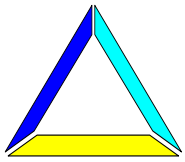
INSTITUTE FOR ECONOMIC RESEARCH AND POLICY CONSULTING IN UKRAINE
GERMAN ADVISORY GROUP ON ECONOMIC REFORM

Reytarska 8/5-A, 01034 Kyiv, Tel. (+38044) 228-6342, 228-6360, Fax 228-6336
E-mail: institute@ier.kiev.ua, http://www.ier.kiev.ua



S32

What Kind of Tax Amnesty does Ukraine Need?

Executive summary

The taxation and legalization of past income should be an important goal of fiscal and economic policy in Ukraine. Thus, we completely agree with the government on the necessity to give incentives to tax evaders to declare their past incomes. But one should be very careful that the incentives given to tax evaders are not simultaneously detrimental for the economic development of Ukraine.

The government plans to conduct an investigation one-shot tax amnesty with reduced tax rates for physical persons. Such an amnesty would be only partially successful in legalizing past incomes and would have important negative effects on the Ukrainian economy. In particular, we are worried about the effects of such an amnesty on corruption, criminal activities and money laundering. For that reason we propose an alternative plan. The government should in our view introduce provisions for the voluntary disclosure of past income (permanent tax amnesty). Tax evaders who voluntarily disclose past incomes should be exempted from prosecution. But they should not be exempted from the possibility of an investigation. Thus, we reject the planned investigation amnesty and favor a return amnesty. Furthermore, tax rates should not be specially reduced for a tax amnesty, because this would encourage activities in the shadow economy and reduce tax compliance in the future. Instead, past incomes should be taxed at the usual rate that prevails when the declaration is done. The sharp reduction of rates envisaged by the draft law on personal income tax provides a strong enough incentive for the legalization of past incomes.

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1. Introduction

Strong evidence exists that huge amounts of taxes were evaded in the past in Ukraine. Unfortunately, tax evaders have currently almost no incentives to declare their past incomes for two main reasons. First, the current system makes almost no distinction between tax evaders who disclose past incomes voluntarily and those who are caught by the tax administration. In particular, the voluntary disclosure of past incomes does not protect tax evaders from prosecution. Second, the tax rates for personal incomes are rather high.

Consequently, if no measures are taken by the government, taxes evaded in the past will remain unpaid and past income will not be legalized. This situation might have negative consequences on fiscal revenues, real investment, development of the banking system and property rights. In order to improve the current situation, the government plans to conduct an investigation one-shot tax amnesty. In this paper we discuss the government's plans and propose an alternative – a return permanent tax amnesty.

In part 2 we report on different types of tax amnesties and on international experience. In part 3 we evaluate the official plans for a tax amnesty and present our alternative to this plan. In part 4 we compare the economic effects of both plans.

2. Types of tax amnesties

In this part we analyze the main issues of tax amnesty concepts important for our further discussion based on classifications to duration and type of the benefit that a taxpayer receives.

Duration criterion

One-shot amnesty: during such amnesties taxpayers are given a pre-determined period of time to legalize their past incomes (typically from two months to a year). It is expected that this offer will not be repeated in the future. The amnesty may be given at existing or reduced rates and civil or criminal penalties might be waived or reduced.

In theory the one-shot tax amnesty *with reduced tax rates* is quite attractive since it creates strong incentives for people to participate in it, thus, widening the tax base. However, it may lead to the future expectations of such amnesties, thus, reducing the tax compliance of individuals. Therefore, in order to ensure the success of the tax amnesty, the tax authorities should impose stricter tax enforcement what requires additional administrative costs.

Intermittent amnesty: amnesties are declared every few years. It has been a common practice in some countries to enact multiple amnesties, even though each one separately is advertised as a one-time-only grace period. For example, India has offered six amnesties since late 1970s. Multiple amnesties were enacted in Argentina, Belgium and the Philippines. The amnesties may be given at existing or reduced tax rates. However, intermittent amnesty is recognized to be the worst kind of a tax amnesty, because it raises permanent expectations concerning amnesties and reduces tax compliance.

Permanent amnesty: under such amnesties the possibility to legalize past incomes exists all the time, under normal, non-reduced tax rates. Except for taxes, taxpayers may be obliged to pay modest interest rates or fines. Criminal immunity is usually granted to tax evaders, who voluntarily paid their delinquent taxes. This amnesty actually represents the postponement of the deadline for the submission of the tax return. The USA, Germany[1], Canada, the Netherlands, Norway, Italy, New Zealand, Switzerland and Sweden have features of permanent amnesties in the tax systems.

As several empirical studies have shown, since the permanent tax amnesty is conducted at the non-reduced tax rates, its implementation leads to no revenue loss or even revenue increase in the long run (as opposed to negative long-run effects of one-shot and intermittent tax amnesties caused by expectations of further amnesties in the future). In

[1] The German permanent tax amnesty is called 'Selbstanzeige'.

addition, permanent amnesties may actually increase the efficiency and equity of the tax system.

Type of benefit to taxpayer

Return amnesty: under such amnesty taxpayers are offered the possibility to revise their tax returns with a reduced penalty. Such amnesty enables taxpayers to correct their income returns (upwards) and pay the missing taxes. Taxpayers accepting the amnesty are not immune from the investigation and auditing activities of the tax administration.

Investigation amnesty: such amnesty grants taxpayers with exemption from investigating the real amount and the origin of declared incomes, sometimes through paying a special amnesty fee. This type has been widely used in Italy (five amnesties between 1973 and 1995), the Philippines (seven amnesties between 1973 and 1986), Columbia (1987) and Argentina (four amnesties between 1970 and 1984).

3. Two options for tax amnesty in Ukraine

3.1. Government's plan: Investigation one-shot tax amnesty with reduced tax rates

At the beginning of 2003, the president raised again the question of the tax amnesty: there should be a one-shot tax amnesty with duration of 3-6 months and tax rate on legalized incomes of 10%. It may be not a tax, but a special deduction to the Pension Fund. Following this statement, at the beginning of March, First Vice-Prime-Minister Azarov announced that the Ukrainian government plans to introduce a tax amnesty on January 1, 2004, simultaneously with the Law on Personal Income Tax. According to his view, this will help to reduce the shadow economy and attract investment. Even though any specific details concerning the planned tax amnesty are not known so far, taking into account the previous discussion on the issue, we assume that the government plans the introduction of *an investigation one-shot tax amnesty* with significantly reduced tax rates.

The issue of a tax amnesty has been discussed most actively since 2000 following the president's decree that highlighted the importance of the legalization of personal incomes. Respective drafts were prepared by the government as well as by deputies. By trying to initiate a one-shot tax amnesty for physical persons, the president and the government pursued the objective of improving the investment climate and developing entrepreneurship activities in the country, reducing the shadow economy, increasing the credit potential and channeling funds into the real economy. The drafts of deputies foresaw a tax amnesty for both physical and juridical persons, and the major objectives was to return financial capital to Ukraine and in such a way expand the tax base for future periods. The common features of all drafts were that the taxpayers who declare past incomes were exempted from prosecution, no source of incomes was required, and criminal incomes could not be legalized. Moreover, the tax amnesties were proposed at reduced or zero[2] tax rates. However, neither of proposed drafts was adopted by the Verkhovne Rada.

3.2. Our proposal: Return permanent tax amnesty with non-reduced tax rates

We propose an alternative type of the tax amnesty - *a return permanent tax amnesty* (or voluntary income disclosure), which is another way to legalize past incomes of physical persons, both held domestically and abroad[3], on which taxes were not paid. Moreover, the provision of voluntary disclosure of incomes concealed in the past should be introduced in Ukraine together with the reduction of personal income tax rates[4]. Past incomes should be taxed at the normal tax rate that prevails when the declaration is done and is expected to

[2] Teryokhin's drafts (2000 and 2002) envisaged no taxes to be paid on the declared incomes.

[3] If the income held abroad was once taxed in Ukraine and left the country in illegal way (capital flight), it should be treated differently.

[4] On March 20, 2003, the Verkhovna Rada adopted in the second reading the Law on the Tax on Incomes of Physical Persons, which will introduce a flat personal income tax rate of 15%. However, the decision on the possibility of a reduced tax rate of 13% for the transitional period till January 1st 2006 will be considered in the third reading.

be in the range of 15%, which is much lower than currently. Thus, taxpayers will have high incentives to participate in the amnesty and the success of the tax amnesty is likely.

The provision of *return* tax amnesty would ensure that taxpayers present the correct information concerning the amount and the type of the taxable income, since it presupposes a possibility of random audits. The decision whether to audit a taxpayer who voluntarily disclosed past incomes should be based on objective factors; the tax authority should have as little room as possible in taking this decision. Furthermore, the government should announce greater tax enforcement, in order to promote even higher success of the amnesty.

4. Comparison of both plans

In this part we compare the economic effects of implementing the government's plan and our proposal. We consider their impact on the de-shadowing the economy, fiscal revenues, investment, the development of the banking sector, and property rights in Ukraine (i-v). Moreover we analyze the possible negative effects related to corruption and money laundering (vi-vii).

(i) De-shadowing

Government's plan

The government plans a tax amnesty with significantly reduced tax rates for declared incomes. Such an amnesty would create the expectation of future tax amnesties with reduced tax rates. Therefore, the taxpayer will have an incentive to wait until the next amnesty to declare his incomes, thus, reducing his tax compliance. Moreover, the compliance of honest taxpayers may also decline, as they see that non-payment of taxes may be forgiven. In such a way, the one-shot tax amnesty would encourage rather than combat the shadow economy. [5]

Our proposal

Since we propose a permanent tax amnesty with non-reduced tax rates, there will be no expectations concerning reduced tax rates in the future as well as no incentives to wait until the next amnesty. Therefore, such tax amnesty will not encourage shadow economy.

(ii) Public revenues

Government's plan

A short-term positive effect on public revenues is one of the major arguments of the advocates of the proposed tax amnesty. As people declare past incomes, they have to pay overdue taxes, that otherwise would have never been paid. However, as experience in the majority of countries shows, the short-term impact on revenues is not very significant. Besides, supporters claim that a one-shot tax amnesty may lead to a tax base widening through attracting personal incomes from the shadow to the official economy. However, in Ukraine such impact of the tax amnesty would be rather limited, since the planned reduction of tax and pension contribution rates is expected to widen the tax base anyway.[6]

Moreover, the fiscal success of any tax amnesty should be evaluated based on not only for short-term effects, but also its long-term effects on fiscal revenues. In the case of one-shot tax amnesties with reduced rates, the long-term effects are negative as shown by empirical studies[7], the major reason for which is reduced tax compliance, discussed in part 4(i). And the negative long-term effect of planned tax amnesty on public revenues would outweigh its positive short-term effect. Therefore, since current fiscal situation is rather stable in Ukraine, there is no rush in conducting one-shot tax amnesty with reduced rates.

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[5] This argument is also used in the part 4(ii).

[6] Due to low tax and pension contribution rates, a legalization of wage payments is expected to happen.

[7] Even the very successful Indian tax amnesty in 1997 (about 500 thousand persons participated in the amnesty and about USD 2.5 bn were collected) was later found to have had negative post-amnesty revenue effects that outweighed the gains during the tax amnesty

Our proposal

Proposed by us permanent tax amnesty will not have a large short-term positive effect on public revenues, since there may be a certain time lag between the introduction of permanent tax amnesty and taxpayer's decision to participate in it. But, in the long run a permanent tax amnesty will have a positive distributed over time effect on revenues. The tax non-compliance will not increase as a consequence of a return permanent tax amnesty, since there is no expectation about lower tax rates in the future, but the threat to be detected by the tax authorities is rather high.

(iii) Real investment

Supporters of a tax amnesty usually argue that during tax amnesty past incomes, held domestically and abroad, will be declared, which could further contribute to higher real investment. However, international experience shows that such linkage is rather weak. While many governments account on repatriated funds as a way to increase investment in the country, not many amnesties succeeded in legalizing funds held abroad. First, it is difficult to make capital return to the country. The amnesties in India (1997) and Kazakhstan (2001), one of the objectives of which was to repatriate capital from abroad, were not successful at all in this respect. Second, even if the amnesty is successful as in Italy (in 2002 about USD 55 bn were returned into the country), the repatriated funds were used for financial investments rather than for productive investments.

Moreover, since the tax amnesty is not the major factor determining the favorable investment climate in the country, just its implementation will not create enough incentives for people to invest more. Investment into Ukrainian economy will continue to be highly risky and costly even after one-shot amnesty due to high regulatory burden, legislative and political instability, etc. In addition, the non-legalization of incomes has not been a major impediment for investment in the past. A part of personal non-legalized incomes has been invested into real estate without facing real problem. Currently, construction and renovation are recognized to be one of the easiest ways to legalize incomes in Ukraine.[8] Besides, people have made investments through offshore zones in the past.[9] The fact that Cyprus is the second major foreign direct investor in Ukraine supports our view.

Government's plan

The effect of the one-shot tax amnesty on investment growth will be of marginal importance for Ukraine, since the investment climate is unlikely to improve during the short time of provision of the amnesty, and thus, the additional incentives for higher investments would not be created.

Our proposal

A permanent tax amnesty will provide the necessary time for an improvement of the investment climate. Thus, people may choose to participate in permanent tax amnesty when they feel that the investment climate has significantly improved and they can obtain a stable return on their investment without taking extra costs of operating in the shadow or through offshore zones.

(iv) Development of the banking sector

Currently the banking sector is developing very fast.[10] The planned reduction of personal income tax and pension contribution rates is expected to lead to further deposits growth, since both employers and employees will declare a higher share of the actual wage than before. Therefore, the banking system will remain growing at a high pace regardless the introduction of the tax amnesty.

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[8] Even at the primary market for real estate it is not required to declare the source of income to finance housing construction. There may be some stricter control as a result of the introduction of the law on money laundering.

[9] According to current regulations on privatization (definition of a strategic investor, privatization program) offshore companies are deprived of the possibility to participate in the privatization process.

[10] In 2002 the deposits of physical person grew by 68%.

Government's plan

If the introduced one-shot tax amnesty is not successful in legalizing incomes, then impact on the banking sector development will be rather low. However, if such amnesty is successful, then the legalization of past incomes and repatriation of capital during short period of time will bring a huge rapid inflow of funds to the banking sector. Therefore, taking into account current high pace of the banking sector development, the "successful" one-shot tax amnesty could rather have a destabilizing effect on it.

Our proposal

The attitude of many people to the Ukrainian banking system continues to be careful, but as time goes by, their trust to the banking system will increase, thus providing smooth and steady inflow of funds. Therefore, a permanent tax amnesty would have a gradual, sustainable and long-term effect on the banking system, characterized by a steady growth of deposits over time.

(v) Property rights

Tax amnesties grant a perfect opportunity to taxpayers to declare officially their incomes, stocks, real estate, cultural values, etc. and, thus, ensure their property rights. Currently, these objects may be registered under the name of unemployed or retired relatives or friends. After settling the old debts with the state, a taxpayer receives an opportunity to legalize all his savings and start his tax life from the very beginning.

However, the success of the tax amnesty in ensuring property rights extensively depends on the credibility of the state, which is rather low though increasing in Ukraine. People wishing to ensure their property rights will not declare their past incomes, if there is a probability of being pursued by tax or law-enforcement authorities in the future. This could happen if new government or parliament is selected.[11] Thus, for some taxpayers the cost and risk of operating in the shadow could be still lower than in the official economy, and thus, they will not participate in the tax amnesty before the credibility of the state improves.

Government's plan

The planned tax amnesty will be installed for a short period of time. Therefore, the possibility to ensure property rights through the declaration of past incomes would not be sufficient for a successful amnesty in Ukraine, since the improvement of the credibility of the government needs time.

Our proposal

Our proposal provides a very good opportunity for taxpayers to legalize their past incomes at a time of theirs' chosen: when there are a higher credibility to the state, no fear to be prosecuted and no threat that the results of the amnesty could be waived. The positive experience of other people who participated in the tax amnesty may provide additional incentives to the taxpayers to take part in the tax amnesty.

(vi) Money laundering

Government's plan

The planned *investigation* tax amnesty may lead to the legalization of incomes from illegal activities, since participants in a tax amnesty are not required to disclose their sources of income. Thus, such an amnesty provides an ideal opportunity for money laundering. Furthermore, it may promote future illegal activities in the country, as conducting a one-shot amnesty would nourish the expectations of future amnesties. Therefore, this type of amnesty might worsen Ukraine's relations with FATF and induce re-imposition of counter-measures.

[11] Extreme example of such treatment was one of the Belarus tax amnesty in the middle of 1990s.

Our proposal

Since we propose the *return* tax amnesty, the possibilities for money laundering will be minimized.

(vii) Corruption

Government's plan

The *investigation* tax amnesty in Ukraine is planned to be for all physical persons, including state employees. Since no source of income is expected to be required under an investigation tax amnesty, incomes received as a result of corruption, mainly through bribes, could be also reported, as some international experience reveals. Therefore, if state employees are given an opportunity to legalize their corrupted incomes, it will be equivalent to acknowledging that corruption can be forgiven and tolerated, which would even further promote corruption in the country. Moreover, this might lead to the worsening of the Ukraine's international reputation.[12]

Of course, the tax amnesty could exclude state employees from participation. However, this would not be a way-out, as incomes could be declared not by state employees themselves, but by their relatives or friends.

Our proposal

Due to the existence of possible random audits under *return* permanent tax amnesty, state employees will be able to legalize only past incomes earned as a result of activities which did not involved corruption.

5. Conclusions

In this paper we present two alternative approaches to achieve the goal of taxation and legalization of past incomes. The government plans to conduct an investigation one-shot tax amnesty with reduced tax rates. We propose to introduce a return permanent tax amnesty with non-reduced tax rates. The comparison of the economic effects of both plans shows that our proposal would be more effective and would not have the negative effects of the government's plan.

The amnesty planned by the government would lead to the expectation future amnesties with reduced rates. Therefore, it would not combat, but encourage activities in the shadow economy. Besides, it may increase public revenues, but only in the short-term and at the expense of public revenues in the long-term. Furthermore, it would only marginally contribute to higher real investment and it would have no positive effect on the banking system. Also, it might lead to an increase in corruption and money laundering.

The implementation of our proposal will not encourage the shadow economy and might have a positive long-term effect on public revenues. It would lead to a gradual increase in investment and to a stable development of the banking system. Besides, it would be effective in ensuring property rights in the long-term, because the provisions for voluntary disclosure of past income will remain in place in the future. Last, it would not allow incomes from criminal and corruption activities to be legalized.

Consequently, we advice the Ukrainian government to reconsider its plans for an amnesty and to introduce a return permanent tax amnesty with non-reduced tax rates.

N.L., S.B., R.G., Lector: F.P.

Kiev, April 2003

[12] For example, although the experience of 2001 tax amnesty in Kazakhstan is often cited as a successful example of tax amnesty, several experts view it as the tax amnesty for state officials (no source of income was required), which had a negative impact on the country's image.