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Administration's Fiscal Year 1990 Budget
Proposals For IRS and the Tax Court

Statement of
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Tax Policy and Administration Issues

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



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ADMINISTRATION'S FISCAL YEAR 1990
BUDGET PROPOSAL FOR IRS

SUMMARY OF STATEMENT
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The Administration's fiscal year 1990 budget request for IRS calls for about \$5.5 billion, an increase of about \$289 million over IRS' authorized level for fiscal year 1989. That increase may not be enough, however to maintain basic operations. IRS is in the midst of a budget shortfall in 1989 that has caused it to impose a hiring freeze and cut back on various administrative costs, and another shortfall in 1990 seems likely.

According to IRS, this year's shortfall is about \$360 million. Some of that shortfall was due to unfunded personnel costs, like the 4.1 percent pay raise that went into effect after IRS prepared its budget request. It is not realistic to expect agencies to continually absorb pay and benefit increases and not suffer adverse operational consequences. Another part of the shortfall was due to IRS' decision to reprogram funds so it could undertake several unfunded program initiatives. Although IRS has had to cut back on supplies, defer equipment replacements, curtail some enforcement efforts, and transfer some staff, the shortfall apparently did not significantly disrupt IRS' operations during the first half of the fiscal year. What lies in store for the rest of the fiscal year will be more clear after IRS completes its mid-year financial review in late April or early May. Congress should ensure that adequate resources are available to fund IRS' current operations before approving funds for new initiatives.

IRS' fiscal year 1990 budget includes \$230 million to fund several initiatives that are intended to improve IRS' responsiveness to taxpayers, modernize ADP systems, or generate additional revenue. Although GAO is generally supportive of those initiatives, it makes little sense to embark on new initiatives when the agency is having difficulty making ends meet for current operations.

It is likely that the agency will face continued problems in funding its current level of services in 1990. The most critical factor that could lead to a shortfall next year is the absence of any funding to cover the costs of implementing three laws that were enacted after IRS prepared that request. Of the three laws, the Technical and Miscellaneous Revenue Act of 1988 will have the greatest effect on IRS' budget.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist the Subcommittee in its inquiry into the Administration's fiscal year 1990 budget request for the Internal Revenue Service (IRS).

That request is for about \$5.5 billion, an increase of about \$289 million from fiscal year 1989. The request would fund about 115,000 average positions, an increase of about 2,050 from fiscal year 1989. Included in the increase is about \$230 million for various new program initiatives.

A key issue appears to us to be unresolved--how much money is really needed to adequately fund IRS' current operations and changes necessitated by legislative mandates and increasing workloads? With IRS' budgetary situation in fiscal year 1989 as a prologue, we question whether the Administration has properly reflected what IRS will need to assure adequate funding of its ongoing activities in fiscal year 1990.

Given the probable shortfall in funds needed for current operations and mandated increases, we question whether it is realistic to consider applying any new funds received to discretionary initiatives.

FISCAL YEAR 1989 SHORTFALL

IRS has said it will experience a budgetary shortfall this year of about \$360 million. Some of the shortfall stemmed from costs that could have been anticipated, but the Administration's budget procedures do not allow agencies to include these projected costs in their budget requests. For example, about a fourth of the shortfall (\$85 million) was due to the 4.1 percent pay raise that became effective in January 1989. All federal agencies knew for months that they would have to absorb that raise and that there would probably not be supplemental appropriations to cover it. IRS' budget also did not reflect unanticipated costs due to such changes as a postal rate increase that became effective in April 1988 or sufficient increases for employee health insurance premiums and retirement benefits.

IRS is no different from other agencies in having to deal with such unfunded costs, nor are those costs a new phenomenon. In the past, agencies were able to recover at least some of these costs through supplemental appropriations. The November 1987 budget agreement between the Administration and the Congress, however, stipulated that requests for supplemental appropriations should only be initiated in cases of dire emergencies. Accordingly, when IRS submitted a request for supplemental funding in spite of this guidance, that request was denied by the Office of Management and Budget (OMB).

IRS exacerbated the shortfall by funding several new program initiatives during fiscal year 1989. According to IRS, about \$82 million of the shortfall was due to initiatives that IRS decided to undertake in fiscal year 1989 even though it received no additional funds for those initiatives. Of that amount, IRS attributed \$57 million to an initiative that was directed at improving the telephone assistance program by stabilizing and upgrading the work force responsible for answering taxpayers' telephone inquiries. Although that initiative is important and responds to GAO's and the Subcommittee's concerns about the quality of IRS' telephone assistance, IRS' decision to fund it and other initiatives in 1989 added to the budgetary problems in other parts of the agency.

Effect of the 1989 shortfall

To deal with this year's shortfall, IRS, at the beginning of the fiscal year, implemented a hiring freeze and imposed restrictions on travel, training, equipment acquisitions, and the like. We discussed those actions with officials in IRS' National Office; its service centers in Andover, Massachusetts, and Fresno, California; its Compliance Center in Austin, Texas; and its District Office in Baltimore, Maryland. We also talked to representatives of the National Treasury Employees Union.

Those discussions indicated that the cutbacks and restrictions have led to reduced supplies; deferments of equipment replacements; cancellation of plans to convert some staff from temporary to permanent positions; and the curtailment of some compliance efforts, such as a reduction in the number of correspondence audits done at the Fresno Service Center. At the service centers, some seasonal employees were furloughed and some personnel were transferred from one function to another, but these changes may not all be due to the budget shortfall. Management at the Andover Service Center told us, for example, that 699 employees had been furloughed since January 1, 1989, primarily because (1) attrition was much lower than expected and (2) staff were more efficient and making fewer errors.

One effect of the shortfall that has apparently not happened to the extent anticipated has been a reduction in compliance staff through the hiring freeze. Examination, for example, originally expected to reduce its staffing by about 1,000 positions nationwide. As of March 30, however, Examination was expecting reductions of no more than 200 positions because attrition had been much lower than anticipated. An Examination official told us that because staffing levels were not going down as much as anticipated, the shortfall had to be made up in other ways. The one significant cutback he mentioned involved a reduction in the amount of funds that would be devoted to the Automated Examination System in 1989.

Because the hiring freeze has apparently not had its intended effect, it is unclear what specific steps IRS will take to completely eliminate the budgetary shortfall or what effect, if any, those actions will have on taxes collected. The situation may become clearer around the end of April when IRS managers in the National Office and in the field are to submit revised financial plans. In preparing their plans and deciding what steps to take to stay below allocated expenditure ceilings, the managers were told to (1) not cut back mandatory training or travel required to resolve specific tax cases; (2) ensure that returns are processed and remittances deposited on time; and (3) provide an 85 percent level of telephone service during the filing season, which is the level IRS strives to achieve every year.

Based on our review of IRS documents and our discussions with IRS personnel, we are not aware of any specific cut backs that would adversely affect IRS' ability to provide telephone assistance, distribute forms and publications, or process tax returns. In fact, when IRS notified its regions in October 1988 of the need to freeze the hiring of technical staff, it specifically exempted returns processing, forms distribution sites, and taxpayer assistance.

IRS' BUDGET REQUEST FOR
FISCAL YEAR 1990

As noted earlier, the Administration's fiscal year 1990 budget request calls for an increase of 2,052 average positions and about \$289 million over IRS' authorized levels for 1989. This increase is a net of (1) increased funds for current services, workload increases, and new program initiatives and (2) decreases because of nonrecurring costs, expected savings, and transfers to other organizations. Although the budget calls for a net increase in IRS' funding, it may not be enough to maintain basic operations. The major reason is the absence of any allowance in the budget for additional costs IRS expects to incur in implementing legislation that was enacted toward the end of 1988.

Program initiatives

IRS' 1990 budget includes about \$230 million to fund several new program initiatives. Each initiative has at least one of three primary objectives--collect additional tax revenue, improve responsiveness to taxpayers, or modernize ADP systems.

We generally support the initiatives in the 1990 budget request. My colleague from GAO's Information Management and Technology Division will testify separately on the initiatives in the ADP area. As for the initiatives to improve responsiveness to

taxpayers, we have testified before this Subcommittee several times about quality problems in the telephone assistance program and in IRS' correspondence with taxpayers. The 1990 budget request includes funds to improve both aspects of communication with taxpayers.

We also support initiatives to collect more taxes owed the government. Our support is founded on a concern over the low level of audit coverage (just over 1 percent in fiscal year 1988), the increasing level of accounts receivable (about \$65 billion as of the end of February 1989), and the size of the overall tax gap (estimated to be \$87.1 billion in 1988). The five revenue initiatives in this year's budget are intended to allow IRS to (1) dispose of 47,000 more delinquent accounts, (2) resolve single issues on 188,000 more tax returns through service center contacts with the taxpayers, (3) work 332,000 more revenue-producing cases in the Combined Annual Wage Reporting Program under which IRS reconciles information reported to the Social Security Administration on annual wage documents and information reported to IRS on employment tax returns, (4) improve overseas tax compliance, and (5) monitor the use of social security numbers to claim exemptions for dependents. IRS estimates that these five initiatives will generate \$318 million in additional taxes, penalties, and interest in fiscal year 1990.

As we have reported to you in prior years, neither we nor IRS know whether specific revenue initiatives are the most efficient and effective use of additional enforcement resources. In addition, we have not reviewed the specific revenue estimates associated with these 1990 initiatives and thus cannot comment on their reliability. The estimates, however, should be balanced against any revenues that might be lost as a result of reduced enforcement staff that may result from this year's shortfall or that may materialize next year.

Prospects for a shortfall
in fiscal year 1990

The Administration's fiscal year 1990 budget request for IRS does not include various costs and includes questionable savings, thus providing the framework for another shortfall next year. Most significantly the 1990 budget request does not include funding to cover the substantial costs that IRS expects to incur in implementing three new pieces of legislation. Like 1989, the 1990 budget does not include sufficient funds for increased salaries, insurance premiums, and retirement benefits. Finally, the budget includes savings that OMB has determined IRS can achieve through efficiencies associated with assessing the possibility of contracting out certain jobs under OMB Circular A-76--savings that IRS claims are unattainable.

Unfunded costs to implement
new legislation

The Administration's budget for fiscal year 1990 does not include funds to cover any additional costs IRS might incur in implementing the Technical and Miscellaneous Revenue Act of 1988, the Anti-Drug Abuse Act of 1988, and the Medicare Catastrophic Coverage Act. As of the end of March 1989, IRS had not finalized its estimates of additional operating costs associated with the three new laws. It had developed preliminary figures, however, which indicated that a total of about 1,800 additional positions and \$150 million would be needed to implement the three laws. Absent supplemental funding, IRS will have to absorb these costs.

Of the three acts, the Technical and Miscellaneous Revenue Act of 1988 affects IRS the most. Of the many provisions in that act, the ones cumulatively known as the Taxpayer Bill of Rights will have the most effect on IRS. Among other things, those provisions require IRS to inform taxpayers of their rights, provide for administrative relief in certain situations, and allow taxpayers to tape record in-person interviews. In its preliminary assessment of the impact of the Bill of Rights, IRS believes that substantial staff and/or dollars will be needed to

do such things as (1) revise and distribute more than 300 forms and publications, (2) insure the validity of written responses to taxpayers' requests for advice, (3) improve the content of tax due and deficiency notices, (4) issue Taxpayer Assistance Orders, and (5) write regulations regarding the award of costs and fees in administrative and court proceedings.

The Anti-Drug Abuse Act of 1988 was passed to prevent the manufacturing, distribution, and use of illegal drugs. According to IRS, its workload, especially in the criminal investigations area, will be increased by the act's provisions relating to international narcotics control, drug trafficking, money laundering, and the requirement that certain businesses file Currency Transaction Reports.

According to IRS, the Medicare Catastrophic Coverage Act requires IRS to collect a supplemental premium from those covered by Medicare. To do that, IRS says it will need to process additional tax forms, rent and install ADP equipment, and respond to more taxpayer service contacts in fiscal year 1990.

Unfunded personnel costs

According to IRS, several of the unfunded personnel costs that contributed to this year's shortfall will also contribute to a shortfall in 1990. IRS' estimates of unfunded costs associated

with the 1990 budget include (1) about \$32 million related to the 4.1 percent federal pay raise that took effect in January 1989, (2) about \$40 million related to the proposed 2 percent raise should it take effect in January 1990, and (3) about \$48 million related to increased insurance premiums and retirement benefits.

Projected savings from

OMB Circular A-76

Among the various reductions in the Administration's 1990 budget for IRS is one for \$13 million that OMB has determined IRS can save through the efficiencies associated with studying, competing for, and possibly contracting out certain jobs as required by OMB Circular A-76. IRS officials we talked to felt that the number of positions subject to study under that Circular are much less than the number OMB believes should be studied. IRS officials felt also that there is little, if any, potential for savings in this area. The Treasury Department has little historical experience with contracting out, and the potential for IRS to save this amount through A-76 reviews is unknown. We have suggested that OMB revise its A-76 approach to allow agencies more latitude in deciding how to achieve efficiency goals rather than imposing such rigid requirements.

TAX COURT'S BUDGET FOR
FISCAL YEAR 1990

You also asked for our comments on the U.S. Tax Court's budget for fiscal year 1990. That budget totals \$28.1 million, the same amount appropriated in fiscal year 1989 if you do not count the \$1.2 million included in the 1989 appropriation for a new chiller/air conditioning system in the Court's Headquarters Building. Funds for the chiller/air conditioning system have been obligated and Tax Court officials expect it to be on line within 2 years. For fiscal year 1990, the Tax Court expects to absorb the costs associated with inflation and its budget includes no request for additional staff.

During the last 2 fiscal years, the Tax Court has made significant progress in reducing its case inventory. During fiscal year 1988, the number of cases filed with the Court declined 23 percent from the prior year and the number of cases closed increased 5 percent over fiscal year 1987. Altogether, the Court's inventory fell 17 percent during fiscal year 1988, from 81,549 cases at the end of fiscal year 1987 to 67,491 cases pending as of September 30, 1988. The Court expects the number of petitions filed in fiscal year 1989 to be at or below the fiscal year 1988 level of about 33,000 cases. The Court also

expects to see a further reduction in its inventory during fiscal year 1989.

Although the Court's inventory of cases has been declining, it is unclear whether this trend will continue in future years. Certain factors, such as the partnership provisions in the Tax Equity and Fiscal Responsibility Act of 1982, which eliminated the need for investors to litigate separately, and IRS' settlement policy, which encourages the resolution of cases before a taxpayer petitions the Tax Court, have helped to reduce the inventory. Other factors, however, such as provisions in the Taxpayer Bill of Rights, which expanded the Court's jurisdiction, could cause the inventory to increase.

CONCLUSION

In conclusion, Mr. Chairman, although there have been cutbacks as a result of this year's budget shortfall, IRS is functioning so far without any significant disruption to its basic operations. We are uncertain, however, what lies in store for the rest of 1989 because IRS has not completed its mid-year financial review. Looking ahead, we question the adequacy of IRS' budget for 1990 because it does not provide for costs IRS will incur to implement new legislation and other increased personnel costs.

IRS' problems during fiscal year 1989 are a microcosm of what all federal agencies are going through to one degree or another because of our inability to effectively deal with the budget deficit. As we have said on countless occasions, we believe the deficit and our inability to effectively deal with it is the most serious domestic problem facing the country.

It is not realistic to expect agencies to continually absorb pay and benefit increases and not suffer adverse operational consequences. In fact, we believe even more serious consequences could occur in the future if such a policy is continually pursued. Not only will current operations suffer but it will be virtually impossible to implement any new initiatives with adequate levels of funding. The likelihood of any change in that policy is slim, however, unless Congress and the Administration effectively deal with the budget deficit.

Until the deficit is dealt with effectively, we believe Congress should examine very carefully any proposed initiatives to determine if there are adequate funds to begin them while assuring that current, needed operations are carried out effectively and efficiently.

That concludes my statement. We are prepared to answer any questions.