United States General Accounting Office

GAO

Report to the Chairman, Committee on the Budget, U.S. Senate

September 1990

TAX ADMINISTRATION

IRS' Improved Estimates of Tax Examination Yield Need to Be Refined

GAO/GGD-90-119

GAO

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

General Government Division

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September 5, 1990

The Honorable Jim Sasser
Chairman, Committee on
the Budget
United States Senate

Dear Mr. Chairman:

The Internal Revenue Service's (IRS) budget for fiscal year 1991 includes several initiatives that are intended to generate additional tax revenues by increasing or modifying IRS' compliance efforts. One initiative calls for increasing IRS' examination staff by adding 750 revenue agents who audit the more complex tax returns and 290 support staff. According to IRS, the audits resulting from such a staff increase will generate additional audit revenues of $1.1 billion by the end of fiscal year 1995. This report responds to your request for information on the methodology IRS used to estimate those additional audit revenues and its plans to track the results of the staffing increase—if the increase is authorized by Congress.

Results in Brief

IRS revised its methodology for estimating audit yield following our 1988 report on problems with the methodology IRS was using at that time.[1] IRS used its revised methodology to compute the $1.1 billion estimate associated with the proposed fiscal year 1991 staffing increase. Although the revised methodology produces a more realistic expectation of the additional revenues to be derived from an increase in examination staff, we consider some of the assumptions IRS used in applying the methodology to the proposed fiscal year 1991 staffing increase to be overly optimistic. IRS assumed that all the new staff would be on board by the beginning of the fiscal year and that a revised (and less costly) training program would be in place at that time—both of which have proven to be overly optimistic considering their current status. Delays in one or both of those events would delay realization of benefits from the staffing increase. IRS also assumed that the influx of new staff would free up experienced agents to work on higher-yield cases, thus further increasing the audit revenues generated by increased staffing. We questioned that assumption in our assessment of IRS' past methodology. IRS agrees that it needs to further study that issue.

[1] Tax Administration: Difficulties in Accurately Estimating Tax Examination Yield (GAO/GGD-88-119, Aug. 8, 1988).

If the examination staffing increase is authorized, IRS plans to monitor its impact. The reliability of that monitoring information will depend, in large part, on the validity of the baseline from which IRS begins tracking results. Because IRS had not yet computed its baseline, we could not assess its validity.

Background

In our August 1988 report to the Chairman of the Senate Budget Committee, we assessed (1) the methodology IRS was then using to estimate the additional revenues associated with an increase in examination staff and (2) IRS' estimate of the amount of revenue actually generated in fiscal year 1987 as a result of a congressionally authorized increase in examination staff that year. We raised several concerns about IRS' methodology for estimating the additional revenues it expected to realize from a staffing increase and reported that IRS' estimate of the increased revenues it actually realized in fiscal year 1987 was overstated. The overstatement occurred primarily because IRS failed to account for any unrealized revenues resulting from the use of experienced revenue agents to train new staff.

In response to our concerns and those raised by the Department of the Treasury, the Office of Management and Budget, and the Congressional Budget Office, IRS revised its estimating methodology.[2] It then used the revised methodology to estimate the additional revenues associated with the requested fiscal year 1991 increase in revenue agents.

Objectives, Scope, and Methodology

As agreed with the Committee, our objectives were to provide information on (1) IRS' methodology for estimating the yield associated with the increase in revenue agents proposed for fiscal year 1991, including any available information relating to IRS' plan to revise its revenue agent training program; and (2) IRS' plans to track the results of that staffing increase.

To develop information on IRS' estimating methodology:

- We reviewed past studies and reports on the estimating process and analyzed statistical data on Examination's plans and accomplishments.

[2] IRS considers the new methodology to be an interim one while it develops more specific data on audit results that can be used to further improve its estimating assumptions.

- We interviewed officials in the Office of Examination Planning and Research and in IRS' Research Division to obtain information on the estimating process.
- We analyzed documentation provided by IRS to show how its estimating methodology works and to support the various assumptions behind that methodology.
- We interviewed officials in the Office of the Assistant Commissioner (Examination) about changes being considered in the training program for revenue agents.
- We interviewed officials and group managers in the Examination Division at 1 of IRS' 63 district offices (San Francisco) to obtain information on IRS' estimating assumption relating to the allocation of audit resources. We chose San Francisco because it was one of the districts we had visited during our assessment of IRS' previous methodology and because the managers in that district were available to meet with us on short notice. We supplemented what we learned in San Francisco with information we had obtained from three other district offices (Atlanta, Chicago, and St. Louis) during an earlier assignment for the Committee.

To obtain information on IRS' plans for tracking the results of a fiscal year 1991 examination staffing increase, we interviewed officials in IRS' Budget Division and in the Office of Examination Planning and Research, and we reviewed documentation describing the tracking methodology.

Our audit work required us to use data generated by IRS' management information systems and by its computerized process for estimating audit yield. We did not assess the reliability of those data. However, we reviewed the data for reasonableness and consistency and attempted to resolve any discrepancies. We did our audit work between April and July 1990 and in accordance with generally accepted government auditing standards. IRS provided written comments on a draft of this report. Those comments are presented and evaluated beginning on page 14 and are included in appendix I.

IRS Has Improved Its Methodology for Estimating Audit Yield

After we issued our August 1988 report, IRS reassessed its methodology for estimating the revenue to be generated by an increase in examination staff. The reassessment identified several problems with the methodology and led IRS to conclude that its estimating process produced projections that "understate the time needed to realize direct benefits" from staffing increases.[3] As a result of that reassessment, IRS revised its estimating methodology.

The revised methodology, which IRS used to estimate audit yield associated with the staffing increase proposed for fiscal year 1991, provides a more realistic indicator of the revenue implications of such an increase than did IRS' past methodology. Unlike past years when IRS estimated that the government would realize significant additional revenues in the first year of a staffing increase, IRS' new methodology has led it to conclude that the proposed staffing increase for fiscal year 1991 will result in decreased revenues in the first year and will not start generating increased revenues until fiscal year 1992.

In revising its methodology, IRS addressed several concerns raised in our August 1988 report including those relating to (1) the productivity of new staff, (2) the audit revenues that go unrealized while experienced examination staff train new staff, and (3) IRS' use of outdated information to determine how much of the additional tax liability recommended by examination staff as a result of their audits would eventually be collected.

Productivity of New Staff

One problem with IRS' past methodology was IRS' assumption that the additional examination time made available by an increase in staff was generally applied to ongoing audits rather than to new audits. IRS' revised methodology, however, assumes that the additional time will be applied to new audits, which means that it will be longer before any audit results are realized. That change more accurately portrays how new staff are used and thus how soon audits worked on by new staff will be closed and how soon the government will realize revenues from those audits.

This change is a major reason why IRS' revised estimating methodology shows almost no additional taxes, penalties, and interest being collected in the first year of a staffing increase compared to the significant first-year collections shown by its previous methodology. As IRS noted in its November 1989 research report, for example, application of the revised methodology to a hypothetical increase of 1,000 revenue agent staff years would show expected first-year collections of $1.1 million compared to the $321.4 million shown by IRS' earlier methodology.

[3] IRS' reassessment was documented in a research report entitled Evaluation of the IRS System of Projecting Enforcement Revenue (Publication 1501) published by IRS in November 1989.

Unrealized Audit Revenues

A second problem with IRS' previous methodology was its failure to recognize that the additional taxes, penalties, and interest generated by new revenue agents had to be offset by the taxes, penalties, and interest that went unrealized because experienced agents, who would otherwise be auditing returns, would have to train the new staff. IRS' revised methodology recognizes that fact.

In an April 1990 report to the Committee, we commented on the extent to which experienced revenue agents were involved in training about 1,100 new hires in five IRS district offices between July 1, 1986, and June 30, 1989, and the cost of that involvement in terms of unrealized audit revenues.[4] We concluded that the government could end up investing about $980 million in unrealized revenues to train those 1,100 agents.

As part of the April 1990 report, we compared our computation of unrealized audit revenues with one that IRS had made using its revised estimating methodology. IRS had determined that the training associated with a hypothetical increase of 1,000 revenue agent staff years nationwide would cost about $527 million in unrealized revenues. We attributed the difference between IRS' and our computations to differences in methodology. As noted in our April 1990 report, the appropriateness of one methodology over another might depend on the number of new revenue agents being hired and trained. We said that (1) our methodology seemed more appropriate for the period covered by our review, when IRS was training about 7,300 newly hired revenue agents nationwide; and (2) IRS' methodology might be more appropriate during periods when it is hiring, and thus training, a much smaller number of agents—which would be the case if the proposed staffing increase for fiscal year 1991 is authorized.

[4]Tax Administration: Potential Audit Revenues Lost While Training New Revenue Agents (GAO/GGD-90-77, Apr. 6, 1990).

Extent to Which Recommended Taxes Are Collected

In our August 1988 report, we noted that IRS used information from its tracking of audits closed in 1972 to determine how much of the recommended tax would be assessed and how much of the assessed amount would eventually be collected.[5] We questioned whether that information was still valid. In revising its estimating methodology, IRS recognized that the 1972 audit results were no longer applicable and used data from the late 1980s to translate recommendations into eventual collections.

Using the more recent data, IRS refined its approach by developing separate assessment and collection rates for audits of individuals, small corporations (those with assets of less than $250 million), and large corporations (those with assets of $250 million or more). In the past, IRS used the same rates for all types of audits. IRS also reassessed the timing of eventual collections and determined that it took much longer for those collections to come into the Treasury than IRS had assumed in its previous methodology, which would cause the amount of interest eventually collected to increase.

Tables 1 and 2 show how the assessment and collection information used by IRS in its revised methodology compared to that used previously. As described by IRS, the comparison in table 1 shows that eventual assessments of tax and penalties are much lower than previously estimated and that eventual collections of tax, penalties, and interest are about the same as was previously estimated, with interest being "a much larger component of total receipts."[6] Table 2 shows that the timing of collections is much slower, reflecting, according to IRS, "longer times in the examination, appeals/litigation and collection processes."

[5]IRS uses different terms to measure audit yield. "Recommended" is the amount of additional tax and penalties examination staff decide a taxpayer owes after auditing the taxpayer's return. "Assessed" is the amount of tax and penalties IRS decides is due and payable from the taxpayer, which often differs from the recommended amount because of reductions resulting from the taxpayer's appeal of the audit findings. "Collected" is the amount IRS receives in payment of the assessed amount, including any penalties and interest.

[6]In computing its yield estimate for the fiscal year 1991 staffing increase, IRS assumed an annual interest rate of 12 percent. According to IRS officials, they used 12 percent because it was the effective rate when they developed the estimate, and they have no way of knowing what future rates will be. To the extent future rates deviate from 12 percent, IRS' estimate will be over- or understated. The current rate, which will remain in effect through September 30, 1990, is 11 percent.

Table 1: Comparison of Assessment and Collection Rates Used in IRS' Past and Revised Estimating Methodologies

As a percent of recommended tax and penalties

		Revised method		
	Past method	Individuals	Small corporations	Large corporations
Recommended tax and penalties	100.0	100.0	100.0	100.0
Assessed tax and penalties	71.2	67.2	56.9	44.5
Assessed tax, penalties, and interest	108.0	100.8	104.5	97.3
Collected tax, penalties, and interest	102.4	103.2	114.2	106.3

Source: IRS' November 1989 research report (Publication 1501).

Table 2: Comparison of Data on the Timing of Collections Used in IRS' Past and Revised Estimating Methodologies

As a percent of recommended tax and penalties

		Revised method		
	Past method	Individuals	Small corporations	Large corporations
Year 1 (year of staffing increase)	76.5	3.9	0.0	0.0
Year 2	11.9	22.0	7.2	0.0
Year 3	4.3	28.5	35.1	18.3
Year 4	3.2	18.5	24.1	25.7
Year 5+	6.5	30.3	47.8	62.3
Collected tax, penalties, and interest	102.4	103.2	114.2	106.3

Source: IRS' November 1989 research report (Publication 1501).

After assessing the documentation behind IRS' revised methodology, it was clear to us that IRS had put forth considerable effort to develop more current information on the rates at which recommendations get assessed and assessments get collected, and the timing of those assessments and collections. IRS appeared to use the best data available in revising its methodology, but those data leave much to be desired due to limitations with IRS' management information systems. More specifically, those systems do not provide data that are compatible across functional lines, thus preventing IRS from tracking audit cases through examination, appeals, and collection. Case tracking would provide precise information on assessment and collection rates and the length of time that transpires between examination and collection. To develop that information for its revised methodology, IRS relied on whatever relevant data it could obtain from various information systems and the collective judgments of employees it considered knowledgeable in their respective operations.

As discussed more fully in our June 1990 report to the Committee's Ranking Minority Member, IRS is developing a system that is intended to track the results of enforcement cases through all the relevant functions from start to final resolution.[7] As noted in IRS' November 1989 research report, it will probably be several years before sufficient data are available from that system for IRS to incorporate into its estimating methodology.

IRS' Expectations for the Proposed Fiscal Year 1991 Staffing Increase Are Based on Some Questionable Assumptions

Using its revised methodology (with some adjustment, as discussed later) IRS estimated that the examination staffing increase proposed in the fiscal year 1991 budget would result in (1) decreased audit revenues of $18.2 million that year, (2) a modest increase of $2.4 million in fiscal year 1992, and (3) sizeable increases ranging from $300 million to $740 million in the next 13 years. IRS' determination that appreciable revenues will not be realized in the short term from the increased staff is a much more realistic assessment than would have been produced by IRS' previous methodology. IRS' ability to achieve even those reduced expectations, however, may be adversely affected by the fact that (1) new staff will not be coming on board as soon as assumed, (2) training program revisions that IRS assumed would limit the amount of unrealized audit revenues and increase the productivity of new staff may not be in place when new staff start coming on board, and (3) IRS' assumption as to the kinds of returns it will be able to audit because of the additional examination staff years appears to be inconsistent with information we received from IRS' field offices.

When Will New Revenue Agents Come on Board?

IRS developed its estimate of the revenues to be generated by the fiscal year 1991 staffing increase in December 1989. At that time, IRS assumed that the 750 new revenue agent positions would be filled at or near the beginning of the fiscal year. IRS officials said they based this assumption on the expectation that the budget/appropriations process for fiscal year 1991 would be completed soon enough for IRS to bring the new staff on board by October 1. Considering recent history, that assumption seems to have been overly optimistic. IRS' appropriations for the last 3 fiscal years were enacted into law on December 22, 1987; September 22, 1988; and November 3, 1989, respectively.

[7] Tax Administration: IRS Needs More Reliable Information on Enforcement Revenues (GAO/GGD-90-85, June 20, 1990).

Considering the current status of budget deliberations, IRS' appropriation for fiscal year 1991 will probably not be enacted before the end of September 1990. By then, it may be too late for IRS to recruit college accounting students who are graduating before December 1990. In the more competitive areas of the country, IRS may have to wait for the May 1991 graduating class.

IRS' experience with respect to a revenue agent increase authorized for fiscal year 1987, although much larger than the increase proposed for 1991, provides an indication of the difficulties that can confront IRS in trying to bring staff on board to fill newly authorized positions. For fiscal year 1987, IRS was authorized an increase of about 1,600 revenue agents and was given advance hiring authority in July 1986. Even though IRS was able to start hiring about 3 months before the start of the fiscal year, it was only able to fill about half of the 1,600 authorized positions by January 1987 —6 months after it started hiring actions.

A delay in bringing new agents on board in fiscal year 1991 will reduce the amount of additional revenues IRS estimated would be generated in the next 5 years. According to IRS officials, for example, if IRS had developed its estimate on the assumption that the 750 positions would be filled by January 1, 1991, instead of October 1, 1990, its estimate of $1.1 billion in revenues through fiscal year 1995 would decline to $963.3 million.

When Will Changes to IRS' Training Program Be Implemented?

As noted earlier, a major reason why little, if any, additional revenue is generated during the first couple of years after an increase in examination staff is the fact that potential audit revenues go unrealized when experienced revenue agents, who would have been auditing returns, are used instead to train the new staff. When IRS revised its estimating methodology to start recognizing the impact of those lost audit revenues, it became apparent that the impact was considerable. As discussed in our April 1990 report, IRS concluded that the training associated with an increase of 1,000 revenue agent staff years would cost about $527 million in unrealized revenues over 10 years. To reduce unrealized audit revenues, IRS has been considering some changes to its training program.

In estimating that the increased examination staffing proposed for fiscal year 1991 would lead to about $1.1 billion in additional revenues over 5 years, IRS assumed that two changes to the training program would be in place at the start of the fiscal year. Those two changes involve (1) using some contract trainers in lieu of revenue agents and (2) restructuring the training program in an attempt to give new agents the training they need in a shorter time and thus increase the time they spend auditing. In estimating the yield to be derived from the proposed fiscal year 1991 staffing increase, IRS assumed that implementation of those changes would save about $93 million in training costs over 5 years.

According to Examination officials, they plan to allow each of IRS' seven regions to contract for its own instructors in fiscal year 1991, with the expectation of moving to a nationwide contract in fiscal year 1992. Depending on each region's ability to find acceptable contract instructors, the ratio of revenue agent instructors to contract instructors in any particular training class could vary from what has been the typical configuration of three agents and no contractors to one agent and two contractors (there will always be at least one agent in each class according to the officials). The hiring of fewer contract instructors would result in a lower yield than IRS had estimated in computing the revenues to be derived from the fiscal year 1991 staffing increase. At that time, IRS assumed a class would always involve one agent and two contract instructors. As of August 3, 1990, IRS' plans to use contract trainers seemed several months from implementation. An Examination official said that (1) IRS cannot request bids on a contract until it knows what the training workload is going to be—something it will not know until its appropriation is enacted—and (2) once bids are requested, it could be 2 to 3 months before contract award.

New revenue agents now receive four phases of training spread out over 26 months. Each phase comprises several weeks of classroom instruction followed by another several weeks of on-the-job training. The first two phases deal with tax laws that pertain to individual taxpayers; the third phase deals with laws pertaining to corporate taxpayers; and the fourth phase deals with, among other things, partnerships. IRS is considering several changes to that training structure. According to an Examination official, IRS is considering (1) reducing the number of training phases from four to three by combining the last two; (2) reducing classroom training from a total of 20 weeks to about 15 weeks; (3) reducing on-the-job training from a total of 41 weeks to 19 weeks; and (4) expanding the length of time between phase 2 and new phase 3 from 26 weeks to 60 weeks, thus allowing trainees to spend more time auditing returns. This proposed restructuring goes beyond what IRS assumed in preparing its $1.1 billion estimate and thus, if implemented, could cause IRS' estimate to be understated. IRS officials said that training time can be reduced without adversely affecting quality by doing such things as eliminating redundancy between phases and using less formal settings, like workshops, to convey some material that had been covered in class.

Because IRS had not begun awarding training contracts and because restructuring plans have not been finalized, it is clear that the training changes will not be implemented by the start of the fiscal year, as IRS assumed in developing its estimate. There may be little impact, however, because, as discussed above, new staff will not be coming on board by the first of the year. We have no basis for determining when these or other changes to the training program might be implemented, whether they will be on-line when newly authorized revenue agents start coming on board, and what their effect will be on training costs and audit revenues.

How Will the Influx of Additional Examination Staff Affect the Workload of Experienced Staff?

One concern we had with IRS' previous estimating methodology that remains a concern with the revised methodology is IRS' assumption that the increased audit time provided by the additional staff will be allocated among numerous tax classes,[8] including ones in which new revenue agents do not typically work. In developing its estimate of the revenue to be derived from the proposed staffing increase for fiscal year 1991, for example, IRS assumed that the increase of 750 revenue agent staff years would translate to about 284 additional staff years that it could devote to auditing returns, after allowing for time that would be charged to training and other nonaudit activities. It then assumed that about 15 of those additional staff years would be devoted to auditing returns in individual tax classes, with the other 269 devoted to returns in more complex, higher-yield tax classes, such as returns filed by corporations.

In explaining this allocation, IRS National Office officials said that as new agents—who generally work the less complex, low-yield individual returns—come into IRS, experienced revenue agents can move into more complex, higher-yield tax classes. It is IRS' position, therefore, that it is appropriate to attribute a portion of the yield from those higher-yield classes to the increased staff. These National Office officials said that although they believe this movement of experienced staff occurs, they do not have empirical data to support the assumption.

[8]A tax class is a grouping of returns on the basis of return type, such as individual or estate; source of income, such as farm or business; and level of income.

District office managers and officials we talked with had a different perception. Managers of revenue agents and Examination officials in IRS' San Francisco District Office and Examination officials in the Atlanta, Chicago, and St. Louis District Offices said that experienced revenue agents do not audit the type of low-complexity returns assigned to first-year trainees. They said that the low-complexity returns are usually examined by tax auditors (IRS employees who audit less complex tax returns than those audited by revenue agents). The managers said that were it not for the trainees, those low-complexity returns would not be audited by their groups of experienced agents. The district officials also said that it takes about 2 years from the beginning of an examination staff expansion before they see an increase in the staff years used in the audits of the more complex, higher-yield tax classes. By this time, the new staff will have been trained to audit the more complex, higher-yield returns and the experienced revenue agents will have returned to auditing from their training assignments.

If IRS had allocated all of the proposed fiscal year 1991 increase in examination staff years to individual tax classes in the first year of the increase, its estimate of $1.1 billion in revenue through fiscal year 1995 would have declined to $668 million.

The Reliability of IRS' Tracking of Fiscal Year 1991 Results Will Depend on the Validity of Its Starting Point

One positive step being taken by IRS with respect to the various revenue-generating initiatives proposed in its fiscal year 1991 budget is the development of methodologies by which it can track the results actually achieved under each of those initiatives. Congress' budget deliberations would be enhanced if it had reliable information on the amount of revenue generated by the various initiatives. IRS could also use the information to verify the reliability of its estimates. The methodology IRS plans to use to track the results associated with the increase in revenue agents seems to be fairly straightforward. IRS plans to compare the number of revenue agent staff years and associated yield that would have been achieved without the increase (referred to as the baseline) with the staff years and yield actually achieved—the difference being attributed to the increased staff. IRS used the same basic methodology when it estimated the yield that had been generated in fiscal year 1987 as a result of the increased examination staff authorized for that year. We raised several concerns with IRS' fiscal year 1987 estimate in our August 1988 report, including the fact that IRS had, in our opinion, overestimated yield by reducing the baseline against which results were compared.

Before the start of fiscal year 1987, IRS expected that the authorized staffing increase for that year would raise its revenue agent staffing level by 1,618 staff years—from a base of 14,227 at the beginning of the year to 15,845 by year's end. In fact, however, IRS' revenue agent staffing level rose to only 14,939 staff years by the end of fiscal year 1987—an increase of 712 years, or 906 years less than expected. If IRS had held its staffing base constant at 14,227 staff years, its computation of additional yield would have been predicated on an increase of 712 revenue agent staff years. Instead, as discussed more fully in our August 1988 report, IRS decided that about 90 percent of the 906 unrealized staff years applied to the base. As a result, IRS (1) reduced its base staffing level from 14,227 to 13,414; (2) determined that the 1,525 staff year difference between the adjusted base (13,414) and the end-of-year staffing level (14,939) represented the increased staff authorized by Congress; and (3) used that increase of 1,525 years to compute the revenue effects of the authorized staffing increase.

We recognize that events, like the need to absorb a pay increase or a management decision to divert staff from Examination to handle a staffing shortage in Taxpayer Service, can lead to reductions in Examination's base staffing level during the fiscal year. Some of these reductions may be necessary because of factors, such as a hiring freeze caused by the need to absorb a pay increase, that are beyond IRS' control. Other reductions, however, represent discretionary management decisions to change staff allocations.

It is important that IRS disclose to Congress the extent of and reasons for any erosion of the base. It does little good, in our opinion, for Congress to approve additional staff with the intent of generating additional revenue if that benefit is eroded by reductions to the base. For Congress to properly assess the effects of staffing increases, therefore, it needs to know how and why the base has changed.

Before the beginning of fiscal year 1991, IRS will be computing the baseline against which it will track the results of a fiscal year 1991 staffing increase. Until it does and until it has specified under what circumstances, if at all, it will adjust the baseline and how, if at all, it will reflect the impact of such adjustments in its tracking results, we have no basis for assessing the methodology's validity or for determining whether the tracking results will be more meaningful than the results reported for 1987.

Conclusions

IRS' revised methodology for estimating the yield from an increase in examination staff is a significant improvement over the methodology IRS used in the past. It addresses most of the concerns raised in our earlier assessment of the past methodology and produces a much more realistic projection of what the government can expect as a result of the staffing increase. In applying that methodology to the proposed staffing increase for fiscal year 1991, however, IRS made assumptions about the hiring and training of new agents that have proven to be overly optimistic. Also, IRS needs to develop information to support its assumption that hiring new agents allows IRS to assign more experienced agents to more complex, high-yield cases. If empirical data do not bear this out, IRS' estimates should be revised to reflect only that revenue generated from audits in the tax classes typically worked by new hires.

IRS plans to monitor the results of the fiscal year 1991 staffing increase, assuming it is authorized. Reliable information on results will be valuable not only to Congress in deliberating future proposed increases but also to IRS as a check on the validity of its estimating methodology. IRS will be establishing a baseline against which results will be monitored. Until then, we cannot begin to determine whether the monitoring will produce reliable information.

Recommendation to the Commissioner of Internal Revenue

To further improve its methodology for estimating the revenue to be derived from an increase in examination staff, IRS should develop empirical data to show whether the influx of new examination staff allows more experienced agents to work higher-yield cases and in what time frame.

Agency Comments and Our Evaluation

The Commissioner of Internal Revenue commented on a draft of this report by letter dated August 29, 1990, (see app. I). The Commissioner agreed that there are some areas in which IRS needed to fine tune its process for estimating examination revenues. He specifically agreed that IRS needed to study the extent to which the influx of new staff allows more experienced staff to do more complex, higher-yielding audits and the timing of any such impact. The Commissioner said that such fine tuning would not materially change the revenue estimate in the President's budget for fiscal year 1991. He noted that the revenue estimate in the President's budget still appears achievable if Congress acts quickly to approve IRS' appropriation and to limit the impact of sequestration. The Commissioner went on to say that greater certainty in the budget process would enable IRS to make commitments to June graduates, bring them on board timely, and schedule training in a way that maximizes productivity.

We agree that the sooner IRS' appropriation is enacted and the less IRS is affected by sequestration, the better IRS' chances of generating revenues. Even then, however, we believe that IRS could have a much harder time meeting its revenue estimate than indicated by the Commissioner. As noted earlier, for example, if empirical data do not support IRS' assumption that the influx of new staff enables experienced staff to work higher-yield cases, IRS' 5-year estimate of $1.1 billion in revenues could be reduced to as low as $668 million.

In discussing the portion of our report dealing with changes to the revenue agent training program, the Commissioner noted that cumbersome procurement rules and budget uncertainties affected IRS' ability to move ahead quickly with planned contract training. He also indicated that we were concerned about the fact that IRS was changing its original contracting plan and might be using more revenue agents as instructors than was originally assumed. We have no basis for judging the relative merits of IRS' original and revised plans. Our only purpose in mentioning the change was to alert the reader that one of the assumptions on which the revenue estimate in the President's budget was based has been revised.

The Commissioner also agreed that the reliability of IRS' monitoring of the revenues generated by the staffing increase depends to a great extent on the validity of the baseline. He emphasized, however, that the baseline (amount of revenue that would have been collected absent the staffing increase) can only be estimated. We agree that the baseline can only be estimated. Our concern is with the estimate's validity and with subsequent changes to the baseline.

As arranged with the Committee, unless you publicly announce its contents earlier, we plan no further distribution of this report until 2 days from the date of issuance. At that time, we will send copies of this report to the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties.

The major contributors to this report are listed in appendix II. Please contact me on 275-6407 if you or your staff have any questions concerning the report.

Sincerely yours,

Jennie S. Stathis

Jennie S. Stathis
Director, Tax Policy and
Administration Issues

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Abbreviation

IRS Internal Revenue Service

Comments From the Internal Revenue Service

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

AUG 29 1990

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, DC 20548

Dear Mr. Fogel:

We have reviewed your draft report concerning IRS's revised methodology for estimating examination yield. We were pleased to see that GAO agrees that we have made substantial improvements in our estimating methodology and that we are making progress in assuring that we are held accountable for our performance. We also agree that there are some areas in which we need to fine tune our estimating process, but believe that our estimates reflected in the President's budget for Fiscal Year 1991 would not materially change because of these findings. Given this and other improvements in restructuring our training programs, our original estimates appear to be achievable if Congress acts quickly to approve our appropriations and to limit the impact of sequestration. It should also be noted that any substantial delay will postpone revenue anticipated for the second and subsequent years.

Revenue estimates aside, we should not lose sight of the fact that what is most important is a long-term commitment to increase IRS resources. Also, the Examination initiative discussed in this report is only one part of our overall FY 1991 revenue initiative. Any discussion of enforcement revenue estimating must be put into this context so Congress will have the benefit of your advice when considering the important issues of raising revenue and funding this agency to collect that revenue.

<u>October 1 Entry on Duty Date Unrealistic for New Agents</u>

IRS' revenue estimate assumes that 750 new revenue agent positions would be filled at or near the beginning of the fiscal year. Although we did not base the estimate on the assumption that advance hiring would be authorized, we did assume that IRS' appropriations would provide funding for this initiative as of October 1, 1990. Because the initiative assumed nationwide hiring in our 63 districts and because we can take many recruitment steps in anticipation of actual hiring, it was reasonable to assume that we could hire 750 new revenue agents very quickly after approval by Congress. We continue to believe we could do that. Although first-year revenue effects may have to be adjusted to reflect any delays, second and later years would not be greatly affected if Congress acts quickly to approve our appropriations.

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Mr. Richard L. Fogel

If IRS could rely on a process that delivered a budget timely without the threat of sequestration, we believe we would be able to deliver the revenue projected for the initiative. Greater certainty in the budget process would enable us to make commitments to June graduates, bring them on board timely, and schedule training in a way that maximizes productivity. The current "stop and go" budgeting process has a continued detrimental impact on our ability to hire, train and retain quality employees. Possible sequestration further jeopardizes planned new initiatives as well as current revenue processing activities.

Changes to IRS' Examination Training Program

GAO also cites our planned improvements in training as another factor affecting potential revenue from the initiative. As noted, IRS initiated these improvements in part to maximize early revenue producing activities of trainees and to free up our more experienced revenue agents for more productive work. GAO agrees that these improvements will, when fully effected, go a long way toward optimizing potential revenue increases in the early years of a revenue initiative, but does not believe we will be ready to contract out training by the beginning of the fiscal year as our estimates assumed. While we agree that there will be a delay of as much as two to three months, we firmly believe that we will be ready with contract trainers as soon as new hires are on board. In addition, we believe that our planned restructuring of training programs will increase revenue producing activities from the initiatives even more than originally projected.

GAO expressed concern that our original plan for contracting out training was being changed to use two rather than one revenue agent per training class. If true, this of course would increase opportunity costs by taking more agents from revenue producing work. Although analysis has indicated that we may use two revenue agents rather than one per class in some locations because of the difficulty of hiring outside instructors, we believe this change will only impact a few of the smaller locations and will not have a substantial impact on our revenue estimates. Further, we believe the restructuring improvements noted above may more than offset any potential effect of this change.

Cumbersome procurement rules, coupled with budget uncertainties, do impact on our ability to move ahead quickly with planned contract training. However, if Congress were to approve our appropriations request and remove the threat of sequestration, we believe we would be able to hire and begin to

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train new employees for the initiative within two to three months. The ability to plan in advance for the long term would greatly aid us in knowing when we could hire and contract for instructors.

Migration of Work

See comment.

Of continuing concern to GAO was our assumption that increased audit time provided by the additional staff would be allocated among numerous tax classes, with new hires freeing up experienced agents to do more complex and higher yielding examinations beginning in the first year (known as "migration"). While we do not believe that the period 1985 - 1989 gives a realistic picture of what could be expected from any new initiative, we agree to study the impact and timing of the migration when new hires are brought on board. As noted by GAO, we have already taken into account, in our estimates, the reduced opportunity costs created when we use experienced revenue agents to train new employees. For this reason, we believe that the effects noted by GAO for the periods 1985 - 1989 reflect factors that have already been taken into account in our estimates. We do, however, welcome GAO's assistance in conducting further study.

See comment.

GAO also compares planned versus actual staffing for the same period. We believe that comparing planned versus actual staffing neither proves nor disproves migration in the first year. Exceeding or underrealizing planned staffing can be caused by various other factors including, but not limited to, delays in training, hiring freezes, and difficulties in recruitment.

Reliability of the Baseline

IRS agrees with GAO that the reliability of estimates of revenue generated by any initiative depends to a great extent on the validity of the baseline, i.e., we must accurately estimate the enforcement revenue that would have been collected in the absence of the initiative. We must reemphasize, however, that this can only be estimated; it cannot be "tracked." The Assistant Commissioner (Finance)/Controller and the Assistant Commissioner (Examination) are working to formalize the method

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for estimating what would have happened in the absence of the initiative.

Thank you for the opportunity to provide our comments on this report.

Best regards.

Sincerely,

Fred T. Goldberg, Jr.

The following is GAO's comment on the Internal Revenue Service's letter dated August 29, 1990.

GAO Comment

1. These references are to data that were in the draft report but are not in the final report.

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