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TAX POLICY

Status of IRS' Studies of the Refund Offset Program





United States
General Accounting Office
Washington, D.C. 20548

General Government Division

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The Honorable Lloyd Bentsen
Chairman, Committee on Finance
United States Senate

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
House of Representatives

This report is in response to Section 9402 of the Omnibus Budget Reconciliation Act of 1987. Section 9402 requires that we, in consultation with the Secretary of the Treasury or his delegate, study the Refund Offset Program and its effect on voluntary compliance with the income tax laws. Under the Refund Offset Program, the Internal Revenue Service (IRS) offsets federal tax refunds due taxpayers who are delinquent in paying such debts as child and spousal support payments or federal education loans.

We have issued two reports that specifically addressed the program.¹ One reported on IRS' implementation of the program in the first year and the program's success in collecting delinquent federal debts. The second report evaluated the methodology IRS used in a 1986 study of the effect of refund offsets on compliance.

IRS' 1986 study indicated that the Refund Offset Program has reduced taxpayers' compliance with tax laws. The report compared a group of taxpayers whose refunds were offset with a control group. Compared to the control group, more taxpayers in the offset group (1) did not file a return in the tax year following the offset or (2) filed a return but did not pay their full tax liability. These IRS conclusions, however, were not fully supported. We found methodological limitations in the study that may have caused IRS to overstate the effect of the program on taxpayer noncompliance.

Because IRS continues to study the program's effects on taxpayer compliance, we agreed with the Joint Committee on Taxation that our current effort would focus on IRS' methodology for measuring the effect. Accordingly, this report (1) discusses IRS' improvements to its methodology but (2) identifies ways to make future studies' results more precise.

¹Tax Administration: Collecting Federal Debts by Offsetting Tax Refunds (GAO/GGD-87-39BR, Feb. 9, 1987); and Tax Policy: Evaluation of IRS' Refund Offset Study (GAO/GGD-88-117, Sept. 1, 1988).

Results in Brief

IRS has strengthened its methodology as it continues to study the Refund Offset Program. A major improvement has been incorporating "prior year analyses" of taxpayers' filing behavior. This change is significant because it shows whether any difference between the offset and control groups after the offset also existed before the offset. If differences already existed, IRS could not conclude that the offset alone reduced compliance. Despite this improvement and improved data quality, study limitations remain.

IRS needs to ensure that the tax and nontax characteristics of the offset and control groups are comparable. Simply matching some tax characteristics (e.g., taxable income and filing status) of the two groups does not rule out the possibility that nontax characteristics (e.g., age or geographic location) may affect compliance with tax laws. Group comparability could also be improved by examining other tax characteristics, such as whether taxpayers were previously noncompliant.

IRS could improve future studies by supplementing its analyses using updated taxpayer information. This would provide IRS with more descriptive data on nonfilers and a better understanding of the magnitude of any nonfiler problem. Updating taxpayer information would enable IRS to determine if any of the "nonfilers" it identified (1) were not required to file or were not pursued by IRS because IRS' enforcement program determined that the potential tax yield was minimal or (2) filed late either voluntarily or because of IRS enforcement actions. Such information also could be used to measure the extent and level of IRS enforcement action required to make taxpayers compliant and to assess whether noncompliance is temporary or permanent.

Background

IRS began offsetting taxpayer refunds for delinquent nontax debts in 1982. Initially, the Omnibus Budget Reconciliation Act of 1981 authorized IRS to offset federal tax refunds due to a taxpayer who was delinquent in making child and spousal support payments. The act applied only to cases where the custodial parent received payments from the Aid to Families with Dependent Children (AFDC) program. The Child Support Enforcement Amendments of 1984 temporarily expanded (until 1991) the offsets to include non-AFDC child and spousal support cases.

Congress also expanded the offset program in 1984 to reduce nontax delinquent federal debts, such as education loans, and to generate additional revenues. The Deficit Reduction Act of 1984 authorized a 2-year test period to permit Treasury to examine the extent to which tax

refund offsets facilitate the collection of nontax federal debts and the effect the Refund Offset Program has on taxpayer compliance. Congress later passed the Family Support Act of 1988, which extended the Refund Offset Program to January 10, 1994.

The Office of Management and Budget (OMB) believes the Refund Offset Program is successful. During calendar years 1986 through 1988, IRS offset refunds due to federal debtors totalling about \$619 million. Thus, OMB considers the program to be an effective method of collecting delinquent federal debts. Appendix I describes the Refund Offset Program and includes a table showing the amount of offsets made during calendar years 1986 through 1988 to pay delinquent federal nontax debts.

IRS has issued two reports evaluating the effect of refund offsets on taxpayer compliance.² The studies addressed cases in which taxpayers were delinquent in their child support payments and the custodial parent received payments from the AFDC program. A major focus of IRS' studies was to compare the filing behavior of debtor taxpayers who filed for a refund and were offset (offset group) with the filing behavior of taxpayers from the general population who filed for a refund but were not offset (control group). Analyzing the differences in taxpayer compliance between the groups, IRS concluded that offsetting refunds reduces taxpayer compliance. IRS found an increase in the nonfiling rate and an increase in the number of taxpayers filing a return without full payment of their tax liability.

Our report entitled Tax Policy: Evaluation of IRS' Refund Offset Study (GAO/GGD-88-117, Sept. 1, 1988) discussed a number of methodological limitations, and we determined that IRS' study conclusions could not be fully supported. One significant limitation was that IRS did not consider whether any observed difference between the groups existed before the

²The first study, Report on the Effect of Refund Offsets for Delinquent Child Support Payments, was issued in October 1983 and analyzed the effect of tax year (TY) 1981 offsets on taxpayer compliance for TY 1982. The second study, Study of the Effect of Refund Offsets for Delinquent Child Support Payments on Compliance, was issued in November 1986 and extended the analysis of TY 1981 offsets to TY 1983 and also analyzed the effect on taxpayer compliance for TY 1983 of offsets made for TY 1982.

IRS also has two ongoing studies. It has a third report in draft that will analyze the TY 1986 filing and tax withholding behavior of taxpayers who were referred because they had delinquent child and spousal support payments or delinquent federal nontax debts and who were offset in TY 1985. A fourth IRS study is presently underway that analyzes the TY 1987 filing behavior of taxpayers offset in TY 1985 and TY 1986. Given the recent extension of the Refund Offset Program, IRS plans to continue studying the program.

offset occurred. Analyzing prior year behavior is important. If the difference in filing behavior after the offset existed before the offset, then IRS could not conclude that the offset alone reduced compliance. We extended IRS' analysis of nonfiling by controlling for prior year filing behavior and also found that offset taxpayers were more likely not to file a tax return than the general control group. The difference in nonfiling, however, was not as great as IRS reported (4.5 percent versus 7 percent). We noted that if the offset and control groups were not comparable, the results could change further.

IRS and GAO recognize control group selection as a study limitation. IRS selected the control groups to closely match tax characteristics (e.g., taxable income and filing status) of the offset groups. It is unknown, however, what effect nontax characteristics would have on the study results. As IRS' study recognizes, a better methodology to address comparability would have been to randomly assign the referred taxpayers having refunds into two groups—one group with refunds offset and the other with refunds purposely not offset. With this procedure, any differences between the two groups could then be attributed to the Refund Offset Program. We would have no reason to believe that the two groups would have any other differences, since they both came from the same population and assignment to groups was random. IRS officials said that the refund offset statute (31 U.S.C. Section 3720A(d)) does not authorize them to refrain from offsetting referred debtors.

Objectives, Scope, and Methodology

The Omnibus Budget Reconciliation Act of 1987 (Section 9402) required that we study the Refund Offset Program and its effect on taxpayer compliance. We discussed the mandated study with the Joint Committee on Taxation. Rather than duplicate IRS' ongoing studies of the effect of refund offsets on taxpayer compliance, we agreed to focus our study on IRS' methodology. Our objectives were to assess IRS' current methodological approach to

- identify any methodological improvements made to correct the limitations of its past studies and
- determine if additional methodological improvements are warranted.

To address these objectives, we reviewed IRS' two issued reports and a draft of a third that analyzed the effect of refund offsets on taxpayer compliance. For these studies and a fourth study presently underway, we also reviewed available internal documents specifying how IRS

extracted and analyzed tax data from the Individual Master File (IMF).³ This was done to identify any methodological changes to the studies. We discussed our methodological concerns with IRS Research Division staff, statisticians, and Computer Services Division personnel. We did not assess the reliability of IRS' data or duplicate its analyses.

To better understand the range of data used in IRS' studies, the complexities involved in doing these studies, and the possible effect of IRS' study methodology on its study results, we selected a small, random sample of 44 noncompliant taxpayers taken from IRS' second study. Our sample consisted of child and spousal support debtors who were offset in 1982 and did not file a return in tax year 1983.⁴ IRS extracted for us tax information from the IMF as of August 15, 1988, that showed each of the taxpayers' filing behavior for tax years 1983 through 1987. Because of the small size of the sample, our analyses can only be used for illustrative purposes.

We did our work at IRS' National Office in Washington, D.C., between May 1988 and January 1989 and in accordance with generally accepted government auditing standards.

IRS Has Improved Its Studies

IRS has improved its ongoing studies of the effect of offsetting refunds on taxpayer compliance. The most significant improvement is the incorporation of prior year filing behavior in its analyses. This improvement establishes specific filing patterns before the offset to compare with post-offset filing patterns. IRS has also taken steps to improve the quality of its study data through better documentation and more data verification.

IRS Now Includes Prior Year Filing Behavior in Its Analyses

IRS significantly improved its study design by examining taxpayer compliance behavior before the offset year. The methodology IRS used in the first and second studies was limited because it did not consider whether the offset and control groups exhibited similar taxpayer compliance characteristics before the offsets. Given this lack of information on prior filing behavior for each group, any taxpayer compliance differences

³IRS' Individual Master File is a comprehensive file containing entity and account information on taxpayers. Entity information includes the taxpayer's name, address, and filing status. Account information shows the different transactions related to a taxpayer's filing and payment of any tax liability.

⁴We dropped 9 of the 44 because they were coded incorrectly and had actually filed on time.

after the offset could not be attributed solely to the offset. IRS corrected this methodological shortcoming in its third study's analysis of taxpayers' nonfiling and balance-due behavior. IRS' fourth study extends the prior year filing behavior to its analysis of the offset and control groups' income tax withholdings and refund size.

IRS Has Taken Steps to Improve Data Quality

IRS has taken steps to improve the quality of its study data. For the earlier studies, IRS Research Division staff depended on the Computer Services Division for all programming and automated edit checks. IRS Research staff said it was difficult to anticipate or schedule additional programming runs to correct errors. Research Division staff are now more involved in checking the data for inconsistencies. In addition, IRS has improved its documentation of study programming requirements to better define how each IMF data item was extracted. Research staff provided the following examples of efforts to improve data quality:

- IRS found that it had defined filers differently for the offset year and preceding years than for the years after the offset. IRS extracted taxpayer data for the offset and control groups for the offset year and preceding years at the end of December of the filing year. IRS considered anyone filing by this extraction date a filer. When comparing the groups' filing behavior in the years after the offset, IRS extracted data at the end of September of the filing year. IRS considered any taxpayer not filing by the end of September a nonfiler. Consequently, taxpayers who filed between the end of September and December in the offset year and preceding years were considered filers, but they were considered nonfilers in the years after the offset. IRS Research staff said this inconsistency will be eliminated in future studies by ensuring that all filing status data are considered as of the end of September.
- After checking the third study's data, IRS found that some taxpayers were misclassified as filers. We were told that this occurred because IRS extracted IMF data without always checking to ensure that a taxpayer's return was posted to the IMF during the filing year. For example, if the posting occurred in a later filing year, the taxpayer should not have been considered to have filed on time. IRS Research staff said this problem has been corrected.

The IMF is a large and complex file designed to control all tax accounting transactions. Care must be taken to ensure that data used for research are extracted and analyzed accurately and consistently. As IRS Research Division staff have gained experience with the data over the

course of the four studies, they have taken steps to improve data quality.

IRS Needs to Assure Greater Comparability Between Offset and Control Groups

Determining how the Refund Offset Program affects filing behavior depends on the comparability of the offset and control groups. The more closely matched the two groups are, the more comparable they are. IRS matched its offset and control groups on some tax characteristics to make the two groups more comparable. However, there is a risk of bias in IRS' findings because IRS has not accounted for all relevant preexisting differences. IRS needs to examine additional tax and nontax characteristics to (1) maximize the comparability between its groups and (2) make its findings more convincing.

Extent to Which Taxpayers in Offset and Control Groups Exhibited Prior Tax Delinquent Behavior Is Unknown

It is important to determine whether taxpayers in the offset and control groups were previously offset for delinquent tax debts or showed other evidence of noncompliance with the tax laws, such as having been assessed a penalty. Unless statistically controlled, dissimilar distributions of such taxpayers in the two groups could result in questionable conclusions. For example, if the offset group had a higher proportion of taxpayers who were previously offset for tax debts than the control group, any subsequent noncompliance with the tax laws may be related to the prior offset. The results, therefore, may not be attributable solely to the nontax offset. IRS needs to examine the offset and control groups and control for this potentially biasing characteristic. IRS Research staff recently told us that they were able to do a limited analysis of past tax-related offsets for IRS' offset and control groups, and they expect the analysis to be included in the fourth study.

Effect of Demographic Characteristics Is Unknown

IRS can improve its estimate of the effect of the offset program by statistically controlling for demographic characteristics, such as a taxpayer's age and geographic location, that could affect filing behavior. For example, separate IRS studies of regional trends in individual voluntary compliance showed that taxpayer noncompliance and tax delinquencies are more likely to occur in southern and western states. Failing to control for regional composition of the groups may systematically bias the results. Information on a taxpayer's geographic location could be obtained using the IMF. However, to consider other demographic characteristics, IRS would have to obtain data from other sources. For example, the IMF does not have information on a taxpayer's age. IRS would have to use Social Security Administration data. IRS Research staff informed

us that they will obtain the dates of birth for all taxpayers in future studies. They also said they will try to modify the approved data extraction procedures for future studies to include the extraction of geographical data.

Use of Updated Taxpayer Data Would Provide More Precise Analyses

IRS' future studies of the effect of refund offsets on taxpayer compliance would also be improved if IRS supplemented its analysis by updating taxpayer information. IRS extracts taxpayer information from the IMF at the end of September of the filing year. For study purposes, IRS defines anyone not filing by the September extraction date as a nonfiler. This definition overstates the number of nonfilers, because some taxpayers may have filed voluntarily after the IRS extraction date. In addition, IRS enforcement measures designed to detect potential nonfilers are not taken until after IRS extracts the data for its studies.⁵ Thus, it is unclear how many of the nonfilers should have filed versus how many did not have a filing requirement or were not identified for follow-up because IRS' enforcement program determined that the potential tax yield was minimal. Updating taxpayer information past the September extraction date would also permit IRS to identify any taxpayer who filed late voluntarily or as a result of any IRS enforcement action. IRS could then measure the level of enforcement action taken to make any nonfiling taxpayer file.⁶

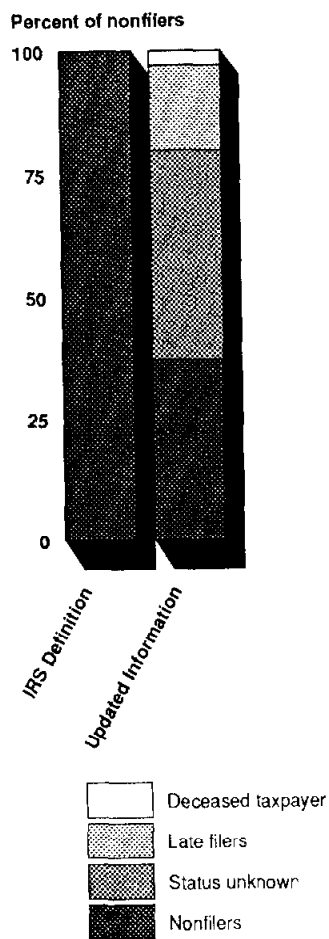
To illustrate how updated tax information provides a better description of filing behavior, we used IRS' second study to randomly select 35 taxpayers who were offset in tax year 1982 and whom IRS would have considered to be nonfilers in tax year 1983. Our review of IRS tax records updated to August 15, 1988, showed that one taxpayer died. Of the remaining 34 nonfilers reported by IRS, updated taxpayer information showed that IRS' enforcement programs identified 19 as potential nonfilers—6 of them eventually filed returns. The other 13 were open cases from which IRS had not obtained returns. The IMF did not contain tax information on the remaining 15 taxpayers for tax year 1983. For these cases it is not clear whether any of the taxpayers were required to file, or whether IRS determined that the taxpayers' potential tax yield

⁵IRS uses information returns supplied by third parties, such as employers and financial institutions, to develop leads on potential delinquent nonfilers. It also identifies potential delinquent nonfilers by considering prior year filings.

⁶IRS officials said taxpayers who were offset and subsequently found noncompliant are handled the same as other noncompliant taxpayers in terms of enforcement activity. IRS does not use information obtained under the offset program to target any special investigations.

was minimal and thus did not pursue them.⁷ Figure 1 shows how these offset nonfilers would be categorized differently using updated tax information.

Figure 1: Tax Year 83 Filing Behavior of Taxpayers Offset in Tax Year 82



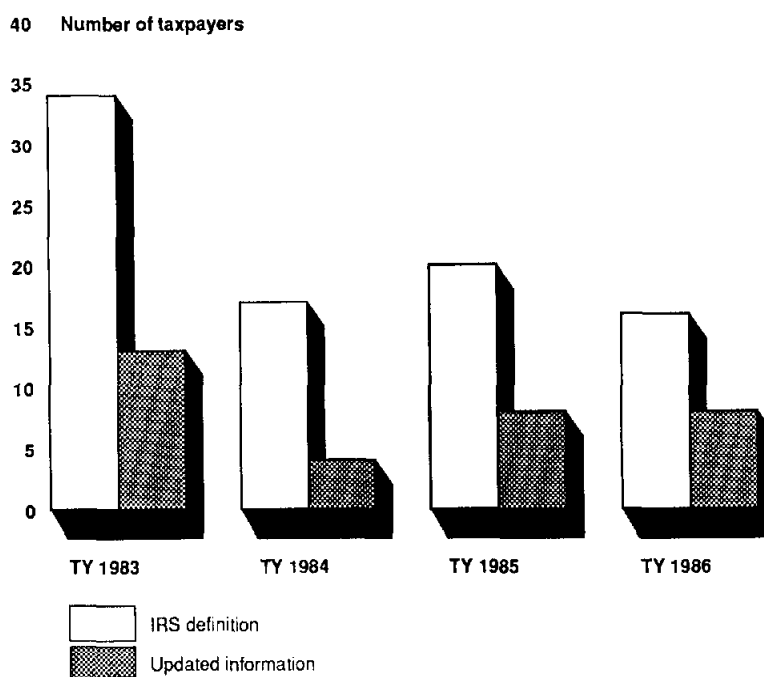
Note: Based on 35 taxpayers.

We next carried this illustration out in time by looking at the filing behavior for the 34 taxpayers (35 minus the deceased taxpayer) for tax

⁷IRS could determine the specific status of these cases, but it would take additional work.

years 1984 through 1986. Figure 2 shows the differences in the aggregate number of offset nonfilers for tax years 1983 through 1986 using IRS' definition versus using updated tax information. We found that an end of September cut-off date for each tax year would show a higher number of nonfilers than that shown in an August 15, 1988, extract of taxpayer information.⁸ For example, 20 of the 34 would be classified as nonfilers for tax year 1985 if the files were not updated. With updated taxpayer information, however, only 8 of the 34 can be classified unambiguously as nonfilers.

Figure 2: Comparison of Nonfilers Over Time Under the Two Approaches



Note: Based on 34 taxpayers.

Updated taxpayer information would also provide a better understanding of whether any nonfiling is temporary (a few years) or permanent. For example, in our sample of the 34 taxpayers, IRS' definition would

⁸When IRS compares taxpayers' filing behavior in years after the offset, it does not update the prior tax year information to determine if a taxpayer's nonfiling status has changed. Thus, IRS' definition includes actual nonfilers, late filers, and taxpayers with filing status unknown. Our definition using updated taxpayer information is confined only to actual nonfilers (open cases). The difference in the number of nonfilers represents the extremes that could exist using the two definitions.

show that 10 of them did not file by the end of September for each of the 4 years after the offset. Updated taxpayer information, however, shows that as of August 15, 1988, only two taxpayers had not filed for each of the 4 years and were cases IRS considered worth pursuing. We did not do a similar analysis for IRS' general control group. Thus, this illustration does not imply an overstatement of the relative difference between nonfilers in the offset group and control group. Rather, it shows how updated taxpayer information could supplement IRS' analysis and provide a better understanding of noncompliance.

For future studies, updated taxpayer information would also be useful to measure the level of enforcement action taken to make any nonfiler file. Updated taxpayer information would provide data necessary to determine whether IRS enforcement measures were required, the types of enforcement actions required, and the overall magnitude of any burden on IRS to make nonfiling taxpayers compliant. A draft report on IRS' third study states that further steps should be taken to enhance the analysis of the Refund Offset Program. For example, the report recognizes the need to determine the characteristics of the nonfilers, especially identifying those that were not required to file, and to analyze the program's effect on revenue. Updating taxpayer information would be one way IRS could supplement its analysis of noncompliance and the effect on revenue.

Conclusion

The effect of offsetting refunds on taxpayer compliance is unclear. IRS studies conclude that the Refund Offset Program has reduced taxpayer compliance with tax laws. These studies, however, have methodological limitations that result in less than conclusive support for IRS' study findings. One study limitation relates to the comparability of IRS' offset and control groups. IRS used some tax characteristics to match the offset and control group. It is unknown, however, if statistically controlling for nontax characteristics or other tax characteristics would produce different study results. IRS has made improvements in the composition and comparability of its study groups; these improvements will alleviate some limitations.

Also, IRS could supplement its analyses in future studies by using updated taxpayer information. This would provide more descriptive information on nonfilers and a better understanding of the magnitude of any nonfiling problem. Such information could also be useful in measuring the level of IRS enforcement action required to make taxpayers compliant and to assess whether noncompliance is temporary or permanent.

Recommendations

To improve future IRS studies of the effect of the Refund Offset Program on compliance with tax laws, we recommend that the Acting Commissioner of Internal Revenue take the following actions in future studies:

- Make the offset and control groups as comparable as possible. The studies should statistically control for prior tax delinquent behavior and nontax characteristics, such as age and geographic location.
- Incorporate the most current taxpayer information. This will result in a better understanding of the magnitude of any noncompliance problem, enable IRS to measure the level of enforcement actions required to make taxpayers compliant, and provide a better basis to analyze the temporary versus permanent nature of noncompliance.

Agency Comments

Responsible IRS officials provided oral comments on a draft of this report. We have incorporated some comments earlier in this report. Other comments focused on two issues. First, they noted some additional IRS methodological improvements. The fourth study has refined the composition of the offset and control groups. The control group was restricted to individuals who were not referred for offset in the offset year or in any prior year. The offset group was restricted to individuals who had their refunds offset for the first time. In addition, the results of the offset group and general control group will be compared with (1) a group of taxpayers who have been referred and/or offset under the refund offset program for some time and (2) a group who had offsets for tax debts.

Finally, the officials believe that defining a “nonfiler” as anyone who has not filed a return by the end of September of a given year is appropriate for the analysis of the differences between groups as long as it is uniformly applied to both groups. This definition may be appropriate for a general analysis of nonfiling. We point out, however, that it includes those who are late filers and those who are not required to file. Thus, IRS’ definition is not appropriate for an analysis of the burden on its enforcement resources and whether the burden is temporary or permanent because IRS extracts taxpayer data from the IMF before enforcement actions are taken.

As arranged with the Committees, we are sending copies of this report to the Acting Commissioner of Internal Revenue and other interested parties.

This report was prepared under the direction of Jennie S. Stathis, Director, Tax Policy and Administration Issues. Other major contributors are listed in appendix II.



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Refund Offset Program Highlights

Participation in the Refund Offset Program has grown from 5 agencies in calendar year 1986 to 12 agencies for calendar year 1989.⁹ Federal agencies must enter into an agreement with IRS specifying the conditions that must be met for an offset to occur. For example, an agency must notify its debtors that it is proposing to refer past due debts to IRS for offset against any overpayment of tax. The debtor must be given 60 days to pay the debt or to present evidence that the debt is either not past due or not legally enforceable. The agency then certifies to IRS that all the conditions for offset have been met and submits a magnetic tape listing the delinquent debtors to IRS. IRS consolidates all delinquent debtor information onto a debtor master file. Offset will occur when a taxpayer is due a refund and the Social Security number from the return matches the Social Security number in the debtor master file.

IRS offset over \$2.4 billion in taxpayer refunds during calendar years 1982 through 1988. Approximately \$1.8 billion of this amount was collected for the nonpayment of child and spousal support payments. The remaining \$0.6 billion was collected during calendar years 1986 through 1988 for nonpayment of federal nontax debts, such as education loans. In addition, participating federal agencies reported collecting an estimated \$247 million in voluntary payments from delinquent debtors during calendar years 1986 through 1988 after notifying the debtors that they were to be referred to IRS for offset. Table I.1 shows the number of taxpayers offset and the value of offsets made for nonpayment of federal nontax debts during calendar years 1986 through 1988.

⁹The five agencies participating in the Federal Refund Offset Program during calendar year 1986 were the Departments of Agriculture, Education, and Housing and Urban Development; the Small Business Administration; and the Veterans Administration. The Departments of Defense, Treasury, Justice, and Health and Human Services joined the program and offsets were made in 1987. The Departments of Energy and Interior and the Railroad Retirement Board are the newest participants, and refunds due their debtors will be offset during calendar year 1989.

**Appendix I
Refund Offset Program Highlights**

Table I.1: Summary Schedule of Offsets Made for Nonpayment of Federal Nontax Debts

Dollars rounded to nearest thousand

Department/agency	CY 1986		CY 1987		CY 1988		Total CY 1986 to 88	
	Number of offsets	Offset amount	Number of offsets	Offset amount	Number of offsets	Offset amount	Number of offsets	Offset amount
Agriculture	1,895	\$1,275	6,505	\$3,470	4,838	\$2,767	13,238	\$7,512
Education	243,135	130,556	278,490	141,664	315,742	172,917	837,367	445,137
Housing and Urban Development	7,673	5,717	9,501	6,739	10,653	8,108	27,827	20,564
Small Business Administration	8,642	6,564	5,834	4,083	3,949	2,662	18,425	13,309
Veterans Administration	17,027	8,388	129,466	55,521	52,602	24,307	199,095	88,216
Defense			54,950	17,838	59,533	18,601	114,483	36,439
Justice			521	251	9,664	7,125	10,185	7,376
Treasury			564	49	189	17	753	66
Health and Human Services			62	101	211	342	273	443
Total	278,372	\$152,500	485,893	\$229,716	457,381	\$236,846	1,221,646	\$619,062

Note: The table does not include offsets made for nonpayment of child and spousal support payments.

Source: Credit Administration Division, Financial Services Division, Department of the Treasury.

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