences on April 01 of a calendar year and ends on March 31 of the following calendar year. Deadline for filing returns and making final payments is November 30th immediately following such year of assessment. For example returns for year of assessment 2002/2003 should be filed on or before November 30, 2003.

(ii) Mechanism of the 2009 Amnesty

An amendment was made to the Inland Revenue Act no 10 of 2006 with the intention of enhancement of Income Tax compliance from both the new tax payers and existing tax payers.

a). Concession for new tax payers

Any person having income earned and invested in assets in Sri Lanka or abroad could have an income tax file opened in the IRD and file the 2008/2009 tax return on or before 30.11.2009 declaring such assets as at April 1, 2009. These new filers were exonerated from paying their past taxes. Thus queries, investigations and prosecutions are not contemplated to income and assets, declared in 2008/2009 return. From the year of assessment 2009/2010, he should pay normal taxes.

b). Concession for current tax payers

With regard to an existing taxpayer who has filed returns up to 31st March 2008, he could make the 2008/2009 tax return with a 20% higher tax payment over the last year's payment, to disclose any amount of undisclosed income and assets up to March 31, 2009 (the end date of the year of assessment 2008/2009).

CHPTER FOUR

Empirical Study and Data Analysis

A. Research Variables and Research Methodology

This study aims to discuss the effects of amnesties on income tax compliance in Sri Lanka. Two indicators have been identified to measure income tax compliance. These are the number of personal income tax files and personal income tax revenue.

First, a descriptive data analysis is used to check the impact of 2003 and 2009 amnesties by checking any climb of compliance indicators with the introduction of tax amnesties. Any performance over and above the normal patterns of compliance indicators that happened soon after amnesty will be considered as the influence of the amnesty and success or failure of it will be decided accordingly.

Secondly, these two dependent variables are investigated in separate regression models. Income tax compliance is a collective outcome of different factors, mainly of tax administration's efforts and country's economic situation as we have already emphasized. As a result of dependency of compliance on several independent variables, a multi-variable analysis is the best way to ascertain each variable's impact on compliance in a given period. In this case tax amnesty is also identified as an independent variable among the other independent variables such as economic growth rate, marginal tax rate & inflation rate and its significance is identified in a multiple regression model.

B. Descriptive Analysis of Data

a). First Compliance Indicator - Number of Personal Income Tax Files.

As the first indicator, the number of new personal income tax files opened resulting from the amnesty can be calculated after removing the number of increase attributable to the normal pattern from the total increase of income tax files in 2003 and 2009.

Table 4.1 shows the number of income tax files in Sri Lanka.[5] Number of newly opened files for amnesty declarants has not been published. However, Figures of personal income tax files reported for 1997, 1998, 2003 and 2009 should include any new files opened as a result of amnesty. Once the effect of such drastic changes is removed from the number of files considering the average increase, we can glimpse the possible number of files in succeeding year and so on, as to arrive at increase without amnesty effects in 2003 and 2009.

Table 3 – Annual Changes in Number of Personal Income Tax Files (1994 – 2009)

Year	*Number of files*	*Increase/Decrease of Files*	**Percentage Growth Rate**
1994	115,608	--	--
1995	118,329	2721	2.35
1996	126,399	8070	6.82
1997	127,742	1343	1.06
1998	131,718	3976	3.11
1999	141,333	9615	7.30
2000	145,513	4180	2.96
2001	152,431	6918	4.75
2002	155,346	2915	1.91
2003	158,267	2921	1.88
2004	158,906	639	0.40
2005	160,570	1664	1.05
2006	161,302	732	0.46
2007	163,438	2136	1.32
2008	200,418	36980	22.63
2009	201,301	883	0.44

Source : Administration Reports of Commissioner General of Inland Revenue

[5] Those who earn only employment income are registered under pay as you earn (PAYE) scheme and tax amount payable are withheld and remitted by employers. Files are not maintained for them unless there are adjustments. Furthermore, like in corporate tax files, the submission of amnesty declarations by this section is also minimal.

1997, 1998, 2003 and 2009 are amnesty years. The average annual increase of personal income tax files from 1994 to 2002 (except 1997 and 1998 amnesty years), has been 5,736 approximately. For this calculation we used data in Table 4.3 and did not consider increases of files experienced in 1997 and 1998, as a result of amnesty programmes implemented in those years. If 5,736 files are assumed and considered to be the reasonable average increase in accordance with the trend in pre-amnesty period, in 2003, the number of files should have been 161,082 (155,346 + 5,736), unless tax amnesty operated. Since the number of personal files at the end of 2003 remained at 158,267 the increase has been only 2,921 files.

Likewise, average annual increase of personal income tax files from 1994 to 2008 (except 1997, 1998 and 2003 amnesty years), has been 6,961 approximately. Based on this reasonable average increase experienced in pre-amnesty period, in 2009, the number of files should have been 207,379 unless tax amnesty was operated. Since the number of personal files at the end of 2009 remained at 201,301 compared to 200,418 in 2008, the increase has been only 883 files. If we adjusted the annual average increase of 6,961 files that could have been possible under normal circumstances the number would have been around 207,379 in 2009, ceteris paribus.

Had the amnesties effectively brought new taxpayers to the books such a small increases would have not been observed. Thus our first variable shows on surface that the amnesties did not increase income tax files compared to the number of declarations and doubts prevail over the reaching of expected goals of the amnesties, “enhanced income tax compliance” by deterring tax evasion.

b). Second Compliance Indicator - Personal Income Tax Revenue.

Post revenue increase resulting from a successful amnesty programme should overtake the pre amnesty average increase of revenue. Table 4.2 shows the government revenue, personal income tax revenue, personal income tax revenue as a percentage of government revenue and percentage growth of it. Given the facts that the amnesty declarants were liable for current year taxes, it should show a steep increase in 2003 and 2009, had the amnesty successfully increased compliance. Increase of compliance of one tax tends to enhance compliance of the other taxes and ultimately the total tax revenue.

Excluding the years 1997 and 1998 (amnesty years), the average annual increase of personal income tax revenue for the period from 1994 to 2002 was Rs.820 million. On this basis, personal income tax revenue in 2003 should have been Rs.13076 million (12.256+ 820), unless tax amnesty was not in operation. But the real figure reported as only Rs 12773 million with a slight increase of Rs.517 million. Likewise, average annual increase of personal income tax revenue from 1994 to 2008 (except 1997, 1998 and 2003 amnesty years), has been Rs.5000 million. Based on this reasonable average increase experienced in pre-amnesty period, in 2009, the number of files should have been Rs.67846 million unless tax amnesty was operated. But the real figure was only Rs.65321 million. It concludes that both these amnesties have failed to maintain at least the pre amnesty trends in compliance indicators.

Table 4 –GDP, Government Revenue and Personal Income Tax Revenue

Year	*GDP Growth Rate (Real Output)*	*Per Capita GDP at Market Prices (Rupees)*	*Government Revenue (Rupees Million)*	*Percentage Increase of Government Revenue*	*Personal income Tax Revenue (Rupees Million)*	*Personal Income Tax Revenue as a Percentage of Government Revenue*	*Percentage Growth of Personal Income Tax Revenue*
1995	5.5	36,869	136,258	--	7,315	5.37	--
1996	3.8	41,940	146,279	7.35	7,358	5.03	0.59
1997	6.3	50,292	165,037	12.82	8,183	4.96	11.21
1998	4.7	56,780	175,032	6.06	8,199	4.68	0.20
1999	4.3	60,741	195,905	11.93	9,169	4.68	11.83
2000	6	68,102	211,282	7.85	10,820	5.12	18.01
2001	-1.5	75.133	234,296	10.89	12,203	5.21	12.78
2002	4	83,267	261,887	11.78	12,256	4.68	0.43
2003	5.9	91,434	276,516	5.59	12,773	4.62	4.22
2004	5.4	104,273	311,473	12.64	14,108	4.53	10.45
2005	6.2	124,709	379,747	21.92	22,443	5.91	59.08
2006	7.7	147,776	477,334	25.70	30,103	6.31	34.13
2007	6.8	178,845	565,051	18.38	51,517	9.12	71.14
2008	6	218,167	655,259	15.96	62,847	9.59	21.99
2009	3.5	235,945	702,644	7.23	65,321	9.30	3.94

Source: Annual Reports of Central Bank of Sri Lanka

C. Multi-Variable Analysis

Initial descriptive data analysis of compliance revealed on surface that robust evidence as for an enhanced compliance status after the amnesty could not be visible. To come to a concrete conclusion a comprehensive quantitative analysis is needed. For this purpose this study proceeds further with an analysis using multiple variables. A multivariable analysis is useful when multiple factors affect the outcome. Thus, projections on depended variable - number of personal income tax files and personal income tax revenue - are extrapolated by using multivariable linear regression to measure the inclination of the lines of trend and to identify the difference of actual and predicted figures for 2003 and 2009. Tax Amnesty labeled as Dummy Variable is used as an independent variable in addition to using other three independent variables named GDP, Inflation Rate and Effective Marginal Tax Rate

a). First Compliance Indicator - Number of Personal Income Tax Files.

The following multivariable linear regression equation is used to predict the behavior of number of files.

$$Y' = a + b_1 X_1 + b_2 X_2$$

Where,

X_1 =GDP (Trillions)

X_2 = Dummy variable (Value 1's for amnesty years and 0's for non amnesty years)

Y' is the dependent variable which denotes number of personal income tax files.

A dummy variable is used considering the tax amnesty in 2003, 2009 and other years. Years with amnesties are given value, 1 while the value of the other years is considered as 0. Value 1 is given for 1997, 1998, 2003 and 2009 considering the amnesties declared in those years during the period from 1995 to 2009. Table 4.6 shows the data used for regression.

Table 5 – Analyzed Data

Year	GDP (Trillions)	Inflation Rate	*Effective Marginal Tax Rate %	Tax Amnesty (Dummy)	No of IT files (,000) (Actual)	IT Revenue (Billions) (Actual)
1995	0.668	7.7	35	0	118.329	7.315
1996	0.778	15.9	35	0	126.399	7.358
1997	0.890	9.6	35	1	127.742	8.183
1998	1.018	9.4	35	1	131.718	8.199
1999	1.106	4.7	30	0	141.333	9.169
2000	1.258	6.2	30	0	145.513	10.820
2001	1.407	14.2	30	0	152.431	12.203
2002	1.583	9.6	30	0	155.346	12.256
2003	1.760	6.3	30	1	158.267	12.773
2004	2.029	7.6	35	0	158.906	14.108
2005	2.453	11.0	30	0	160.570	22.443
2006	2.939	10.0	35	0	161.302	30.103
2007	3.579	15.8	35	0	163.438	51.517
2008	4.411	22.6	35	0	200.418	62.847
2009	4.825	13.4	35	1	201.301	65.321

**Effective marginal tax rate is the tax rate applicable for taxing the last slab of the individual's taxable income.*

Sources: Annual Reports of Central Bank of Sri Lanka /Administration Reports of Commissioner General of Inland Revenue

Table 6 – Regression Results for Number of Files

SUMMARY OUTPUT

Regression Statistics	
Multiple R	0.939749852
R Square	0.883129784
Adjusted R Square	0.863651415
Standard Error	8.867348599
Observations	15

ANOVA

	df	*SS*	*MS*	*F*	*Significance F*
Regression	2	7129.999464	3564.999732	45.33900004	0.000002548138735593990
Residual	12	943.558454	78.62987117		
Total	14	8073.557918			

	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*	*Lower 95.0%*	*Upper 95.0%*
Intercept	118.8076371	4.485944744	26.48441831	0.000000000005145954091	109.0336031	128.581671	109.0336031	128.581671
GDP(Trillions)	16.97811859	1.783968281	9.517051826	0.000000609755177457219	13.09118561	20.86505156	13.09118561	20.86505156
Tax Amnesty	-0.099427387	5.180743714	-0.019191721	0.985003576989189000000	-11.38729825	11.18844347	-11.38729825	11.18844347

RESIDUAL OUTPUT

Observation	Year	Actual No of IT files (,000)	Predicted No of IT files (,000)	Residuals
1	1995	118.329	130.1490203	-11.82002031
2	1996	126.399	132.0166134	-5.617613354
3	1997	127.742	133.8187352	-6.07673525
4	1998	131.718	135.9919344	-4.273934429
5	1999	141.333	137.5854363	3.747563748
6	2000	145.513	140.1661103	5.346889723
7	2001	152.431	142.6958499	9.735150053
8	2002	155.346	145.6839988	9.662001181
9	2003	158.267	148.5896984	9.677301578
10	2004	158.906	153.2562397	5.64976029
11	2005	160.570	160.454962	0.115038008
12	2006	161.302	168.7063276	-7.404327626
13	2007	163.438	179.5723235	-16.13432352
14	2008	200.418	193.6981182	6.71988181
15	2009	201.301	200.6276319	0.673368101

The equation concerning the number of files is as follows.

$$Y' = a + b_1 X_1 + b_2 X_2$$

$$Y' = 118.80 + 16.97 X_1 - 0.09\ X_2$$

R^2 = 88.31%

R^2 denotes the total explanatory power of this equation. 88.31% of the total variation in the dependent variable that is “Number of Personal Income Tax Files” is explained by the variation in the independent variables, that is GDP (Trillions) and Dummy variable for amnesty years.

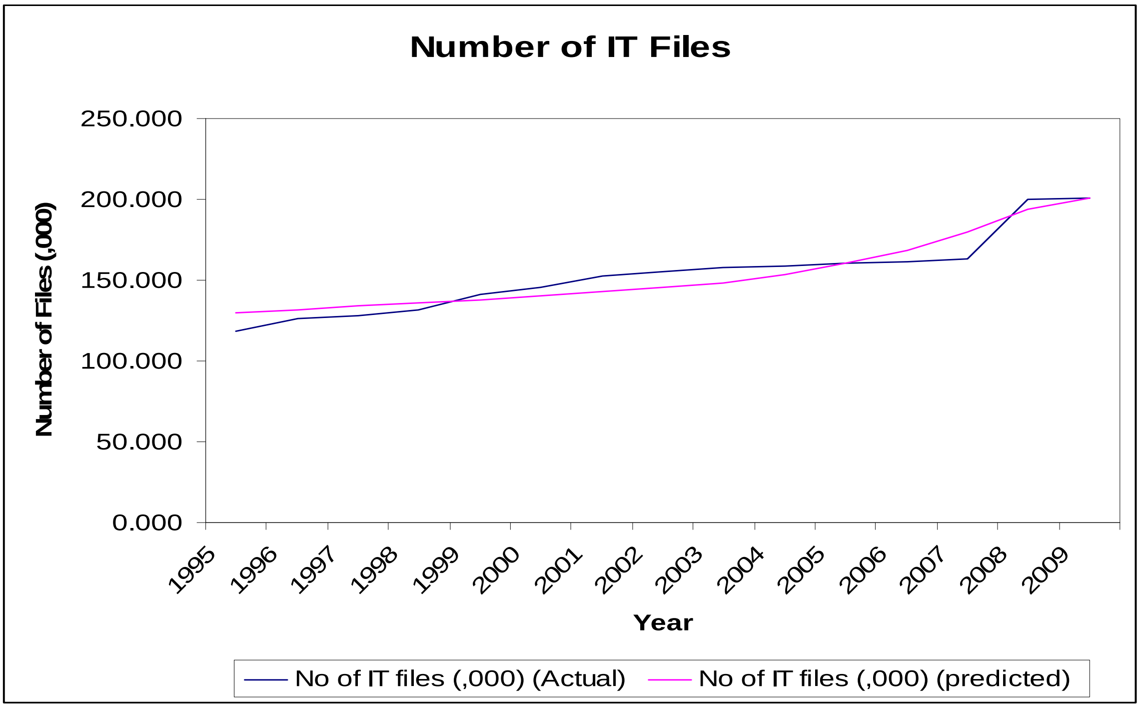
F value = 78.45

Using the “F distribution” we can calculate the ***critical value of F***. At a 5% level of significance the ***critical value of F*** is 3.89. [Degrees of freedom for the numerator = k = 2, degrees of freedom for the denominator = n – (k+1) = 12]. The ***computed F*** is in the region of rejection because the *computed F* (45.33) is higher than ***critical value of F*** (3.89). The null hypothesis (H_0), that all "b" (all Coefficients) are equal to zero (Could the R^2 occur by chance), is rejected since the ***computed F*** is in the region of rejection.

In this equation the coefficient for dummy variable; amnesty, is negative, although the significance of it is low with a higher p value (0.98). GDP is the most significant independent variable since the't' value of 9.52 with a lower 'p' value of 0.0000006097. (Hypothesis testing for coefficients based on t values are given in appendix A). The reason for the lower significance of dummy variable could be the different movements of actual number of files in 1997, 1998, 2003 and 2009 even with declaration of amnesties in these years. For example, as shown by the Table 4.1, actual number of personal income tax files has reported only a slight increase in these years. Thus the effects on files of all four amnesties introduced during the considered period could not be noticeable (A further explanation of this situation will follow after considering the tax revenue in the next section). However, coefficient for the dummy variable is negative showing an impact that it discourages the number of files.

Then R^2 *indicating* the measure of fit of the predicted line to actual line stands at 88.31% to show that the predicted line is very close to the actual line. The *actual umber of files* and *predicted number of files* has a close overlapping as shown in the Figure 4.1.

Figure 4.1 – Actual and Fitted Values of Personal Income Tax Files



b). Second Compliance Indicator - Personal Income Tax Revenue.

The following multivariable linear regression equation is used to predict the behavior of income tax revenue.

$$Y' = a + b_1X_1 + b_2X_2 + b_3X_3 + b_4X_4$$

Where,

X_1 =GDP (Trillions)

X_2 = Inflation Rate

X_3 = Effective Marginal Tax Rate %

X_4 = Dummy variable for amnesty years (Value 1's for amnesty years and 0's for non amnesty years)

Y' is the dependent variable which denotes personal income tax revenue.

A dummy variable is used considering the tax amnesty in 2003, 2009 and other years. Years with amnesties are given value, 1 while the value of the other years is considered as 0. Value 1 is given for 1997, 1998, 2003 and 2009 considering the amnesties declared in those years during the period from 1995 to 2009. Table 4.6 shows the data used for regression.

Table 7 – Regression Results for Personal Income Tax Revenue.

SUMMARY OUTPUT

Regression Statistics	
Multiple R	0.984438448
R Square	0.969119057
Adjusted R Square	0.95676668
Standard Error	4.275784582
Observations	15

ANOVA

	df	*SS*	*MS*	*F*	*Significance F*
Regression	4	5737.440755	1434.360189	78.45607707	0.000000164165
Residual	10	182.8233379	18.28233379		
Total	14	5920.264093			

	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*
Intercept	-28.27844252	15.70548387	-1.800545768	0.101961555	-63.27244117	6.715556126
GDP(Trillions)	13.56038757	1.080553484	12.54948299	0.000000192	11.15276438	15.96801076
Inflation Rate	0.591077626	0.330750155	1.787081932	0.104220500	-0.145879642	1.328034893
Effective Marginal Tax Rate %	0.488750203	0.513683062	0.951462562	0.363799586	-0.655806981	1.633307387
Dummy(Tax Amnesty)	0.891354249	2.66996133	0.333845378	0.745391388	-5.057690298	6.840398796

RESIDUAL OUTPUT

Observation	Year	*Predicted IT Revenue(Billions)*	Actual IT Revenue(Billions)	*Residuals*
1	1995	2.437451185	7.315	4.877548815
2	1996	8.775930349	7.358	-1.417930349
3	1997	7.462258963	8.183	0.720741037
4	1998	9.079773047	8.199	-0.880773047
5	1999	4.159917049	9.169	5.009082951
6	2000	7.107712398	10.82	3.712287602
7	2001	13.85683115	12.203	-1.653831152
8	2002	13.52450229	12.256	-1.268502286
9	2003	14.86548897	12.773	-2.092488969
10	2004	20.8340309	14.108	-6.726030902
11	2005	26.14954815	22.443	-3.706548146
12	2006	34.59256989	30.103	-4.489569891
13	2007	46.69946816	51.517	4.817531836
14	2008	62.00103848	62.847	0.845961523
15	2009	63.06847902	65.321	2.252520979

The equation concerning the **Personal Income Tax Revenue** is as follows.

$$Y' = a + 13.56X_1 + 0.59X_2 + 0.49b_3X_3 + 0.89X_4$$

R^2 = 96.91%

R^2 denotes the total explanatory power of this equation. 96.91% of the total variation in the dependent variable, that is "**Personal Income Tax Revenue",** is explained by the variation in the independent variables, that is GDP (Trillions), Inflation Rate, Effective Marginal Tax Rate % and Dummy variable for amnesty years.

F value = 78.45

Using the "F distribution" we can calculate the ***critical value of F***. At a 5% level of significance the ***critical value of F*** is 3.48. [Degrees of freedom for the numerator = k = 4, degrees of freedom for the denominator = n – (k+1) = 10]. The ***computed F*** is in the region of rejection because the *computed F* (78.45) is higher than ***critical value of F*** (3.48). The null hypothesis (H_0), that all "b" (all Coefficients) are equal to zero (Could the R^2 occur by chance), is rejected since the ***computed F*** is in the region of rejection.

With a higher *t* value of 12.54 and lower p value of 0.000000192, GDP is again the most significant variable. (Hypothesis testing for coefficients based on t values is given in appendix B). Effective marginal tax rate with a *t* value of 0.95 and p value of 0.36% is not much significant and so is inflation rate with a *t* value of 1.78 having 0.104 as p value. Dummy variable has the lowest significance with a p value of 0.74 according to its *t* value of 0.33. Different movements of actual revenue in years 1997, 1998, 2003 and 2009 in which amnesties have been declared, could be the reason for the lower significance of dummy variable, in this case too. As shown by the Table 4.2, actual revenue in 2003 has only a little increase compared to 2002 while actual revenue in 2009 has also a slight increase compared to 2008. Thus the effects on revenue of all four amnesties introduced during the considered period could not be the same.

Measure of fit of the predicted line to the actual line, as shown by R^2, stands at *96.91%*, showing that the predicted line is highly close to the actual line.

Figure 4.2 – Actual and Fitted Values of Personal Income Tax Revenue

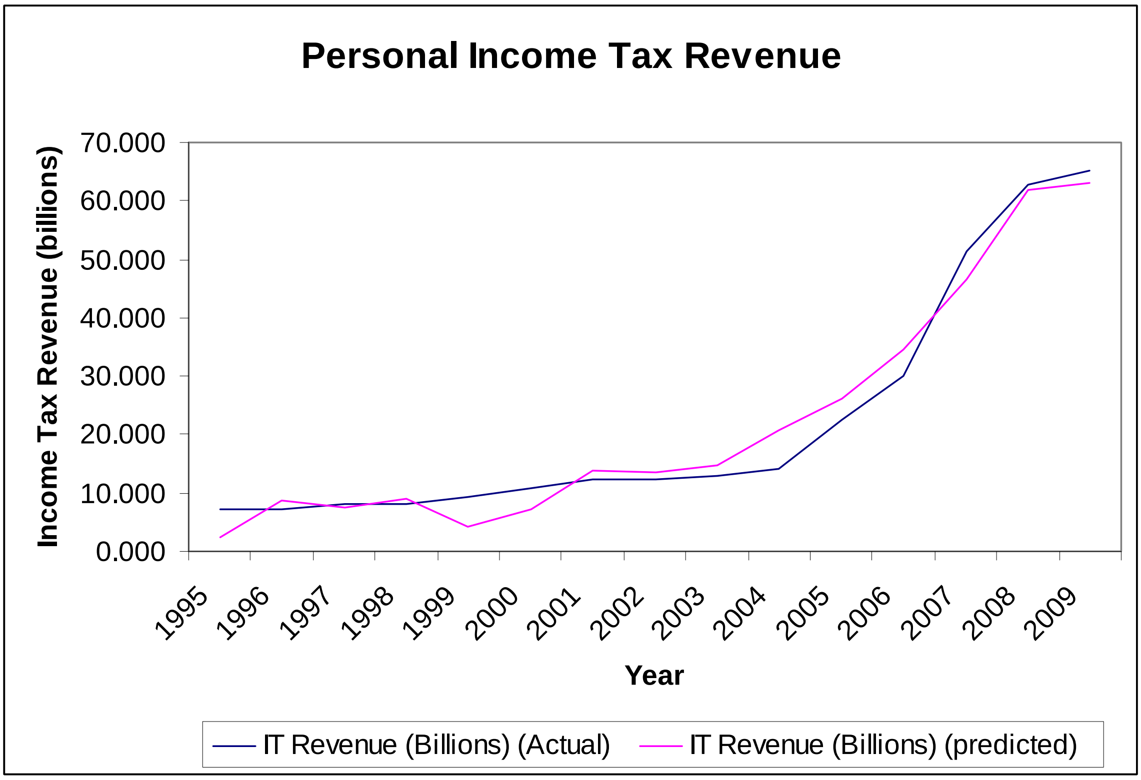


Figure 4.2 shows the actual line and fitted line of personal income tax revenue. The predicted line of tax revenue follows the actual line reflecting a low dispersion.

D. Research Findings

By using the dummy variable (as 1), effect of the amnesty has been considered for the estimated lines of both number of *personal income tax files* and *personal income tax revenue*. As per the regression results, coefficient in dummy variable, amnesty, is negative in equation concerning number of personal income tax files suggesting that amnesty discourages files. With regard to the personal income tax revenue it is non significant although positive in equation. However, the dummy variable shows the lowest significance in both equations.

We have projected number of personal income tax files and personal income tax revenue for the period by considering some of the probable variables to affect such compliance indicators, in a multivariable analysis. Convincing evidence was not found for a considerable rise of short run compliance in case of 2003 and 2009 amnesties in Sri Lanka according to the indicators that were tested within our methodology.[6]

As the most popular amnesty programmes in the history of Sri Lankan amnesties, 2003 and 2009 amnesties raised altogether 72,200 declarations as reported. But such declarations were not reflected by corresponding increases of personal income tax files. Thus, even the prevailing trend of increase of files has not been maintained after the amnesty as discussed in the descriptive analysis. This reveals that amnesty declarations were not effectively instrumental in enhancing number of taxpayers.

Amnesties under which back taxes are not payable should be highly attractive among wrong –doers as we have hypothesized in Chapter Two. The only liability they have to meet relates to the future taxes, while whole of their past acts can be corrected without being subjected to punishment and investigations. In addition, psychic costs of stress and stigma of a future detection could also be avoided by this. However, this study does not show a considerable increase of tax revenue even with declaration over 72,000. It suggests that most of the evaders, who are out of the tax net at the moment, still want to remain as evaders.

The above findings as a whole suggest that 2003 and 2009 amnesties, even with huge number of declarations do not seem to be successful in increasing the number of tax payers and revenue.

[6] However it is meticulously proven fact by Alm et al (1990) that amnesties without increased enforcement undermine the long run compliance.

Circumstances Behind the Research Findings

A vast majority of previous theoretical and empirical literature shows that tax amnesties mostly undermine compliance, especially when introduced repeatedly. Nevertheless, some literature has emphasized immediate increases of compliance after an amnesty programme. However, declines in the long-term compliance as well as negligible or negative revenue effects have also been discussed by previous work.

In addition to multivariable analysis, in a descriptive analysis, we explained the fluctuations of the number of files and revenue of personal income tax during amnesty periods in 2003 and 2009. We found that there has been reluctance from non-taxpayers to come to the tax net under amnesties in Sri Lanka. There can be several reasons behind such outcomes. In line with the literature reviewed and the facts that were hypothesized by us in the second chapter, such reasons can be analyzed in two flows

a). Problems with Repeated Amnesties

Introduction of repeated amnesties seems, first to lead the taxpayers and non-taxpayers to understand the inability of the governments to enforce taxation effectively and, finally to exacerbation of the state of compliance and the whole tax system. Even though a considerable decline of compliance indicators after the amnesty could not be seen, many tax cheats in Sri Lanka seem to be waiting for another opportunity that will come later. Besides, the declaration of an amnesty as the last one might not have been effective since there had been previous amnesties introduced in the same way.

b). Problems with follow up enforcement

Theoretically, amnesties might provide positive effects on tax compliance only when they are followed by a strong enforcement mechanism. 2003 and 2009 amnesties did not seem to be followed by an enhanced and vigorous enforcement mechanism. Psychologically , when there is no or less risk of being detected and punishment, there is no need for evaders to come under an amnesty considering the liability for future taxes, which most probably be exonerated by a future amnesty programme according to the past experience. Tax evaders with colossal amounts of past evasions and future probable taxes might go on this way with the help of weaknesses in tax system. In Sri Lanka, on the other hand, taxpayers always have a higher risk of detection than non- taxpayers. Possibility of getting away by using weaknesses of tax administration is always available for non tax payers. They can still continue evading, since there is no high probability of an immediate detection within the weak enforcement. Risks of evasion are not high in a state of weak enforcement. Hence such weaknesses seem to have deprived non- taxpayers of coming under the amnesty.

c). Dissatisfaction among Current Tax Payers

On the other hand, dissatisfaction among honest taxpayers, who have already paid their past dues for which declarants are exonerated, could be one reason for the decline of current revenue. In this background, most of the declarations under 2003 and 2009 amnesties seem to have been made by the existing taxpayers whilst the amnesty seems less attractive to tax cheats among non- taxpayers.

d). Weaknesses within the Sri Lankan Tax Administration

Effective administration of all facilitating measures of tax compliance makes the way for reaching a higher level of compliance in a country. Even though a tax administration has effective strategies to enhance compliance, hindrances affecting smooth functioning of them in practice, can arise within the system itself. Certain amount of criticism over administrative weaknesses such as lack of expertise and corruption of tax officials prevail in Sri Lanka too.

Lack of both physical and human resources and inadequate provision of taxpayer services, especially in the field of consultancy and tax education, form the other weaknesses. Inadequate taxpayer services lead the taxpayers to seek for professional advice, making compliance less effective.

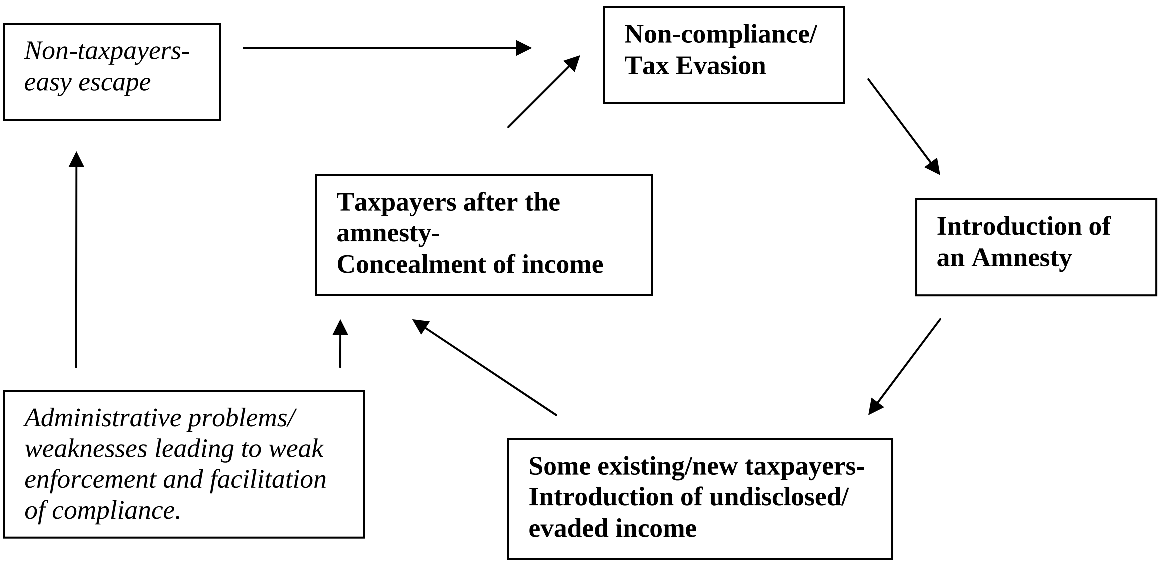
Understatement of income and overstatement of expenses or use of any other means to reduce tax liabilities take place as long as the aforesaid weaknesses prevail within the tax system. For example, official who are not competent enough or corrupted weaken tax administration's effort and become means for tax cheats to under-declaration of tax liabilities or escape from detections. In this situation compliance is affected in any facet, whether it is filing, reporting or payment thus undermining the overall compliance. Then it leads to non-compliance and tax evasion.

As per findings and analysis of this study the major share of amnesty declarations seems to have come from those who are already in the tax registers. This situation itself reveals another crucial aspect. How could such a huge number of taxpayers who are under scrutiny of the tax administration conceal their evasions, if not for the weaknesses in this system itself? Conditions seem to work favorably for evaders. Even if evasions are not revealed under an amnesty and later detected and caught they still have a chance to escape by using the weaknesses of tax administration. Hence, the status quo of the Sri Lankan tax system seems to be sluggish towards achieving compliance, due to weaknesses of tax administration.

CHPTER FIVE

Conclusion and Recommendations

This study proved that personal income tax compliance has not been considerably affected by the introduction of 2003 and 2009 tax amnesties. Personal income tax files and personal income tax revenue have not increased after the amnesty suggesting that amnesties could perform contrary to the objectives of introducing them, when weaknesses in a tax system and administration prevail. It confirms, therefore, the idea that if the problems of a tax system are not addressed by an amnesty, it is likely to do more harm than good, as pointed out by Alm (1998). Hence, tax amnesties are not a universal remedy and cannot cure all ills in a tax system. In this background it is doubtful whether problems facing the Sri Lankan tax system can be addressed by an amnesty. If the practice of introducing frequent amnesties continues instead of a proper understanding of the problems and dealing with them by using competent strategies, optimal personal income tax compliance might be difficult to achieve. Only a continuation of a probable vicious circle of amnesties is the worst case scenario in such a situation.



According to preceding paragraphs, reason for frequent amnesties in any country seems to be inspired from none reaching of compliance to the expected level even after introduction of an amnesty. However, in my view a vicious cycle of frequent amnesties might exist, when the circumstances to undermine income tax compliance continue to prevail. Figure 5.1 describes this situation.

The objective of introducing tax amnesties in Sri Lanka has been securing future compliance. According to established theory, tax amnesties, which are better to be avoided unless excellent and inarguable reason for declaration of them is found, undermine compliance in the long-run, while bringing negative revenue effects. Moreover, frequent amnesties discourage honest taxpayers and even the tax cheats keep on waiting; anticipating further amnesties in this situation.

Furthermore, since the back taxes are not collected by Sri Lankan tax amnesties, the exchequer seems to be in loosing end even in the short-run in addition to the long-run, where achieving other long term objectives of amnesties looks controversial.

Considering the present situation of the Sri Lankan tax system following recommendations can be made.

First, further Tax amnesties should be avoided in Sri Lanka according to the prevailing situation. Tax amnesties, which are identified as a controversial revenue tool in many researches even when back taxes are collected under them, do not seem to have achieved its objectives in Sri Lankan case too, in which full immunity is granted, expecting only an increase of compliance.

Secondly, a vigorous and effective enforcement mechanism should be implemented. Adequate human and physical resources should be provided for conducting investigations and audits sufficiently. With the goal of upgrading the investigation and enforcement, staff training programmes should emphasize providing necessary expertise with auditing and tax legislation as to tackle cases. Technical expertise and vigilance of the officials lead to thoroughness of audits including field investigations

When corruption prevails in the tax administration, cases of evasion do not come to the surface and/ or are mishandled to affect government tax revenue. Hence, thirdly, as a vital feature of compliance enforcement and facilitation, prevention of officials' misconduct and corruption must also be ensured by education and improving their moral courage and citizenship behavior. Not only monetary benefits like maintaining of proper salary standards but morale boosting activities will also be fruitful. Moreover, upgrading internal control will be effective for countering this weakness. Furthermore, taxpayers and general public also have to be educated in this respect.

Finally, and more importantly, attention should be paid to facilitating compliance by avoiding weaknesses in this aspect. Tax compliance in Sri Lanka seems to be hampered by lack of awareness about taxes that lead to high compliance costs. In addition, existence of reluctance among the public to visit tax offices increases cases of evasion. A long – term plan to enhance public relations activities and island wide tax education programmes should be implemented. The Sri Lankan tax administration already has a little experience in this regard. Year 2008 was a remarkable year in which 36,980 new tax payers came to the tax net reporting a 22.63% annual progress in number of personal income tax files through implementation of a successful non-amnesty tax-base widening programes. Although costly, such progrmmes will certainly deliver the goods in the long-run, in comparison to un-secured future compliance and huge tax cuts granted by tax amnesties. Persuading the public to think about the other side of the government ledger, public services and other benefits, provided in return for taxes paid, makes them understand the importance of taxes. Effective public relations and tax education are steps for providing the nation with a tax paying culture that sets social norms and a national mindset for that purpose in the long –run. For this purpose policy changes and new strategies might be necessary.

APPENDIX - A

First Compliance Indicator - Number of Personal Income Tax Files.

$$Y' = 118.80 + 16.97X_1 - 0.09\,X_2$$

t Statistics for the coefficients

Using the "t distribution" we can calculate the ***critical value of t***. At a 5% level of significance the ***critical value of t*** is 2.179. [Degrees of freedom = n – (k+1) = 12].

Coefficient	Test	Significance
b_1	The ***computed t*** is in the region of rejected because the ***computed t*** (9.52) is higher than ***critical value of t*** (2.179). The null hypothesis (H_0), that "b_1" (Coefficient) is equal to zero, is rejected since the ***computed t*** is in the region of rejected.	Significant
b_2	The ***computed t*** is in the region of not rejected because the ***computed t*** (0.02) is lower than ***critical value of t*** (2.179). The null hypothesis (H_0), that "b_2" (Coefficient) is equal to zero, is not rejected since the ***computed t*** is in the region of not rejected.	Not significant

APPENDIX - B

Second Compliance Indicator - Personal Income Tax Revenue.

$$Y' = a + 13.56X_1 + 0.59X_2 + 0.49b_3X_3 + 0.89X_4$$

t Statistics for the coefficients

Using the "t distribution" we can calculate the ***critical value of t***. At a 5% level of significance the ***critical value of t*** is 2.228. [Degrees of freedom = n – (k+1) = 10].

Coefficient	Test	Significance
b_1	The ***computed t*** is in the region of rejected because the ***computed t*** (12.55) is higher than ***critical value of t*** (2.228). The null hypothesis (H_0), that "b_1" (Coefficient) is equal to zero, is rejected since the ***computed t*** is in the region of rejected.	Significant
b_2	The ***computed t*** is in the region of not rejected because the ***computed t*** (1.79) is lower than ***critical value of t*** (2.228). The null hypothesis (H_0), that "b_2" (Coefficient) is equal to zero, is not rejected since the ***computed t*** is in the region of not rejected.	Not significant
b_3	The ***computed t*** is in the region of not rejected because the ***computed t*** (0.95) is lower than ***critical value of t*** (2.228). The null hypothesis (H_0), that "b_3" (Coefficient) is equal to zero, is not rejected since the ***computed t*** is in the region of not rejected.	Not significant
b_4	The ***computed t*** is in the region of not rejected because the ***computed t*** (0.33) is lower than ***critical value of t*** (2.228). The null hypothesis (H_0), that "b_4" (Coefficient) is equal to zero, is not rejected since the ***computed t*** is in the region of not rejected.	Not significant

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