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IRS' Fiscal Year 1988 Budget Request

Statement of
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Before the
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist the Subcommittee in considering the Administration's fiscal year 1987 supplemental and fiscal year 1988 budget requests for the Internal Revenue Service (IRS). Together, the two requests call for increasing IRS' staffing by 10,395 average positions, to a total of 110,661 positions, and increasing IRS' funding to $5.1 billion. About 84 percent of the increased staffing and 49 percent of the increased funding in the fiscal year 1988 budget are targeted for enforcement activities that are intended to increase revenues by $2.4 billion in fiscal year 1988 and by about $14 billion through fiscal year 1992.

My testimony today will emphasize five points.

-- First, although increased funding for IRS' enforcement activities may be warranted, we must qualify our support for the increases provided in the fiscal year 1988 budget. As we have noted in prior years' testimony, IRS has not developed an analytical framework and does not have the necessary information to determine whether the proposed allocation of additional resources within and among all of IRS' various enforcement activities is the most appropriate. For example, IRS does not include accounts receivable in the model it has developed to identify the optimal distribution of enforcement resources and the marginal yield associated with that distribution. Moreover, IRS has not yet determined the true amount and composition of its accounts receivable, which is paramount to deciding how many and what kind of collection resources it needs. Also, we have reservations about IRS' ability to actually increase its enforcement staff to the extent indicated in the budget request, and we question the adequacy of IRS' information systems to demonstrate that the additional enforcement resources actually generated as much revenue as estimated in the budget.

-- Second, we are concerned about the returns processing workforce--a workforce that is significantly seasonal and inexperienced. We believe that more attention should be focused on stabilizing service center staffing with a view toward improving the quality of work generated by that staff.

-- Third, the importance of IRS' Taxpayer Service function in helping taxpayers comply with the tax laws and the potential implications of tax reform on the demand for taxpayer service cause us to question the adequacy of the budget request as it relates to that function. IRS has already experienced considerable demand for assistance in interpreting the Tax Reform Act, and that demand is likely to grow next year when taxpayers, for the first time, have to prepare their returns in compliance with the act.

-- Fourth, ADP and Information Technology has grown to account for about 17 percent of IRS' overall budget.

Given the increasing importance of ADP in IRS and the challenges facing IRS with respect to several of its ADP projects, we believe that the progress of these projects should be closely monitored.

-- Fifth, the 1986 Tax Reform Act casts a cloud of uncertainty over IRS' budget. IRS has attempted to forecast the impact of that act on its activities; but recent events surrounding the new Form W-4 provide a vivid example of how those forecasts can go awry. One critical step in IRS' implementation of tax reform involves the rewriting of many computer programs. One of the reasons IRS ran into problems when it implemented the Service Center Replacement System in 1985 was the fact that rewritten computer programs were put into production without being adequately tested. We do not know whether IRS will have sufficient time this year to adequately test the programs it will be rewriting because of tax reform. Inadequately tested programs could cause problems that will put unforeseen demands on IRS' returns processing and taxpayer service functions.

INCREASES PROPOSED FOR ENFORCEMENT ACTIVITIES

In an attempt to reduce the federal deficit through increased revenues, IRS' fiscal year 1988 budget calls for a significant increase in resources devoted to revenue-producing enforcement activities. Those increased resources include

-- 3,002 positions and $121 million for the second year of a 3-year examination initiative, which IRS expects will increase audit coverage from 1.44 percent in fiscal year 1987 to 1.61 percent in fiscal year 1988 and increase tax collections in fiscal year 1988 by $443 million;

-- 2,967 positions and $122 million to accelerate the collection of $1.125 billion in accounts receivable;

-- 1,362 positions and $35 million to expand document matching, with a special emphasis on underreported income and an expected increase of $224 million in revenues;

-- 487 positions and $23 million to expedite resolution of tax shelter cases and to accelerate collection of $519 million in revenues; and

-- 172 positions and $5 million to expand examinations conducted by the service centers, which IRS expects will generate $70 million in additional revenue.

Although these increases are likely to enhance IRS' enforcement efforts, we are not sure to what degree. I would now like to discuss various factors contributing to that uncertainty.

Resource allocation models
need refining

In testifying last year on IRS' fiscal year 1987 budget, we noted that IRS was planning to implement an Enforcement Resource Allocation Model in June 1986. That model, which is designed to identify the optimal distribution of enforcement resources and the marginal yield associated with that distribution, was completed in November 1986 and thus was not used when IRS developed its fiscal year 1988 budget submission. Consequently, that part of IRS' budget request relating to enforcement activities was developed using output generated by various models or micro-based adaptations of models developed for specific enforcement activities.

IRS' enforcement activities are so interdependent and their relationships so complex that an analytical tool, like the Enforcement Resource Allocation Model, should greatly facilitate sound decisions on the level of budgetary support each activity should receive. We believe, however, that IRS needs to reconsider one feature of that model.

The Enforcement Resource Allocation Model, as we understand it, provides IRS with a capability to determine the best way to allocate additional resources among all of its enforcement activities except one--the collection of accounts receivable. According to an IRS briefing document, accounts receivable are excluded because IRS does not think additional resources for the examination function, which assesses new taxes, should compete with additional resources for pursuing assessments that taxpayers have already agreed they owe. IRS associates examination resources with additional revenue and accounts receivable resources with revenue it already expects to receive. We question whether IRS can estimate the optimal distribution of enforcement resources with a model that does not consider all enforcement activities.

IRS' Research Division worked with contractors to develop the Enforcement Resource Allocation Model and individual resource allocation models for the Collection and Information Returns activities. Examination's model was developed in-house and has been used for several years. On the other hand, Collection and Information Returns found their models too cumbersome and complex to work with, so they developed micro-based adaptations of those models. IRS' contractual costs to develop the Collection and Information Returns models amounted to $607,000 and $391,000 respectively. These cost figures exclude computer time and IRS staff costs. IRS has started to design a new Information Returns model and is considering several alternatives for developing a new Collection model.

Composition of accounts receivable still unclear

In our testimony last year before this Subcommittee, we noted that IRS' accounts receivable, which are taxes that have been assessed but not collected, had risen dramatically to $45 billion in December 1985. More recent information obtained from IRS shows that the dollar value of its receivables had increased to $47.6 billion as of September 1986 and is expected to approach $51 billion by the end of fiscal year 1987 and $53 billion by the end of fiscal year 1988.

Since our testimony last year, IRS has established a study group and initiated a quality improvement project to analyze the composition of its accounts receivable and to identify reasons for the growth in those accounts. IRS does not expect to complete its analysis until the spring of 1988. Hopefully, that analysis will provide IRS with reliable information on (1) the content of and reasons for the growth in its accounts receivable and (2) the kinds of operational changes needed to better assure that receivables are more accurately reported in the future. IRS needs this information to allocate resources effectively.

According to IRS officials, IRS reports its receivables in accordance with guidance established by the Department of the Treasury, the Office of Management and Budget, and GAO. IRS officials informed us, however, that its quarterly report to Treasury contains some inaccurate information, specifically with respect to interest and penalties, and that IRS has notified Treasury that it will discontinue reporting this information until the problem has been corrected.

Attachments I and II show the composition of IRS' accounts receivable for fiscal years 1981 through 1986, as categorized by IRS. Attachment II also includes a definition of the various categories IRS uses. Some of the categories include accounts that are more than likely never going to be collected. One category, for example, includes corporate accounts that are considered uncollectible because the corporation is defunct while another category includes accounts that have been suspended because of bankruptcy proceedings. Title 2 of GAO's Policy and Procedures Manual for Guidance of Federal Agencies provides for establishing an allowance to reduce receivables by the amount estimated as uncollectible. The allowance must be based on past experience, present market conditions, and an analysis of outstanding balances. IRS has established such an allowance in its report to Treasury, but that allowance may not accurately reflect the value of IRS' uncollectible accounts.

Based on discussions with Collection management and with members of the study group and quality improvement project, it seems likely that the actual value of IRS' accounts receivable is something other than what is being reported. It is unclear, however, whether the reported figure is over or understated. The study group, for example, has identified receivables that were caused by posting errors and thus were not really outstanding debts. On the other hand, the amount being reported as receivable does not include interest that has accrued since the time the tax was assessed. Although computing accrued interest for accounts that are unlikely to ever be collected would inflate the value of receivables, computing such interest for collectible accounts, like those included in the notice, taxpayer delinquent account, and installment categories, would provide a more accurate accounting of money due the government. IRS officials told us that because interest rates have changed more than 50 times over the past 10 years, computing accrued interest would be labor intensive. We do not know how difficult or costly it would be for IRS to compute accrued interest, but doing so would lead to a more proper accounting for receivables.

Based on its inquiries to date, IRS has identified several factors contributing to the growth in accounts receivable. In a February 1987 memorandum to Treasury concerning discussions with the Office of Management and Budget, the Commissioner of Internal Revenue partially attributed the growth to errors committed when posting quarterly federal tax deposits to business accounts. He added that this problem was exacerbated by the processing problems experienced during the 1985 filing season. The Commissioner also mentioned that the average dollar amount of taxpayer delinquent accounts continues to increase. For example, the average delinquent account in fiscal year 1982 was $3,415 compared to $6,152 in fiscal year 1986.

Allocation of proposed
Collection resources may
not be the most appropriate

The additional 2,967 Collection staff years requested in the fiscal year 1988 budget are all targeted to help IRS pursue accounts receivable. Given IRS' uncertainty about the composition of those receivables, we can not assure this Subcommittee that IRS needs that many additional Collection resources, or assuming it does, that its plan for allocating those resources represents the most efficient and effective use of the additional staff years.

IRS' Collection function is primarily concerned with pursuing accounts receivable and delinquent returns. It is important to recognize that delinquent returns, or non-filers, may pose a more serious threat to voluntary compliance than accounts receivable. With non-filers, returns have not been filed and taxes have not been assessed. Accounts receivable, on the other hand, represent taxes assessed and owed but not yet paid. IRS can readily identify these taxpayers, whereas it must rely on information matching or other compliance programs to identify non-filers.

IRS' fiscal year 1988 budget submission to Treasury proposed allocating 1,000 of the additional Collection positions to the delinquent returns program and the remaining 1,967 positions to the accounts receivable program. That allocation was subsequently revised to provide for directing all 2,967 positions to the accounts receivable program in order to accelerate revenue collections and facilitate meeting Gramm-Rudman deficit reduction targets. Consequently, IRS will not receive any additional resources to help it identify and pursue nonfilers.

IRS estimates that about half of the additional positions designated for the accounts receivable program will be filled by revenue officers. The remaining positions will be allocated to the Automated Collection System and support functions. In the past, IRS has allocated most of its additional Collection resources to staffing the Automated Collection System, which is a less costly means of collecting taxes owed. According to Collection staff, IRS decided to reverse the allocation in 1988 because it considers revenue officers better suited to work on high dollar, complex accounts.

We are not in a position to advise the Subcommittee on the most appropriate allocation of additional Collection resources. We believe, however, that the uncertainty over the composition of accounts receivable and the serious compliance problem caused by nonfilers call into question the decisions to allocate all those resources to accounts receivable and to designate so many of those resources to revenue officer positions rather than to the more cost effective Automated Collection System.

IRS' ability to assimilate
additional enforcement staff

In September 1986, the Commissioner of Internal Revenue forwarded to this Subcommittee estimates of the maximum number of staff IRS could assimilate between 1987 and 1991. The additional enforcement resources called for in IRS' fiscal year 1988 budget request approximate the numbers in that document. These figures were based in part on recommendations made by the President's Private Sector Survey on Cost Control as well as the best estimates of IRS' functional managers.

In reviewing IRS' implementation of the fiscal year 1987 phase of the 3-year examination initiative, we identified several factors that could affect IRS' ability to effectively recruit and assimilate the large numbers of staff called for in the 1988 budget. One factor relates to IRS' inability to make firm hiring commitments at a time that would enable it to better compete with the private sector in recruiting college seniors who are due to graduate in May or June. Accounting firms make offers during the winter months preceding a college senior's spring graduation. IRS cannot make a firm commitment, however, until late summer or early fall when it knows how many people it is authorized to hire.

A second factor involves training. A significant amount of a new hire's time is spent being trained, either in a classroom or on the job. IRS estimates that newly hired revenue agents spend 33 percent of their time conducting examinations during the first year and newly hired collection staff work at 65 percent capacity in the first year. Classroom training of newly hired revenue agents and the coaching of newly hired agents during on-the-job training is provided by experienced revenue agents. To the extent experienced agents are training and coaching, they are not conducting audits--a factor that IRS says it considers in developing its annual examination plan and budget.

A couple of issues relating to revenue agent training need to be recognized as IRS moves into the second and third phases of its examination initiative. Because an agent's training spreads over several years, the hiring of a second large class of new agents will increase the training workload and the need to divert experienced agents from doing audits. The second class will be receiving the initial phases of its training while the first class is receiving a subsequent phase of its training. Also, experienced agents who are responsible for training the new hires will have to be trained themselves to deal with the changes brought on by the 1986 Tax Reform Act.

A third factor that could affect IRS' ability to achieve the increased staffing levels provided in the 1988 budget is the possibility that enforcement resources will have to be diverted to fill a need in areas like Taxpayer Service and Returns Processing. Last year, for example, the Commissioner saw a need to increase the level of telephone assistance provided by Taxpayer Service and to insure that the service centers were sufficiently staffed so as to avoid a recurrence of the returns processing problems that affected IRS in 1985. Consequently, other functions, such as Examination, were unable to fill attrition vacancies until IRS received its supplemental appropriation for fiscal year 1986. That supplemental included funds to allow IRS to advance hire about 1,600 additional revenue agents for the first phase of the examination initiative. Before it could hire additional agents, however, Examination had to fill its vacancies. Because of that, IRS, as of January 1, 1987, had increased its on-board strength of revenue agents by 799--less than half of the budgeted increase. This could adversely affect IRS' ability to generate the additional examination revenues projected in the fiscal year 1987 budget. Fiscal year 1988 revenues could be similarly affected if IRS has to divert enforcement resources to implement the Tax Reform Act of 1986. That is discussed in more detail later in my statement.

IRS' ability to track revenues

The fiscal year 1988 budget cites various estimates of increased revenues the government can expect to collect as a result of the additional enforcement resources proposed in that budget. Although we believe the additional resources will generate additional revenues, we cannot assure this Subcommittee that the specific revenue estimates cited in the budget are reliable. The estimates were computed based on various assumptions that we did not validate. Examination, for example, based its revenue estimate on the assumption that IRS eventually collects 95 percent of the tax assessed as a result of audits.

One way to assess the reliability of an IRS estimate is to compare it with actual accomplishments. Although such a comparison comes too late to be of any value in making decisions based on that particular estimate, it does provide a base for determining the level of confidence that can be attributed to future estimates. The information IRS provides Congress in its budget documents, however, does not lend itself to that kind of analysis. IRS is claiming, for example, that the fiscal year 1988 phase of the 3-year revenue agent initiative will generate additional collections of $443 million in fiscal year 1988 and that continued implementation of the Automated Examination System will generate $58 million in additional revenue in fiscal year 1988. The revenue data that IRS tracks from year to year in the Examination portion of its budget, however, is presented in terms of additional taxes recommended and additional taxes, penalties, and interest assessed--amounts that may or may not translate into actual collections in the future. We believe this Subcommittee's oversight of IRS and the Congress' ability to evaluate future requests for additional staff or automation would be enhanced if IRS were required, from year to year, to show how much it actually collected as a result of its various staffing and automation initiatives and to explain how those figures were computed.

RETENTION PROBLEMS AFFECT SERVICE CENTER QUALITY

During this Subcommittee's hearings on IRS' fiscal year 1987 budget, one of the main issues centered around the adequacy of service center staffing levels. We believe that service center staffing still deserves special attention, but with a different focus. In the past we focused our concern on the number of staff years budgeted for the service centers. We are now equally concerned with the quality of that staff's work.

The following information, obtained from various IRS sources, provides the basis for our concern about quality:

-- Historically, seasonal employees have constituted a large segment of a service center's staff. According to an IRS staffing document, for example, 61 percent of the returns processing staff at IRS' ten centers as of February 28, 1987, were seasonal employees. In the past, many seasonal employees would return to the service centers from one year to the next, bringing their experience with them. The percentage of new hires in the seasonal workforce has been increasing, however, from 45 percent in fiscal year 1984 to 65 percent in fiscal year 1986.

The percentages in some service centers are much higher. At Austin, Andover, and Atlanta, for example, the percentages of new hires in fiscal year 1986 were 91, 80, and 79 respectively.

-- During the 1985/1986 recruiting season, the speed and accuracy rates used by the 10 service centers to determine whether newly hired data transcribers had successfully passed their training and were ready to process real tax returns ranged from 2,400 keystrokes an hour in Andover to 4,670 keystrokes an hour in Atlanta and from a 10 percent error rate in Memphis to a 25 percent error rate in Philadelphia. In 8 of the 10 service centers, the acceptable error rate was 18 percent or higher.

-- Staff inexperience decreases production and, more importantly, increases the risk of error. During the first 4 months of 1986, for example, inexperienced code and edit staff in the Philadelphia Service Center processed 16 percent less Form 1040s per hour than experienced staff and committed 71 percent more errors.

Among other things, poor quality work at a service center increases the risk of untimely refunds and erroneous notices to taxpayers and can have a significant impact on inventories of adjustments/correspondence and unpostables--inventories that have been the cause of much concern over the past couple of years. Although the service centers have generally succeeded in reducing the size of those inventories, as of January 2, 1987, 8 of the centers had adjustments/correspondence inventories and 9 had unpostable inventories that still exceeded IRS' criteria for manageability. Attachments III and IV show those inventory levels by service center and relate those levels to IRS' criteria for manageability.

IRS recognizes the detrimental effect of inexperienced staff on quality. As evidence of that recognition, IRS' budget submission to Treasury included several proposals directed at enhancing the quality of service center work, none of which were approved. Included among those initiatives was one directed at converting seasonal positions to permanent positions. IRS has taken steps in most service centers to convert some seasonals to permanents by training them to perform more than one job. For example, an employee could work as a data transcriber in returns processing for part of a year and an examiner in document matching for the rest of the year. IRS' proposal to Treasury would have given this effort more momentum by providing about $2.8 million to allow for salary increases to convert 1,620 employees to permanent positions.

The benefits from converting seasonals to permanents or from any other steps that might be taken to stabilize the service center workforce are critical. Without such stability, IRS will find itself using more and more of its limited resources to avoid and/or correct errors caused by inexperience. We would suggest that the Subcommittee pursue the service center staffing issue with IRS and Treasury, with particular emphasis on identifying steps that can be taken to stabilize that workforce and opportunities that might exist to convert more seasonal employees to permanents. In its fiscal year 1988 request, for example, IRS is asking for over 1300 additional positions to expand document matching at the service centers. Maybe some of those positions could be filled by crosstraining seasonal returns processing staff and converting that staff to permanent positions.

FUNDING LEVEL FOR TAXPAYER SERVICE MAY BE INSUFFICIENT

This country's tax system hinges on the willingness and ability of taxpayers to voluntarily comply with the tax laws. Taxpayer service is IRS' primary vehicle for assisting taxpayers in understanding and complying with those laws. A major aspect of that service involves assistance to taxpayers who phone IRS seeking information that will help them correctly prepare their tax returns or otherwise meet their obligations. The proposed fiscal year 1988 budget includes 5,704 positions and $260.5 million for taxpayer service.

In reviewing recent years' budget requests for IRS, this Subcommittee has questioned whether the funds being provided for taxpayer service were sufficient to support an adequate level of service to taxpayers. That question seems appropriate again this year.

As a minimum, IRS strives to provide an 80 percent level of service to taxpayers phoning in for assistance; that is, have enough staff to respond to 80 of 100 taxpayers calling taxpayer service at any given moment. According to IRS, the fiscal year 1987 budget for Taxpayer Service only included enough resources to enable IRS to provide about a 65 percent level of service. To raise that level, the Commissioner redirected funds to Taxpayer Service from other IRS activities. According to IRS statistics, for the 13 weeks ended March 28, 1987, Taxpayer Service provided a 77 percent level of service compared to 82 percent during the same period last year.

The budget submission for fiscal year 1988 includes $15.1 million and 411 positions to help Taxpayer Service handle its tax-reform related workload next year. Even with those additional resources, however, IRS is estimating that it will only be able to achieve a 65 percent level of service in 1988. If the Commissioner chooses to reprogram funds to increase that level of service, he may have to do so at the expense of IRS' enforcement activities.

As evidence of the potential impact of tax reform on the demand for assistance, IRS' monitoring of calls received on March 24, 1987, indicated that 17 percent of the calls pertained to the Tax Reform Act. About one fourth of those calls related to the new W-4.

ADP AND INFORMATION TECHNOLOGY

Of IRS' fiscal year 1988 budget, about 17 percent, or $847 million, is targeted to provide staff and fund projects related to ADP and information technology. That is an increase of about $213 million, or 34 percent, over the amount originally included in the budget for fiscal year 1987 and reflects IRS' growing dependence on computers and information technology.

The $847 million includes about $122 million for three projects about which GAO testified before this Subcommittee on February 6, 1987. Those projects involve (1) replacing front-end processors and computer terminals at the service centers, (2) leasing and maintaining the existing mainframe computers used to process tax return information, and (3) redesigning IRS' tax processing system. As GAO noted during its testimony, IRS faces challenges with each of those projects.

GAO noted, for example, that because of hardware and software problems, IRS does not expect new front-end processors to be installed in all service centers until September 1988, or about 1 year after the original scheduled date. Consequently, IRS will have to rely on existing outdated and capacity-limited processors for the 1987 and 1988 tax filing seasons. IRS also must begin to successfully implement several planned initiatives designed to make more efficient use of its existing mainframe tax processing computers. If it can do so, the computers should be able to handle IRS' needs until mid-1991. Otherwise, problems could occur as early as mid-1988. Finally, IRS' plans for redesigning its tax processing system represent an extremely important, yet highly complex and difficult transition from outdated computer technology to state-of-the-art computer and telecommunications technology. IRS envisions this redesign as an evolutionary process and is taking the first step in that process by developing a preliminary design concept, an acquisition strategy, a transition plan, and a management plan. This step, which IRS expects to complete by February 1988, is essential if IRS, Treasury, and the Congress are to understand this long-term overhaul and its budgetary implications.

Information systems are also a large and growing part of IRS' compliance activities. The fiscal year 1988 budget, for example, includes $67 million to maintain and enhance operation of the Automated Collection System, $25 million for the Integrated Collection System which will be pilot tested in the Southwest region, and about $129 million to continue implementing the Automated Examination System.

Given all these automation efforts, fiscal year 1988 may be the most pivotal year to date in IRS' increasing dependence on computers. In view of the growing importance of ADP to IRS' mission and the number of dollars already authorized and to be requested in the future, we believe that the Subcommittee's oversight would be facilitated if IRS were to more fully describe what each of its major automation efforts is intended to accomplish. With each fiscal year budget submission, IRS should spell out the anticipated budget requirements for each major project as well as any significant changes in previously funded projects and the potential impact on related programs and activities. The Subcommittee could use this information to help judge whether IRS is effectively planning and executing its ADP initiatives and whether IRS can, in fact, successfully improve its ability to process tax returns, make timely refunds, accomplish compliance objectives, and accurately maintain taxpayer accounts in the face of an increasing tax administration workload.

IMPACT OF TAX REFORM

The Tax Reform Act of 1986 was the most extensive change in tax law since 1954. Some of the act's provisions likely to affect IRS and the taxpaying public include: changes in the basic tax rate structure for individuals, elimination or reduction of certain itemized deductions, repeal of the deduction for contributions made to an Individual Retirement Account for many of those participating in an employer-maintained retirement plan, taxation of a minor's unearned income at the higher of the minor's or the parent's marginal tax rate, a requirement that social security numbers be reported for all dependents age 5 and older claimed as deductions, and a requirement that employees submit revised withholding (W-4) forms.

In order to implement the new tax law and to assist the taxpaying public, IRS must, among other things, extensively reprogram its computers, develop and print new regulations and tax forms, review employee benefit plans, educate taxpayers so they can understand and comply with the new law, respond to what is expected to be a significant increase in taxpayer requests for direct assistance, and train IRS employees.

IRS has developed a preliminary plan for implementing the Tax Reform Act which identifies specific actions that must be taken, assigns responsibility for those actions, and establishes milestones. The plan is being refined based on input from the various IRS components and is expected to become final in May 1987. Some of the actions called for in the plan have already been completed and others are being worked on.

In preparing its supplemental appropriation request for fiscal year 1987, IRS had estimated that it would need $119 million to implement the Tax Reform Act. The Administration approved $80 million of that request--the amount that is included as part of the request now before Congress for approval. The fiscal year 1988 budget provides for another $80 million to continue implementing the Act--about $10 million less than Treasury had requested in its submission to OMB.

As IRS implements tax reform, unforeseen problems may arise that will require resources beyond those provided for in the budget. In estimating its resource needs, for example, IRS did not anticipate the controversy that surrounded its new form W-4 and the need to develop a second form--an effort which cost about $6 million according to IRS. The potential impact of unforeseen problems on activities like Returns Processing and Taxpayer Service could be significant and could, as happened in 1986, cause IRS to divert resources away from its revenue-producing functions. As mentioned earlier, that, in turn, would affect IRS' ability to fully realize the additional revenues cited in the budget.

One of the more important steps IRS must take in implementing the act is to revise many of the computer programs used in processing returns. It is critical not only that the programs be revised but also that the revisions be adequately tested before the programs are put into production. One reason IRS encountered problems when it implemented its new service center computer system (called the Service Center Replacement System) in 1985 was the fact that rewritten computer programs were not adequately tested before they were put into production. The new system had to be in operation in January 1985, and IRS had no choice but to put programs into production no matter how well they had been tested and "debugged."

Time is also of the essence with respect to tax reform. The rewritten programs have to be in operation by January 1988. Recent conversations with the Chief of IRS' Testing Branch indicate that there may be insufficient time to test all those programs to the extent desirable. If defective programs are put into production, the impact on IRS operations and taxpayer relations could be severe. For example, inventory levels that the service centers have been trying to bring under control could swell again.

Because of the potentially adverse effects if IRS' implementation of tax reform should run into problems, we would suggest that the Subcommittee require IRS to provide periodic reports on the status of its implementation of the Tax Reform Act, with specific emphasis on any unforeseen problems.

CONCLUSION

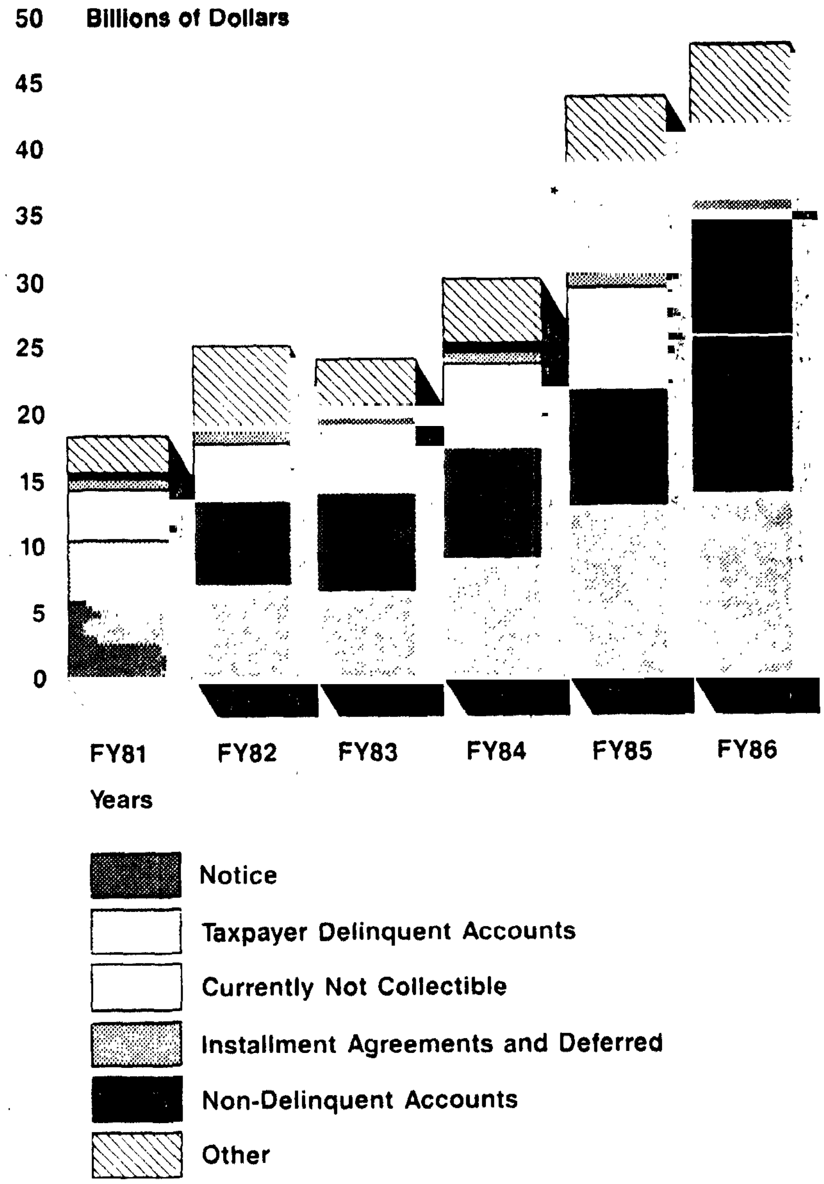
In conclusion, although increasing IRS' budget for fiscal year 1988 may be warranted, we can not verify the extent to which the requested increases will enhance IRS' ability to collect additional revenues and ensure greater compliance with the tax system. We also want to emphasize the importance of allocating sufficient funds and resources to Taxpayer Service. Even though it is a non-revenue producing activity, Taxpayer Service helps taxpayers comply with the tax laws and plays a vital role in the success of a tax administration system that is based on voluntary compliance. Considering the potential implications of tax reform and the sizeable number of tax reform-related calls IRS has been receiving this year, we think the Subcommittee should question the adequacy of IRS' budget for Taxpayer Service.

There are three other budget-related issues that we believe would benefit from Subcommittee oversight. First, the Subcommittee should discuss with IRS steps that can be taken to stabilize the service center workforce. To the extent IRS is able to retain experienced service center employees, the quality of its work is likely to improve. Such an improvement should enhance public confidence in the tax system. Second, the Subcommittee should ask IRS to define anticipated accomplishments for each of its major automation efforts and to provide periodic status reports on the progress of these efforts. Computer and information technology comprises an increasing percentage of IRS' total budget and plays an integral role in virtually all of IRS' primary tax administration responsibilities. Third, the Subcommittee should request IRS to provide periodic status reports on its implementation of the Tax Reform Act. A failure to successfully reprogram computers, write regulations, devise new tax forms, or train IRS employees could have serious consequences.

This concludes my prepared statement. I will be pleased to answer any questions.

ATTACHMENT I

Status of Accounts Receivable, Fiscal Years 1981-1986



*An Accounting Change Was Made in Fiscal Year 85 That Reclassified Balance Due Notices Under 30 Days From Delinquent to Non-Delinquent Status

Source: IRS

IRS' ACCOUNTS RECEIVABLE
FY 1981 through FY 1986 (000,000)

Type of Account	FY 81	FY 82	FY 83	FY 84	FY 85	FY 86
Notice[1]	$ 5,739	$ 6,890	$ 6,273	$ 8,796	$12,720	$13,661
Taxpayer Delinquent Account[2]	4,679	6,717	7,708	8,512	9,143	11,922
Currently Not Collectible[3]	3,935	4,138	4,995	6,262	7,588	8,995
Installment[4]	569	472	582	683	685	777
Deferred[5]	199	243	251	253	254	392
Non-delinquent[6]	595	598	668	712	8,174	5,746
Other[7]	2,652	6,275	3,621	4,891	4,893	6,152
Total	$18,368	$25,333	$24,098	$30,109	$43,457	$47,645

Source: IRS

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[1]Notices: Unpaid accounts for which a notice has been issued by a service center and which are more than 30 days past the latest assessment date. Routine notice cases remain in notice status 13 weeks for businesses or 25 weeks for individuals. Depending on the circumstances this can be accelerated or extended.

[2]Taxpayer Delinquent Accounts: Accounts completing the notice stage which are pursued either through IRS' Automated Collection System or by a collection officer in the field.

[3]Currently Not Collectible: Accounts which IRS has determined to be currently not collectible due to hardship, inability to locate a taxpayer or because a corporate taxpayer is defunct. These accounts are inactive, but are monitored to update status and offset refunds.

[4]Installment Agreements: Accounts for which IRS and the taxpayer have entered into an agreement that provides for the account to be paid off in regular installments.

[5]Deferred: Inactive accounts whose aggregate balance falls below established thresholds and which IRS does not consider cost-effective to pursue.

[6]Non-delinquent: Accounts in notice stage less than 30 days and accounts for which the taxpayer has elected a statutory installment privilege (e.g. payment of estate tax).

[7]Other: Accounts in litigation (e.g. bankruptcy) or accounts with adjustments pending that will satisfy the liability.

IRS' ADJUSTMENTS/CORRESPONDENCE INVENTORY[1]

Service Center	Total Inventory 12/20/85	Total Inventory 1/2/87	Controlled Inventory[2] 12/20/85	Controlled Inventory[2] 1/2/87	Overage Cases[3] 12/20/85	Overage Cases[3] 1/2/87	Percentage of Overage Cases[4] 12/20/85	Percentage of Overage Cases[4] 1/2/87
Andover	91,195	53,777	68,396	40,333	13,423	19,240	19.6	47.7
Atlanta	207,191	70,391	155,393	52,793	146,592	25,942	94.3	49.1
Austin	156,061	61,461	117,046	46,096	91,578	15,525	78.2	33.7
Brookhaven	110,176	73,536	82,632	55,152	66,323	41,058	80.3	74.4
Cincinnati	25,827	36,228	19,370	27,171	1,989	3,296	10.3	12.1
Fresno	213,299	55,011	159,974	41,258	144,791	12,152	90.5	29.5
Kansas City	47,067	32,980	35,300	24,735	13,800	2,775	39.1	11.2
Memphis	86,808	55,073	65,106	41,305	54,640	16,773	83.9	40.6
Ogden	85,507	39,587	64,130	29,690	49,792	12,771	80.1	43.0
Philadelphia	93,770	64,832	70,328	48,624	15,175	12,245	21.6	25.2
National	1,116,901	542,876	837,675	407,157	598,103	161,777	71.4	39.7

Source: IRS

[1]IRS considers an adjustments/correspondence inventory manageable when no more than 20 percent of the controlled cases are active beyond 45 days. A case is controlled if it is entered on IRS' Integrated Data Retrieval System along with the identity of the tax examiner working it. A case is supposed to be controlled if it cannot be closed within 14 days of its receipt by IRS.

[2]These numbers were computed based on an IRS estimate that 75 percent of the total inventory is controlled.

[3]Overage cases are those more than 45 days old.

[4]These percents were computed by dividing the number of overage cases by the number of controlled cases.

IRS' UNPOSTABLES INVENTORY[1]

Service Center	Total Inventory 12/27/85	1/2/87	Overage Cases 12/27/85	1/2/87	Percentage of Overage Cases[2] 12/27/85	1/2/87
Andover	97,450	53,678	3,570	17,604	3.7	32.8
Atlanta	247,134	121,241	64,379	42,821	26.1	35.3
Austin	276,403	70,042	103,547	17,884	37.5	25.5
Brookhaven	217,192	90,580	55,012	25,305	25.3	27.9
Cincinnati	57,566	45,962	9,579	10,245	16.6	22.3
Fresno	220,712	76,713	63,828	18,975	28.9	24.7
Kansas City	62,876	64,893	28,393	21,464	45.2	33.1
Memphis	77,886	46,706	17,866	13,532	22.9	29.0
Ogden	75,617	34,464	11,248	6,403	14.9	18.6
Philadelphia	244,130	114,185	44,824	27,415	18.4	24.0
National	1,576,966	718,464	402,246	201,648	25.5	28.1

Source: IRS

[1]IRS considers an unpostables inventory manageable when no more than 20 percent of the cases are overage.

[2]These percentages were computed by dividing the total inventory into the number of overage cases.