BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Further Research Into Noncompliance Is Needed To Reduce Growing Tax Losses

The Federal Government is losing billions of dollars in tax revenues annually because individuals are not complying with the laws.

IRS has several programs for deterring noncompliance but has relied mainly on the process of examining tax returns as a stimulus--a process that requires more than one-half of IRS' enforcement staff. Other programs might be more cost-effective, but IRS is not sure that its staff is appropriately allocated among these programs to obtain the maximum voluntary compliance and to substantially increase tax revenues.

GAO recommends that IRS undertake research to better understand how its various compliance activities might best be structured. GAO also recommends that, in the interim, IRS make better use of its staff within the various programs and implement an information system for improving program management.

UNITED STATES GENERAL ACCOUNTING OFFICE

GAO/GGD-82-34

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This report discusses the need for IRS to find out how to best structure its compliance activities. We recommend that IRS take various steps, including reallocating some resources, to improve compliance and thus reduce the Federal Government's mounting tax losses. The need for these actions is further emphasized by preliminary IRS estimates, developed after our review, which indicate that the noncompliance problem may be as much as three times the size discussed in this report.

Copies of the report are being sent to the Director, Office of Management and Budget; the Secretary of the Treasury; the Commissioner of Internal Revenue; and other interested parties.

Charles A. Bowsher
Comptroller General
of the United States

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ABBREVIATIONS

DIF	Discriminant function
GAO	General Accounting Office
GGD	General Government Division
IRS	Internal Revenue Service
OMB	Office of Management and Budget
TCMP	Taxpayer Compliance Measurement Program

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

FURTHER RESEARCH INTO NONCOMPLIANCE IS NEEDED TO REDUCE GROWING TAX LOSSES

D I G E S T

There is a growing trend in the Nation toward disregard for the principle of voluntary tax compliance--a trend which IRS estimates increased tax revenue losses from $12 billion in 1976 to at least $20 billion in 1980. 1/

IRS has attempted to reverse this trend, but with little success. It needs more complete information and insight on what makes people willing to comply. Such data is essential for determining the most cost-effective strategy in combating unreported income, IRS' most severe compliance problem by far.

GAO concluded that, until IRS has better compliance data, it should place more emphasis on increasing the tax revenue yield from its various programs. To do so, IRS must use its present cost/yield data more effectively.

GAO made this review because the Congress has frequently indicated through hearings, proposed legislation, and in other ways a strong interest in the degree of compliance with the Nation's tax laws.

MORE COMPLIANCE RESEARCH NEEDED

IRS has nine principal programs for deterring noncompliance. Relying on the examination of tax returns as its primary strategy for stimulating compliance, IRS has allocated more than one-half of its compliance resources to the examination program, distributing the balance among the remaining eight. (See pp. 12 to 18.)

The examination program, however, has not stemmed the decline in voluntary compliance. Moreover, the compliance of all income tax groups that IRS measures has declined. In one extreme

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1/In May 1982, after GAO finished its work, IRS released preliminary estimates which indicate that the total tax revenue loss from noncompliance for 1981 may be as much as $97 billion. (See p. 7.)

case, business taxpayers with income under $10,000, the compliance rate dropped from 78 percent to 43 percent between 1965 and 1976. Compliance among corporate taxpayers has also declined. (See pp. 19 to 20.)

A decrease in the percentage of tax returns that IRS examines may be a factor in the decline in voluntary compliance. But, the actual effect of the examination program on voluntary compliance is, at best, unclear. For example, although IRS increased the percentage of returns examined in some earlier years, compliance still declined. (See pp. 20 to 24.)

IRS' most severe compliance problem involves unreported income, which accounts for almost three-fourths of the estimated tax revenue lost through taxpayer noncompliance. This problem is compounded by the fact that normal audit procedures are not very successful in detecting unreported income. In this regard, IRS' recent studies of the unreported income problem indicate that even its most intensive examinations--those performed as part of its taxpayer compliance measurement program--were only detecting about 25 percent of the income not reported by those persons audited. This fact has obvious implications regarding the extent to which IRS can rely on its normal, less intensive audits to detect unreported income. Thus, IRS needs to find out which of its various compliance programs can be brought to bear in dealing with this problem. (See pp. 24 to 29.)

IRS has completed some research to find out how the examination program affected taxpayers who were selected for examination. These people, however, constitute a small and decreasing percentage of the taxpaying population. Although IRS had several compliance research projects planned or underway at the time of GAO's review

--none was designated a high priority;

--none addressed the impact of IRS' compliance programs on taxpayers not contacted in a program, the "ripple effect;" and

--none related to how well compliance programs deal with unreported income. (See pp. 29 to 31.)

GAO does not know the extent to which IRS can measure the overall effects of its compliance programs. However, given the billions of dollars of tax revenue at stake, GAO believes that further research is necessary.

INCREASING TAX REVENUE YIELD SHOULD BE AN INTERIM GOAL

Until IRS has better data on how its programs actually affect voluntary compliance, it should place greater emphasis on increasing the tax revenue yield from its programs.

IRS has allocated resources within and among its compliance programs on the premise that voluntary compliance is a function of the examination of tax returns. In so doing, IRS has purposely sacrificed some tax revenue by trying to stimulate voluntary compliance through broad coverage of the taxpaying population, rather than maximizing the tax revenue available from the examination program. Some resource shifts could, GAO believes, increase tax revenue yield. For example, IRS could increase tax revenue by examining a higher percentage of tax returns which historically have extremely favorable cost/yield ratios and by shifting resources to programs, such as the taxpayer delinquent accounts program, that have a higher average yield-to-cost ratio than other programs.

IRS generally lacks cost and marginal yield data needed to maximize revenue from its programs--a notable exception being the examination program. Adequate data are available, however, to show that the tax revenue yield is, on the average, much higher for some IRS programs than for others. Thus, even a small shift of resources to those programs could increase overall tax revenue. Using average yield data, GAO determined, for example, that a 1- or 2-percent shift of resources among four IRS programs could increase annual tax revenue by $93 million and $190 million, respectively. (See pp. 36 and 37.)

Allocating resources to obtain maximum revenues would also increase tax revenue in the examination program. GAO determined that such an approach would

--increase the costs assigned to the examination program,

--change the percentage of tax returns examined for various taxpayer classes, and

--increase tax revenue. (See pp. 38 to 48.)

Better cost/yield data needed

While IRS can immediately increase tax revenue yield from its programs, it still needs more complete data to determine how it should allocate resources effectively over the longer term. IRS has no agencywide information system, however, to provide complete cost/yield and other needed data. (See pp. 49 to 52.)

Although IRS recognized the need for an agencywide system as early as 1976, no information system is yet operational. Such a system is long overdue. (See pp. 52 and 54.)

IRS' RESOURCES LAG BEHIND GROWING DEMANDS

IRS' resources have not kept pace with the increasing demands placed on the tax system. One measure of the resource gap is the growth in tax return filings compared to increases in IRS' budget. Although increases in return filings do not necessarily require a proportionate increase in budget, the number of returns will have grown 17 percent between 1976 and 1983, whereas IRS' fiscal 1983 budget request provides only 5 percent more staffyears than its 1976 budget.

IRS needs, along with more compliance research and better resource allocations, adequate resources to effectively and efficiently operate the Nation's tax system. (See p. 31.)

RECOMMENDATIONS

GAO recommends that IRS do further compliance research, with emphasis on learning how to get people to accurately report their income and how people, in general, respond to IRS programs. (See p. 33.)

GAO also recommends that, until IRS better understands how its programs affect voluntary compliance, it emphasize getting maximum tax revenue from its programs. Specifically, GAO recommends that IRS use existing cost/revenue data to reallocate resources within and among certain programs. Also, to improve IRS' compliance management, including resource allocations, GAO recommends that IRS implement a system to provide agencywide cost, revenue, and other data for its programs. (See pp. 54 and 55.)

IRS COMMENTS AND GAO'S EVALUATION

IRS agreed that GAO's recommendations have merit and stated that it intends to continue research to determine the impact of its programs on voluntary compliance.

However, IRS felt that GAO's recommendations failed to consider certain IRS limitations and offered little guidance as to how IRS should proceed. GAO recognizes that completing the needed compliance research will be a difficult and long-term endeavor. GAO believes that IRS is headed in the right direction with some of its ongoing research projects and that IRS should assign a higher priority to compliance research.

IRS also stated that although it had long recognized the urgent need for a management information system, it has been unable to develop one because of a lack of resources. IRS said that it has sent its plan for obtaining better management information to Treasury. IRS requested funds for fiscal year 1983 to implement such a system. GAO views these actions as major steps toward meeting a critical need and encourages IRS to continue the emphasis on filling that need.

IRS provided various comments on GAO's findings regarding the examination program. These and IRS' other comments are included as appendix IV. GAO's evaluations of those comments are on pages 34 and 35 and pages 55, 56, and 57.

MATTER TO BE CONSIDERED
BY THE CONGRESS

To help determine appropriate IRS resource levels, the Congress may wish to request that IRS periodically provide additional data showing the cost, revenue, and other effects of its programs at various funding levels.

CHAPTER 1

INTRODUCTION

The Internal Revenue Service (IRS) seeks to encourage or force taxpayers to properly assess and pay their taxes. To the extent it cannot, a windfall accrues to those not paying. Moreover, the success of the whole voluntary assessment system depends, in large measure, on taxpayers' perception that all are paying their fair share.

This report is about IRS' efforts to get individuals to comply with the tax laws. Specifically, the report discusses how IRS has used its programs and resources to encourage and achieve the highest possible degree of voluntary compliance with the Nation's tax laws.

THE VOLUNTARY ASSESSMENT SYSTEM

The principle that individuals should and will pay their fair share of taxes is fundamental to the American tax system. Operating under this principle, the Federal Government is able to raise the revenue that finances over 90 percent of its activities. A system of voluntary compliance, it is argued, represents the most efficient and effective approach to collecting taxes and is likely to promote the highest degree of public acceptance of this basically unpopular governmental function.

To illustrate the system's efficiency, in 1981, individual and corporate taxpayers voluntarily filed about 97 million returns and paid $407 billion in income taxes to the Government. Total revenue collections, from all sources, amounted to $607 billion, while IRS' operating costs totaled $2.5 billion. Thus, the average cost of collecting $100 was 41 cents.

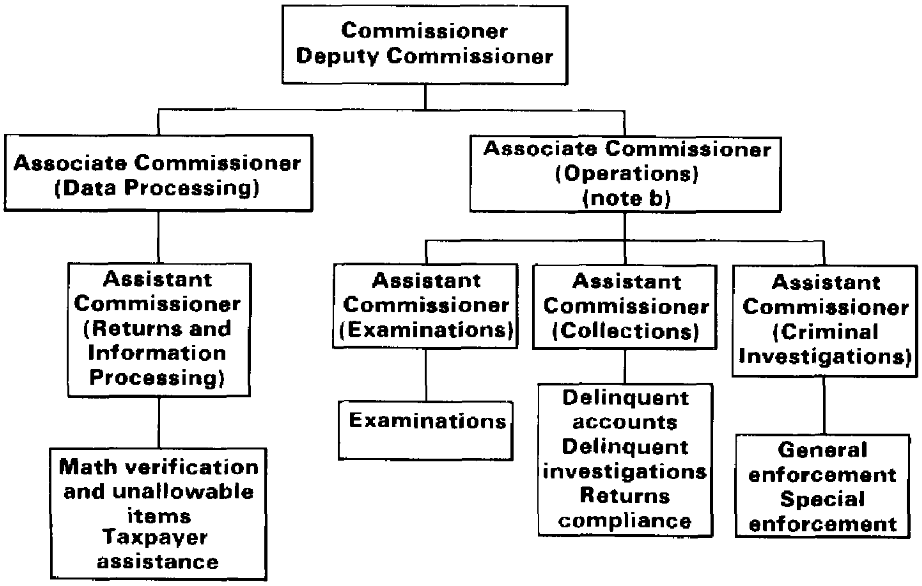
The goal of tax administration, then, is to ensure the highest possible degree of voluntary compliance with the tax laws. However, a natural desire to obey the law or a deep sense of patriotism are not always sufficient to motivate the taxpaying public to comply. Although most people comply voluntarily, many do not.

Some people evade taxes by simply not filing a return. Others file, but do not accurately report their income; or in filing, they overstate offsets, such as exemptions and itemized deductions, to the income reported. Still others do not pay taxes legally assessed and due. Some could comply but consciously elect not to; while others, due to ignorance or other reasons, may have no real choice but to not comply. Whatever the situation, these people create a problem for IRS and, collectively, they account for billions of dollars of losses in tax revenue annually. IRS' compliance role is to identify them and try to get them to comply.

IRS' COMPLIANCE PROGRAMS

To administer and enforce the tax laws, IRS' appropriation for fiscal year 1981 was $2.5 billion. Of that amount, IRS allocated $1.6 billion, or 64 percent, to nine programs which we believed could be expected to most significantly affect taxpayer compliance. Organizationally, the programs were under five IRS divisions and two assistant commissioners until December 1981. In January 1982, the Secretary of the Treasury issued an order reorganizing IRS and changing its compliance structure, especially at the assistant commissioner level. IRS' current compliance structure is as follows:

IRS COMPLIANCE STRUCTURE
As of May 1982
(note a)



a/Excludes various IRS national office elements that are not directly involved in identifying and eliminating taxpayer noncompliance. Also excludes 7 regional offices, 59 district offices, 10 service centers, and numerous posts of duty that actually carry out IRS compliance programs and other activities.

b/A ninth program, the information returns program, not shown above, is under the Associate Commissioner (Operations) for overall program coordination, planning, and budgeting purposes. The processing of information returns, including screening discrepancies and contacting taxpayers, is closely linked to the returns processing function under the Associate Commissioner (Data Processing). Responsibility for followup on discrepancies is assigned to the Associate Commissioner (Operations).

Some IRS compliance programs deal with just one aspect or form of noncompliance; others deal with several forms. For example, the special enforcement program focuses solely on detection of unreported income. The examination program, on the other hand, concerns itself with both unreported income and overstated offsets. Generally, the various programs deal mainly with the forms of noncompliance shown in the following table.

	Noncompliance Element			
Program	Nonfiling	Underreporting income	Overstating offsets	Nonpaying
Math verification			X	
Information returns	X	X		
Taxpayer service	X	X	X	
Examinations		X	X	
Taxpayer delinquency accounts				X
Taxpayer delinquency investigations	X			
Returns compliance	X			
General enforcement		X	X	
Special enforcement		X		

Appendix I provides additional information on how each program detects noncompliance, along with data on actual accomplishments in fiscal year 1981.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our objective was to evaluate the adequacy of IRS' resource allocations among and within those programs--nine in all--which we believed could be expected to most significantly affect taxpayers' compliance with the tax laws. Specifically, we wanted to determine the appropriateness of such allocations in relation to available data on

--the voluntary compliance levels of specific taxpayer groups, as determined by IRS for certain years from 1965 to 1976,

--the nature and size of the various forms of taxpayer noncompliance,

--the effects that the compliance programs have on the willingness of people to improve their compliance, and

--the estimated cost and tax revenue history of the various programs.

Although we looked mainly at IRS' fiscal year 1980 and 1981 allocations among the nine programs, we obtained data to show the allocation patterns for the 10 fiscal years 1972 through 1981. We directed much of our attention to the examination program because IRS had allocated at least 3 times more resources to that program than to any of the other eight programs.

Our review covered IRS compliance activities affecting both individual and corporate taxpayers. Because of data limitations, however, we limited parts of our review, primarily where we analyzed voluntary compliance trends, to those taxpayers who must file individual income tax returns. These individual taxpayers accounted for 96 percent of the individual and corporate returns filed and 81 percent of the related income taxes collected in 1981.

In September 1979, IRS released estimates indicating that for 1976 individual taxpayers failed to report on their tax returns between $100 billion and $135 billion of taxable income from legal and illegal sources. Because of the significance of those estimates and because of the congressional interest indicated, we looked especially at IRS' efforts to deal with the problem of unreported income. However, we also wanted to know how IRS deals with all major forms of noncompliance and whether it could more efficiently and effectively use its compliance resources.

We examined data available from various IRS reports and records relating to the compliance problem to determine the relative size of its components. We reviewed IRS compliance plans and budgets, including the process followed in developing them, for dealing with the overall problem.

Adequate data were not available to enable us to measure the impact of the compliance programs on voluntary compliance. Consequently, we could not quantify probable changes in taxpayer behavior that would result from alternative IRS compliance policies, approaches, and resource allocations. We were, however, able to evaluate (1) how well IRS uses existing data in attempting to achieve the greatest overall impact on the compliance problem and (2) whether IRS has made adequate provision for obtaining the data necessary to achieve that impact.

We accumulated data on the possible revenue effects of reallocating among certain programs a portion of IRS' compliance resources. We also determined, through IRS' computerized cost/yield model for the examination program, the coverage, direct tax revenue, and other outcomes that could be anticipated using certain assumptions and cost/revenue data that differ from those IRS used in developing its 1980 examination plans. IRS lacked the data necessary to permit similar analyses for other compliance programs.

Our work was performed in accordance with GAO's current "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions."

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Because it lacks the necessary data, IRS is not sure that it is using its compliance resources as efficiently and effectively as possible to stimulate compliance and reduce the Government's tax losses. In chapter 2, we discuss the need for IRS to conduct the research necessary to better understand (1) what motivates people to comply with the tax laws and (2) how IRS might restructure its compliance activities to motivate people to comply. Chapter 3 shows how IRS can, in the interim, reduce the tax revenue losses through alternate resource allocations and discusses IRS' need for adequate compliance program data for use in allocating resources.

We have issued various reports and statements to the Congress or certain of its committees and subcommittees on individual IRS programs and activities discussed in this report. A listing of these documents, showing title and date, is included as appendix II.

CHAPTER 2

TAXPAYER NONCOMPLIANCE: A MASSIVE PROBLEM

ABOUT WHICH IRS KNOWS TOO LITTLE

IRS faces a complex, multibillion dollar problem--the unwillingness or inability of a growing number of people to comply with the tax laws. IRS is at a serious disadvantage in dealing with the problem because it lacks sufficient data to understand what motivates people to comply and how to best structure its compliance activities to get them to comply. IRS needs to do further research to find out how its programs affect compliance with a view toward, ultimately, measuring and comparing the effects of those programs on compliance.

DETERIORATING COMPLIANCE IS A COMPLEX MULTIBILLION DOLLAR PROBLEM

Considerable evidence exists to indicate that people are complying with the tax laws less today than ever before. Exact figures on total noncompliance are not available. However, failure to comply takes several forms, and each contributes to a large and growing national problem.

Various studies have indicated that willful abuse of the Nation's tax laws is widespread and growing. One study, completed for IRS by CSR, Incorporated 1/ in March 1980, showed that, while the results varied depending on the interview method used, there were strong indications that at least 26 percent of the people interviewed admitted to purposely understating their tax liabilities. The CSR study noted that the noncompliance among those interviewed involved not reporting income more often than overstating offsets to income. Similarly, 26.6 percent of those polled in a study 2/ done in Oregon admitted to at least one tax violation. The study, involving compliance with Oregon's income tax laws, showed that understating income was about 3 times as prevalent among those interviewed as overstating offsets--17.4 percent compared to 6.1 percent.

IRS' voluntary compliance studies also indicate that voluntary compliance has deteriorated and that the Government's tax losses are increasing at a rapid rate. The "gross tax gap," the additional taxes owed as disclosed by examination of a national sample of tax returns, was $12 billion in tax year 1976. IRS

1/CSR, Incorporated, "A General Taxpayer Opinion Survey," Mar. 1980.

2/Survey Research Center, Oregon State University, "An Estimate of Income Tax Evasion in Oregon," Jan. 1981.

estimated that the tax gap grew at a compound rate of 13.5 percent between 1973 and 1976 and that the gap was more than $20 billion in 1980 alone. At this rate, the tax gap will be about $38 billion in 1985, and the sum of unreported taxes will be about $148.5 billion for the 5-year period 1981-85.

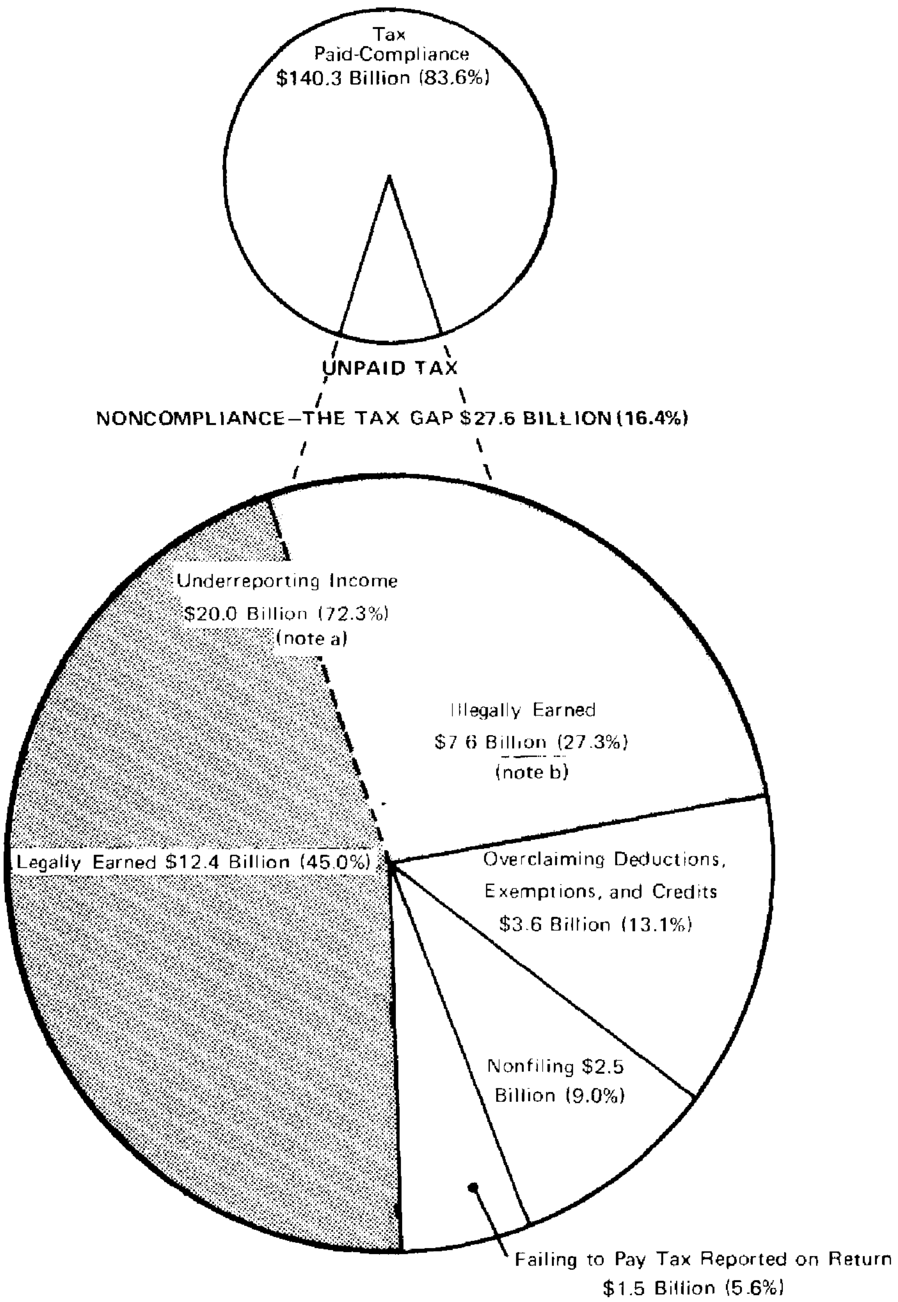
Significant as they are, the above estimates are understated because they are based only on the results of IRS' Taxpayer Compliance Measurement Program (TCMP). That program, discussed in more detail later, does not accurately measure unreported income and does not attempt to measure nonfiling. 1/ Also, the program provides no data on those people who fail to pay taxes.

To provide a more accurate picture of total noncompliance, we assembled data from various IRS studies and records on each of four major forms of noncompliance--unreported income, nonfiling, overstating deductions, and nonpaying. Those data indicate that the aggregate voluntary compliance rate for individuals was about 84 percent in 1976 with a total revenue loss of about $27.6 billion. As the graph on the following page shows, unreported income earned legally and illegally accounted for about 72 percent of the tax loss; the other forms combined accounted for about 28 percent.

1/Recognizing this, IRS has been experimenting with additional ways to estimate the revenue loss resulting from all forms of noncompliance. In May 1982, after we completed our work, IRS released some preliminary estimates which indicate that the total tax revenue loss for 1981 may be as much as $97 billion. The major components of the $97 billion estimate were: (1) unreported income by individuals--$66.1 billion; (2) overstated expenses, deductions, and credits by individuals--$12.3 billion; (3) nonfiling by individuals--$4.9 billion; (4) noncompliance by corporations--$3.9 billion; and (5) tax losses on income derived from illegal sources--$9.8 billion.

ESTIMATED INDIVIDUAL INCOME TAX OWED U.S. IN 1976

TOTAL $167.9 BILLION



a/ Excludes underreported income from nonfilers.

b/ Estimate includes only major criminal activity.

Unreported income--IRS' most severe compliance problem

Individuals who do not accurately report their income pose the largest single problem for IRS. In September 1979, IRS released a report 1/ showing that, for tax year 1976, individuals failed to report legal source income totaling $75 to $100 billion on which about $13 to $17 billion in taxes was due the Government. IRS also estimated that the Government lost an additional $6 to $9 billion in taxes due on $25 to $35 billion in income from certain illegal sources, namely narcotics, gambling, and prostitution. Of the total $135 billion of unreported income from legal and illegal sources, IRS estimated that about $99 billion, or 74 percent, related to returns filed, and $36 billion, or 26 percent, to nonfiling.

IRS acknowledged that some of its estimates were more reliable than others and that its illegal income estimates were particularly "soft." Other estimates have been much larger. For example, Professor Peter Gutmann of the City University of New York estimated unreported income, or what he termed the subterranean gross national product, to be about $176 billion for 1976 2/; he later revised the estimate to $200 billion for 1976 and to $265 billion for 1980.

Even though IRS' estimates may be understated, they were large enough to cause considerable concern in the Congress. Both the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Committee on Government Operations and the Subcommittee on Oversight of the House Committee on Ways and Means conducted hearings into the so-called subterranean economy during 1979. Also, in March 1982, a bill entitled the Taxpayer Compliance Improvement Act of 1982 (S. 2198) was introduced in the Congress to deal with unreported income.

Failing to pay income taxes is a large and rapidly growing problem

The number of individuals who are delinquent in paying taxes is large and growing. The table on the following page illustrates the rate of growth by showing the increase in the number and dollar amount of delinquent accounts between 1977 and 1981.

1/Department of the Treasury, Internal Revenue Service, "Estimates of Income Unreported on Individual Income Tax Returns," Publication 1104, Sept. 1979.

2/Gutmann, Peter M., "The Subterranean Economy," Financial Analysts Journal, Nov./Dec. 1977, p. 26.

Delinquent accounts	Fiscal year 1977	Fiscal year 1980	Percentage increase
Number	844,000	1,400,000	66
Amount	$2.0 billion	$4.7 billion	135

Other forms of noncompliance also pose major problems for IRS

Individuals who avoid taxes by simply not filing a return also account for billions of dollars of lost revenue. In an earlier report 1/, we estimated that about 5 million people, owing some $2 billion in income taxes, did not file returns in 1972, the most recent year for which reliable data were available at the time.

Another major problem for IRS involves individuals who overstate offsets to the income and/or tax liabilities reported. Such offsets, which may be in the form of improper adjustments to income, excessive deductions or exemptions, and/or erroneous credits to tax liabilities, represent a multibillion dollar tax loss to the Government annually. IRS estimates that through these means individual taxpayers understated their taxes by $5.3 billion in 1976 alone.

Although each of the above forms of noncompliance is significant, the vast majority of the people in this country comply with the tax laws. Unfortunately, IRS does not know enough about what makes people comply.

IRS LACKS ADEQUATE DATA ON WHAT MOTIVATES PEOPLE TO COMPLY

To best stimulate voluntary compliance, IRS needs to improve its understanding of what causes people to comply with the tax laws and how to best structure its compliance activities to cause more people to comply. IRS completed three studies to better understand how examining tax returns affects taxpayer compliance. However, none of the studies considered the effect of other compliance programs. The studies also failed to assess the impact of the examination program on taxpayers not actually examined or of factors outside IRS control.

One IRS study, completed in 1970, was designed to measure the deterrent effect of an examination for those actually examined. This study showed that examining tax returns did generate

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1/"Who's Not Filing Income Tax Returns? IRS Needs Better Ways To Find Them and Collect Their Taxes" (GGD-79-69, July 11, 1979).

a deterrent effect for both business and nonbusiness taxpayers with adjusted gross income under $10,000 and for nonbusiness taxpayers with income from $10,000 to $20,000. However, the deterrent effect appeared to decay within 2 or 3 years after the examination. The study did not establish a deterrent effect for the other higher income classes of taxpayers. IRS concluded that its data were too sparse and its model too simplistic to statistically isolate the deterrent effect for these taxpayers, who typically have complex tax returns.

Another study involved three classes of individual taxpayers whose tax returns IRS examined under two sequential TCMP surveys for tax years 1969 and 1971 as follows: nonbusiness, with income under $10,000 (itemized); nonbusiness, $10,000 to under $50,000; and business, under $10,000. Although the study did not consider higher income taxpayers, it did show that compliance increased among the low and medium income taxpayers included in the study whereas compliance for the total individual taxpayer population, as determined by TCMP, decreased.

Also, as part of its TCMP survey for tax year 1973 individual returns, IRS conducted followup examinations on a subsample of taxpayers whose 1969 returns it had examined during an earlier study for tax year 1971. The 1973 study showed that, whereas voluntary compliance for the overall TCMP population within certain classes dropped between 1969 and 1973, the taxpayers in the subsample experienced either a smaller decline or an increase in compliance. Although the compliance for one class, high income nonbusiness taxpayers, increased for the overall TCMP population, the compliance for taxpayers in the subsample increased slightly more.

Because the research in these three studies dealt only with the examination program, the results really apply to only those taxpayers whose returns IRS examines in a given year--about 1.8 percent of the taxpaying population in 1981. Also, the research provided no insight into whether IRS' other compliance programs have a greater or lesser effect on compliance than the examination program.

IRS conducted a fourth study which was broader in scope and directed at more basic questions regarding taxpayer behavior. In that study, concluded in 1972, IRS attempted to develop a model that would account for voluntary compliance in terms of 16 internal factors under IRS' control, such as examination coverage, collection effort, and civil fraud cases, and 17 factors outside IRS' control, such as age, sex, and education of taxpayers. Preliminary findings indicated that some external variables may have a significant influence on taxpayer compliance. A ranking of the 33 variables showed that none of the internal variables were ranked in the top 10 for any of the 7 classes. IRS considered the results of the study to be too preliminary, however, to be useful.

In our November 1976 report 1/, we commented on the need for IRS to clarify the relationship between compliance and the examination program as well as between compliance and other factors. We recommended that IRS expand and accelerate its research into factors which influence compliance, including certain external factors.

In line with our recommendation, IRS contracted with a private firm for a study, the initial phase of which was completed in May 1980 at a cost of $379,000, to develop methods for identifying and measuring factors that influence compliance with the tax laws. The firm proposed essentially three such methods: econometric modeling, controlled experiments to test alternative policies and programs, and special studies and analyses. IRS chose not to pursue the proposed methods because of the anticipated cost and because of its stated lack of assurance that the study results would have practical significance. IRS decided instead to direct its research efforts into areas other than the effects of its compliance programs and to deal with the compliance problem in other ways.

Although IRS has not identified what factors motivate people to comply with the tax laws, it believes that the examination of tax returns has a significant positive effect on taxpayer compliance. IRS has, therefore, structured its compliance activities around the examination program.

IRS EMPHASIZES EXAMINATION OF TAX RETURNS TO ENCOURAGE VOLUNTARY COMPLIANCE

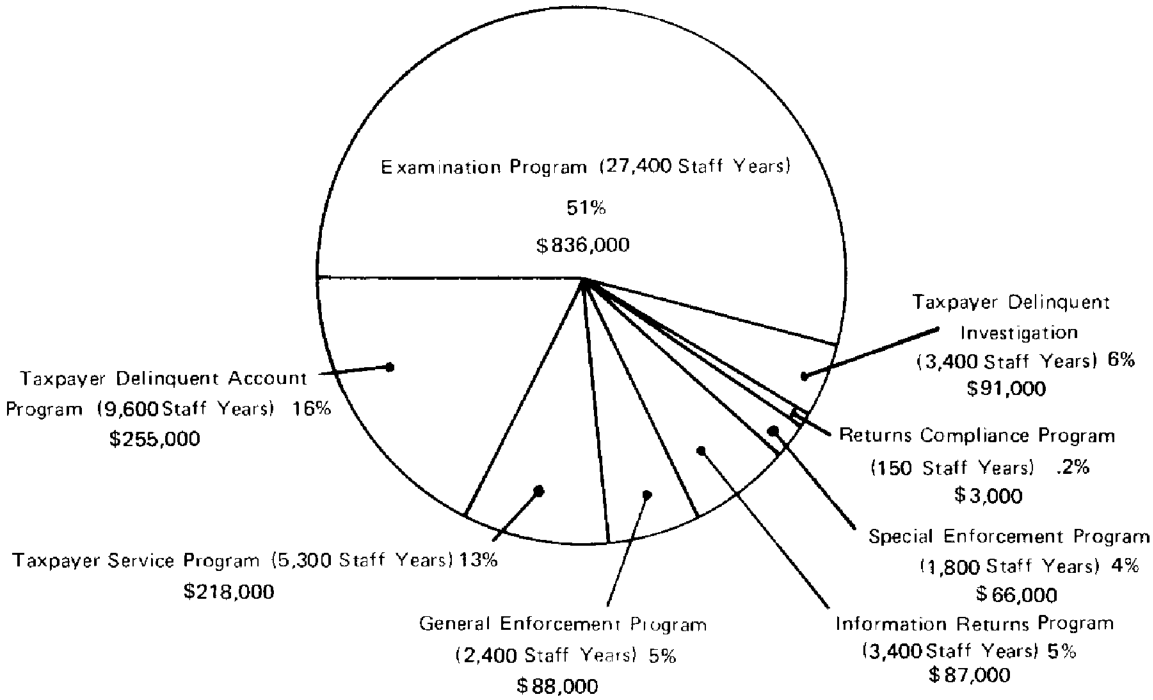
Much like IRS' overall mission, the examination program's purpose is to encourage and achieve the highest possible degree of voluntary compliance with the tax laws through correct reporting of income taxes and certain other taxes. IRS has long used the examination program and the supporting Taxpayer Compliance Measurement Program as the primary means for accomplishing its overall compliance goals. The Congress, too, has focused attention on the examination program and is concerned with ensuring adequate examination coverage.

Examination program accounts for bulk of IRS' compliance resources

Of its $1.6 billion in compliance resources for fiscal year 1981, IRS allocated $836 million, or 51 percent, to the examination program and the remainder to other compliance programs, as shown on the next page.

1/"How the Internal Revenue Service Selects Individual Income Tax Returns For Audit" (GGD-76-55, Nov. 5, 1976).

COMPLIANCE RESOURCE ALLOCATIONS (note a)
FISCAL YEAR 1981



a/Data for the above chart were taken from IRS budget documents. Also, the math verification and unallowable items program is excluded from the chart because data for that program were not available. All figures have been rounded and 000's have been omitted from dollar figures.

The resource allocation pattern for 1981 is consistent with IRS' allocation patterns for earlier years. IRS has usually allotted a relatively large portion of its compliance resources to the examination program and much smaller portions to other compliance programs, as appendix III shows for the 10 fiscal years 1972 to 1981.

TCMP: IRS' measure of voluntary compliance

TCMP is a program that provides IRS with its only periodic measurement of voluntary compliance. IRS uses TCMP data to evaluate how well it is fulfilling its mission of encouraging and achieving the highest possible compliance with the tax laws.

TCMP measures taxpayer compliance through specialized examinations of randomly selected returns. Unlike other examinations, TCMP examinations involve a thorough review of the entire return. IRS instructs its examiners to review every item, regardless of the dollar amount, and to be especially alert to discovering unreported income and additional deductions or credits to which taxpayers are entitled.

On the basis of TCMP results, IRS has periodically estimated the voluntary compliance levels for seven classes--groupings of taxpayers by income levels--of the taxpaying public. 1/

Examination program follows balanced approach in attempting to encourage compliance

Through the examination program, IRS attempts to maintain total compliance, voluntary and enforced, among all taxpayer classes at 90 percent or higher. To accomplish that goal, IRS follows a balanced examination approach in an attempt to achieve:

--A high degree of voluntary compliance.

--Equity for all taxpayers (even-handed enforcement of the tax laws).

--Maximum direct revenue flow to the Treasury.

--Effective use of resources.

IRS examination planning entails an elaborate, lengthy process for determining how many and which returns to examine. Essentially, however, that process involves the following three major steps. 2/

1. Establishing staffing constraints that are based on the number of additional employees IRS can hire, train, and absorb over the planning period.

2. Determining, through a computerized statistical model, the coverage (tax returns examined as a percentage of returns filed) that will optimize tax revenue for all taxpayer classes during the planning period.

3. Increasing the coverage for low-compliant (below 90 percent) classes by shifting some resources, previously distributed

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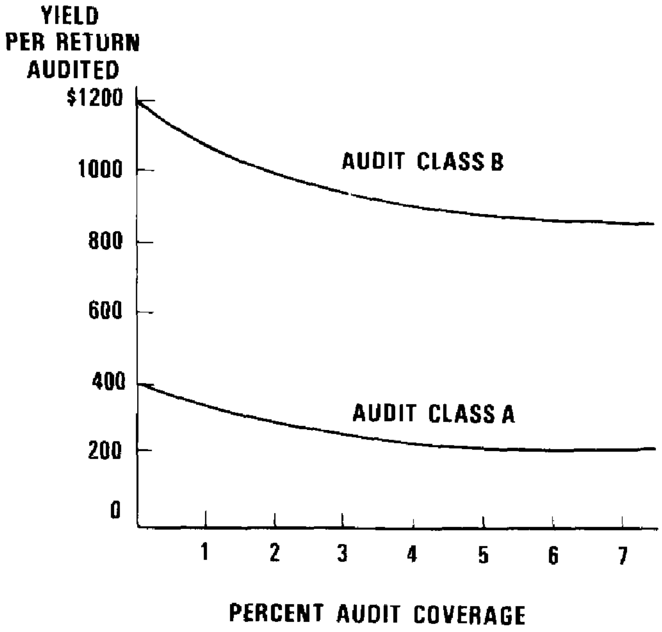
1/Until tax year 1980, IRS grouped individual returns on the basis of adjusted gross income. We have used adjusted gross income to distinguish taxpayer groups in this report. During 1980, IRS began grouping individual nonbusiness and business returns on the basis of "total positive income" or "total gross receipts," respectively, which is the sum of all positive income amounts on a tax return with losses treated as zero. IRS believes such amounts result in more homogenous taxpayer groups.

2/Additional information on IRS' selection of returns can be found in our earlier reports on how IRS selects individual and corporate returns for audit. (See app. II.)

to optimize tax revenue, from other classes to the low-compliant classes. (However, IRS does not shift resources to low-compliant classes beyond the point where the average cost to examine returns in those classes would be greater than the additional tax revenue.)

As indicated above, direct marginal yield is a major consideration in developing the plans. This yield is the additional revenue (assessed taxes) IRS expects to realize from examining one additional return for a particular taxpayer class. 1/ Graphically, this relationship can be illustrated as follows.



1/Using TCMP results, IRS develops discriminant function (DIF) formulas to assign a numerical score to most tax returns filed each year. IRS uses a DIF formula for each taxpayer class to compute scores for all individual returns and most corporate returns, on the basis of information on the returns that indicates the relative probability of tax error. IRS develops yield curves by arranging TCMP-examined returns in descending order of their DIF scores and their revenue yield. IRS correlates DIF score ranges with the number of returns filed for each taxpayer class to plot the average yield for each percentage of coverage. IRS selects returns most in need of examination first, or in descending order of their DIF scores, and the curves, therefore, provide estimates of marginal yield as a function of coverage. Because IRS selects TCMP-examined returns randomly and selects returns for regular examination on the basis of their DIF scores (or probability of error) and because the depth and scope of the two types of examinations differ, IRS annually adjusts the DIF derived yield curves on the basis of regular yields.

The examination of tax returns annually produces substantial direct tax revenue. In fiscal year 1981, IRS examined a total of 1,930,292 returns. IRS selected most of these returns from the 126,575,000 returns of all types filed in calendar year 1980. These examinations resulted in total recommended additional taxes and penalties of about $10.75 billion. The examination coverage and results for individual, corporate, and other returns were as follows:

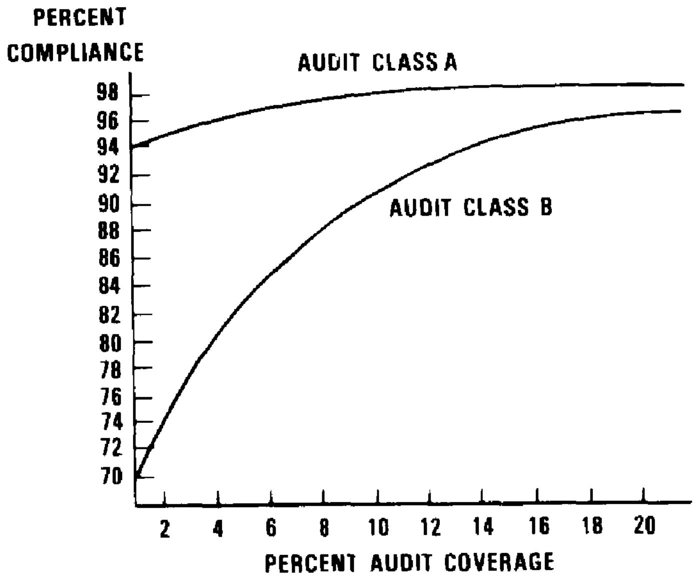
	Calendar year 1980 filings	Fiscal year 1981 Returns examined		Fiscal year 1981 Additional taxes and penalties recommended
		(number)	(percent)	(billions)
Individual	93,052,000	1,644,104	1.77	$ 2.572
Corporate	2,124,000	107,363	5.05	6.339
Other (note a)	4,137,000	75,120	1.81	1.507
Total	99,313,000	1,826,587	1.84	$10.418

a/Includes fiduciary, partnership, small business corporations, domestic international sales corporations, estate, and gift tax returns, but does not include 27.2 million excise and employment tax returns which IRS does not consider when calculating examination coverage.

IRS does not, however, pursue an examination strategy aimed solely at increasing direct tax revenue. Rather, IRS adjusts examination coverage and, as discussed specifically in chapter 3, foregoes some direct revenue in the interest of reducing the tax gap for low-compliant (below 90 percent) taxpayer classes. IRS also makes such adjustments among the classes in the interest of taxpayer equity. These adjustments involve shifting some resources from more compliant taxpayer classes which offer higher direct examination yield to less compliant classes offering lower direct yield.

IRS believes that the compliance for a taxpayer class correlates positively with the examination coverage for that class; and that, given certain high rates of examination coverage, voluntary compliance will, over time, approach 100 percent. Until 1976, IRS used a "Gompertz" curve (shown on the next page) to express this relationship.

ILLUSTRATION OF "GOMPERTZ" CURVE
SHOWING THE RELATIONSHIP BETWEEN
VOLUNTARY COMPLIANCE AND EXAMINATION COVERAGE



However, TCMP surveys and actual examination experience later showed that the Gompertz curve did not accurately depict the coverage/compliance relationship. In some years, IRS increased examination coverage for certain taxpayer classes only to have compliance for those classes, as measured through TCMP, decline. IRS, therefore, stopped using the Gompertz curve, but still believes that a significant positive correlation between coverage and compliance exists.

In 1976, IRS began allocating resources to less compliant classes on the basis of the expected revenue losses for each class. In order to increase total compliance for those classes to at least 90 percent by the end of the planning period, IRS assumes that resources will be available and sets coverage rates at levels necessary to recover the anticipated loss. To illustrate, on the basis of the compliance for each taxpayer class as measured by the 1976 TCMP survey, IRS planned to recover the following anticipated losses over the 5 years from 1979 through 1983:

Voluntary compliance	Percentage of tax loss to be recovered
85-90	5
80-84	10
75-79	15
70-74	20
65-69	25
60-64	30
55-50	35
50-54	40

OTHER COMPLIANCE PROGRAMS RECEIVE LESS EMPHASIS AND FEWER RESOURCES

Unlike examination program plans, other compliance program plans do not specifically address how resources should be allocated to encourage and achieve voluntary compliance among specific taxpayer groups. Generally, the plans emphasize annually processing and closing a minimum number of cases and do not discuss whether or how such efforts relate to voluntary compliance.

For example, the principal objective of the criminal investigation program, as stated in the most recent program plan, was to increase the number of investigations from 8,720 in 1981, to 9,380 in 1983. The plans for that program made no mention of how the investigations might affect voluntary compliance among those investigated or among taxpayers generally.

IRS believes that its information returns program, wherein IRS matches third-party documents showing wages, interest, dividends, and other payments with tax returns, significantly affects voluntary compliance. However, that program's plans are not tied to a goal or strategy for encouraging voluntary compliance, even though IRS believes the program increases IRS' ability to enforce the tax laws and to foster a high degree of voluntary compliance.

Even the examination plans do not fully consider the contributions to closing the tax gap that result from certain examination-type activities conducted at IRS service centers. In allocating examination resources, IRS considers just those examinations conducted by district offices and service centers. Other IRS contacts at service centers involve resolving and verifying issues through correspondence with taxpayers. IRS does not consider these service center contacts to be audits because such contacts do not involve a review of the taxpayer's books and records. In 1981, IRS service centers questioned 814,023 returns resulting in recommended additional tax and penalties totaling $205 million.

In our November 1976 report on how IRS selects individual tax returns for audit, we recommended that IRS modify its planning process to consider the impact of service center examination-type contacts. In February 1982, IRS said that it was developing a system to consider the impact of these contacts.

As discussed on the following page, even though IRS depends heavily on the examination of returns to encourage and achieve the highest possible degree of voluntary compliance, available data show that voluntary compliance is declining and that the Government is losing substantial tax revenue.

EXAMINATION PROGRAM HAS NOT BEEN SUFFICIENT TO STEM THE DECLINE IN VOLUNTARY COMPLIANCE

Although the examination program results in billions of dollars in additional revenue each year, the program has not been sufficient to stem the decline in voluntary compliance. Rather, voluntary compliance continues to decline, even though IRS has shifted examination resources among various classes of taxpayers and sacrificed revenues in an attempt to reverse that decline.

Voluntary compliance has steadily declined since IRS' first TCMP survey for tax year 1965 and was below 90 percent for most taxpayer classes as of 1976. During that 12-year period, IRS' examination coverage for individual tax returns ranged from a high of 4.8 percent in 1965 to a low of 1.7 percent in 1981, and averaged 2.43 percent. IRS expects the coverage rate to be 1.56 percent in fiscal year 1982. The following table shows the trend in declining compliance based on TCMP data for individual business and nonbusiness taxpayers.

	Compliance percentages				
	1976	1973	1971	1969	1965
Nonbusiness	94.8	95.1	(a)	95.2	95.7
Business	83.3	84.7	(a)	85.5	89.0
Total	92.3	92.8	(a)	93.1	94.3

a/IRS made no overall estimates for tax year 1971.

Compliance among specific taxpayer classes was below 90 percent for four of the seven classes in 1976, whereas just one class was below 90 percent in 1965, as shown below.

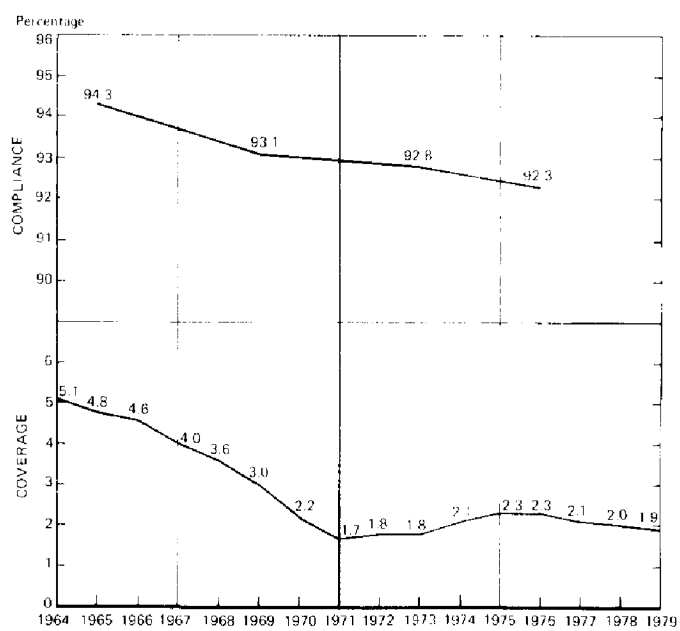
Individual taxpayer class	Compliance percentage	
	1976	1965
Nonbusiness:	94.8	95.7
Under \$10,000 standard	91.7	96.1
Under \$10,000 itemized	84.8	93.1
\$10,000-under \$50,000	95.4	97.0
\$50,000 and over	95.0	96.2
Business:	83.3	89.0
Under \$10,000	43.2	78.2
\$10,000-under \$30,000	86.0	91.4
\$30,000 and over	89.1	93.7
Total	92.3	94.3

Deteriorating compliance is not restricted to individual taxpayers. For example, according to TCMP results, compliance among small corporations (those with assets of up to $1 million) dropped about 10 percent, from 83.1 to 73.3, between 1969 and 1978. Tax revenue losses for those corporate classes measured through TCMP in both 1969 and 1978 more than doubled between those years--from $600 million to $1.3 billion.

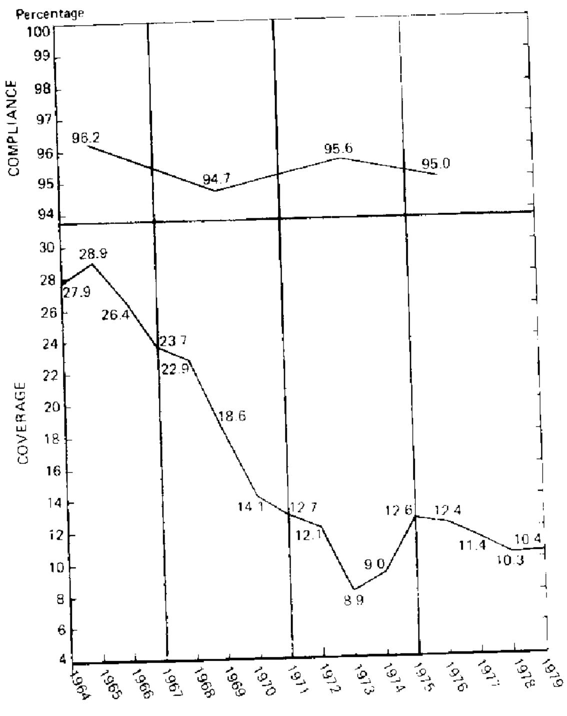
<u>Examination's effect on compliance is unclear</u>

Although both examination coverage and voluntary compliance have declined generally, IRS does not know how much of the decline in compliance is caused by the decline in examination coverage. As can be seen in the charts that follow, however, it is clear that the coverage IRS was able to provide was insufficient to stem the decline in voluntary compliance for specific taxpayer classes and for individual taxpayers generally.

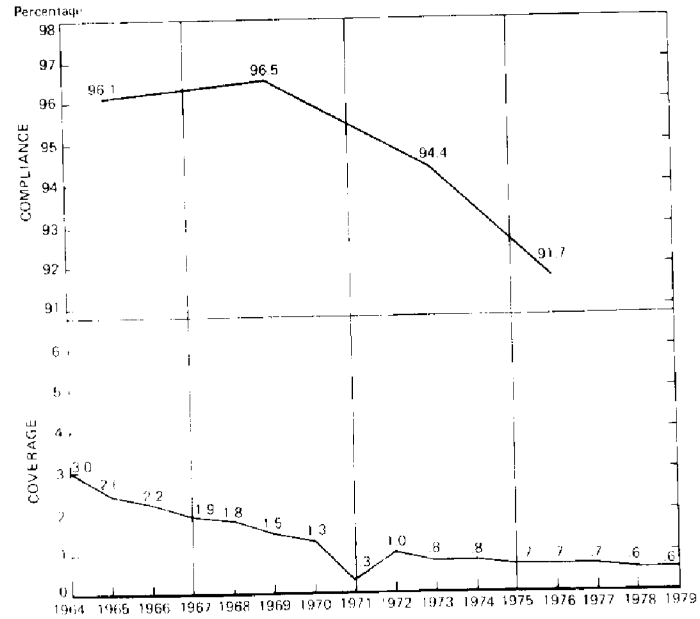
OVERALL INDIVIDUAL INCOME



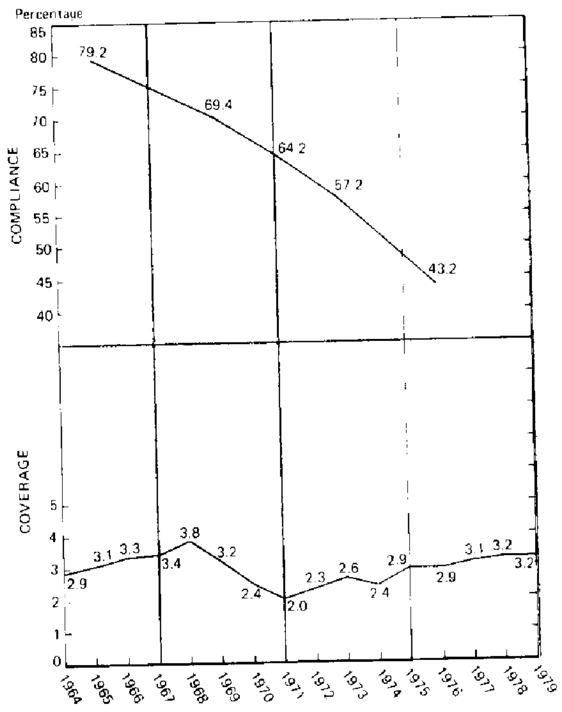
NONBUSINESS - $50,000 AND OVER



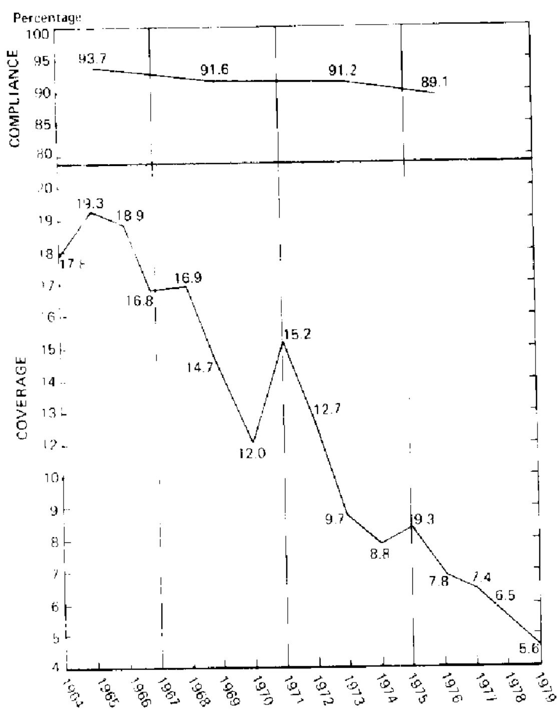
NONBUSINESS, UNDER $10,000 STANDARD



BUSINESS - UNDER $10,000



BUSINESS - $30,000 AND OVER



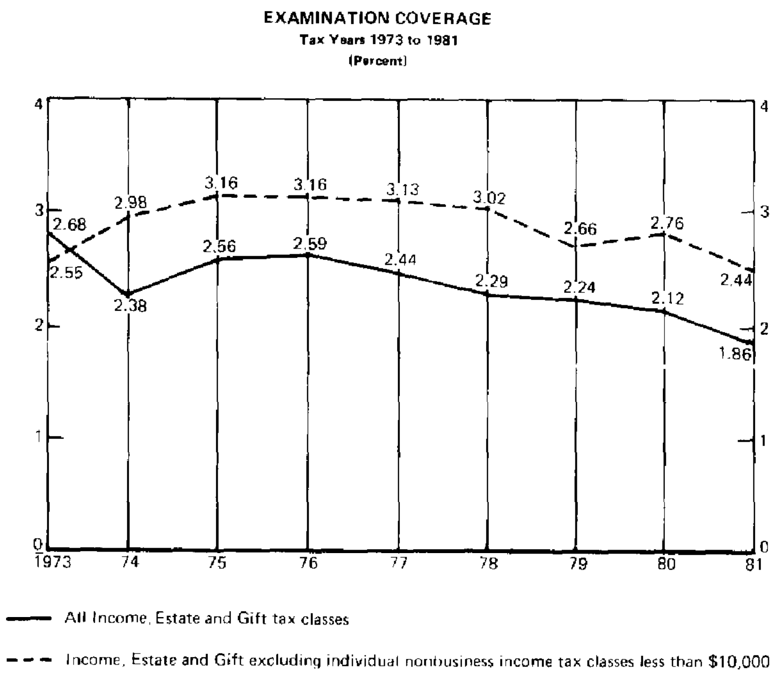
The previous charts indicate that generally both IRS examination coverage and voluntary compliance have declined over the years. But, even where IRS was able to increase coverage for some years, compliance still declined. For example, IRS increased coverage from 1.8 to 2.3 percent between 1973 and 1976 for all individual taxpayers, and compliance still declined, from 92.8 in 1973 to 92.3 percent in 1976.

During our review, IRS computed the correlation coefficient for changes in examination coverage and voluntary compliance. A correlation coefficient measures the relationship between two variables--coverage and compliance, in this instance--and is expressed in the range of -1 to +1. IRS' calculations showed that coverage and compliance were positively related for all classes. As shown below, the relationship was strong (the coefficient was +.75 or higher) for four classes and was marginal or weak for the other three classes.

Taxpayer class	Correlation coefficient	Confidence that positive correlation exists
		(percent)
Nonbusiness:		
Under $10,000 standard	.75	84
Under $10,000 itemized	.44	75
$10,000-under $50,000	.80	94
$50,000 and over	.40	66
Business:		
Under $10,000	.11	56
$10,000-under $30,000	.92	93
$30,000 and over	.92	93
Total	.85	90

Even though IRS was able to show a positive correlation between declining coverage and declining compliance, the exact relationship between the two factors remains obscure. The relationship becomes even less clear considering that since 1973 the examination coverage provided those taxpayer classes most in need of examination has been much higher than IRS' overall coverage rates indicate. As explained on the following page, even though IRS' examination resources remained about the same between 1973 and 1980, IRS shifted examination resources from classes involving simple returns into classes involving more complex returns.

We wanted to determine the effects of these resource shifts in terms of the coverage provided just the more complex returns. Although no generally accepted definitions of "complex" versus "simple" returns exist, IRS generally regards individual returns in two classes as simple returns: nonbusiness, gross income less than $10,000, standard deduction; and nonbusiness, gross income less than $10,000, itemized deduction. Because these simpler returns require less examination attention, we adjusted IRS' coverage rates to eliminate these simpler returns and compared the adjusted rates with the rates for all returns. As the following chart shows, overall coverage declined between fiscal year 1973 and 1981, but coverage for the more complex returns decreased only slightly, from 2.55 percent to 2.44 percent.



The above comparison, when associated with TCMP data, provides further evidence that declining compliance is not necessarily a function of reduced examination coverage. For example, TCMP data indicate that compliance declined for all individual taxpayer classes between 1973 and 1976. As shown above, IRS increased coverage for more complex returns from 2.55 to 3.16 percent during this period.

Thus, IRS is not achieving, through the examination program, the goal of 90 percent total compliance for all taxpayer classes. Rather, voluntary compliance has steadily declined, and even a minor decline translates into substantial tax revenue losses. For example, overall compliance dropped from 92.8 percent in 1973 to 92.3 percent in 1976, or .5 percent. Although a .5-percent decline may not seem large, the revenue loss for such a decline is substantial. We estimated, on the basis of tax year 1980 returns filed in 1981, that a .5-percent decrease in compliance by individual taxpayers represented a $1.2 billion tax revenue loss in 1980. This assumes that the compliance rate remained at 92.3 percent through tax year 1980.

IRS' analysis shows
tax gap is widening

In January 1981, IRS completed a detailed analysis of TCMP data, with emphasis on data recently compiled from individual returns filed for tax year 1976, which provided additional evidence that examination coverage has been insufficient to stem the decline in compliance.

IRS used trends in the "tax gap," the additional taxes estimated to be owed as determined by TCMP surveys, to indicate the examination program's effectiveness in detecting noncompliance. IRS used TCMP data to measure and compare the gross and net tax gap, the difference being the estimated taxes recovered through the examination program. Although the examination program has produced increasing amounts of tax assessments for each staff year invested, the data show that the program is closing increasingly smaller percentages of the tax gap.

For example, the gross tax gap had quadrupled from $3 billion to $12.1 billion between 1965 and 1976, and the net tax gap had grown even faster--more than fivefold--from $2 billion in 1965 to $10.4 billion in 1976. In other words, the proportion of the gross tax gap detected by examination dropped from 33 percent in 1965 to 14 percent in 1976.

IRS believes the increase in the tax gap has many causes, some of which are external and thus not controllable by IRS. While examination increased its recommended tax for individuals from $1.1 billion in 1965 to $1.6 billion in 1976, the net tax gap continued to increase. Some of the reasons that IRS cites for this are:

--Examination coverage declined from 4.8 percent in 1965 to 2.3 percent in 1976 because of a lack of resources to keep pace with the growing workload and the increasing complexity of returns filed.

--The number of individual returns filed increased 29 percent whereas direct examination staff years applied to examine individual returns remained about the same, 5,091 in 1965 and 5,086 in 1976.

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Although voluntary compliance continues to decline and the tax gap widens, IRS and, in turn, the Congress continue to look to the examination program as a means to encourage overall compliance. For example, for fiscal year 1980, the Congress appropriated funds for 450 additional examination staff years, primarily to combat the subterranean economy. Various congressional committees have expressed the desire that examination coverage not fall below the 2.1 percent provided in 1979.

There well may be some rate of examination coverage that would be sufficient to stem the declining patterns of voluntary compliance. We do not know what that rate is. Nor do we know what level of examination resources might be required to improve overall compliance. However, the data show that the rates of examination coverage actually provided since 1965 have not been sufficient to have either effect. In fact, the declining compliance in all classes since 1965 is sufficient reason to seriously question whether IRS can provide adequate examination coverage to stem or reverse the decline. Some alternative strategies may strike a better balance among the various compliance programs, especially in dealing with unreported income.

SOME COMPLIANCE PROGRAMS OTHER THAN EXAMINATION MAY BETTER DEAL WITH CERTAIN TYPES OF UNREPORTED INCOME

The examination program, IRS' mainstay for encouraging compliance, often fails to detect unreported income. Thus, the program does not adequately deal with the major form of noncompliance even though it accounts for over one-half of IRS' compliance resources. Some of IRS' other compliance programs, which receive much smaller portions of available resources, appear to be better designed to detect certain types of unreported income. However, IRS lacks adequate data to determine which of its various programs best deals with unreported income--an area requiring further IRS research.

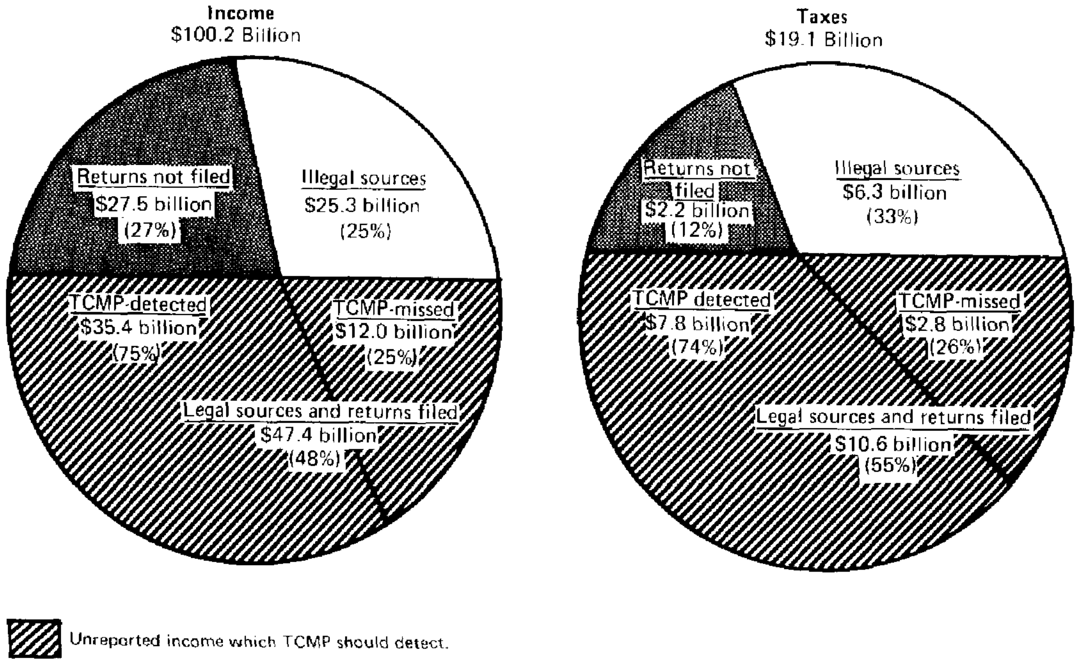
Intensive TCMP examinations cannot always detect certain unreported income

Unreported income often involves cash or barter transactions for which no tax returns are filed and/or no written records are established. In addition, the income may come from illegal activities, such as gambling, the sale of narcotics, or the sale of stolen merchandise, which the taxpayer may conceal or intermingle with truly legitimate activities. IRS does not expect even intensive TCMP examinations to always detect such unreported income.

IRS' unreported income study, discussed on page 9 of this report, showed that individuals understated their income, from both legal and illegal sources, by $100.2 billion to $134.9 billion in tax year 1976. IRS estimated that the related tax loss totaled $19.1 billion to $25.9 billion. To provide an insight into how well IRS' examinations detect unreported income, we compared IRS' lower unreported income estimates with the amount of unreported income disclosed through TCMP examinations. TCMP examinations accounted for about 35 percent of the estimated $100.2 billion in unreported income and for about 41 percent of the $19.1 billion tax loss.

IRS' estimates include unreported income for both legal and illegal sources and unreported income for returns not filed. IRS does not expect TCMP examinations to detect all types of unreported income, but it does expect the examinations to generally detect unreported income from legal sources where taxpayers file returns. Much of the estimated unreported income was of the type that TCMP examinations cannot be expected to detect. A significant portion, however, was of the type that the examinations should detect but did not. The following charts show the estimated unreported income and taxes broken out as to the various types involved.

ESTIMATES OF UNREPORTED INCOME
AND RELATED TAXES BY TYPE
TAX YEAR 1976

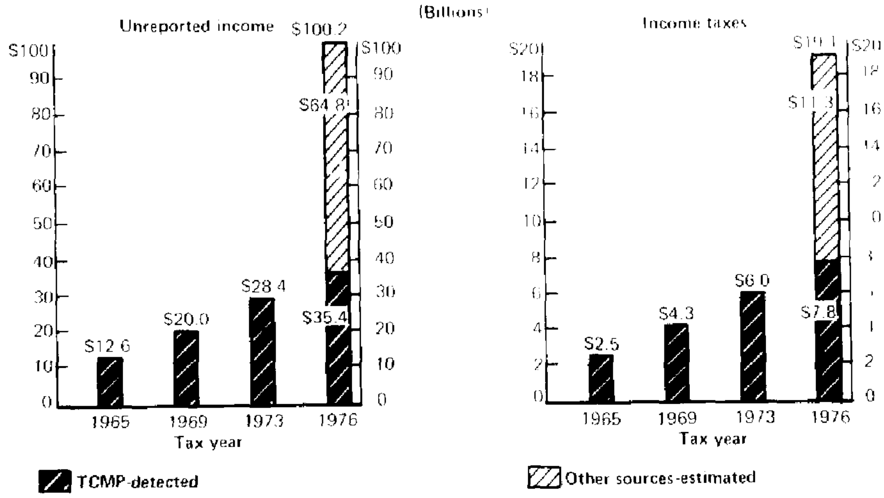


The previous charts, based on IRS' lower estimates, indicate that TCMP missed about $12 billion (25 percent) of the estimated unreported income for legal sources where taxpayers filed returns, or $2.8 billion (26 percent) of the related taxes. Compared to IRS' higher estimate of $64.1 billion for this type of unreported income, TCMP examinations missed $27.6 billion (44 percent) of that amount.

IRS must, of course, concern itself with all types of unreported income, and the overall problem appears to be much greater than earlier TCMP results indicated. For example, the estimated $100.2 billion in unreported income of all types for 1976 is about 3 times greater than the unreported income estimated through TCMP for 1973 and even greater than that for earlier years. The following charts compare the estimates for 1965, 1969, 1973, and 1976.

UNREPORTED INCOME--AND RELATED TAXES--DETECTED THROUGH TCMP AND ESTIMATED USING OTHER IRS SOURCES

(Billions)



Compared to IRS' higher estimate of $135 billion in legal and illegal source income including nonfiling, TCMP did not measure $98.4 billion, or 73 percent. In other words, TCMP measured about one-fourth of IRS' higher unreported income estimate for 1976.

Since IRS' intensive TCMP examinations fail to detect a significant percentage of unreported income, it is reasonable to assume that the regular examinations detect even less. Even though IRS has some other compliance programs which are specifically designed to deal with certain types of unreported income, IRS has allocated relatively small portions of its compliance resources to those programs.

Some other programs are designed specifically to detect certain types of unreported income

Although IRS has limited data on how well its compliance programs deal with the various forms of noncompliance, the data available indicate that examining tax returns may not be IRS' most effective program for dealing with unreported income. As discussed previously, that program is not expected to detect certain types of unreported income, and the program also misses some of the unreported income it should detect. IRS has some other compliance programs, however, which deal specifically with unreported income and which may provide a better way to combat this problem.

IRS has allocated a relatively small share of its compliance resources to programs which appear to deal almost entirely with unreported income--the largest form of noncompliance. One such program is the information returns program which provides for computerized matching of the income reported on tax returns with information documents showing wages, dividends, interest, and other payments, submitted to IRS by employers, lending institutions, and other organizations. IRS allocated only about 5 percent of its compliance resources to that program in fiscal year 1981.

IRS matched more than 450 million information documents in fiscal year 1979, which resulted in 9.4 million "discrepancy" cases involving unreported income. However, because of resource constraints, IRS could resolve only 3.3 million, or 34 percent, of the cases. Also, IRS could not follow up at the district offices on numerous cases where the matching process indicated taxpayers had not filed tax returns.

IRS' two criminal investigation programs also deal primarily with unreported income. The special enforcement program, which deals with people who derive income from illegal activities, accounted for about 4 percent of IRS' compliance resources in fiscal year 1981. The general enforcement program, which is directed at other people suspected of tax fraud, accounted for about 5 percent of IRS' compliance resources in fiscal year 1981.

Thus, IRS' information returns program and its two criminal investigation programs, which are effective enforcement tools in detecting certain types of unreported income, accounted for only 14 percent of IRS' compliance resources. Yet, as stated earlier, unreported income is clearly IRS' most significant compliance problem, accounting for as much as 72 percent of the total estimated tax loss from all forms of noncompliance in 1976. (See p. 7.)

Given the nature of the compliance problem and the current allocation of IRS' resources, it is even more essential that

IRS accumulate data to better understand which of its compliance programs best deals with unreported income. For example, matching information documents with tax returns and using correspondence to inquire about differences may be one of IRS' most cost-effective programs for detecting unreported income and encouraging compliance. If so, some shifts of compliance resources among programs might be warranted.

FURTHER COMPLIANCE RESEARCH IS NEEDED TO FIND OUT HOW IRS' PROGRAMS AFFECT COMPLIANCE

IRS will not be sure that it is using its compliance resources as effectively as possible until it better understands how its various programs affect the willingness of people to comply with the tax laws. The evidence presented previously showing generally declining levels of voluntary compliance underscores the longstanding need for IRS to better understand the impact of its compliance efforts on taxpayer motivation.

To deal with the problem, IRS has completed several studies and has taken other steps to strengthen its compliance efforts. In addition, IRS has included in its research plans some projects to improve its understanding of how to best motivate taxpayers. These research projects were, however, assigned a relatively low priority at the time of our review and did not consider the compliance effects of the programs on taxpayers not contacted by IRS.

IRS has taken additional steps to combat noncompliance

IRS has taken various steps to respond more effectively to the problem of deteriorating compliance. For example, IRS

--revised its long range planning process;

--designated a coordinator for the information returns program (document matching) and required that such returns be furnished to examiners for use in verifying tax returns;

--established a project directed specifically at unreported income; and

--performed various studies to better understand special compliance problems such as tax protesters, tax shelters, and the like.

One major step IRS took was to study its entire examination strategy. Some of the study's purposes were to review the objectives, planning assumptions, and resource allocation processes used in developing the annual and long-range plans and the budgets for the examination program. A final report on that study, which deals with many of the matters discussed in this report, was not available as of May 1982.

More research is needed

As discussed earlier (pp. 9 to 11), IRS had completed some research to find out how the examination program affected taxpayers who were selected for examination. These people, however, constitute a small and decreasing percentage of the taxpaying population.

IRS needs to do more research to obtain the data necessary to determine what motivates people to comply and to ultimately measure and compare the effects of its various compliance programs on compliance. Although IRS had several research projects planned or underway in December 1981, none of the projects will attempt to provide the data necessary to measure and compare the relative impact of the various compliance programs on the willingness of people to comply.

IRS' September 1981 research plan identified and assigned priorities to 69 projects to be conducted during fiscal year 1982. Three of those projects--ranked in priority 33, 34, and 41 out of 69--related to the effects of IRS' programs on taxpayer compliance. One project related to the question of how IRS can best structure certain of its compliance activities to encourage voluntary compliance. In that study, IRS is looking at "enforcement presence" as an indicator of its interaction with taxpayers, in contrast to the concept of examination coverage. As used in the IRS study, the term enforcement presence refers to taxpayers' perception of various IRS contacts. These contacts include not only the audit of taxpayers' books and records but other contacts as well, such as those involving the unallowable items and information returns programs. Also, the study deals with the impact of the math verification and unallowable items program on the accuracy of tax returns subsequently filed by individuals contacted under that program. Although the final results of that study were not available as of May 1982, the study focuses on questions which have significant implications for the allocation of IRS' compliance resources.

Another project is designed to track and measure the subsequent compliance of those taxpayers identified in the information returns program as not reporting taxable income. The study, expected to be completed in December 1982, is intended to show whether taxpayers contacted under that program tend to improve their compliance after the contact, compared to taxpayers not so contacted. The third study deals with the future revenue yield resulting from IRS' contacts under the taxpayer delinquency investigation program, which deals with people who do not file returns as required. The estimated completion date for that study is December 1985.

Generally, the projects discussed above focus on individual programs and the effects each has on taxpayers actually contacted by IRS; they are not designed to compare the effects of one program with another or to examine the effects on taxpayers not contacted by IRS--the so-called "ripple" effects of IRS' programs. The studies indicate, however, that IRS is generally moving in the right direction to better understand how its various programs affect compliance. IRS needs not only to understand how and why its compliance efforts affect taxpayers' compliance but also to measure and compare those effects. Until then, it will be hindered in developing compliance plans and allocating resources to best stimulate compliance.

ADDITIONAL COMPLIANCE RESOURCES ARE NEEDED TO COPE WITH GROWING DEMANDS

Although the reasons for deteriorating taxpayer compliance are unclear, it is clear that IRS needs additional resources to respond effectively to its growing demands. As the tax administering agency for the Federal Government, IRS must respond not only to deteriorating compliance but must also cope with the increasing workload created by the year-to-year growth in the taxpaying population. For the past 7 years, 1976 to 1982, IRS resources have failed to keep pace with this growth, and IRS expects this growth to continue.

For 1983, IRS expects 144 million tax returns to be filed, including 98 million forms 1040 and forms 1040A; whereas, in 1976, only 123 million were filed, including 83 million forms 1040 and forms 1040A--an overall growth of 17 percent. While increases in return filings do not necessarily require proportionate increases in IRS resources, such resources obviously have not kept pace. Whereas the number of returns filed will have increased by 17 percent by 1983, IRS resources will have increased by only 5 percent, from 84,300 to 88,700 staff years--less than one-third the growth in workload--assuming IRS' budget request is approved by the Congress.

Our work in this and prior reviews has shown that improvements in IRS' compliance programs and its other activities can be made to permit more efficient use of existing resources. Even so, the magnitude of the compliance problem, the growth of return filings, and the increase in complexity of the tax returns being filed pose demands for IRS so great that program efficiencies, including optimal resource allocations among programs, will go only so far in protecting the tax system.

We have testified before subcommittees of the Congress regarding IRS' budget requests for both fiscal year 1982 and 1983.

We stated in both instances that IRS needed additional resources to cope with the growing demands on the tax system. (See app. II.)

CONCLUSIONS

IRS is unsure that its compliance resources are appropriately allocated among its several programs to maximize voluntary compliance. IRS believes that examining tax returns best stimulates people to comply with the tax laws. The examination program produces substantial additional tax revenue annually. But, how and to what extent does the program affect the willingness of those people not examined to properly assess their taxes? IRS lacks the data necessary to answer that question.

Compliance has continually deteriorated among all taxpayer groups that IRS measures. Neither IRS nor we know why. The trend may be due to factors such as inflation or changing attitudes that are outside IRS' control. Or, it may be that taxpayers have become more effective in finding ways to evade taxes without being caught. Omitting taxable income from tax returns, for example, appears to be growing at a faster rate than overstating deductions; the former is more difficult to detect. Another factor that might appear to help explain the trend toward declining compliance is reduced examination coverage. However, as we have shown, the coverage rate for more complex returns has declined only slightly since 1973. Also, the compliance of specific taxpayer groups seems to decline whether IRS increases or decreases coverage for those groups.

Effective and efficient tax administration obviously requires the commitment of adequate resources. What the appropriate level of these compliance resources should be is a difficult question and one we cannot specifically answer. We cannot state precisely to which programs additional resources should be allocated to optimize use of all available resources. We do know, however, that additional resources in some programs are needed to keep pace with the growing demands and, as discussed in chapter 3, additional resources will result in a large and immediate flow of tax revenue to the Treasury. These resources are not only justified by the increasing workload and potential revenue gains, but--and this is equally or more important--the need to cope with the general problem of decreasing compliance.

Unreported income, IRS' most severe compliance problem, requires special attention because examining tax returns more often than not does not disclose it. Where unreported income is involved, IRS often has no figures to question and no records to examine. Thus, other IRS techniques, such as investigation of "leads" and matching of third-party documents with tax returns, may be the best way to detect unreported income. IRS has, however, emphasized the examination of tax returns as a means to encourage voluntary compliance and has devoted relatively small percentages of its resources to its investigation and matching programs. Whether examining returns, investigating taxpayers, matching documents, some other technique, or a combination of various techniques will have the greatest effect on compliance is, however, unknown.

IRS' compliance programs may have varying effects on the willingness or ability of taxpayers to improve their compliance in a later year. If such effects do in fact vary and if they can be reasonably predicted, the implications for IRS' compliance policies and approaches are far-reaching.

For example, one approach might be to provide general compliance coverage among all taxpayers through less-costly, less-intrusive, and perhaps more effective techniques such as verifying the accuracy of returns and matching returns with other documents through computers and following up on discrepancies through correspondence, phone calls, and visits. In such an approach, specific problems such as high-dollar areas of noncompliance involving specific taxpayer groups or unusual schemes might be addressed through other techniques, such as district office examination and investigation.

The important thing is for IRS to find out what effects its programs have on compliance. IRS needs to determine, first of all, if one program has any greater effect than another on taxpayer motivation and, if so, whether the effects are consistent enough to be accurately predicted. Having done this, IRS can then begin to formulate an approach which appropriately combines its compliance resources so as to achieve the greatest impact on compliance.

IRS has not assigned a high priority to research efforts designed to show how and why its compliance programs affect compliance. We believe the matter deserves a much higher priority.

RECOMMENDATIONS TO THE COMMISSIONER OF INTERNAL REVENUE

We do not know the extent to which IRS will be able to measure the overall effects of its compliance programs. However, given the billions of dollars of tax revenue at stake, we believe that further research is necessary. Accordingly, we recommend that the Commissioner design, and assign a high priority to, compliance research which will:

--Provide data on how and why IRS compliance programs, both collectively and individually, affect peoples' willingness and ability to accurately report taxable income and to otherwise comply with the tax laws.

--Identify techniques for measuring and analyzing the effects of the compliance programs on both those taxpayers actually contacted and others who might be affected.

--Determine the overall effectiveness of the current IRS approach, including the appropriateness of the resource allocations, for dealing with unreported income and other forms of noncompliance.

AGENCY COMMENTS AND OUR EVALUATION

In a letter dated March 5, 1982, the Commissioner of Internal Revenue stated that our recommendations had merit and that IRS intended to continue research to determine the impact of its programs on voluntary compliance. The Commissioner also stated, however, that our recommendations did not consider certain IRS limitations and offered little guidance as to how IRS should proceed. He said that much of what needs to be measured may not be measurable and that our report would be more useful if it identified promising new research areas and effective research techniques.

Although IRS agreed to do further compliance research, its pessimistic view concerns us. We recognize that the successful completion of needed compliance research will be a difficult and long-term endeavor. Furthermore, there is necessarily an element of risk in any research project and success cannot be guaranteed. Neither IRS nor we know for certain whether the total effects of IRS' compliance programs can be accurately measured. The first step should be to understand what those effects are.

The intent of our recommendation was to have IRS (1) obtain data on how and why its compliance programs affect voluntary compliance and (2) identify techniques for measuring and analyzing the effects of its programs. Although IRS had various research efforts underway, those efforts generally did not address the fundamental question of what strategy would be most cost effective for combating unreported income--by far the most severe compliance problem--and for causing people generally to improve their compliance. For example, none of the projects that IRS had initiated were designed to explore the "ripple effects" of IRS programs, that is, the impact on persons not contacted. Moreover, none dealt with the impact of IRS' programs on unreported income.

IRS' past and ongoing compliance research efforts convince us that adequate research techniques and data can be developed to enable IRS to substantially improve its understanding of taxpayer compliance. The compliance research that IRS has completed, however, has been limited mainly to the effects of the examination program. The research involved the use of the Taxpayer Compliance Measurement Program--a valuable research instrument--and produced some enlightening data on how the program affects taxpayers actually audited. IRS could use this research instrument to show how the compliance of taxpayers contacted under other programs was affected and to compare the effects of one compliance program with another.

Another IRS research effort, involving the use of TCMP data arrayed by ZIP code area and correlated with 33 factors which IRS believed might affect compliance, also produced some revealing preliminary data on controllable and noncontrollable factors affecting compliance. The preliminary results of that study were promising, and IRS could complete efforts of this kind to shed further light on how its programs and other factors affect compliance.

As stated previously, we believe that IRS is moving in the right direction with some of its ongoing research projects. One such project is IRS' study of an "enforcement presence" in contrast to examination coverage. The study involves the use of IRS master files to determine the extent and effects of IRS' interactions with individual taxpayers or classes of taxpayers. The study could produce some useful information for determining what strategy is most cost-effective in making IRS' presence felt among all taxpayer groups. IRS could expand this research to include certain compliance programs, such as the information returns programs, that are not presently covered in the research.

Finally, we believe that the success of IRS' research depends in part on the priority it receives within the agency and the attention the research gets from top management. IRS had not assigned a high priority to the few compliance research projects it had planned or underway. Given the magnitude of the Government's tax losses that result from even a slight decline in voluntary compliance, we believe that IRS should assign a higher priority to research directed at finding out how to best stem that decline. Such research should specifically address some major concerns discussed in our report, namely, detecting unreported income and determining the "ripple effects" of IRS' programs.

CHAPTER 3

IRS CAN REDUCE LOST TAX REVENUE

THROUGH ALTERNATE RESOURCE ALLOCATIONS

As discussed in chapter 2, IRS cannot be assured that its compliance resources are being used most effectively until it learns more about why people do not comply and how to best get them to comply. In the interim, IRS needs to give greater attention to reducing the amount of tax revenue that the Government knowingly sacrifices each year.

IRS has not allocated resources within the examination program and among its various compliance programs to optimize tax revenue available from those programs. By placing more emphasis on the relative cost and revenue potential of each program, IRS could increase the flow of tax revenue to the Federal Government. Also, IRS needs to obtain and use better cost and revenue data in allocating resources.

IRS CAN INCREASE TAX REVENUE THROUGH DIFFERENT ALLOCATIONS AMONG PROGRAMS

IRS has not allocated resources among its various compliance programs to achieve the greatest tax revenue impact. Available cost/revenue data indicate that there are large differences among the programs in the average revenue yield for each dollar invested. Such differences not only point strongly to the need for IRS to obtain better cost and revenue yield data but also to the desirability of shifting some resources to those programs having a history of producing average yields that far exceed the average yields for other programs.

We compared program yield and cost data for four IRS compliance programs--examination, taxpayer delinquency investigations, returns compliance, and taxpayer delinquent accounts. The data, taken from IRS' fiscal year 1983 budget documents, indicate that the programs' average-yield-per-dollar-cost varied widely among the four programs as indicated in the following table.

Comparison of cost and yield
for selected IRS programs
fiscal year 1983 (note a)

Program	Cost	Total yield	Yield/cost ratio
	------------(millions)-------------		
Examination	$836.4	$9,500	$11.3 : 1
Taxpayer delinquent accounts	254.9	5,584	21.9 : 1
Taxpayer delinquency investigations	90.6	1,333	14.7 : 1
Returns compliance	3.9	13	3.3 : 1

a/IRS reports yields for the examination and taxpayer delinquent accounts programs in terms of estimated collections. For taxpayer delinquency investigations and returns compliance programs, the only measure of yield is in terms of assessments. We assumed that the portion of assessments that would be collected in those programs would be the same as for the examination program--95 percent. We therefore adjusted the yield figures on this basis.

We discuss later the limitations of using average yield data for making resource allocation decisions where the yield/cost ratios for two or more programs are similar. This is the case, for example, for the examination program and the taxpayer delinquency investigation programs, as the data above show. However, the difference in the average-yield-to-cost ratio for the taxpayer delinquent account program is large when compared to the ratio for any of the other three programs. Thus, a shift of resources from the other programs to that program might increase tax revenue from the several programs with the same level of resources. For example, a 1- or 2-percent shift of resources from the other three programs to the delinquent accounts program, assuming a constant rate of return, would increase overall tax revenue from the four programs by $93 million and $190 million, respectively.

Such differences in the additional revenue yields that might be obtained through alternate resource allocations dictate that IRS examine closely the cost and tax revenue data available for each program and use that data, insofar as practicable, to ensure optimal resource allocations among the programs. Because the differences in yield are large among some programs, IRS could shift, with reasonable confidence, some resources among those programs and thereby increase overall tax revenue. Where the differences are small, however, IRS will need marginal yield data. As we discuss later, marginal yield data is generally not available except for the examination program.

EXAMINATION RESOURCES CAN BE ALLOCATED TO INCREASE TAX REVENUE

IRS does not follow a revenue-maximizing approach in allocating examination resources among various taxpayer classes. Rather, as discussed earlier, its allocations are based, in part, on the voluntary compliance levels of the taxpayer classes. Also, the allocations do not consider the full costs of examining tax returns or the tax revenue actually collected as a result of the examinations. IRS' 1980 examination plan showed a net yield for the program of about $5.1 billion for fiscal year 1980. We estimate that IRS could increase tax revenue by about $92 million annually in the examination program by allocating resources in that program to maximize tax revenue on the basis of the program's full cost and actual revenue results.

Allocations to low-compliance groups result in lost tax revenue

In developing its annual examination plans, IRS increases examination coverage for less compliant taxpayer classes, and thereby sacrifices some tax revenue. IRS sacrifices this tax revenue because it does not examine returns from other classes that would produce more revenue yield for each examination dollar invested.

At our request, IRS estimated that, with essentially the same examination resources it had available, it could have realized additional revenue (assessments and interest) totaling about $67 million in 1980. Generally, the higher revenue yield would have resulted from slightly higher coverage among higher income taxpayer groups and correspondingly lower coverage among lower income groups. Examination costs, however, would have increased slightly, $5.3 million. This increase would occur primarily because higher graded examiners generally review returns for higher income groups. Thus, the net increase in revenue yield would be about $62 million.

A comparison between IRS' plan for 1980 (Plan A) which included coverage adjustments for low compliant classes and a plan without such adjustments (Plan B) is shown on the next page.

Comparison Of Alternative Examination Plans
For Fiscal Year 1980

	Plans A	Plans B	Increase (decrease)
	Coverage (in percentages)		
Taxpayer class individuals			
Nonbusiness:			
Under $10,000-standard	.29	.34	.05
Under $10,000-itemized	2.35	2.74	.39
$10,000-$15,000	.67	.76	.09
$15,000-$50,000	3.90	4.88	.98
$50,000 and over	11.61	12.77	1.16
Business:			
Under $10,000	3.65	.43	(3.22)
$10,000-$30,000	.49	.28	(.21)
$30,000 and over	3.92	4.32	.40
Total	1.96	2.19	.23
Corporations			
No balance sheet	7.96	11.49	3.53
Under $50,000	2.81	.73	(2.08)
$50,000-$100,000	3.34	.93	(2.41)
$100,000-$250,000	2.67	3.99	1.32
$250,000-$500,000	8.64	11.24	2.60
$500,000-$1 million	6.87	10.15	3.28
$1-$5 million	22.31	29.12	6.81
$5-$10 million	17.02	20.48	3.46
$10-$50 million	25.06	30.21	5.15
$50-$100 million	75.00	75.00	-
$100 million and over	85.00	85.00	-
Total	5.97	6.32	.35
Total coverage	2.07	2.29	.22
Yield (in millions)			
Recommended assessments	$6,774.9	$6,888.7	$118.8
Assessments (after appeals):			
Without interest	4,741.7	4,797.7	56.0
With interest	6,094.1	6,163.0	68.9
Collections:			
Without interest	4,529.9	4,584.6	54.7
With interest	5,811.9	5,878.9	67.0
Cost (in millions)	$ 722.0	$ 727.3	$ 5.3
Net yield (collections with interest, in millions)	$5,089.9	$5,151.6	$ 61.7

As our comparison shows, IRS would still provide coverage in all taxpayer classes under Plan B. The lowest rate for a class is .28 percent under Plan B, as compared with a .29 percent coverage rate as the lowest for a class under Plan A.

Allocations do not consider the full cost and actual revenue results

Because of the fragmented nature of IRS' compliance planning, the various divisions involved do not always consider the impact of their programs on other divisions' programs. As we will discuss later, IRS' management information systems generally do not permit accurate measurement of these impacts. However, IRS has available or can obtain some data on how the examination program affects certain other IRS programs. Such data more accurately reflect the actual collection of proposed tax assessments and the full cost of processing assessments than the data actually used. Use of the most complete cost/revenue data would significantly change IRS' examination coverage for certain taxpayer classes. Use of these data could also reduce the number of examination assessments that become delinquent accounts and are eventually written off.

Certain examination-related costs are not considered

In developing its plans, the examination division considers only the costs incurred within that division. In so doing, it excludes significant costs which other divisions incur as a result of the examination program.

To develop cost estimates for its 1980 examination plan, the division determined the average cost to examine returns for each taxpayer class by using the average grade of examiners working historically in each class. Included in the costs were the examiners' salaries and benefits plus clerical, administrative, and management costs, the total of which equaled the examination division's budget. The division excluded appellate, counsel, collection, and other costs related to the examination of tax returns that would be incurred by other IRS divisions. We estimated, primarily on the basis of various workload data supplied by the other divisions, that these costs totaled about $174 million, or about 24 percent of the examination division's budgeted cost for fiscal year 1980. By division, the costs were as follows.

Division	Estimated examination-related cost
	(millions)
Criminal investigation	$ 53.6
Appellate	59.5
Counsel	27.5
Data services	2.8
Collections	24.9
Technical	5.3
Total	$173.6

Until 1979, the examination division considered other divisions' examination-related costs in developing its plans. For the 1978 plan, for example, the division estimated these costs to be about 19 percent of its budgeted cost for that year. However, the examination division discontinued using such costs so that its plans would be more comparable with other divisions' plans, which included only costs incurred within the respective division.

A comparison between the plan shown earlier (Plan B) which includes costs incurred just within the examination division and a plan (Plan B-1) which includes other examination-related costs is shown on the next page.

Comparison Of Alternative Examination Plans For Fiscal Year 1980

	Plans B	Plans B-1	Increase (decrease)
	Coverage (in percentages)		
Taxpayer class individuals			
Nonbusiness:			
Under $10,000-standard	.34	.36	.02
Under $10,000-itemized	2.74	3.34	.60
$10,000-$15,000	.76	1.11	.35
$15,000-$50,000	4.88	4.32	(.56)
$50,000 and over	12.77	17.32	4.55
Business:			
Under $10,000	.43	.60	.17
$10,000-$30,000	.28	.23	(.05)
$30,000 and over	4.32	4.65	.33
Total	2.19	2.22	.03
Corporations			
No balance sheet	11.49	8.45	(3.04)
Under $50,000	.73	.65	(.08)
$50,000-$100,000	.93	.44	(.49)
$100,000-$250,000	3.99	2.97	(1.02)
$250,000-$500,000	11.24	10.03	(1.21)
$500,000-$1 million	10.15	8.87	(1.28)
$1-$5 million	29.12	26.08	(3.04)
$5-$10 million	20.48	18.97	(1.51)
$10-$50 million	30.21	28.14	(2.07)
$50-$100 million	75.00	75.00	0
$100 million and over	85.00	85.00	0
Total	6.32	5.42	(.90)
Total coverage	2.29	2.30	.01
Yield (in millions)			
Recommended assessments	$6,888.7	$6,915.2	$ 26.5
Assessments (after appeals):			
Without interest	4,797.7	4,820.2	22.5
With interest	6,163.0	6,188.4	25.4
Collections:			
Without interest	4,584.6	4,604.0	19.4
With interest	5,878.9	5,900.8	21.9
Cost (in millions)	$ 727.3	$ 895.0	a/$167.7
Net yield (collections with interest, in millions)	$5,151.6	$5,005.8	($145.8)

a/This increase for the most part results from reallocating certain costs from other IRS programs to the examination program. Thus, no major increase in overall funding for IRS would be involved under Plan B-1, even though the plan would increase yield to the Treasury by $21.9 million.

Taxes assessed but not collected are not considered

When the examination division assesses additional taxes, taxpayers often disagree with the proposed assessments. If a taxpayer files an appeal, the case moves from the examination division to the IRS appeals division and/or directly to a court of law for litigation. The examination division also may assess taxes that later end up as a delinquent account and eventually may be written off in the collection division. The examination division adjusts its estimated yield rates for likely actions of administrative and legal appeals, but not for collection actions.

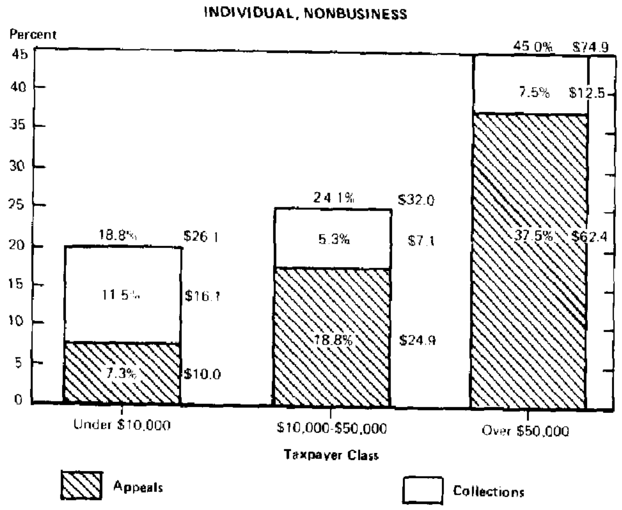
Through an automated retrieval system, IRS can obtain data showing the impact on proposed assessments that results from the appeals and collection processes. We used such data for tax year 1972--the most complete data available when we did our review--to illustrate how other IRS divisions can affect the examination program's outcome. The examination division's total proposed assessments for that year decreased from $1.471 billion to $988.2 million (32.8 percent) in appeals and to $946.8 million (2.8 percent) in collections, a total reduction of $524.1 million (35.6 percent).

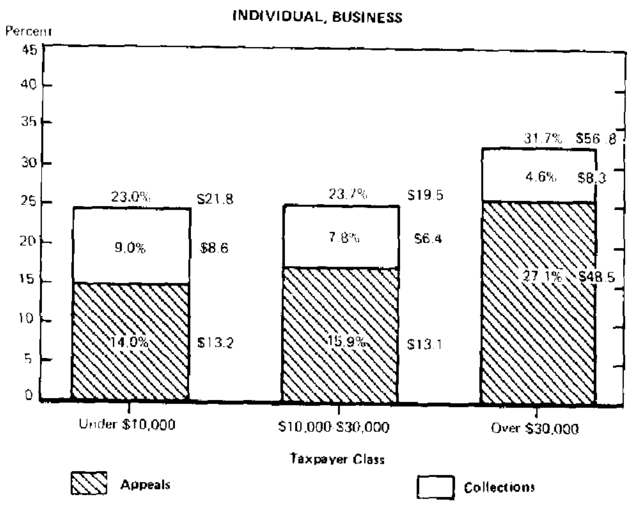
Although most of the overall reduction related to actions in appeals, which IRS considers in determining yield rates, the collection and appeals processes affect proposed assessments among specific taxpayer classes in significantly varying degrees. For example, proposed assessments for the under $10,000 individual class dropped from $138.9 million to $128.9 million (7.3 percent) in appeals and to $112.8 million in collections (11.5 percent), for a total reduction of $26.1 million (18.8 percent). Proposed assessments for the over $50,000 individual class, on the other hand, dropped from $166.4 million to $104.0 million (37.5 percent) in appeals and to $91.5 million (7.5 percent) in collections, for a total reduction of $74.9 million (45 percent). As the following charts show, similar trends held true in other classes.

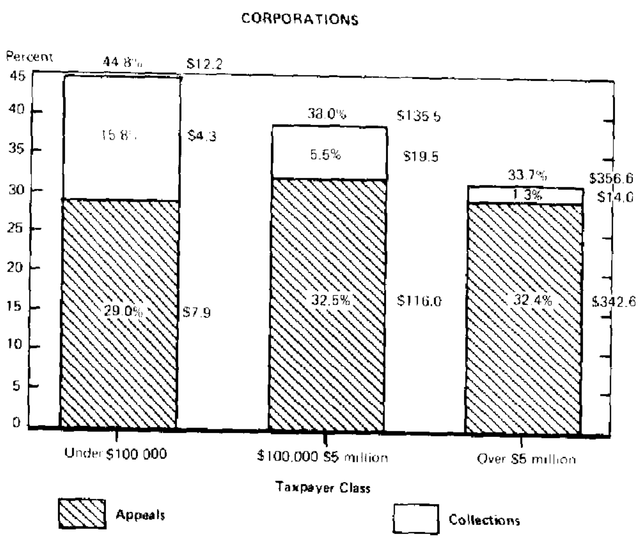
COMPARISON OF PERCENTAGE AND DOLLAR REDUCTIONS IN PROPOSED ASSESSMENTS (BY TAXPAYER CLASS) AS A RESULT OF APPEALS AND COLLECTION ACTIONS

For tax year 1972

Dollars in millions







Thus, to accurately determine yield rates for the various classes, IRS should consider both the appeals and collection processes. In developing its plans for 1980, the examination division used the appeals data for tax year 1972 to adjust its marginal yield rates and initially set examination coverage for the various taxpayer classes. However, it made no adjustments on the basis of the collection data. This resulted in overstated yield rates and, in turn, affected the planned coverage for the classes.

Because IRS does not develop tax revenue estimates on the basis of anticipated tax dollars to be collected, it overstates the amount of tax revenue yield available from examining the various taxpayer classes. To show these effects, at our request, IRS prepared a 1980 examination plan to recognize the impact of the collection process. That plan (Plan B-2), when compared with the earlier plan (Plan B) would further change the yield, cost, and coverage for the various taxpayer classes as follows.

Comparison Of Alternative Examination Plans
For Fiscal Year 1980

Taxpayer class	Plans: B	Plans: B-2	Increase (decrease)
	Coverage (in percentages)		
individuals			
Nonbusiness:			
Under $10,000-standard	.34	.30	(.04)
Under $10,000-itemized	2.74	2.37	(.37)
$10,000-$15,000	.76	.73	(.03)
$15,000-$50,000	4.88	5.08	.20
$50,000 and over	12.77	11.87	(.90)
Business:			
Under $10,000	.43	.40	(.03)
$10,000-$30,000	.28	.27	(.01)
$30,000 and over	4.32	4.53	.21
Total	2.19	2.18	(.01)
Corporations			
No balance sheet	11.49	4.13	(7.36)
Under $50,000	.73	.47	(.26)
$50,000-$100,000	.93	.60	(.33)
$100,000-$250,000	3.99	4.32	.33
$250,000-$500,000	11.24	11.61	.37
$500,000-$1 million	10.15	12.03	1.88
$1-$5 million	29.12	31.97	2.85
$5-$10 million	20.48	23.89	3.48
$10-$50 million	30.21	35.02	4.81
$50-$100 million	75.00	75.00	0
$100 million and over	85.00	85.00	0
Total	6.32	6.19	(.13)
Total coverage	2.29	2.28	(.01)
Yield (in millions)			
Recommended assessments	$6,888.7	$6,856.7	($ 32.0)
Assessments (after appeals):			
Without interest	4,797.7	4,792.4	(5.3)
With interest	6,163.0	6,155.6	(7.4)
Collections:			
Without interest	4,584.6	4,588.9	4.3
With interest	5,878.9	5,881.8	2.9
Cost (in millions)	$ 727.3	$ 729.0	$ 1.7
Net yield (collections with interest, in millions)	$5,151.6	$5,152.8	$ 1.2

We were told that IRS does not adjust its examination plans for its collection experience because it does not want the selection of returns for examination to be influenced by whether the collection division will collect the additional taxes assessed. To avoid selecting specific returns with high potential for tax change merely because of anticipated collection problems would indeed pose equity questions. However, using actual data on IRS' overall collection experience as a basis to allocate resources does not mean that a particular tax return would be selected or rejected for examination on the basis of the taxpayer's payment history. Rather, it means that IRS would recognize its collection experience as a reality, just like it currently recognizes its appeals experience.

A revenue-maximizing approach would alter IRS' examination plans

At our request, IRS prepared a 1980 examination plan which would maximize tax revenue by allocating examination resources among taxpayer groups on the basis of total cost and tax revenue data. The requested plan showed the effects of all the changes discussed above: no adjustments in coverage for low-compliant classes (Plan B, $67 million); inclusion of examination-related cost incurred by other divisions (Plan B-1, $22 million); and recognition of IRS' collection experience for the various taxpayer classes (Plan B-2, $3 million). That plan (Plan C, $92 million) is compared with IRS' 1980 examination plan (Plan A) on the following page.

Comparison Of Alternative Examination Plans For Fiscal Year 1980

Taxpayer class individuals	Plans A	Plans C	Increase (decrease)
	Coverage (in percentages)		
Nonbusiness:			
Under $10,000-standard	.29	.32	.03
Under $10,000-itemized	2.35	2.97	.62
$10,000-$15,000	.67	1.06	.39
$15,000-$50,000	3.90	4.55	.65
$50,000 and over	11.61	15.93	4.32
Business:			
Under $10,000	3.65	.56	(3.09)
$10,000-$30,000	.49	.22	(.27)
$30,000 and over	3.92	4.85	.93
Total	1.96	2.21	.25
Corporations			
No balance sheet	7.96	2.48	(5.48)
Under $50,000	2.81	.42	(2.39)
$50,000-$100,000	3.34	.12	(3.22)
$100,000-$250,000	2.67	3.27	.60
$250,000-$500,000	8.64	10.52	1.88
$500,000-$1 million	6.87	10.71	3.84
$1-$5 million	22.31	28.82	6.51
$5-$10 million	17.02	22.31	5.29
$10-$50 million	25.06	32.76	7.70
$50-$100 million	75.00	75.00	-
$100 million and over	85.00	85.00	-
Total	5.97	5.38	(.59)
Total coverage	2.07	2.29	.22
Yield (in millions)			
Recommended assessments	$6,774.9	$6,885.5	$110.6
Assessments (after appeals):			
Without interest	4,741.7	4,815.5	73.8
With interest	6,094.1	6,181.8	87.7
Collections:			
Without interest	4,529.9	4,608.5	78.6
With interest	5,811.9	5,904.0	92.1
Cost (in millions)	$ 722.0	$ 896.7	a/$174.7
Net yield (collections with interest, in millions)	$5,089.9	$5,007.3	($ 82.6)

a/This increase for the most part results from reallocating certain costs from other IRS programs to the examination program. Thus, no major increase in overall funding for IRS would be involved under Plan C, even though yield to the Treasury would be increased by $92.1 million.

Use of collection data could reduce IRS' delinquent accounts inventory

IRS should consider its collection experience for various taxpayer classes to achieve optimal resource allocations among those classes. This would result in examining fewer returns for those taxpayers who, as a class, are less apt to pay their taxes and could, in turn, reduce a growing number of delinquent accounts.

An IRS internal audit study, completed in January 1981, provided evidence that the examination division accounts for a large percentage of IRS' delinquent accounts. Internal auditors reviewed a sample of 1,173 cases covering 6 IRS districts and found that 313 of the cases, or 27 percent, involved examination division assessments.

We could not determine the specific impact a collection-based examination plan would have on IRS' delinquent accounts inventory. However, IRS data show that lower income taxpayers are generally more apt to become delinquent in their taxes than higher income taxpayers. If IRS recognized this in developing its annual examination plan, it would shift, to a degree, its examination coverage from lower income to higher income taxpayer classes. This should result in fewer of the examination division's tax assessments ending up in the collection division's delinquent accounts inventory to be further processed and possibly written off.

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Our discussion above relates primarily to the examination program. However, IRS also fails to consider the full cost and revenue impact of other compliance programs. For example, the information returns program results in additional costs in various compliance divisions that follow up on discrepancies noted in the matching process. However, because IRS' information systems generally do not accumulate data across divisional boundaries other than for the examination program, we could not show how actions in the various divisions affect other programs' costs and revenue results.

BETTER COST/TAX REVENUE DATA ARE NEEDED FOR RESOURCE ALLOCATIONS

IRS' management information systems do not provide adequate data to optimally allocate resources within and among its various compliance programs. The systems generally do not accumulate and report complete cost and revenue data for a compliance program, even though the data components exist at various places within the agency. Generally, each division or function within IRS has its own information systems, designed to serve its own needs, and the systems usually do not track cases or projects across divisional lines. As a result, cost/revenue data for a particular program are often incomplete.

IRS recognized the need for an agencywide management information system as early as 1976. National, regional, and district managers have expressed a critical need for data that cross divisional lines. IRS' progress in developing a system to meet those needs has been slow, however.

Accurate IRS compliance program data: a critical need at many levels

IRS program cost and revenue data--including estimates of how much additional revenue will flow to the Treasury as a result of additional resources--affect policy, budget, and program decisions throughout IRS and at the highest levels of the Federal Government. Because of these far-reaching implications, it is especially important that IRS gather and report accurate program data.

The Office of Management and Budget (OMB) and Treasury have frequently stressed to IRS the need to accumulate data showing the additional revenue collected as a result of resources expended. The President and OMB have requested such information in order to determine whether IRS could realize enough additional revenue to justify expanding its revenue-producing programs. In March 1981, OMB requested information from Treasury to better understand the methodology that IRS used to estimate revenue yields for its revenue-producing activities.

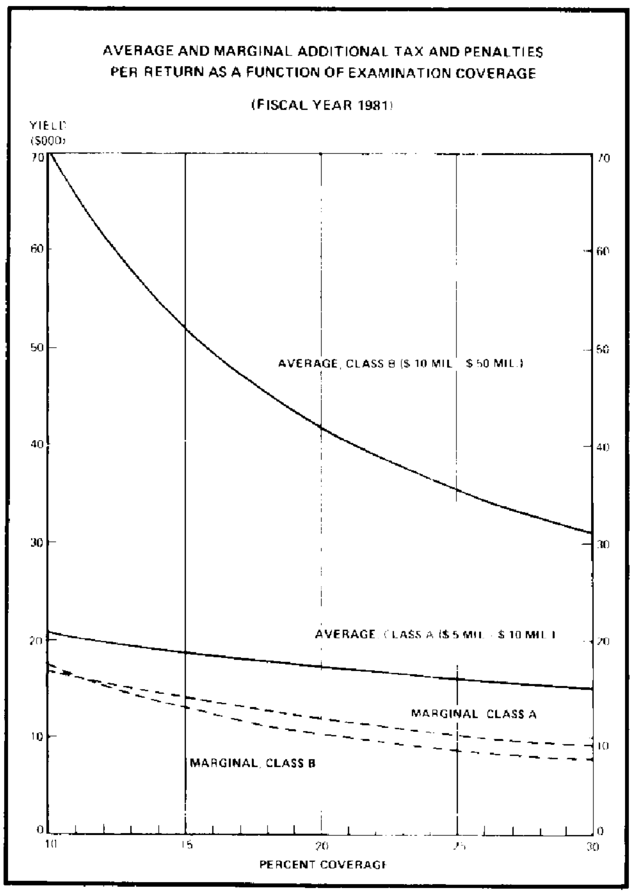
IRS often uses cost/revenue data to justify its budget requests before congressional appropriation committees. The Commissioner and other IRS officials, for example, often cite a return of $5 to $6 for every $1 spent in the examination program, and IRS compiles similar ratios for other programs. IRS also requires that all its divisions support their budget requests with data on costs and benefits, both measurable and intangible. A recent IRS long-range plan included several programs with benefit/cost ratios that ranged from 4:1 to 15:1.

Notwithstanding these needs and even though IRS computes benefit/cost ratios for some programs, its information systems generally do not provide adequate data on the cost and revenue impact of its compliance programs. IRS has numerous information systems, but they do not uniformly accumulate and report data among the various divisions. As a result, IRS does not always have useful cost/revenue data for resource allocation purposes.

__Lack of marginal yield data__
__is a critical shortcoming__
__of IRS data bases__

Except for the examination program, IRS' information systems generally do not provide data necessary for estimating marginal revenue yield. This data is critically needed for making various resource allocations within or among the programs. Without marginal yield data, decisions on how to best allocate resources for optimizing tax revenue must be based on average yield data. The use of average yield data, however, can lead to misallocation of resources in some instances.

How this might happen can be illustrated by using marginal and average yield data available in the examination program for two classes of taxpayers--the $5 million-$10 million (class A) and $10 million-$50 million (class B) classes of corporate taxpayers. As the following chart shows, the average yield for class A is much lower than the average yield for class B; however, class A has a generally higher marginal yield for the various coverage levels shown (10 percent to 30 percent) than class B.



Thus if resources are allocated on the basis of average yield, all resources would go to class B. However, if marginal yield data are used, resources would be devoted to class B up to about 11 percent of coverage and beyond that point the resources would be allocated to class A. This shift would occur because after selecting those early tax returns in class B which have extremely high yield, the next returns selected in class A would have a yield larger than the next return selected in class B. Thus, using a strict average yield approach would misdirect resources in this case. The examination division has data, however, with which it can make judgements on a marginal basis. This is not the case for other IRS divisions.

<u>Agencywide management information is a long-standing IRS need</u>

IRS has long recognized the need for a better management information system. As of May 1982, however, it still had not approved the proposed initial design for a system.

Various IRS studies have pointed to the need for an information system to accumulate program data agencywide. As early as January 1976, IRS recognized, as a result of one such study, that its information systems were not well integrated. IRS' research staff proposed a system that would integrate data on a programmatic and organizational basis, thus recognizing the interdependency of IRS' programs. In that same year, an independent contractor also reported the need for overall performance data within the agency. The contractor recommended that IRS implement a reporting structure to accumulate such data and an integrated cost accounting system.

A later IRS study, completed in May 1978, described IRS' management information network as "numerous parallel, independently developed, and operationally oriented systems." The study group reported that such systems were satisfactory as long as IRS was willing to manage itself on a fragmented basis but that the systems no longer met IRS needs. The study included interviews with over 400 IRS managers--from the level of the Commissioner to the level of the district manager--and disclosed a multitude of information needs not being met. Managers at all levels emphasized the need for cost and outcome data related to specific programs and organizational elements.

To meet these needs, the study group began developing a coding scheme to collect data on cases and projects uniformly throughout IRS. In April 1979, the group completed a master plan for a management information system to accumulate data by organizational element as well as by tax class and program. However, various internal changes have occurred since then, and IRS has made little progress toward actually implementing an agencywide system.

In another attempt to obtain consistent program data, the Assistant Commissioner for Compliance requested a study to deal with varying approaches used by the divisions to justify resources. The purpose of the study, terminated in October 1979, was to develop criteria, or a "common denominator," which the divisions would use in justifying their resource requests. A document resulting from the study noted that, while the examination, collection, and criminal investigation divisions were all directly involved in carrying out a common mission, they determined program costs and outcomes and justified their resources on the basis of different criteria and approaches. For example, to justify resources, the examination division used marginal yield stated in dollar assessments and the collection division used average yield stated in dollar collections.

The study did not receive a high priority and was discontinued primarily because IRS planned to develop an agencywide information system to provide uniform program data. However, as discussed below, that system still had not been designed at the time of our review.

<u>A system to provide adequate program data is still a distant goal</u>

Currently, IRS' management systems division is responsible for developing an overall management information system. Although the division's purpose is to ensure that the information systems operate in the most cost-effective manner, it has not taken an aggressive role in developing standards, practices, and procedures to govern the overall design of IRS' systems. Instead, the various operating divisions have continued to design systems to satisfy their own information needs and have not concerned themselves with integrating those systems with other divisions' systems so as to provide overall compliance program data.

For example, as of May 1982, both the appeals division and the office of chief counsel were each designing an information system to meet needs peculiar to their own operations. We were told that the management system division had had little involvement in the design of the two systems. Unless adequate consideration is given to making these and other systems and the resulting data compatible, IRS will continue to lack adequate information on the cost and revenue impact of its compliance programs.

IRS' management systems division had completed a "system definition" phase of an agencywide information system. However, as of May 1982 it had not yet presented the plan to IRS management for approval. After that phase, the division will design a system to meet various information needs, beginning with the district level. As of May 1982, IRS did not expect to have the system implemented before late in fiscal year 1986.

CONCLUSIONS

IRS' current approach to allocating resources results in substantial lost tax revenue annually. IRS has not fully maximized tax revenue in the examination program primarily because it has tried to close the tax gap for low-compliant classes. Also, through 1981, IRS consistently favored the examination program over other programs in allocating resources even though some of these other programs have significantly higher revenue yield potential. Given the evidence presented in chapter 2 coupled with our estimates of IRS' relinquished revenue, a different approach emphasizing the revenue potential of each program is in order.

A revenue-maximizing approach within and among the various programs will require IRS to make better use of cost/yield data. In addition to emphasizing the tax revenue potential within the examination program and other programs, IRS will need to consider the revenue potential across programs. To maximize total revenue, IRS will have to allocate resources on the basis of all its programs' cost/revenue history.

Incomplete and inaccurate cost/revenue data presently hinder IRS in making its resource allocations both within and among the programs. However, as we have shown, IRS has, or can obtain, sufficient data to substantially increase tax revenue through some different allocations. Thus, while IRS needs better cost/yield data to fully optimize its allocations, it should also make better use of data it has already.

Over the longer term, IRS should obtain more complete cost, yield, and other needed data on its programs by implementing a management information system which accumulates data across divisional lines. While the compliance program data needed are generally available within IRS, the parochial design of the divisions' systems precludes overall data accumulation. As a result, managers who must allocate resources to programs which cross divisional lines and take other similar actions are deprived of essential management information. This information represents a critical need which has been unmet too long.

RECOMMENDATIONS TO THE COMMISSIONER OF INTERNAL REVENUE

We recommend that, until IRS has adequate data to determine the overall impact of its compliance programs (see chapter 2), the Commissioner place more emphasis on allocating resources both among and within the programs so as to optimize tax revenue. Specifically, we recommend that IRS:

--Use existing cost/revenue data to reallocate staff years from those compliance programs with historically lower average revenue yields to those with much higher yields in order to increase tax revenues from those programs.

--Develop additional data so that resources can be allocated among all compliance programs to increase, insofar as practicable, overall tax revenue. For example, rather than using the current approach of developing revenue estimates in terms of dollars assessed, IRS could develop estimates in terms of dollars actually collected for such programs as the taxpayer delinquency investigations program.

--Plan and budget within each program to maximize revenue using the best available cost/revenue data.

We also recommend that, to further improve IRS' resource allocations and the overall management of IRS' compliance resources, the Commissioner implement a system to provide cost, revenue, and other needed data from a total program and agencywide perspective.

AGENCY COMMENTS AND OUR EVALUATION

The Commissioner of Internal Revenue stated in a March 5, 1982, letter that IRS would consider a revenue-maximizing approach in the examination program during an upcoming planning cycle. He made no commitment, however, to adopting such an approach in allocating resources within that program or among IRS' various programs. He stated that an agencywide revenue-maximizing approach would require comparable data which IRS had been unable to develop.

We agree that IRS needs cost/yield data which are comparable among programs. IRS does not expect to have a system that might provide these data until fiscal year 1986. Until IRS can improve its data, we believe that IRS should attempt to use existing cost/revenue data to reallocate, insofar as practicable, staff years among certain programs so as to increase overall tax revenue.

Specifically, for all of its programs, with the exception of the examination program, IRS generally does not have the necessary marginal revenue data which are needed to optimally allocate resources "at the margin" and thereby maximize tax revenue. IRS does have average yield data, however, and those data indicate IRS could incrementally shift some resources among programs and increase overall tax revenue.

As our report shows, the taxpayer delinquent accounts program, for example, has tax revenue yields which are, on the average, much higher than those of other IRS programs. IRS stated that of the additional 5,000 staff years it has requested for compliance activities in its fiscal year 1983 budget request, it will allocate 3,000 staff years to the taxpayer delinquent account program. Available data indicate that IRS might also be able to shift some resources from other programs to that program and increase tax revenue.

The Commissioner also stated that IRS had long recognized the urgent need for a management information system and that a lack of resources had been an obstacle in the past. He said that IRS had sent a plan to Treasury concerning management information and was well on the way to developing a comprehensive management information system. IRS included funds for implementing a system in its fiscal year 1983 budget request to the Congress. We view these actions as major steps toward meeting what IRS and others long ago recognized as a critical need. We also encourage IRS to continue the emphasis on filling that need.

The Commissioner made various other comments regarding the examination program. He stated that the program had not achieved the goal of 90-percent compliance for all taxpayer classes, in part because of resource constraints. He also pointed out that IRS had increased the program's efficiency and had increased total taxes and penalties recommended in that program between 1976 and 1981. We agree and, in fact, our report generally recognizes these facts.

He also amplified IRS' reasons for not using data on its actual collection experience when developing annual examination plans, stating generally that the goal of the examination function is to ensure the correct reporting of tax liabilities. IRS contended that this function does not include ensuring that the taxes are actually paid. This comment reflects essentially an examination perspective whereas our report and our recommendations reflect an overall compliance perspective. We believe that in developing its compliance plans and budgets, IRS should adopt this broader compliance perspective. Otherwise, the cost and tax revenue yields for IRS' compliance programs will continue to be misstated.

The Commissioner also stated, in effect, that the use of data on IRS' collection experience would reduce coverage for those classes having less favorable payment histories. IRS contended that this would be inequitable. As discussed in detail on page 47 of this report, we do not agree with these contentions. Because the classes of taxpayers that would be affected by our recommendation would be paying a lower percentage of their taxes anyway, we do not believe a policy of reducing examination coverage to recognize this fact would be inequitable.

Finally, the Commissioner noted that our report shows that the change to a collection-based examination plan would have increased yield by only $3 million. While this is true, the suggested change is only one of many that we believe IRS should make to increase tax revenue. In total, we estimated that the changes would have increased tax revenue yield from the examination program by $92 million in 1980.

MATTER FOR CONSIDERATION BY THE CONGRESS

Because of the significant tax revenue implications involved in IRS' resource allocations, the appropriate committees of the Congress may wish to ask IRS to provide additional cost and tax revenue data in support of its annual appropriation requests. For example, from time to time, IRS could provide cost and revenue data for several specific programs to facilitate resource determinations, including decisions on the appropriate program levels and the mix among programs.

COMPLIANCE PROGRAM DESCRIPTIONS

Following are brief descriptions of nine IRS programs that are specially designed to detect and eliminate taxpayer noncompliance. Also included are the program accomplishments as reported by IRS for fiscal year 1981.

MATH VERIFICATION AND UNALLOWABLE ITEMS

This program provides IRS' first check on the compliance of taxpayers who voluntarily file tax returns. The check is part of the normal returns processing at IRS' 10 service centers. Through various computer and manual procedures, IRS verifies the accuracy of math computations on tax returns and the propriety of certain items included on returns.

During fiscal year 1981, IRS verified 91.4 million tax returns under this program which resulted in a $1.2 billion increase and a $778 million decrease in taxpayers' liabilities.

INFORMATION RETURNS

This program provides for matching information from taxpayers' returns with documents furnished to IRS by third parties such as banks, dividend paying establishments, and the Social Security Administration. IRS uses such documents to (1) verify wages, salaries, dividends, interest, and other income reported on tax returns and (2) identify individuals not filing tax returns. Where discrepancies exist, IRS sends notices to taxpayers assessing additional taxes or requesting that returns be filed. Under this program, cases may also be referred to Examination, Collection, or Criminal Investigation Division personnel for compliance action.

IRS received over 588 million information documents of all types for tax year 1981. IRS compared 80 percent of the documents with related tax returns. Document matching resulted in additional tax assessments totaling about $500 million for cases generated in prior years and completed in fiscal year 1981.

TAXPAYER SERVICE

IRS helps taxpayers to voluntarily comply with the tax laws by providing them with the information and assistance needed to file an accurate return. IRS offers a broad range of services to taxpayers including explanations of Federal tax requirements, assistance in preparing returns, distribution of tax forms and instructions, educational services, and resolution of taxpayers' complaints.

IRS received about 102,000 written, 35 million telephone, and 8 million walk-in inquiries during fiscal year 1980.

EXAMINATIONS

The examination program, IRS' largest compliance program, provides for verification of tax liabilities reported on tax returns. IRS uses a computer model and mathematical formula to select individual returns for examination on the basis of probability of error. IRS examines returns and supporting books and records to verify that taxpayers accurately reported income and claimed deductions, exemptions, and other offsets to income.

In fiscal year 1981, IRS examined 1.8 million individual, corporate, estate, and gift tax returns or 1.86 percent of the 99.3 million such returns filed. The Examination Division recommended additional tax assessments and penalties totaling $10.4 billion, $6.339 billion of which related to corporate tax returns. In addition, IRS service center contacts were made for about 800,000 returns which resulted in proposed tax assessments totaling about $205 million.

TAXPAYER DELINQUENCY ACCOUNTS

This program is IRS' primary means of enhancing payment compliance. To secure delinquent taxes, IRS first screens taxpayers' accounts to offset tax debts against any refunds due the taxpayers. IRS then sends a series of computer-generated notices to taxpayers requesting payment. Where the taxpayer fails to pay and the debt exceeds a certain amount, IRS classifies the case as a delinquent account and attempts to contact the taxpayer directly and secure payment. If the debt is small, IRS holds it for possible offset against future refund claims or for other action.

In fiscal year 1981, IRS disposed of 2.2 million delinquent accounts and collected almost $5.869 billion in late taxes, including $2.149 billion as a result of computer-generated notices.

TAXPAYER DELINQUENCY INVESTIGATIONS

This is IRS' primary program for dealing with individuals who do not file a required tax return. IRS identifies potentially delinquent returns by either checking (1) information returns such as wage statements submitted by employers and interest payments submitted by financial institutions or (2) its master file for individuals who did not file in the tax year. IRS screens, selects, and investigates nonfiler cases to secure the returns and taxes due.

IRS secured about 1.3 million delinquent returns, involving about $1.403 billion in additional tax assessments, during fiscal year 1981.

RETURNS COMPLIANCE

Under this program, IRS secures tax returns from individuals who have never filed a required return or have not filed for several years. Thus IRS has no record of these individuals. IRS uses sources such as newspaper articles, television, and IRS employees to initiate specific projects, and the names of potential investigative subjects come from sources such as private business lists and government lists.

IRS secured about 29,000 returns from individuals and assessed additional taxes of about $14 million under this program during fiscal year 1981.

GENERAL ENFORCEMENT

IRS investigates taxpayers based on information from three basic sources--referrals from the examination and collection divisions, information gathering efforts, and unsolicited communications from various sources such as the general public, public agencies, financial institutions, and IRS employees. The general enforcement program identifies tax evasion cases with prosecution potential. This program also provides for balanced criminal tax enforcement and geographical and occupational coverage of various types of alleged violations of the tax laws.

In fiscal year 1981, IRS completed 4,003 criminal investigations under the general enforcement program and recommended prosecution in 1,282 cases. During that year, 1,171 cases were successfully completed. Of the 1,303 taxpayers who were sentenced in fiscal year 1981, 607 received jail sentences.

SPECIAL ENFORCEMENT

The special enforcement program identifies and investigates those individuals who derive substantial income from illegal activities and in the process violate the tax laws. This program also includes the Federal strike force program against organized crime, the high-level drug dealers project, wagering tax enforcement, and other efforts against racketeers.

IRS completed 1,478 criminal investigations under the special enforcement program and recommended prosecution in 696 cases in fiscal year 1981. During that year, 323 prosecutions from these and earlier cases were successfully completed. Of the 312 taxpayers sentenced that year, 195 received jail sentences.

LISTING OF
GAO REPORTS AND STATEMENTS
RELATING TO MATTERS DISCUSSED IN THIS REPORT

	Reports	Date
1.	What IRS Can Do to Collect More Delinquent Taxes (GGD-82-4)	November 5, 1981
2.	Illegal Tax Protesters Threaten Tax System (GGD-81-83)	July 7, 1981
3.	Streamlining Legal Review of Criminal Tax Cases Would Strengthen Enforcement of Federal Tax Laws (GGD-81-25)	April 29, 1981
4.	IRS Can Expand and Improve Computer Processing of Information Returns (FGMSD-81-4)	October 20, 1980
5.	Oregon's Offset Program for Collecting Delinquent Debts Has Been Highly Effective (FGMSD-80-68)	July 17, 1980
6.	Improved Planning for Developing and Selecting IRS Criminal Tax Cases Can Strengthen Enforcement of Federal Tax Laws (GGD-80-9)	November 6, 1979
7.	IRS' Audits of Individual Taxpayers and Its Audit Quality Control System Need to be Better (GGD-79-59)	August 15, 1979
8.	IRS Can Improve Its Process for Deciding Which Corporate Returns to Audit (GGD-79-43)	August 3, 1979
9.	Who's Not Filing Income Tax Returns? IRS Needs Better Ways to Find Them and Collect Their Taxes (GGD-79-69)	July 11, 1979
10.	Additional IRS Actions Needed to Make Sure That Individuals Pay the Correct Social Security Tax (GGD-78-70)	August 15, 1978

	Reports	Date
11.	IRS Seizure of Taxpayer Property: Effective But Not Uniformly Applied (GGD-78-42)	July 31, 1978
12.	IRS Can Improve its Programs to Collect Taxes Withheld by Employers (GGD-78-14)	February 21, 1978
13.	Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions (GGD-77-88)	November 21, 1977
14.	Repetitive IRS Audits of Taxpayers are Justified (GGD-77-74)	November 18, 1977
15.	Internal Revenue Service's Controls Over the Use of Confidential Informants: Recent Improvements Not Adequate (GGD-77-46)	September 1, 1977
16.	Audit of Individual Income Tax Returns by the Internal Revenue Service (GGD-76-54)	December 2, 1976
17.	How the Internal Revenue Service Selects Individual Income Tax Returns for Audit (GGD-76-55)	November 5, 1976
18.	Use of Jeopardy and Termination Assessments by the Internal Revenue Service (GGD-76-14)	November 16, 1976
19.	Collection of Taxpayer's Delinquent Accounts by the Internal Revenue Service, B-137762	August 9, 1973

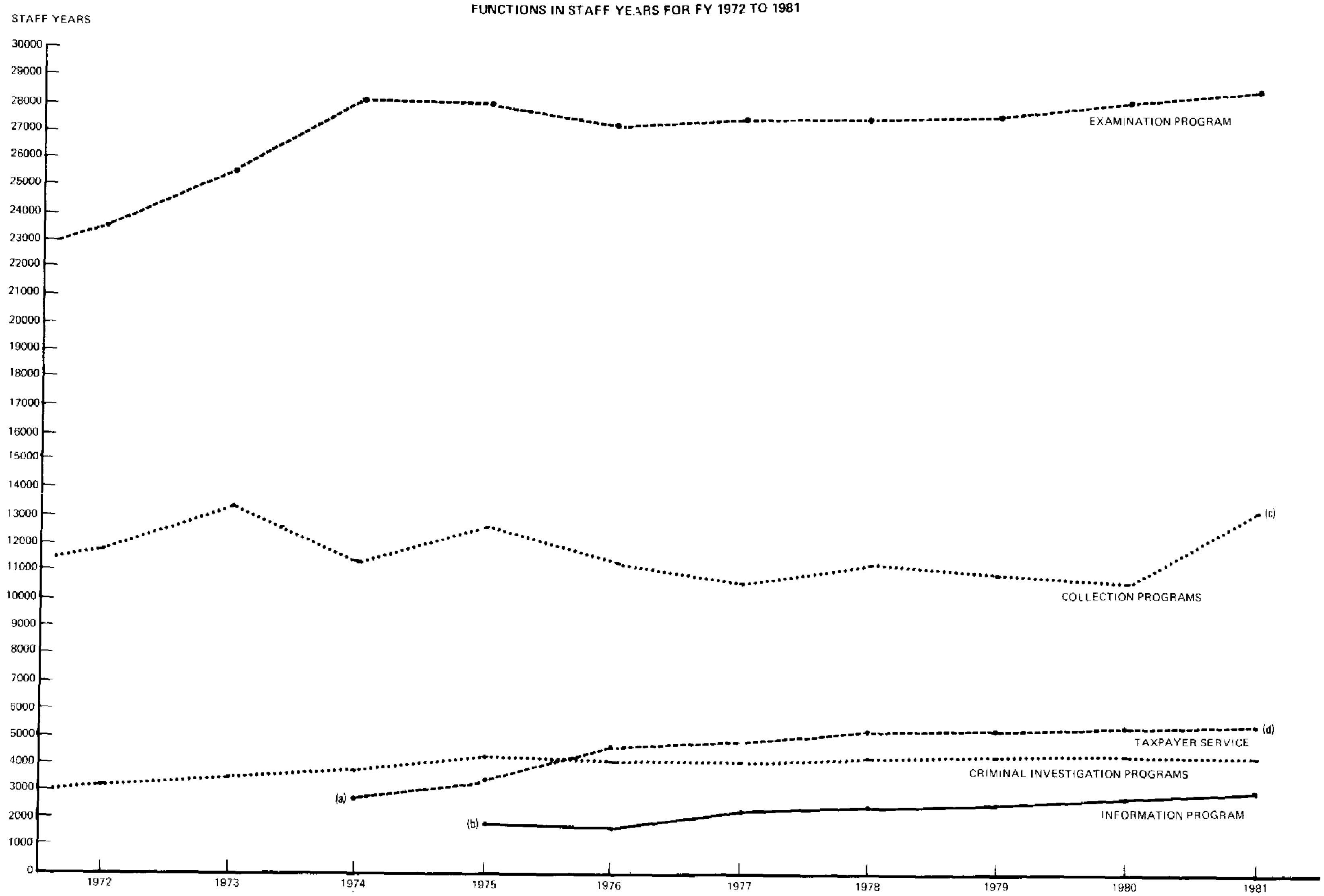
Statements	Date
1. Statement of William J. Anderson, Director, GGD, before the House Committee on Ways and Means, on the Tax Compliance Act of 1982 (H.R. 6300)	May 18, 1982
2. Statement of Daniel F. Stanton, Deputy Director, GGD, before the Subcommittee on Oversight of the Internal Revenue Service, Senate Committee on Finance, Senate Bill 2369, Independent Contractor Tax Classification and Compliance Act of 1982	April 26, 1982
3. Statement of William J. Anderson, Director, GGD, before the Subcommittee on Oversight, House Committee on Ways and Means, concerning IRS Policies and Procedures to Safeguard Taxpayer Rights and the Effects of Certain Provisions of the 1976 Tax Reform Act	April 26, 1982
4. Statement of William J. Anderson, Director, GGD, before the Subcommittee on Oversight of Government Management, Senate Committee on Governmental Affairs, on the Status of IRS' Taxpayer Service Program	March 24, 1982
5. Statement of William J. Anderson, Director, GGD, before the Senate Committee on Finance, on the proposed Taxpayer Compliance Improvement Act of 1982	March 22, 1982
6. Statement of William J. Anderson, Director, GGD, before the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations, on the Adequacy of IRS' Resources	March 17, 1982

Statements	Date
7. Statement of William J. Anderson, Director, GGD, before the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations, on the Internal Revenue Service's Efforts Against Illegal Tax Protesters	June 10, 1981
8. Statement of William J. Anderson, Director, GGD, before the Subcommittee on Oversight, House Committee on Ways and Means, on the Adequacy of IRS Compliance Resources for Fiscal Year 1982	May 11, 1981
9. Statement of William J. Anderson, Director, GGD, before the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations, on IRS' Document Matching Program	October 1, 1980
10. Statement of William J. Anderson, Director, GGD, before the Subcommittee on Oversight, House Committee on Ways and Means, on the Subject of Compliance by Federal Agencies With the Requirements to File 1099 Information Returns	September 18, 1980
11. Statement of Arnold P. Jones, Associate Director, GGD, before the Subcommittee on Treasury, Postal Service, and General Government, Senate Committee on Appropriations, on Changes Needed to Strengthen Federal Efforts to Combat Narcotics Trafficking	April 22, 1980
12. Statement of Elmer B. Staats, Comptroller General, before the Permanent Subcommittee on Investigations, Senate Committee on Governmental Affairs, on IRS' Efforts to Combat Narcotics Traffickers	November 13, 1979

Statements	Date
13. Statement of Richard L. Fogel, Associate Director, GGD, before the Subcommittee on General Oversight and Renegotiation, House Committee on Banking, Finance, and Urban Affairs, on the Use of Currency and Foreign Account Reports to Detect Narcotic Traffickers	November 29, 1979
14. Statement of Richard L. Fogel, Associate Director, GGD, before the Joint Economic Committee, on the Underground Economy	November 15, 1979
15. Statement of Richard L. Fogel, Associate Director, GGD, before the Subcommittee on Oversight, Committee on Ways and Means, on the Efforts of IRS' Criminal Investigation Division to Detect and Deter Underreporters	October 11, 1979
16. Statement of Richard L. Fogel, Associate Director, GGD, before the Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations, on the Subterranean Economy	September 6, 1979
17. Statement of Richard L. Fogel, Associate Director, GGD, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, on Compliance Problems of Independent Contractors	July 17, 1979
18. Statement of Allen Voss, Director, GGD, before the Subcommittee on Oversight, House Committee on Ways and Means, on IRS' Efforts to Identify and Pursue Income Tax Nonfilers and Underreporters	July 16, 1979

Statements	Date
19. Statement of Richard L. Fogel, Associate Director, GGD, before the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, on IRS' Efforts Directed at Multiple False Filers	April 24, 1979
20. Statement of Victor L. Lowe, Director, GGD, before the Subcommittee on Oversight, House Committee on Ways and Means, on IRS' Efforts to Detect Slush Funds in Large Corporations	September 13, 1979
21. Statement of Victor L. Lowe, Director, GGD, before the Subcommittee on Oversight, House Committee on Ways and Means, on How the IRS Selects and Audits Individual Income Tax Returns	December 14, 1976

ALLOCATION OF RESOURCES AMONG IRS COMPLIANCE FUNCTIONS IN STAFF YEARS FOR FY 1972 TO 1981



a/ Taxpayer Service Program established as a separate program in FY 1974.
b/ Information Returns Program established in FY 1975.
c/ Includes Taxpayer Delinquent Accounts, Returns Compliance, and Taxpayer Delinquency Investigations Programs organizationally within Collection.
d/ Includes Special Enforcement Programs organizationally within Criminal Investigation.

APPENDIX III

COMMISSIONER OF INTERNAL REVENUE
Washington, DC 20224

MAR 0 5 1982

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Anderson:

Thank you for the opportunity to review your draft of a proposed report currently entitled "Billions of Tax Revenue are Lost Annually -- Further IRS Research and Improved Resource Allocations are Needed."

While we believe the recommendations made in the proposed report have merit, we are concerned that they fail to take into account a number of limitations over which the Service has little or no control and provide little guidance over how the Service should proceed to correct the problems that have been identified.

The second Chapter of the report looks at the Service's efforts at research in those programs that positively affect voluntary compliance. The report is accurate as to what has been done in the past and, of course, we fully agree that additional research in these areas is needed to identify pockets of noncompliance and programs or procedures to deal with such pockets. However, the report fails to point out that while the Service has tried a number of things that haven't been very successful, this is mainly due to the fact much of what needs to be measured may not be measurable given current research techniques. We certainly intend to continue research into determining the impact our programs have on voluntary compliance, but the report could be much more helpful if it suggested promising new areas of research and measurement techniques that might be effective.

A principal recommendation in Chapter 3 of the report criticizes the Service for failing to implement an agencywide management information system to provide marginal cost, revenue and other pertinent data from a total program and agency perspective. The Service has long recognized the urgent need for a management information system. However, because of a lack of resources in the past, we did not have the personnel to gather the necessary information nor could we have replaced our current computer processing system which simply does not have the extra capacity that is needed to implement a comprehensive management information system. As you are aware, we are now in the initial stages of receiving the needed resources for our equipment replacement program. Once that program has been completed, we will have the necessary computer capacity. In the meantime a strategic plan for management information and process automation for the Service has been completed and has been forwarded to the Treasury. Thus, within the restrictions of available resources, we are well on the way to developing a comprehensive management information system.

-2-

Mr. William J. Anderson

The second principal recommendation in Chapter 3 of the report recommends that the Service strictly adhere to a revenue-maximizing approach in preparing compliance plans and budgets for the various compliance programs using the most complete and accurate cost/revenue yield data available. In order to implement a Service wide revenue maximizing program, it is essential that we have comparable data. However, as mentioned above the Service historically has not had the resources to develop this data. The issue of adopting a pure revenue-maximizing Examination Plan rather than a plan which diverts some resources to increase coverage in low compliance classes is usually considered by the Service in its long-range planning process. Because of considerations of equity to all taxpayers, we have in the past decided the issue in favor of increased examinations in low compliance areas at the cost of some foregone revenue. It is a policy question that we will again address in the 1984 Multi-Year Plan. It is important to point out, however, that under the new revenue initiatives being proposed by the Administration as part of the FY 1983 proposed budget, 80 percent of the recommended 5,000 new staff persons would be allocated to high yield programs other than the Examination program. For FY 1983, Examination's budget request includes an increase of 1,000 staffyears, but collections FY 1983 budget request includes 3,000 staffyears to help collect the substantial backlogs of taxes that are due but unpaid, and 1,000 staff-years to secure additional delinquent returns.

There are also a number of other more specific issues on which we would like to comment. The report states that the Internal Revenue Service is not achieving, through the examination program, the goal of 90 percent total compliance for all taxpayer classes. This is, in part, explained by the fact that the Service has not received the resources required to achieve our planning objectives. As a result, the examination program has had to scale back its plans, including its coverage of classes where voluntary compliance is below 90 percent, to a level that is achievable under available resources.

Nevertheless, our examination program has been able to minimize what would otherwise have been a greater growth in the net tax gap through increased efficiency and effective utilization of its limited resources. This increase in efficiency is reflected by the increase in recommended tax per staffyear from $184,000 in FY 1976 to $385,000 in 1981. In aggregate terms, total additional tax and penalties recommended by Examination increased from $5.1 billion in FY 1976 to 10.7 billion in FY 1981.

Mr. William J. Anderson

The report points out that in developing its plans for 1980, the Examination Division used the appeals data to adjust its marginal yield rates and to initially set examination coverage, but made no adjustments to reflect that not all tax is ultimately collected. The report concludes that this results in overstated yield rates and, in turn, affected the planned coverage for the classes. We do not believe that the report adequately reflects the reasons for our use of assessed yield, rather than collected yield in examination planning. The goal of our examination function is to encourage and achieve the highest possible degree of voluntary compliance with the requirements of the internal revenue laws for the correct reporting of income. Correct tax liability is the tax legally owed, not that portion of the tax that is successfully collected. Since additional tax becomes the taxpayer's legal liability after the appeals process is complete, Examination adjusts for reductions in Appeals and from litigation.

If examination coverage in classes where taxpayers have lower compliance in paying taxes due were reduced for collection experience as the draft report recommends, the Service would, in effect, reward taxpayers who do not pay taxes due. We believe this would produce an inequitable result. While it is true that particular individuals would not be excluded from being examined because of their own nonpayment history, they might still avoid examination because of their class' nonpayment history since Examination planning is by class, not by individual taxpayer. Furthermore, since Examination cannot determine beforehand whether a taxpayer's assessment will end up as uncollectable, it is conceivable that the proportion of nonpayers within a class would be increased by reduced coverage in that class simply because they may be the ones who also have the highest DIF scores. We know of no system that could identify for examination in advance only those taxpayers who will pay their assessed taxes. Even so, as shown in the report's comparison tables, the issue of developing examination coverages on a collected instead of an assessed yield basis would only result in an additional yield of approximately $3 million.

We hope our comments will be helpful to you in the preparation of your final report.

With kind regards,

Sincerely,

Roscoe Egger

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