

GAO

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FEDERAL BUDGET

Opportunities for  
Oversight and Improved  
Use of Taxpayer Funds

Statement of David M. Walker  
Comptroller General of the United States



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Highlights of [GAO-03-1030T](#), testimony before the Committee on Ways and Means, House of Representatives

## Why GAO Did This Study

The hearing today deals with the important congressional obligation to exercise oversight over the use of taxpayer funds, recognizing that waste, fraud, abuse, and mismanagement are not victimless activities. When resources are diverted for inappropriate, illegal, inefficient, or ineffective purposes, both taxpayers and legitimate program beneficiaries are cheated. Beyond preventing obvious abuse, government also has an obligation to modernize its practices and processes and fundamentally reexamine and reprioritize its activities to meet the demands and needs of today's changing world.

## What GAO Recommends

Tackling areas at risk for fraud, waste, abuse, and mismanagement will require determination, persistence, and sustained attention by both agency managers and Congressional committees. In addition, there is a need to fundamentally review and reassess, the proper role of the federal government, how the government should do business in the future, and—sometimes—who should do the government's business in the 21<sup>st</sup> century. Periodic review of programs on the mandatory and discretionary sides of the budget, as well as tax preferences, can prompt a healthy reassessment of our priorities and of the changes needed in program design, resources and management to achieve results. Congressional support and oversight will be key.

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# FEDERAL BUDGET

## Opportunities for Oversight and Improved Use of Taxpayer Funds

### What GAO Found

This testimony focuses on program reviews, oversight, and stewardship of taxpayer funds in three tiers: (1) areas vulnerable to fraud, waste, abuse, and mismanagement. For example, payments made to ineligible recipients drain resources that could otherwise go to the intended beneficiaries of a program. Everyone should be concerned about the diversion of resources and subsequent undermining of program integrity. (2) improving the economy, efficiency and effectiveness of federal programs and activities to enhance and maintain government performance. (3) fundamental reassessment and reprioritization of government programs, policies & activities to meet the challenges of the 21<sup>st</sup> century, especially in light of the demographic tidal wave looming on our fiscal horizon.

Each of these tiers is relevant to the areas on which the Committee is focusing attention as part of this hearing: Social security programs, Medicare, and tax compliance and preferences.

- The Social Security Administration (SSA) must modernize its disability programs to bring them in line with the current status of science, medicine, technology, law, and labor market conditions. GAO placed federal disability programs on its high-risk list in 2003 to focus attention on this multi-agency challenge. SSA needs also to ensure the integrity of its programs, and in particular should give continuing management attention to problems in the SSI program.
- Medicare is one of the largest and most complex programs in the federal government, making it highly vulnerable to waste, fraud, abuse, and mismanagement. GAO designated the Medicare program as a high-risk area in 1990, and the risk remains. Weaknesses in contractor performance and agency oversight increase the risks of improper payments, and—along with difficulties in payment setting—lead to wasteful spending. Structural reform is also necessary given the pressures of demographics and rising health care costs.
- Ensuring that taxpayers meet their tax obligations under an increasingly complex tax code has long presented the Internal Revenue Service (IRS) with daunting challenges. The potential revenue losses and the threat to voluntary compliance make the collection of unpaid taxes a high-risk area. Congress and others have been concerned that declines in IRS's enforcement programs are eroding taxpayers' confidence in the fairness of our tax system. Further, any reassessment of government's activities must include tax preferences. These often are not subject to the same review processes applied to spending programs but, given their growth and importance, they must be part of any comprehensive approach to the challenges ahead.

Mr. Chairman, Mr. Rangel, members of the Committee

It is a pleasure to be here today as you deal with one of your important obligations—to exercise oversight over the use of taxpayer funds. No government should waste its taxpayers’ money, whether we are operating during a period of budget surpluses or deficits. And, as you all recognize, waste, fraud, abuse, and mismanagement are not victimless activities. Our resources are not unlimited, and when they are diverted for inappropriate, illegal, inefficient, or ineffective purposes, both taxpayers and legitimate program beneficiaries are cheated. Both the Administration and the Congress have an obligation to safeguard benefits for those that deserve them and avoid abuse of taxpayer funds by preventing such diversions. Beyond preventing obvious abuse, government also has an obligation to modernize its priorities, practices, and processes so that it can meet the demands and needs of today’s changing world. More broadly, the federal government must reexamine the entire range of policies and programs—entitlements, discretionary spending, and tax preferences<sup>1</sup>—in the context of the 21<sup>st</sup> century. Both the Congress and the executive branch have a fiduciary and stewardship obligation to gain control over our fiscal future.

Periodic reexamination and revaluation of government activities has never been more important than it is today. Our nation faces large and growing long-term fiscal challenges. Increased pressure also comes from world events: both from the recognition that we cannot consider ourselves “safe” between two oceans—which has increased demands for spending on homeland security—and from the U.S. role in an increasingly interdependent world. Government also faces increased demands from the American public for modern organizations and workforces that are results-oriented, capable, responsive, agile, and accountable.

This committee has jurisdiction over some of the most important programs in the federal government: Social Security—including related programs such as SSI—Medicare, and TANF. As the committee with jurisdiction over our tax system—over raising the revenue to finance government’s activities—you also oversee the growing number of “programs” conducted through the tax code in the form of tax preferences. By anyone’s definitions, your oversight agenda is massive. It is important that you take it seriously. Today’s hearing is a positive step in this regard.

And, of course, as everyone on this committee knows well, today discretionary spending makes up less than 40 percent of the budget. Net interest and other mandatory spending<sup>2</sup>—including

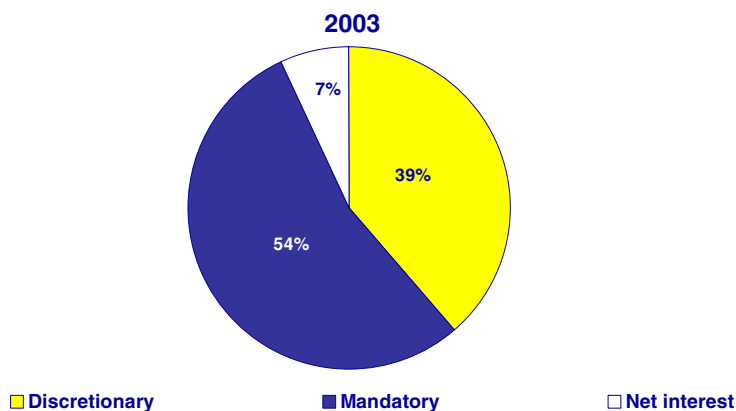
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<sup>1</sup> In this testimony the term “tax preferences” is used to describe provisions in the tax code sometimes referred to as “tax incentives” or “tax expenditures.” “Tax expenditures” are defined under the Congressional Budget and Impoundment Control Act of 1974 as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.” The Joint Committee on Taxation describes tax expenditures as including any reductions of income tax liabilities that result from special tax provisions or regulations that provide tax benefits to particular taxpayers.

<sup>2</sup> While Social Security and Medicare are the largest direct spending or mandatory programs, this category also includes such others as farm price supports, insurance programs, food stamps, TANF block grants to the states, federal civilian and military pension and health.

the programs under your control—represent over 60 percent of the federal budget. Figure 1 shows the composition of federal spending in 2003. Including the Iraq war supplemental mandatory spending makes up 54 percent of the budget--up from 25 percent in 1963 before the creation of Medicare and 45 percent in 1983.<sup>3</sup> If you look only at programmatic spending (i.e., excluding interest on the debt) the shares are 58 percent mandatory and 42 percent discretionary.

**Figure 1: Composition of Federal Spending, 2003**



Source: GAO analysis of data from the Congressional Budget Office.

Note: Includes \$41 billion in discretionary spending and about \$1 billion in mandatory spending for the Iraq war supplemental. Includes \$11 billion in mandatory spending for the 2003 tax cut package.

Direct, or mandatory, spending programs and tax preferences are by definition assumed in the baseline and not automatically subject to annual congressional decisions as are appropriated discretionary programs. In our view, a periodic reassessment of these programs and tax preferences is critical to achieving fiscal discipline in the budget as a whole. Moreover, such a review can help ascertain whether these programs are protected from the risk of fraud, waste, and abuse, and are designed to be as economical, efficient, and effective as possible.

As you know, the Budget Resolution directs GAO to prepare a report identifying “instances in which the committees of jurisdiction may make legislative changes to improve the economy, efficiency, and effectiveness of programs within their jurisdiction.” My testimony draws in part on some of the items that will be included in that report, which is due August 1, 2003. You asked me today to focus on several areas within this Committee’s jurisdiction: Social Security and disability, unemployment insurance, Medicare, and tax preferences and compliance activities.

<sup>3</sup> Excluding the Iraq war supplemental the figures are 56 percent mandatory and 37 percent discretionary.

With me today are four GAO Directors with detailed knowledge in these areas: Barbara Bovbjerg of our Education, Workforce and Income Security Team [Social security, disability], Leslie Aronovitz and Laura Dummit of our Health Care Team [Medicare] and Michael Brostek who is a Tax Director in our Strategic Issues Team.

In this testimony, I will discuss program reviews, oversight, and stewardship of taxpayer funds on three levels:

- First are those areas vulnerable to fraud, waste, abuse, and mismanagement. Payments to ineligibles drain resources that could otherwise go to the intended beneficiaries of a program. Everyone should be concerned about the diversion of resources and subsequent undermining of program integrity.
- Second, and more broadly, policymakers and managers need to look at ways to improve the economy, efficiency, and effectiveness of federal functions, programs, and policies—including specific tax preferences. Even where we agree on the goals, numerous opportunities exist to streamline, target, and consolidate programs to improve their delivery. This means looking at program consolidation, at overlap, and at fragmentation. It means improved targeting in both spending programs and tax preferences.
- Finally, a fundamental reassessment of government programs, policies, and activities can help weed out programs that are outdated, ineffective, unsustainable, or simply a lower priority than they used to be. In most federal mission areas national goals are achieved through the use of a variety of tools and, increasingly, through the participation of many organizations, such as state and local governments and international organizations, that are beyond the direct control of the federal government. Government cannot accept as “givens” all of its existing major programs, policies, and operations. A fundamental review, reassessment, and reprioritization of what the federal government does, how it does it, and in some cases, who does the government’s business will be required, particularly given the demographic tidal wave that is starting to show on our fiscal horizon.

Before turning to the three program areas on which you asked us to focus today, let me briefly discuss each of the three levels of review.

### **Addressing Vulnerabilities to Fraud, Waste, Abuse, and Mismanagement**

Programs and functions central to national goals and objectives have been hampered by daunting financial and program management problems, exposing these activities to fraud, waste, abuse, and mismanagement. These weaknesses have real consequences with large stakes that are important and visible to many Americans. Some of the problems involve the waste of scarce federal resources. Other problems compromise the ability of the federal government to deliver critically needed services, such as ensuring airline safety and efficiently collecting taxes. Still others may undermine government’s ability to safeguard critical assets from theft and misuse.

In recent years, GAO's work across the many areas of government program and operations has highlighted threats to the integrity of programs which prompt potential for fraud, waste, abuse, and mismanagement. As the sections in this testimony on social security programs and unemployment insurance, health care, and tax issues illustrate, much of our work for the Congress is in fact dedicated to helping redesign programs and improve management to address these long standing problems, in areas ranging from uncollected taxes—both corporate and individual—to critical entitlement programs that provide health and social services.

In 1990, GAO began a program to report on government operations we identified as “high risk.” This label has helped draw attention to chronic, systemic performance and management shortfalls threatening taxpayer dollars and the integrity of government operations. Over the years GAO has made many recommendations to improve these high-risk operations. We discovered that the label often inspired corrective action—indeed 13 areas have come off the list since its inception. For each of these areas, we focus on (1) why the area is high-risk; (2) the actions that have been taken and that are under way to address the problem since our last update report and the issues that are yet to be resolved; and (3) what remains to be done to address the risk.

In January of this year we provided an update for the 108<sup>th</sup> Congress, giving the status of high-risk areas included in our January 2001 report and identifying new high-risk areas warranting attention by the Congress and the administration.<sup>4</sup> GAO's 2003 high-risk list is shown in Attachment I. This Committee has jurisdiction over a number of these areas. Lasting solutions to high-risk problems offer the potential to save billions of dollars, dramatically improve service to the American public, strengthen public confidence and trust in the performance and accountability of our national government, and ensure the ability of government to deliver on its promises. We have noted that continued congressional interest and oversight, such as that exemplified by this hearing today are of crucial importance. In addition, perseverance by the administration in implementing needed solutions is needed. The administration has looked to our recommendations in shaping government-wide initiatives such as the President's Management Agenda, which has at its base many of the areas we have previously designated as high risk.

Clearly progress has been made in addressing most of the areas on our current high risk list, both through executive actions and congressional initiatives. However, many of these problems and risks are chronic and long standing in nature and their ultimate solution will require persistent and dedicated efforts on many fronts and by many actors over a period of time. Some will require changes in laws to simplify or change rules for eligibility, provide improved incentives or to give federal agencies additional tools, such as additional tools to track and correct improper payments. Continued progress in improving agencies' financial systems, information technology, and human capital management will be vital in attacking and mitigating risks to federal program integrity. Some areas may indeed require additional investments in people, process, and technology to provide effective information, oversight, and enforcement that protects programs from abuse. Ultimately, a transformation will be needed in the cultures and operations of many agencies to permit them to manage risks and foster the kind of sustained improvements in program operations that is called for. Continued persistence and perseverance in addressing the high-risk areas will ultimately yield significant benefits for the taxpayers over time. Finding

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<sup>4</sup> U.S. General Accounting Office, *High-Risk Series: An Update*, GAO-03-119 (Washington, D.C.: January 2003).

lasting solutions offers the potential to achieve savings, improve services, and strengthen public trust in government.

### **Improving Economy, Efficiency, and Effectiveness**

Important as safeguarding funds from fraud, waste, abuse, and mismanagement is, I believe that for long-lasting improvements in government performance the federal government needs to move to the next step: to pursue widespread opportunities to improve the economy, efficiency, and effectiveness of existing federal goals and program commitments. The basic goals of many federal programs—both mandatory and discretionary—enjoy broad support. That support only makes it more important for us to pay attention to the substantial opportunities to improve cost effectiveness and the delivery of services and activities. No activity should be exempt from some key questions about its design and management.

#### **Key Questions for Program Oversight**

- Is the program targeted appropriately?
- Does the program duplicate or even work at cross purposes with related programs and tools?
- Is the program financially sustainable and are there opportunities for instituting appropriate cost sharing and recovery from nonfederal parties including private entities that benefit from federal activities?
- Can the program be made more efficient through reengineering or streamlining processes or restructuring organizational roles and responsibilities?
- Are there clear goals, measures and data with which to track progress, results costs, and benefits?

GAO's work illustrates numerous examples where programs can and should be changed to improve their impact and efficiency.

For example, our work has shown that scarce federal funds could have a greater impact on program goals by improving their targeting to places or people most in need of assistance. Poorly targeted funding can result in providing assistance to recipients who have the resources and interest to undertake the subsidized activity on their own without federal financing. Moreover, lax eligibility rules and controls can permit scarce funds to be diverted to clients with marginal needs for program funds. Federal grant programs with formula distributions to state and local



governments could be better targeted to places with high needs but low fiscal capacity. Other programs should be re-examined for perverse incentives (e.g. flood insurance, which provides an incentive to rebuild in areas vulnerable to flooding).

GAO's work over the years has also shown that numerous program areas are characterized by significant program overlap and duplication. In program area after program area, we have found that unfocused and uncoordinated programs cutting across federal agency boundaries waste scarce resources, confuse and frustrate taxpayers and beneficiaries and limit program effectiveness.

And finally, the allocation of costs that once made sense when programs were created needs to be periodically reexamined to keep up with the evolution of markets. In some cases, private markets and program beneficiaries can play greater roles in financing and delivery of program services.

## **Reassessing What Government Does**

I have talked about the need to protect taxpayer dollars from fraud, waste, abuse, and mismanagement and about the need to take actions improving the economy, efficiency, and effectiveness of government programs, policies, and activities. However, to meet the challenges of today and the future, we must move beyond these levels to undertake a more fundamental reassessment of what government does and how it does it.

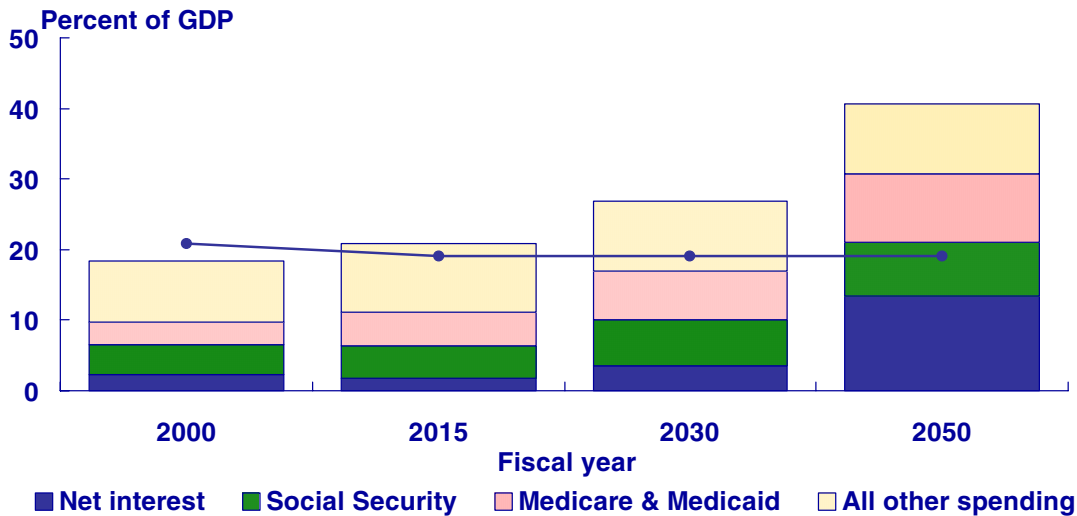
In part, this requires looking at current federal programs—both spending and tax—in terms of their goals and results. Why does the program/activity exist? Is the activity achieving its intended objective? If not, can it be fixed? If so, how? If not, what other approaches might succeed in achieving the goal/objective? More fundamentally, even if a program or activity is achieving its stated mission—or can be “fixed” so that it does so—where does it fit in competition for federal resources? Are the taxpayers getting a good “return on investment” from the program? Is its priority higher or lower today given the nation's evolving challenges and fiscal constraints?

A fundamental reassessment also requires asking whether an existing program, policy, or activity “fits” the world that we face today and will face in the future. It is important not to fall into the trap of accepting all existing activities as “givens” while subjecting new proposals to greater scrutiny than existing ones undergo. Think about how much the world has changed in the past few decades and how much it will change in future years. We need a fundamental reassessment and reconsideration of “the base.” We need to ask: What is the purpose? What tools are used? What resources? What are the results? What are the costs and benefits? Who benefits? What other programs or activities exist in the same area or with the same goal? How do they compare?

I do not need to tell this Committee that any discussion about the role of the federal government, about the design and performance of federal activities, and about the near-term federal fiscal outlook takes place within the context of two dominating facts: a demographic tidal wave is on the horizon, and it, combined with rising health care costs, threatens to overwhelm the nation's fiscal future. The numbers do not add up. The fiscal gap is too great for any realistic

expectation that the country can grow its way out of the problem. Figure 2 is just one illustration of this.

**Figure 2: Composition of Spending as a Share of GDP**



Source: GAO's March 2003 analysis.

Note: Assumes currently scheduled Social Security benefits are paid in full throughout the simulation period.

Now, Mr. Chairman, Mr. Rangel, members of the Committee, let me turn to each of the areas that are the subject of this hearing: Social Security programs and unemployment insurance, Medicare, and tax compliance activities and preferences. In each of these areas the three levels of review I described are relevant: vulnerability to fraud, waste, abuse, and mismanagement; improvements in economy, efficiency, and effectiveness; and, finally, re-examining what government does, how it does business, and sometimes who does the government's business. Needless to say, I will not be discussing all the challenges faced in these program areas or by the departments and agencies that administer them.

### **SOCIAL SECURITY PROGRAMS**

The Social Security Administration (SSA) faces a number of difficult management and policy challenges. This Committee has shown great leadership in pressing SSA to address such concerns, and indeed has achieved many management improvements that have saved millions of dollars, but much remains to be done. First, the agency needs to ensure the integrity of its three programs—Old Age and Survivors Insurance (OASI), Disability Insurance (DI), and Supplemental Security Income (SSI). In particular, it needs to provide continuing management attention to problems in the SSI program, including monitoring new initiatives to correct program weaknesses, and addressing the continuing problem of program complexity. Second, SSA must focus on improving the economy, efficiency, and effectiveness of these programs. SSA urgently needs to address the disappointing results of its efforts to improve the disability claims process it currently uses. Further, the Government Pension Offset (GPO) and the

Windfall Elimination Provision (WEP) both need attention to assure they are administered effectively and equitably. Third and finally, SSA must focus on modernizing its disability programs. GAO has placed modernizing federal disability programs on its high-risk list in recognition of the transformation these programs must undergo to serve the needs of 21st century Americans.

### SSA Needs to Continue to Strengthen the Integrity of the SSI Program of SSA's Programs

SSI is the nation's largest cash assistance program for the poor. The SSI program poses a special challenge for SSA because, unlike its insurance programs (OASI and DI), SSI is a means-tested program. For this reason, SSA must collect and verify information on income, resources, and recipient living arrangements to determine initial and continuing eligibility for the program.

We designated SSI a high-risk program in 1997, after several years of reporting on specific instances of abuse and mismanagement, increasing overpayments, and poor recovery of outstanding SSI overpayments. In response to our high-risk designation, SSA made sufficient progress in improving SSI's financial integrity and management to warrant removing its high-risk designation earlier this year. SSA's actions included developing a major legislative proposal with numerous overpayment deterrence and recovery provisions. Many of these provisions were incorporated into the Foster Care Independence Act, which passed in 1999 thanks to the leadership of this Committee. The act directly addresses a number of our prior recommendations and provides SSA with additional tools to prevent and recover overpayments. SSA also took a number of internal administrative actions to strengthen SSI program integrity, many in response to GAO recommendations.<sup>5</sup> These include using tax refund offsets for collecting SSI overpayments and more frequent automated matches to identify ineligible SSI recipients living in nursing homes and other institutions.

Although SSA's current initiatives demonstrate a stronger management commitment to SSI integrity and have the potential to significantly improve program management, challenges remain. In prior work, we have reported that SSI living arrangement and in-kind support and maintenance policies used by SSA to calculate eligibility and benefit amounts were complex, prone to error, and a major source of overpayments.<sup>6</sup> We also recommended that SSA develop options for simplifying the program. Although SSA is considering various options, it has not moved forward in recommending specific proposals for change.

Our current work, to be issued by the end of this month for the Human Resources Subcommittee, suggests that some of these complex policies—such as living arrangements—remain a problem. In recent years, SSA has identified a general increase in the amount of annual overpayments made to (1) individuals who are found to have violated program residency requirements, or (2) recipients who leave the United States and live outside the country for more than 30 consecutive

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<sup>5</sup> U.S. General Accounting Office, *Supplemental Security Income: Action Needed on Long-Standing Problems Affecting Program Integrity*, GAO/HEHS-98-158 (Washington, D.C.: Sept. 14, 1998).

<sup>6</sup> GAO/HEHS-98-158.

days without informing SSA. The Social Security Act requires that an individual be a resident of the United States to be eligible for SSI benefits.<sup>7</sup> SSA guidelines define a resident as a person who has established a dwelling in the United States with the intent to live in the country. The Act also stipulates that no individual is eligible for SSI benefits for any full month that the individual is outside the United States.<sup>8</sup> Further, an individual who is outside the United States for 30 consecutive days cannot be eligible for SSI benefits until he or she has been back in the country for 30 days. SSA detected overpayments of \$118 million for residency violations between 1997 and 2001, but interviews with OIG and agency officials suggest that the agency detects only a portion of the violations that occur each year, at least in some parts of the country.

We identified three kinds of weaknesses which impede SSA's ability to detect and deter residency violations: First, in asking SSI recipients about their current residence, field staff often rely on recipients' own assertions and may accept only minimal documentation from them, such as rent receipts and statements from neighbors or clergy. Recipients who wish to misreport their residency can manipulate such documents. Second, the agency makes limited use of tools at its disposal to detect possible violators. For example, while SSA routinely employs a risk analysis system to identify SSI recipients who are more likely to incur overpayments, it does not use this tool to specifically consider and target potential residency violators. Finally, SSA has not adequately pursued the use of independent, third party data, such as recipient bank account information, to help detect residency violations. Although SSA is currently working with an independent contractor to obtain access to SSI recipients' financial data, the agency plans to use the information only to verify their financial resources. It does not plan to use the information to detect those who may be living and making financial transactions outside the United States for extended periods of time.

As a consequence of the SSI program's problems, we believe that sustained management attention continues to be necessary to improve SSI program integrity. Following our most recent review of SSA's progress,<sup>9</sup> the agency agreed with our recommendations to (1) sustain and expand its program integrity activities underway and continue to develop additional tools to improve program operations and management, (2) identify and move forward with implementing cost-effective options for simplifying complex policies, (3) evaluate current policies for applying penalties for individuals who fail to report essential eligibility information and remove barriers to their use and effectiveness, and (4) reexamine its policies for waiving recovery of SSI overpayments

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<sup>7</sup> See 42 U.S.C. sec. 1382c(a)(1)(B)(i).

<sup>8</sup> See 42 U.S.C. sec. 1382(f).

<sup>9</sup> U.S. General Accounting Office, *Supplemental Security Income: Progress Made in Detecting and Recovering Overpayments, but Management Attention Should Continue*, GAO-02-849 (Washington, D.C.: Sept. 16, 2002).

## Improving the Economy, Efficiency, and Effectiveness of SSA's Programs

As important as ensuring the integrity of SSA's programs is, the agency also faces difficult challenges in improving the economy, efficiency, and effectiveness of its programs, including administering certain provisions of the Social Security Act such as the Government Pension Offset (GPO) and the Windfall Elimination Provision (WEP). Most importantly, the agency must place greater emphasis on improving its flawed disability claim process.

### *Administration of the Government Pension Offset and Windfall Elimination Provision Remains a Concern*

The GPO and the WEP reduce Social Security benefits for those who receive noncovered pension benefits.<sup>10</sup> The GPO affects spouse and survivor benefits and the WEP affects retired worker benefits. Both provisions depend on having complete and accurate information on receipt of noncovered pension benefits. However, such information is not always available for the state and local pension plans that do not participate in Social Security. In particular, our prior work found that SSA is often unable to determine whether applicants should be subject to the GPO and WEP because it does not have access to any independent source of noncovered pension information. Thus, both the GPO and WEP have proven difficult for SSA to administer. To help correct this situation, we previously recommended that SSA work with the Internal Revenue Service (IRS) to revise the reporting of pension information on IRS Form 1099R, so that SSA would be able to identify people receiving a pension from noncovered employment, especially in state and local governments.<sup>11</sup> However, IRS does not believe it can make the recommended change without new legislative authority. Thus, in a recent testimony before the Ways and Means Social Security Subcommittee, we recommended that the Congress consider giving the Service the authority to collect this information.<sup>12</sup> We estimate that millions of dollars in reduced overpayments could be achieved by implementing such payment controls.

In addition to this administrative problem, we continue to be concerned about the GPO "last day" exemption. As you know, the GPO prevents workers from receiving a full Social Security spousal benefit on top of a pension earned from government employment not covered by Social Security. However, the law provides an exemption from the GPO if an individual's last day of state/local employment is in a position that is covered by both Social Security and the state/local government's pension system. In a recent study, we found instances where individuals performed

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<sup>10</sup> Social Security's provisions regarding public employees are rooted in the fact that about one-fourth of them do not pay Social Security taxes on the earnings from their government jobs. Even though these noncovered employees may have many years of earnings on which they do not pay Social Security taxes, they can still be eligible for Social Security benefits based on their spouses' or their own earnings in covered employment.

<sup>11</sup> See U.S. General Accounting Office, *Social Security Administration: Better Payment Controls for Benefit Reduction Provisions Could Save Millions*, GAO/HEHS-98-76 (Washington, D.C.: Apr. 30, 1998).

<sup>12</sup> See U.S. General Accounting Office, *Social Security: Issues Relating to Noncoverage of Public Employees*, GAO-03-710T (Washington, D.C.: May 1, 2003).

work in Social Security covered positions for short periods to qualify for the GPO last-day exemption. The practices we identified in Texas and Georgia alone could increase long-term benefit payments from the Social Security Trust Fund by \$450 million. In response to a recommendation we made, this committee—and subsequently the full House—passed the Social Security Protection Act of 2003 (H.R. 743), which includes a provision to lengthen the time period to qualify for the GPO exemption from 1 day to 5 years. The bill is still pending in the Senate, and if passed, will narrow this loophole significantly.

### *Efforts to Improve the Disability Claims Process Have Been Disappointing*

SSA's disability determination process is time-consuming, complex, and expensive. Although the agency has been working for years to improve this process, ensuring the quality and timeliness of its disability decisions remains one of SSA's greatest unmet challenges. Individuals initially denied benefits by SSA who appeal their claims may wait a year or more for a final decision on their eligibility. These long waits result, in part, from complex and fragmented decision-making processes that are laden with many layers of reviews and multiple handoffs from one person to another. The demanding nature of the process can be seen in the cost of administering the DI and SSI programs. Although SSI and DI program benefits account for less than 20 percent of SSA's total benefit payments, they consume nearly 55 percent of the annual administrative resources.

SSA has also had difficulty ensuring accurate and consistent decisions regarding a claimant's eligibility for disability benefits across all levels of the decision-making process. Our work shows that in fiscal year 2000, about 40 percent of the applicants whose cases were denied at the initial level appealed this decision and about two-thirds of those who appealed were awarded benefits at a hearing.<sup>13</sup> The large proportion of cases awarded benefits at the hearings level and the potential inconsistency of decisions at these two levels has raised questions about the fairness, integrity, and cost of SSA's disability programs.

SSA is at a crossroads in its efforts to redesign and improve its disability claims process. SSA's new Commissioner has acknowledged the limited progress to date, has made the issue one of the agency's priorities, and has taken the first steps to address this problem. However, as we testified in May 2002, the agency's past experience may argue for SSA to undertake a new and comprehensive analysis of the fundamental issues impeding progress.<sup>14</sup> Such an analysis should include reassessing the root causes contributing to the programmatic weaknesses in the agency's disability determination process that we noted earlier. The outcome of this analysis may, in some cases, require legislative changes to the disability determination process.

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<sup>13</sup> U.S. General Accounting Office, *Social Security Disability: Efforts to Improve Claims Process Have Fallen Short and Further Action is Needed*, GAO-02-826T (Washington, D.C.: June 11, 2002).

<sup>14</sup> U.S. General Accounting Office, *Social Security Administration: Agency Must Position Itself Now to Meet Profound Challenges*, GAO-02-289T (Washington, D.C.: May 2, 2002).

## Reassessing What Government Does: Disability Programs Must be Modernized

Although SSA's disability claims process requires urgent management attention, the *policies* underlying federal disability programs also require transformation. Federal disability programs represent an example of a disconnect between program design and today's world—a disconnect great enough to warrant our designation as a high-risk area this year.<sup>15</sup> Already growing, SSA's disability programs are poised to surge as baby-boomers age, yet the programs remain mired in outdated economic, workforce, and medical concepts and are not well positioned to provide meaningful and timely support to Americans with disabilities. These outdated concepts persist despite scientific advances and economic and social changes that have redefined the relationship between impairments and the ability to work. In addition, while SSA has taken some steps in trying to return beneficiaries to work, it has not developed, as we have recommended, a comprehensive return-to-work strategy that focuses on identifying and enhancing beneficiaries' work capacities.

Over the last 10 years, the number of working-age beneficiaries of the DI and SSI programs has increased by 38 percent even as changes in medicine, technology, society, and the nature of work have increased the potential for some people with disabilities to return to, or remain in, the labor force. In addition, legislative changes have also focused on returning disability beneficiaries to work. Specifically, the Americans with Disabilities Act of 1990 supports the premise that people with disabilities can work and have the right to work and the Ticket to Work and Work Incentives Improvement Act of 1999 increased beneficiaries' access to vocational services.

About 12 years ago, SSA began reviewing relevant medical advances and updating the criteria used to evaluate disability claims.<sup>16</sup> SSA's efforts to update the criteria were curtailed in the mid-1990s by staff shortages, competing priorities, and lack of adequate research on disability issues. The updates resumed in 1998, but progress has been slow and the lengthy time frames could undermine the very purpose of an update.

Using outdated information calls into question the validity of disability decisions and raises the risk of overcompensating some individuals while under compensating or inappropriately denying compensation entirely to others. SSA needs to reexamine the criteria—both medical and vocational—it uses to determine whether individuals are eligible for benefits.

Even if SSA modernizes its criteria, it will continue to face difficulties in returning beneficiaries to work, in part, due to weaknesses in the design of the disability programs.<sup>17</sup> The current process produces a strong incentive for applicants to establish their inability to work to qualify for benefits. Moreover, instead of receiving assistance to stay in the workforce or return to

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<sup>15</sup> GAO-03-119.

<sup>16</sup> These updates include adding or dropping conditions that qualify one for benefits, modifying the criteria needed to establish the presence and severity of certain medical conditions, and wording changes for clarification and guidance in decision making.

<sup>17</sup> U.S. General Accounting Office, *SSA Disability: Program Redesign Necessary to Encourage Return to Work*, GAO/HEHS-96-62 (Washington, D.C.: Apr. 24, 1996).

work—and thus to stay off the long-term disability rolls—an individual can obtain assistance through DI or SSI only by proving his or her inability to work. And even in its efforts to redesign the decision-making process, SSA has yet to incorporate into these initiatives an evaluation of what an individual may need to return to work.

Although the agency has taken a number of actions to improve its return-to-work practices, it has achieved poor results in this arena and few DI and SSI beneficiaries leave the disability rolls to work. As we have recommended previously, SSA still needs to move forward in developing a comprehensive return-to-work strategy that integrates, as appropriate, earlier intervention, including earlier and more effective identification of work capacities and the expansion of such capacities by providing essential return-to-work assistance for applicants and beneficiaries.<sup>18</sup>

Modernizing and fully incorporating work-oriented policies in the disability programs requires fundamental change, such as revisiting the programs' basic orientation. Such a reorientation would require examining complex program design issues such as beneficiaries' access to medical care and assistive technologies, the benefits offered and their associated costs, mechanisms to return beneficiaries to work, as well as the integration of SSA's programs with other programs and policies affecting people with disabilities. Success in implementing fundamental change to the orientation of the disability programs will be dependent upon consultation and cooperation between the executive and legislative branches as well as cross-agency efforts, and will likely require statutory as well as regulatory action.

## **UNEMPLOYMENT INSURANCE**

We have identified program integrity weaknesses similar to those we have identified in the SSI program in another program that falls under this committee's jurisdiction: the Department of Labor's (Labor) Unemployment Insurance (UI) program. We found problems at both the federal and state level that contribute to overpayments in this program, including an insufficient balance between the need to process and pay UI claims in a timely manner with the need to control program payments.

Of the \$30 billion in UI benefits paid in calendar year 2001, Labor estimates that a total of about \$2.4 billion in overpayments occurred, including about \$577 million (24 percent) attributable to fraud or abuse. Overpayments in the UI program result from management and operational practices we identified at both the state and federal level. At the state level, we found that many states do not sufficiently balance the need to quickly process and pay UI claims with the need to control program payments. For example, we found that five of the six states we visited had diverted staff from benefit payment control operations to claims processing activities over the past year in response to increases in the volume of UI claims. Moreover, while a number of states we visited routinely use independent automated data sources to verify key information that can affect claimants' eligibility for benefits—such as an individual's wages and employment status—they also rely heavily on self-reported information from claimants for other important data, such as a claimant's receipt of other federal or state program benefits and whether they are citizens of the United States. Many of these states lack access to data sources for verifying

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<sup>18</sup> U.S. General Accounting Office, *SSA Disability: Return-to-Work Strategies From Other Systems May Improve Federal Programs*, GAO/HEHS-96-133 (Washington, D.C.: July 11, 1996).



claimants' identity in a timely manner and thus rely on verification processes that are incomplete or information sources that are only checked periodically.

In addition to the practices we identified at the state level that contribute to overpayments, we found that policies and directives from the Department of Labor affect states' priorities and procedures in a manner that makes overpayments more likely. For example, the performance measures that Labor uses to gauge states' operations tend to emphasize payment timeliness more heavily than payment accuracy. Labor has also been reluctant to link the states' performance on payment accuracy to the annual administrative budget as a way of providing incentives or sanctions for good or poor performers. Despite these problems, we found that Labor has taken actions to improve UI program integrity by working to obtain data from additional sources that could help states make more accurate eligibility decisions and developing a performance measure in its fiscal year 2003 performance plan for gauging state payment accuracy in future years. In addition, under the leadership of this committee, the House recently passed the Welfare Reform bill of 2003 (H.R. 4), which authorizes state unemployment insurance agencies to obtain wage and new hire information from the Department of Health and Human Service's National Directory of New Hires.<sup>19</sup> These data could be used to more effectively verify individuals' eligibility for UI benefits.

## **MEDICARE**

Medicare is one of the largest and most complex programs in the federal government, making it highly vulnerable to waste, fraud, abuse, and mismanagement. We placed Medicare on our list of high-risk programs more than a decade ago and it remains on that list today. In fiscal year 2002, Medicare paid about \$257 billion for a wide variety of inpatient and outpatient health care services for over 40 million elderly and disabled Americans. The Centers for Medicare & Medicaid Services (CMS) contracts with 38 health insurance companies to pay and process about 1 billion fee-for-service claims submitted each year by over 1 million hospitals, physicians, and other health care providers. Over the years, we have reported on challenges the agency has faced to safeguard billions of program dollars and obtain current and reliable data to set payments and monitor its programs. While CMS has made progress in improving Medicare's financial management, much more could be done to improve Medicare's operations.

### Oversight of Contractor Performance Critical to Program Integrity

Medicare contractors are charged with ensuring that claims are paid properly and that fraud or abuse is prevented or detected. However, contractors' performance has varied and CMS has not always overseen their efforts effectively, as the following illustrates:

- *Medical review*—Medical review is a program safeguard designed to detect improper billing and payment. Medical reviews involve detailed examinations of a sample of claims by clinically trained staff and require that physicians submit medical records to substantiate their claims. Although our assessment found that claims administration contractors' decisions to

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<sup>19</sup> This bill is currently pending in the Senate.

pay or deny claims were generally accurate, contractors were less effective at targeting for review those claims most likely to be billed inappropriately.<sup>20</sup> Furthermore, CMS did not guide the contractors in selecting the most effective criteria for medical review or encourage them to share best practices—two steps that could help reduce improper payments.

- *Communication with physicians*—In order to bill Medicare correctly, physicians need to understand program rules and how to implement billing changes as they occur. We found that contractors’ communications with physicians were often incomplete, confusing, untimely, or even incorrect—making it more difficult for physicians to bill correctly.<sup>21</sup> For example, only 15 percent of the calls we placed to contractors’ call centers asking “frequently asked questions” were answered accurately and completely by contractors’ staff. CMS has set few standards to guide claims administration contractors’ communications with physicians.

Weaknesses in contractor performance and agency oversight increase the risk of improper payment. Since 1996, the Department of Health and Human Services’ (HHS) Office of the Inspector General (OIG) has estimated that Medicare’s contractors improperly paid claims worth billions of dollars each year—more than \$13 billion in fiscal year 2002 alone. While useful to focus attention on the extent of the problem, this error rate did not provide CMS with information to target improvements. To address this shortcoming, in August 2000, CMS began implementing a new error rate measurement methodology that will provide national error rates beginning in fiscal year 2003, as well as error rates by contractor, provider type, and benefit category. Better error rate data is a first step toward enhancing CMS’s ability to hold individual Medicare contractors accountable or help contractors identify and take steps to correct problematic billing practices.

### Difficulties in Setting Appropriate Payment Rates Increase Medicare Spending

We have reported in many instances that Medicare has paid too much for items and services provided to its beneficiaries. Such wasteful spending is disturbing news for both the American taxpayer and Medicare beneficiaries, who pay higher co-payments when the amount Medicare pays is too high. While the problem of excessive Medicare payments has been clearly identified, solutions may not be quick or easy.

- *Skilled nursing facilities and home health agencies*—Medicare payments are significantly more than the cost of caring for beneficiaries in most skilled nursing facilities and by most home health agencies.<sup>22</sup> In 2000, Medicare paid nearly one quarter of skilled nursing facility

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<sup>20</sup> U.S. General Accounting Office, *Medicare: Recent CMS Reforms Address Carrier Scrutiny of Physicians’ Claims for Payment*, GAO-02-693 (Washington, D.C.: May 28, 2002).

<sup>21</sup> U.S. General Accounting Office, *Medicare: Communications With Physicians Can Be Improved*, GAO-02-249 (Washington, D.C.: Feb. 27, 2002).

<sup>22</sup> In fiscal year 2001, Medicare paid \$13 billion to skilled nursing facilities and \$9 billion for home health services.

providers over 30 percent more than costs.<sup>23</sup> In the first 6 months of 2001, Medicare paid, on average, 35 percent more than providers' costs for home health care.<sup>24</sup> We have recommended that CMS minimize excessive payments to home health agencies by introducing risk sharing.<sup>25</sup> Risk sharing would limit the total losses or gains a home health agency could experience by sharing them with the federal government. Such an approach would protect the Medicare program from overpaying for services and home health agencies from the financial risk of serving beneficiaries with greater than average needs, when those service costs are not accounted for under the current payment system.

- *Medical equipment and supplies*—Over the years, studies have shown that Medicare has been paying too much—in some cases more than three times suppliers' acquisition costs—for certain medical equipment and supplies.<sup>26</sup> For example, we estimated that Medicare could have saved over \$500 million in fiscal year 1996 if it paid rates for home oxygen services comparable to those paid by the Department of Veterans Affairs (VA).<sup>27</sup> Since then, the Balanced Budget Act of 1997 reduced oxygen payment rates by 25 percent effective in 1998, and by an additional 5 percent effective in 1999. Nevertheless, in a demonstration of competitive acquisition, CMS was able to reduce Medicare's payments by at least 16 percent more in the demonstration areas, while requiring suppliers to meet additional quality standards. Medicare pricing for medical equipment and supplies is problematic because payments are based on fee schedules that are generally tied to suppliers' historical charges to the program—not to current actual or market prices. Moreover, the process for adjusting these fees nationally has been cumbersome and rarely used.
- *Covered prescription drugs*—The pricing of covered prescription drugs—for which Medicare and its beneficiaries paid more than \$8.2 billion fiscal year 2002—is particularly

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<sup>23</sup> U.S. General Accounting Office, *Skilled Nursing Facilities: Medicare Payments Exceed Costs for Most but Not All Facilities*, GAO-03-183 (Washington, D.C.: Dec. 31, 2002).

<sup>24</sup> U.S. General Accounting Office, *Medicare Home Health Care: Payments to Home Health Agencies Are Considerably Higher than Costs*, GAO-02-663 (Washington, D.C.: May 6, 2002).

<sup>25</sup> U.S. General Accounting Office, *Medicare Home Health Care: Prospective Payment System Will Need Refinement as Data Become Available*, GAO/HEHS-00-9 (Washington, D.C.: Apr. 7, 2000) and U.S. General Accounting Office, *Medicare Home Health Care: Prospective Payment System Could Reverse Recent Declines in Spending*, GAO/HEHS-00-176 (Washington, D.C.: Sept. 8, 2000).

<sup>26</sup> Medicare fee payments and beneficiary cost sharing for medical equipment and supplies, which includes prosthetics (or artificial limbs or other body parts) and orthotics (or braces) totaled approximately \$9 billion for calendar year 2002. This category includes some drugs covered under part B, such as drugs used in a piece of equipment—for example, a nebulizer or an infusion pump.

<sup>27</sup> U.S. General Accounting Office, *Medicare: Home Oxygen Program Warrants Continued HCFA Attention*, GAO/HEHS-98-17 (Washington, D.C.: Nov. 7, 1997).

problematic. In 2000, Medicare paid over \$1 billion more than other purchasers for outpatient drugs that the program covers.<sup>28</sup> Medicare's method for establishing drug payments is flawed because it is based on 95 percent of the average wholesale price (AWP), which is neither an average, nor a price that wholesalers charge. For example, in January 2003, we reported that Medicare paid significantly more than the two major types of suppliers for blood clotting factor, which is used to treat people with hemophilia. While Medicare received a 5 percent discount from AWP, one type of supplier acquired the clotting factor at a discount of 35 percent to 48 percent.<sup>29</sup> Similarly, we reported in 2001 that pharmacy suppliers could acquire the two most common inhalation drugs, which are among the five drugs with the highest Medicare payments, for a 78 percent to 85 percent discount from AWP.<sup>30</sup> As a consequence of Medicare's pricing method, its payments are not related to market prices that physicians and suppliers actually pay.

We made two recommendations to improve drug pricing that could also be applicable to pricing for medical equipment and supplies. They are to: 1) use information on market transactions already available to VA and HHS as a benchmark for Medicare payment and 2) examine the benefits and risks of expanding competitive bidding.

CMS's recent competitive bidding demonstration to set fees for selected medical equipment, supplies, and covered outpatient drugs suggests that such competition can lead to lower prices. Preliminary annual gross savings from competitive bidding were estimated to range from 17 percent to 22 percent for the products bid compared to fee schedule amounts. However, CMS would need statutory authority to use this method of setting fees on a wider scale.

### Current Legislation Introduces Operational Changes To Address Certain Program Administration and Payment Issues

In this session of the Congress, both Houses have passed major legislation that—if reconciled and signed into law—would restructure Medicare through adding a prescription drug benefit. Depending on how it is finalized, this legislation may also introduce significant operational changes to the Medicare program.

- *Competitive contracting for claims administration*—Under Medicare's current statute and regulations, its contracting authority and practices differ from those embodied in standard federal contracting law and regulations. One key difference is that CMS generally does not

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<sup>28</sup> While Medicare does not have a comprehensive outpatient drug benefit, certain drugs and biologicals are covered under part B of the program, which also provides coverage for certain physician, outpatient hospital, laboratory, and other services to beneficiaries who pay monthly premiums. See U.S. General Accounting Office, *Medicare: Payments for Covered Outpatient Drugs Exceed Providers' Cost*, GAO-01-1118 (Washington, D.C.: Sept. 21, 2001).

<sup>29</sup> Hemophilia treatment centers and homecare companies are the two major providers of clotting factors to beneficiaries. See U.S. General Accounting Office, *Medicare: Payment for Blood Clotting Factor Exceeds Providers' Acquisition Cost*, GAO-03-184 (Washington, D.C.: Jan. 10, 2003).

<sup>30</sup> GAO-01-1118.

competitively bid for the services of its claims administration contractors. Both the Senate and the House bills amend the Medicare statute to require competitive contracting for claims administration. This authority has the potential for significantly improving Medicare program administration. Nevertheless, managing the transition to a competitive contracting environment will be an enormous new challenge. Federal agencies that manage large procurements of contracted services—such as the departments of Energy and Defense—have had problems with cost and schedule overruns and have failed to hold their contractors accountable for performance.<sup>31</sup> CMS would need to carefully manage its own contracting efforts to avoid some of the pitfalls experienced by other agencies.

- *Setting payments for medical equipment and supplies and covered outpatient drugs*—The House and the Senate bills have taken different approaches to this issue, but both have sections that are designed to address payment-setting for medical equipment, supplies, and currently covered prescription drugs. The House passed legislation that would give CMS authority to use competitive bidding to set payments for certain medical equipment, supplies, and certain drugs. It would also allow market information from these efforts to be used as a benchmark for national payments. The Senate bill continued to rely on AWP as a pricing mechanism for currently covered outpatient drugs. However, it allowed CMS to substitute payment amounts that differed from those linked to AWP, using amounts developed through a new process and based on market price information from a number of specified sources.

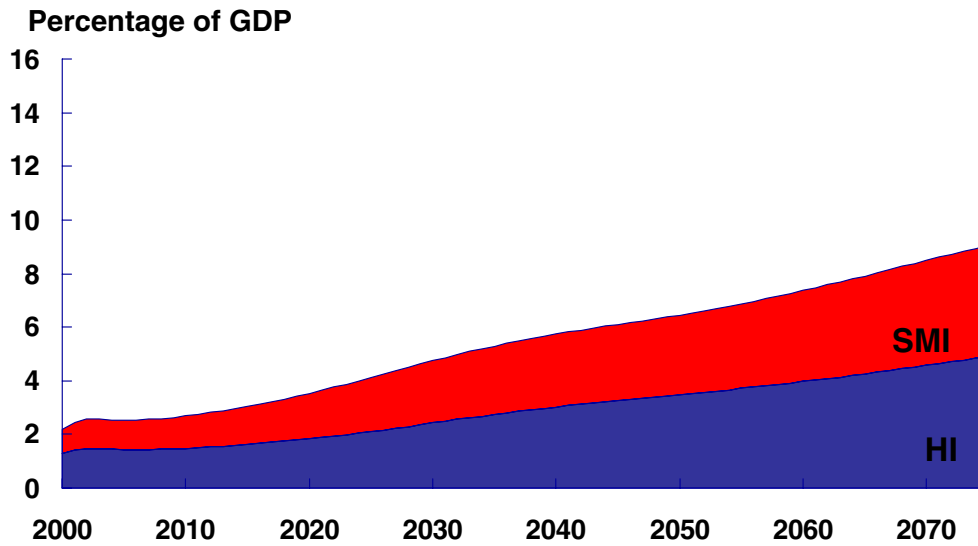
### Medicare Reform Calls for Aligning Incentives and Strengthening Accountability

The 2003 Trustees' annual report reminds us that Medicare as it is currently structured is not fiscally sustainable. The retirement of the baby boom generation will place huge fiscal pressures on the program. Between now and 2035, the number of people age 65 and older will double. Federal health and retirement spending on Medicare and Social Security are expected to increase, as people live longer and spend more time in retirement, as shown in figure 3.

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<sup>31</sup> U.S. General Accounting Office, *High-Risk Series: An Update*, GAO-01-263 (Washington, D.C.: January 2001).

Figure 3: Medicare Is Projected to Grow Dramatically As A Share of GDP



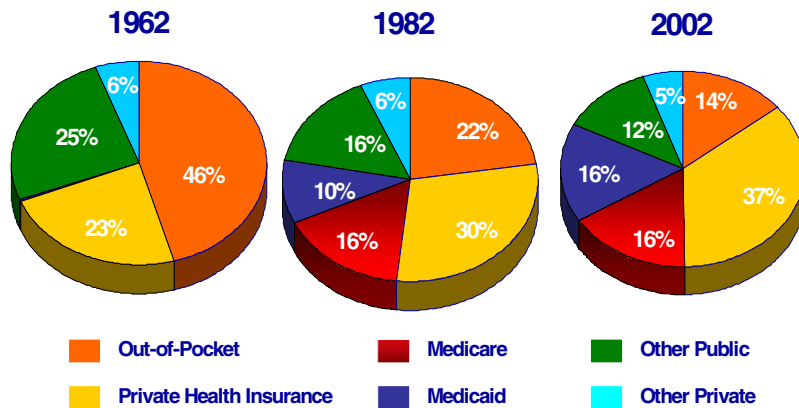
Source: CMS, Office of the Actuary

Notes: Projections are based on the intermediate assumptions of the 2003 Trustees' Reports for Hospital Insurance (HI) and Supplemental Medical Insurance (SMI).

Moreover, the baby boomers will have fewer workers to support them in retirement. Further fiscal pressures will be placed on the program by a new prescription drug benefit, although adding coverage that includes protection against financially devastating drug costs will help beneficiaries who lack prescription drug coverage.

While the demographic trends will affect both Medicare and Social Security, Medicare spending growth also reflects rising health care costs. The growth of medical technology has contributed to the number and quality of health care services, but has helped increase health care costs, which have risen faster than inflation. Consumers are less sensitive to those costs when third parties pay most of the price tag. As figure 4 shows, the percentage of health care costs paid through out-of-pocket spending has declined in the last 40 years, with private and public insurance paying a larger share.

**Figure 4: Out-of-Pocket Spending Has Declined Substantially Over The Last Four Decades**



Source: CMS, Office of the Actuary, National Health Statistics Group

Note: The figure for 2002 is estimated. Out-of-pocket spending includes direct spending by consumers on coinsurance, deductibles, and any amounts not covered by insurance. Out-of-pocket premiums paid by individuals are not counted here, but are counted as part of Private Health Insurance.

Providing tax preferences for health insurance further masks the full costs of care and can work at cross purposes to the goal of moderating health care spending. This suggests that some of the solutions to Medicare’s dilemma reside outside the program—in the larger arena of the health care system, its cost drivers, and the tax preferences that support them.

Given this context, aligning incentives to restrain spending growth and strengthen accountability within the program—while not sufficient by themselves—are still necessary. This is an ongoing effort that has to be accomplished in myriad small and large steps in the current program and as changes are made to it. At present, 84 percent of beneficiaries are in the traditional fee-for-service Medicare program. As a consequence, traditional Medicare is likely to have a significant role for years. Addressing its flaws—such as billions in improper payments and sometimes overly generous payments—is critical to any effort to restrain spending growth.

Unfortunately, addressing these flaws is unlikely to be sufficient to restrain Medicare’s growth. Substantive financing and programmatic reforms will be necessary to put Medicare on a sustainable footing for the future. Without such fundamental reforms, Medicare’s growth threatens to absorb ever-increasing shares of the nation’s budgetary and economic resources. As we seek to bring our government in line with 21<sup>st</sup> century challenges, we must be mindful that health care costs compete with other legitimate priorities in the federal budget, and their projected growth threatens to crowd out future generation’s flexibility to decide which competing priorities will be met. The public sector can play an important role in educating the nation about the limits of public support. In this regard, we are preparing a health care

framework that includes a set of principles to help policymakers in their efforts to assess various health financing reform options. By facilitating debate, the framework can encourage acceptance of changes necessary to put us on a path to fiscal sustainability.

## **TAX COMPLIANCE AND PREFERENCES**

Ensuring that taxpayers meet their tax obligations under an increasingly complex tax code has long presented the IRS with daunting challenges. Although the majority of taxpayers voluntarily and timely pay the taxes they owe, regrettably high levels of noncompliance by some taxpayers persist. Some noncompliance is intentional and may be due to outright fraud and the use of abusive tax shelters or schemes. In other cases, noncompliance stems from unintentional errors and taxpayers' misunderstanding of their obligations. Regardless of the cause or type of taxpayer—corporate, individual, or other—we have designated the collection of unpaid taxes as a high-risk area. This high-risk area includes detecting noncompliance and collecting taxes due but not paid. More broadly, Congress has created an increasing number of tax preferences that IRS must administer. In some cases, those tax preferences are among the largest federal efforts to address social and other problems. Yet the economy, efficiency, and effectiveness of those preferences in achieving their purposes are often not well understood. A better understanding of how well these preferences work would both support improving them as well as reconsidering whether certain preferences should be retained.

### Tax Compliance and Collection Activity Declines Are Of Increasing Concern

Because of the potential revenue losses and the threat to voluntary compliance, the collection of unpaid taxes is a high-risk area. Collecting taxes due the government has always been a challenge for IRS, but in recent years the challenge has grown. Collecting taxes due includes both compliance programs, like audits, that identify those who owe more than they self-report, and collection programs that seek payment of taxes assessed but not timely paid. However, IRS compliance and collections programs have seen larger workloads, less staffing, and fewer cases closed per employee.

For the last several years, Congress and others have been concerned that the declines in IRS's enforcement programs are eroding taxpayers' confidence that their friends, neighbors, and business competitors are also paying their fair share of taxes, which may put at risk their willingness to voluntarily comply with the tax laws. Further, there is some evidence that willingness to voluntarily comply with the tax laws may be declining. A survey conducted by the IRS Oversight Board in 2001 found that the percentage of respondents who thought it was never acceptable to cheat on their income taxes was 76 percent, which was down from 87 percent who felt that way in a 1999 survey. Also, 42 percent of respondents to the 2001 survey said that they believed it was more likely than in the past that people do not report and



pay their fair amount of taxes and 9 percent said that they were more likely to take a chance on being audited than they had been before.<sup>32</sup>

Unfortunately, not enough is known at present about the extent of noncompliance and where problems are the most serious. IRS only recently restarted the research program necessary to develop this information after many years without such research. When last IRS last conducted detailed compliance research using tax year 1988 data, some types of taxpayers were found to have especially serious compliance problems. For example, small business noncompliance was about 40 percent, farm and non-farm sole proprietor noncompliance was about 32 percent, and informal suppliers' noncompliance was about 81 percent.<sup>33</sup> While specific, current data is not yet available, the IRS Commissioner said in May 2002 congressional hearings that IRS was not providing taxpayers with adequate assurance that their neighbors or competitors were complying with the tax laws and paying what they owed.

The number of tax returns increases every year. Between 1993 and 2002, the number of individual returns filed went from 114.7 million to approximately 130 million—a 13 percent increase over those 10 years. IRS projects the number of total individual returns filed will be 132.3 million in 2003 and continue to increase at an annual rate of 1.5 percent until 2009. Such a rate of increase would lead to 145.3 million total individual returns filed in 2009. Returns from businesses and other entities have also increased substantially.

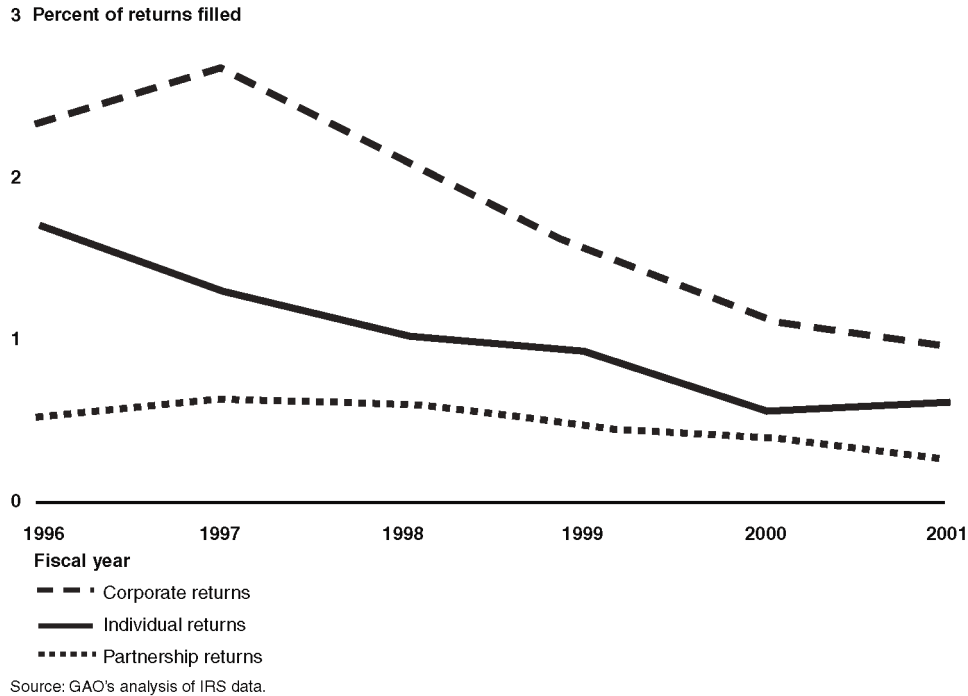
While the number of tax returns has increased, key compliance program rates have declined. In testimonies and reports, GAO has highlighted large and pervasive declines in IRS's compliance programs. These programs, not all of which have seen declines, include computerized checks for nonfiling and underreported income as well as audits of both individual taxpayers and business entities. Between 1996 and 2001, key programs generally experienced growing workloads, decreased staffing, and decreases in the number of cases closed per employee. Figure 5 shows the decline in audit rates for different types of taxpayers.

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<sup>32</sup> These two questions were new in the 2001 survey so there are not comparative figures from 1999.

<sup>33</sup> Informal suppliers are sole proprietors who operate in an informal business style, such as door-to-door sales and individuals who moonlight to augment their wage income.

**Figure 5: Change in Percentage of Returns Audited, 1996 – 2001**



Even as these audit rates decline, IRS has faced new challenges in ensuring that individuals, small businesses, and corporations pay the taxes they owe. IRS's Chief Counsel has said that, in the 1990s, thousands of corporations and wealthy individuals participated in abusive tax shelters promoted by accounting firms, law firms, investment banks, and others, and the tax benefits claimed per taxpayer were significant. To deal with this and other problems, the President's fiscal year 2004 budget proposal noted that IRS is shifting enforcement resources from the tax returns of lower-income individuals and small corporations. One recent IRS initiative resulted in 1,206 taxpayers disclosing transactions involving \$30 billion in claimed losses and deductions.

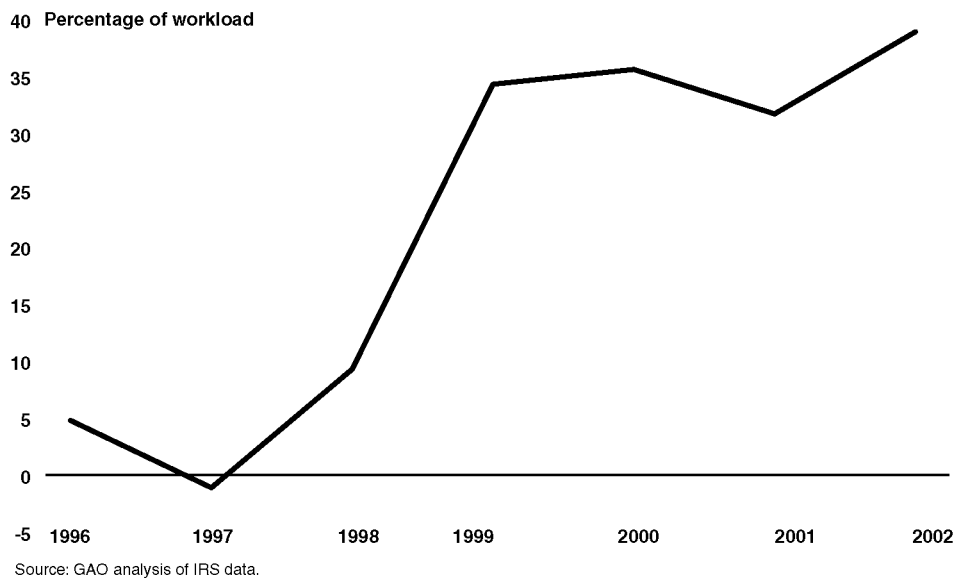
IRS faces challenges in executing its strategy for dealing with tax shelters and schemes. As the former Commissioner of Internal Revenue noted, abusive shelters have been factually and legally complex, accompanied by tax opinions legitimizing transactions and encouraging litigation. Also, in a September 2001 report, the Treasury Inspector General for Tax Administration recommended that IRS start laying a better foundation for its strategy by more precisely estimating the shelter problem. IRS agreed to estimate abusive corporate shelters' potential tax revenue effect.

Another increasingly challenging area is that of corporate inversions. According to a 2002 Department of a Treasury report, corporate inversions are transactions that change a U.S.-based multinational group's structure "so that a new foreign corporation, typically located in a low- or no-tax country, replaces the existing U.S. parent corporation as the parent of the corporate

group.”<sup>34</sup> The report stated that although such transactions were not new, they were growing in frequency, size, and profile. Instead of being motivated by market conditions, they were motivated largely by available tax savings and involved little or no immediate operational change. According to Treasury, the fact that our tax law operates so that substantial tax reductions are available through transactions of more form than substance is troubling to both policymakers and the public.

IRS collections programs are also increasingly stressed. As we reported in May 2002, between fiscal years 1996 and 2001 trends in the collection of delinquent taxes showed almost universal declines in collection program performance in terms of coverage of workload, cases closed, direct staff time used, productivity, and dollars of unpaid taxes collected.<sup>35</sup> Although the number of delinquent cases assigned to collectors went down during this period, the number of collections cases closed declined more rapidly, creating an increasing gap. During that 6-year period, the gap between the new collection workload and collection cases closed grew at an average annual rate of about 31 percent, as shown in figure 6.<sup>36</sup>

**Figure 6: Percentage Gap Between New Collection Workload and Work Completed, Fiscal Years 1996-2002**



The increasing gap between collection workload and collection work completed led IRS in March 1999 to start deferring collection action on billions of dollars in delinquencies. Officials recognized that they could not work all collection cases, and they believed that they needed to be

<sup>34</sup>Department of the Treasury, Office of Tax Policy, *Corporate Inversion Transactions: Tax Policy Implications*, (Washington, D.C.: May 17, 2002).

<sup>35</sup> U.S. General Accounting Office, *Tax Administration: Impact of Compliance and Collection Program Declines on Taxpayers*, GAO-02-674 (Washington, D.C.: May 22, 2002).

<sup>36</sup> Workload is the number of delinquent accounts assigned to field and telephone collection. Work completed is the number of delinquent accounts worked to closure, excluding accounts for which collection work has been deferred.

able to deal with taxpayers more quickly; particularly taxpayers who were still in business and owed employment taxes.<sup>37</sup>

By the end of fiscal year 2002, after the deferral policy had been in place for about 3 and one-half years, IRS had deferred taking collection action on about \$15 billion in unpaid taxes, interest, and penalties that are likely collectable. IRS's deferral of collection action has declined somewhat since the deferral policy was adopted. Although the rate has declined from 45 percent in 2000, in 2002 IRS was still deferring collection action on about one out of three collection cases—about 32 percent.

IRS is working to reverse these declines. One key element of improving IRS's compliance programs is obtaining current measures of compliance to use in targeting IRS's scarce resources to known compliance problems. The National Research Program (NRP) is a major effort now underway at IRS to identify the extent and sources of noncompliance. The current NRP initiative includes individual returns, including taxpayers reporting income from small businesses. IRS plans to conduct future iterations of NRP for different types of returns and to return to individual filers every 3 years. We have reported that the program's design is likely to yield the detailed information IRS needs about the extent and causes of noncompliance and enable IRS to improve its targeting of compliance programs.<sup>38</sup>

Another key to improving IRS's compliance and collections programs is to make more efficient use of its resources. IRS has a number of reengineering efforts underway to improve its compliance and collection processes. These efforts range from relatively small-scale improvements to much more ambitious changes. For example, IRS is seeking to substantially increase the amount of information available to its auditors before they first contact a taxpayer. The goal is to make the best use of the information IRS already has available to it before commencing an audit. IRS is also seeking to change the way it identifies collections cases to pursue in order to improve targeting of scarce collections resources towards cases that it is most worthwhile to pursue.

Yet another key to ensuring that taxpayers meet their obligations is adequately staffing IRS's compliance and collections programs. Since 2001, IRS's budget requests have made increasing its compliance and collection staff one of several key priorities. However, staffing in two key compliance and collection occupations – revenue agents and revenue officers – was lower in 2002 than in 2000. This continues a general trend of declining staffing in these occupations for a number of years.

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<sup>37</sup> IRS considers employment tax compliance to be among the most challenging issues for small business, since delinquent tax can rapidly compound beyond the employer's ability to pay. See U.S. General Accounting Office, *Tax Administration: IRS's Efforts to Improve Compliance with Employment Tax Requirements Should Be Evaluated*, GAO-02-92, (Washington, D.C.; Jan. 15, 2002).

<sup>38</sup> U.S. General Accounting Office, *Tax Administration: New Compliance Research Effort is on Track, but Important Work Remains*, GAO-02-769, (Washington, D.C.: June 27, 2002); and U.S. General Accounting Office, *Internal Revenue Service: Assessment of Fiscal Year 2004 Budget Request and 2003 Filing Season Performance to Date*, GAO-03-641T, (Washington, D.C.: Apr. 8, 2003).

While tax compliance and collection issues can be found in many areas, I would like to give a few examples of persistent compliance issues. This is by no means an inclusive list. For example, compliance issues are also pervasive in the area of excise taxes, such as fuel tax evasion.

### Employment Tax Compliance

In fiscal year 2000, IRS collected \$1.3 trillion in amounts withheld by employers from employees' salaries to cover individual federal income tax, Social Security, and Medicare taxes; and in employers' matching amounts for Social Security and Medicare taxes. Although the majority of employers withhold, match, and deposit these taxes as required, for those who fail to do so, the amount of unpaid employment taxes, penalty and interest has grown significantly. As of September 30, 2001, IRS data showed that employers owed about \$49 billion in delinquent employment taxes, penalties and interest.

The businesses that failed to remit payroll taxes were typically in wage-based industries and had few available assets from which IRS could recover these taxes. They were usually small, closely held businesses using a corporate structure. The most common types of businesses or industries with unpaid payroll taxes included construction companies and restaurants, although other types of businesses (including computer software, child care, and professional services such as legal, medical, and accounting firms) also have unpaid payroll taxes. Most unpaid payroll taxes are not fully collectible, and there is often no recovery potential as many of the businesses are insolvent, defunct, and otherwise unable to pay.

To the extent that withholdings are not forwarded to the federal government, the business is liable for these amounts, as well as its matching contributions. Under the Internal Revenue Code, individuals—typically officers of a corporation such as a president or treasurer—who are determined by IRS to be “willful and responsible” for the nonpayment of federal income taxes and the employee’s Social Security and Medicare taxes can be held personally liable for the unpaid taxes and assessed penalties. More than one individual can be found willful and responsible for a business’s failure to pay the federal government withheld payroll taxes and can be assessed a penalty. IRS considers employment tax compliance to among the most challenging issues for small businesses, since delinquent tax may rapidly compound beyond the employers’ ability to pay—ultimately placing their business in financial jeopardy.

In 2002, we reported that IRS had four programs to prevent or reduce employers’ tax delinquencies. Two of these programs were designed to achieve early contact with employers and two were designed to identify employers with existing, multiple employment tax delinquencies and help them to return to compliance. However, we found that IRS had not successfully evaluated these programs. We recommended IRS do so since without an evaluation IRS does not know the benefits, if any, of the programs, whether they need to be improved, or whether the programs should even be continued.<sup>39</sup>

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<sup>39</sup> U.S. General Accounting Office, *Tax Administration: IRS’s Efforts to Improve Compliance with Employment Tax Requirements Should Be Evaluated*, GAO-02-92 (Washington, D.C.: Jan. 15, 2002).

## Levies of Federal Payments

Many taxpayers who are delinquent in paying their federal taxes are receiving billions of dollars in federal payments annually. IRS and federal payment records indicate that nearly 1 million taxpayers owed about \$26 billion in delinquent taxes as of February 2002 and were receiving some type of federal payments. To help the IRS collect these delinquent tax debts, provisions in the Taxpayer Relief Act of 1997 gave IRS authority to continuously levy<sup>40</sup> up to 15 percent of certain federal payments made to delinquent taxpayers.<sup>41</sup> Payments subject to IRS's continuous levy program include Social Security, federal salary and retirement payments, and federal vendor payments. According to IRS, the program resulted in collecting over \$60 million in fiscal year 2002 by directly levying federal payments.

GAO has issued three reports including several recommendations focused on increasing collections and assuring that safeguards are in place so that only taxpayers with valid tax debts are levied. Although progress has been made in establishing the continuous levy program, several changes to the continuous levy program, which have yet to be implemented, could yield millions of dollars in additional revenue. For example, in our 2000 report we estimated that as much as \$77.7 million<sup>42</sup> annually in additional revenue could be generated if IRS broadened the program to include spouses held by IRS to be liable for joint tax delinquencies and individuals with multiple IRS identification numbers.<sup>43</sup> IRS has not yet implemented this recommendation.

In our 2001 report, we found that several large agencies were not included in the continuous levy program.<sup>44</sup> We found, that as of June 30, 2000, about 70,400 individuals and businesses that received an estimated \$8.2 billion annually in federal payments collectively from three large agencies—the United States Postal Service, the Department of Defense, and CMS, which disburses Medicare fee-for-service payments—owed over \$1 billion in federal taxes. We estimated that IRS could recover at least \$270 million annually in delinquent federal taxes if these payments were included in the continuous levy program.

In our 2003 report we found that IRS blocks many eligible delinquent accounts from being included in the Federal Payment Levy Program, missing an opportunity to gather information on

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<sup>40</sup> Levy is the legal process by which IRS orders a third party to turn over property in its possession that belongs to the delinquent taxpayer named in a notice of levy. A continuous levy remains in effect from the date such levy is first made until the tax debt is fully paid or IRS releases the levy.

<sup>41</sup> Specifically, the 1997 legislation allows continuous levy of “specified payments,” including nonmeans-tested federal payments, as well as certain previously exempt payments.

<sup>42</sup> The 95-percent confidence interval for the \$77.7 million ranges from \$73.5 million to \$81.9 million.

<sup>43</sup> U.S. General Accounting Office, *Tax Administration: IRS's Levy of Federal Payments Could Generate Millions of Dollars*, GAO/GGD-00-65, (Washington, D.C.: Apr. 7, 2000).

<sup>44</sup> U.S. General Accounting Office, *Tax Administration: Millions of Dollars Could be Collected if IRS Levied More Federal Payments*, GAO-01-711, (Washington, D.C.: July 20, 2001).

which debtors are receiving federal payments.<sup>45</sup> IRS officials imposed these blocks because of concerns that the potential volume of levies—about 1.4 million taxpayer accounts—would disrupt ongoing collection activities. However, we estimate that about 112,000 would actually qualify for levy. These taxpayers were collectively receiving about \$6.7 billion in federal payments and owed about \$1.5 billion in delinquent taxes. In January 2003, IRS unblocked and began matching delinquent taxpayer accounts identified as receiving a federal salary or annuity payment. IRS officials will not unblock the remaining delinquent accounts until sometime in 2005.

Earned Income Credit (EIC) Noncompliance

For tax year 2001, about \$31 billion was paid to about 19 million EIC claimants. Although researchers have reported that the EIC has generally been a successful incentive-based antipoverty program, IRS has reported high levels of EIC overpayments going back to 1985. IRS's most recent study, released in 2002, estimated that between \$8.5 and \$9.9 billion should not have been paid out to EIC claimants for tax year 1999, and earlier IRS studies also found significant problems with the program. Table 1 shows the rates of EIC overclaims estimated by IRS in three EIC compliance studies.

**Table 1: EIC Overclaim Rates for Selected Years**

Tax year	Overclaim rate estimates	
	Lower-bound	Upper-bound
1994	--	23.5
1997	23.8	25.6
1999	27.0	31.7

Source: IRS reports.

Notes: All overclaim rates were adjusted by IRS to reflect dollars recovered from ineligible recipients. For 1994 only a single estimate was available. In 1997 and 1999, because not all individuals responded to audit contacts, IRS used certain assumptions to estimate an overclaim rate range. The lower bound assumes that the overclaim rate for nonrespondents is the same as for the respondents, while the upper bound assumes that all nonrespondents are overclaims.

Administering the EIC is not an easy task—IRS has to balance its efforts to help ensure that all qualified persons claim the credit with its efforts to protect the integrity of the tax system and guard against fraud and other forms of noncompliance associated with the credit. Further, the complexity of the EIC may contribute to noncompliance. The EIC is among the more complex provisions of the tax code, which can contribute to unintentional errors by taxpayers. In addition, unlike other income transfer programs, the EIC relies more on self-reported qualifications of

<sup>45</sup> U.S. General Accounting Office, *Tax Administration: Federal Payment Levy Program Measures, Performance, and Equity Can Be Improved*, GAO-03-356, (Washington, D.C.: Mar. 6, 2003).

individuals than on program staff reviewing documents and other evidence before judging claimants to be qualified for assistance.

Early in 2002, the Assistant Secretary of the Treasury and the IRS commissioner established a joint task force to seek new approaches to reduce EIC noncompliance. The task force sought to develop an approach to validate EIC claimants' eligibility before refunds are made, while minimizing claimants' burden and any impact on the EIC's relatively high participation rate. Through this initiative, administration of the EIC program would become more like that of a social service program for which proof of eligibility is required prior to receipt of any benefit.

According to IRS, three areas—qualifying child eligibility, improper filing status, and income misreporting (i.e., underreporting)—account for nearly 70 percent of all EIC refund errors. Although the task force initiative is designed to address each of these sources of EIC noncompliance, many of the details about its implementation are still to be settled. A significant change to the initiative was announced on June 13, 2003, when IRS said that its pilot effort to precertify the eligibility of qualifying children for the EIC would not include requesting claimants to show their relationship to the qualifying child. Because planning and implementation for the EIC initiative will proceed simultaneously, its success will depend on careful planning and close management attention.

As with other tax compliance issues such as corporate tax evasion, Congress has focused oversight attention on the EIC initiative and continued oversight can help ensure that the initiative balances efforts to reduce EIC overpayments with continued efforts to maintain or increase the portion of the EIC-eligible population that receives the credit. Further, Congress can consider making the several definitions of children in the tax code more uniform. The differing definitions contribute to the complexity taxpayers face and complexity is widely believed to contribute to errors taxpayers make in claiming the EIC. As early as 1993 we had suggested that Congress consider changes that would have made the definitions for children more similar for several tax purposes. More recently, IRS's Taxpayer Advocate, the Joint Committee on Taxation, and the Department of the Treasury have made proposals as well.

#### The Economy, Efficiency, or Effectiveness of Tax Preferences Are Often Not Well Understood

Tax preferences are often intended to achieve policy goals that may be similar to those of federal spending programs. However, data on the economy efficiency, and effectiveness of tax preferences is often lacking. Further, tax preferences are not subject to some review processes that would support more integrated and informed decisions about what the government does and how it does it.

Tax preferences refer to departures from the normal tax structure designed to favor a particular industry, activity, or class of persons through special deductions, credits, and other tax benefits. Tax preferences currently in place include programs to encourage economic development in disadvantaged areas, build affordable housing, make education more accessible, reduce pollution, and stimulate capital investment, research, and development. Many tax preferences have counterparts in direct spending programs created to accomplish similar goals. In some cases, a tax preference may be among the largest federal efforts dealing with a social issue. For

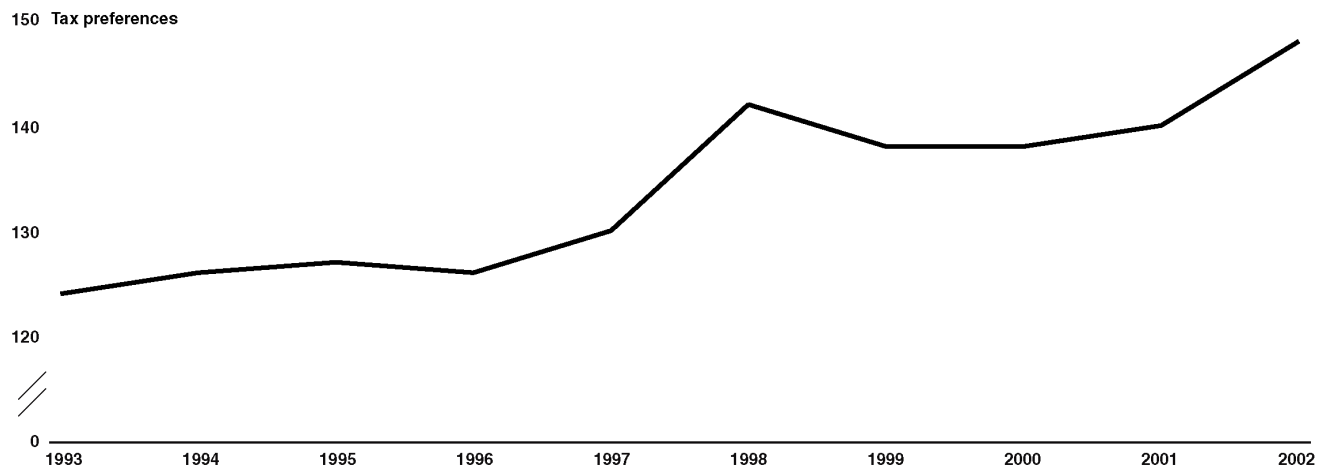


instance, we reported in 1997 that the Low-Income Housing Tax Credit was the largest federal source of federal funds to develop or substantially rehabilitate rental housing for low-income households.

Tax preferences have become a growing part of the federal fiscal picture over the past 30 years. Based on Joint Committee on Taxation estimates, the total revenue loss due to tax preferences increased by twice the rate of overall federal outlays over the last 10 years. Tax preferences grew about 50 percent, from about \$488 billion in 1993 to about \$730 billion in 2003, while federal outlays grew about 25 percent, from \$1.7 trillion to \$2.1 trillion over the same period.<sup>46</sup>

Not only has the dollar sum associated with these tax preferences grown over the past 10 years, but the number of programs has also increased. The number of tax preference programs has doubled since the Joint Committee on Taxation started reporting on them in 1974, growing from 74 to 148. As shown in figure 7, this growth continued over the past 10 years, from 124 tax preference programs in 1993 to 148 programs in 2002.<sup>47</sup> Table 2 lists the ten largest tax preference programs in terms of dollars claimed in 2002.

**Figure 7: Growth in the Number of Tax Preference Programs Listed in Joint Committee on Taxation Reports, 1993 through 2002**



Source: GAO analysis of Joint Committee on Taxation *Estimates of Federal Tax Expenditures, 1992-2002*.

<sup>46</sup> All dollar figures are reported in 2003 adjusted dollars. Though it is not precisely correct to add up all tax expenditures because some have interactive effects though they are reported individually, these figures provide a useful gauge of the general magnitude of these provisions. The tax preference figures only include the portions of the refundable child tax credit and EIC that offset income taxes paid.

<sup>47</sup> Although we refer to them as tax preferences, these annual figures come from the Joint Committee on Taxation's annual reports on tax expenditures.

**Table 2: 10 Largest Tax Preferences by Estimated Dollars Claimed in 2003**

Provision	Dollars projected for FY 2003 (in billions of dollars)	Description
Net exclusion of pension contributions and earnings: Employer Plans	83.5	Certain employer contributions to pension plans are excluded from an employee's gross income even though the employers can deduct the contributions. In addition, the tax on the investment income earned by the pension plan is deferred until the money is withdrawn.
Exclusion of employer contributions for medical insurance premiums and medical care	79.6 <sup>(a)</sup>	Employer's can deduct employer-paid health insurance premiums and other medical expenses (including long-term care) as a business expense, but they are not included in employee gross income. The self-employed may also deduct part of their family health insurance premiums.
Deductibility of mortgage interest on owner-occupied homes	69.9	Owner-occupants of homes may deduct mortgage interest limited to interest on debt no greater than the owner's basis in the residence; for debt incurred after October 13, 1987, it is limited to no more than \$1 million. Interest on up to \$100,000 of other debt (less than market value of residence) secured by a lien on a principal or second residence is also deductible.
Capital gains (except agriculture, timber, iron ore, and coal) (normal tax method)	55.3	Currently, the capital gains rate has been reduced from 20 percent to 15 percent and from 10 percent to 5 percent for taxpayers in the 10 percent and 15 percent marginal income tax bracket. The special tax rates (18 percent top rate, 8 percent for taxpayers in the 10 and 15 percent tax brackets) for assets held over 5 years have been removed.
Deductibility of nonbusiness state and local taxes other than on owner-occupied homes	50.9	Taxpayers may deduct state and local income and property taxes.
Depreciation of equipment in excess of alternative depreciation system	49.8	A tax expenditure provision that arises from the depreciation of machinery and equipment in excess of the normal tax baseline.
Step-up basis of capital gains at death	38.1	Currently the cost basis for an appreciated asset is adjusted up to the market value at the owner's death. With the repeal of the estate tax for 2010, the basis for property acquired from a decedent will be the lesser of market value or decedent's basis.
Deductibility of charitable contributions, other than education and health	34.2	Taxpayers may deduct charitable, religious, and other non-profit contributions up to 50 percent of Adjusted Gross Income. Corporations' deductions are limited to 10 percent of pre-tax income.
Earned Income Credit	34.1 <sup>(b)</sup>	The EIC is a refundable tax credit that offsets the impact of Social Security taxes paid by low-income workers and encourages low-income persons to seek work rather than welfare. The EIC is available to taxpayers with and without children and depends on the nature and amount of qualifying income and on the number of children who meet age, relationship, and residency tests.
Tax credit for children under age 17	27.1	Taxpayers with children under age 17 can qualify for a \$600 refundable per child credit. The credit is phased out for taxpayers at the rate of \$50 per \$1,000 of modified Adjusted Gross Income above \$110,000 (\$75,000 for singles).

Sources: Ten largest tax preference programs taken from program cost estimates identified in the Joint Committee on Taxation's December 2002 report, *Estimates of Federal Tax Expenditures for Fiscal Years 2003-2007*, report number JCS-5-02. Tax preference descriptions from the U.S. Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004* (Washington, DC: Government Printing Office) 2003 and Congressional Research Service, Taxation Briefing Book, *Individual Capital Gains Tax Issues*; and *Federal Taxes: Information on Payroll Taxes and Earned Income Tax Credit Noncompliance*, GAO-01-487T, March 7, 2001.

Note (a): This is the single largest health-related tax preference reported by the Joint Committee on Taxation. The Joint Committee on Taxation reports also includes other health-related tax preferences.

Note (b): The tax preference figure for the EIC only includes the portion of the EIC that offsets income taxes paid.

Despite the importance of tax preferences, the economy, efficiency, and effectiveness of tax preferences in achieving their purposes is often not well understood, in part because data on their use and effectiveness may not be available. For example, we recently studied business tax preferences to encourage the hiring, retention, and accommodation of workers with disabilities and found that information on the effectiveness of the programs was limited and inconclusive.<sup>48</sup> In 2002, we studied the use of tax preferences intended to help families meet the costs of postsecondary education and found that Congress did not have the information it needed to weigh the relative effectiveness of the range of tools created to accomplish this goal.<sup>49</sup> In 1999 we reviewed businesses' use of empowerment zone tax preferences and had to conduct our own survey to find information about businesses that were and were not using the preferences.<sup>50</sup>

When critical information about the economy, efficiency, and effectiveness of tax preferences is made available, it can be very valuable to congressional decision makers. For example, in 1993 we described the impacts of a tax credit designed to encourage investment in Puerto Rico.<sup>51</sup> This tax preference effectively exempted income earned by U.S. firms from operations in U.S. possessions from federal corporate income taxes. We found that the credit per employee was, on average, slightly higher than the wages paid per employee and in some industries was considerably higher. Congress subsequently chose to phase out the tax credit program.

A decade ago we concluded that greater scrutiny of tax preferences is warranted. We made a number of recommendations intended to achieve that end, including recommendations to OMB to incorporate tax preferences, to the extent possible, into the annual budget review process. Our intent was that tax preferences be assessed and considered along with related federal efforts so that the relative effectiveness of both spending and tax preferences could be considered jointly. However, tax preferences are still excluded from important review processes that apply to spending programs. Tax preferences are not explicitly covered by the Government Performance and Results Act (GPRA) of 1993 and therefore are not subject to its requirements that are intended to help ensure that federal programs are achieving their intended results. However, the Senate Governmental Affairs Committee Report on GPRA says that tax preferences should be taken into consideration in a comprehensive examination of government performance.<sup>52</sup> Nevertheless, tax preferences often are not currently covered by agencies or executive branch processes that consider the effectiveness of government programs. For example the new

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<sup>48</sup> U.S. General Accounting Office, *Business Tax Incentives: Incentives to Employ Workers with Disabilities Receive Limited Use and Have an Uncertain Impact*, GAO-03-39, (Washington, D.C.: Dec. 11, 2002).

<sup>49</sup> U.S. General Accounting Office, *Student Aid and Tax Benefits: Better Research and Guidance will Facilitate Comparison of Effectiveness and Student Use*, GAO-02-751, (Washington, D.C.: Sept. 13, 2002).

<sup>50</sup> U.S. General Accounting Office, *Community Development: Businesses' Use of Empowerment Zone Tax Incentives*, GAO/RCED-99-253, (Washington, D.C.: Sept. 30, 1999).

<sup>51</sup> U.S. General Accounting Office, *Tax Policy; Puerto Rico and the Section 936 Tax Credit*, GAO/GGD-93-109, (Washington, D.C.: June 8, 1993).

<sup>52</sup> Report of the Committee on Governmental Affairs, United States Senate, *Government Performance and Results Act of 1993*, (June 16, 1993, Report 103-58).

program performance reviews conducted by OMB in connection with the annual budget process generally do not cover tax preferences.

According to OMB, the Executive Branch is continuing to focus on the availability of data needed to assess the effects of the tax expenditures designed to increase savings.<sup>53</sup> Treasury's Office of Tax Analysis and IRS's Statistics of Income Division have developed a new sample of individual income tax filers as one part of this effort. This new "panel" sample will follow the same taxpayers over a period of at least 10 years. Data from this sample will enhance OMB's ability to analyze the effect of tax expenditures designed to increase savings. Other efforts by OMB, Treasury, and other agencies to improve data available for the analysis of tax expenditures are expected to continue over the next several years, according to OMB. In practice, data availability is likely to be a major challenge, and data constraints may limit the assessment of the effectiveness of many provisions. In addition, such assessments can raise significant challenges in economic modeling.

## **REASSESSING WHAT THE GOVERNMENT DOES SHOULD INCLUDE TAX PREFERENCES**

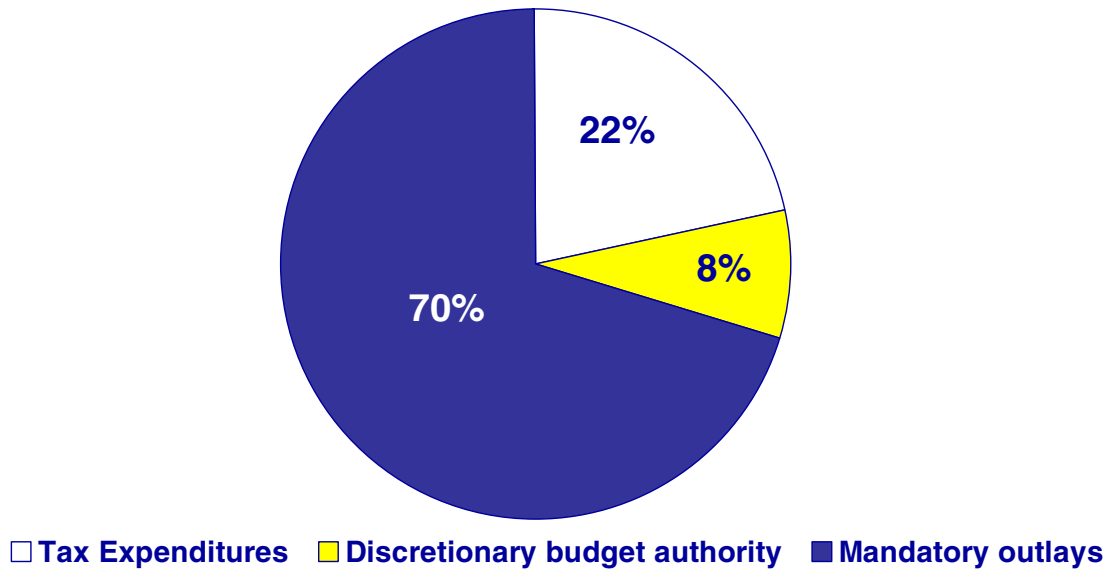
Given their growth and importance, tax preferences must be part of any comprehensive review of existing programs and activities to adapt government for the challenges of this century. Any reassessment of federal missions and strategies should include the entire set of tools the federal government can use to address national objectives. These tools include discretionary and mandatory spending, tax provisions, loans and loan guarantees, and regulations. Spending is most visible and it is all too easy when we look to define federal support for an activity to only look at the spending side of the budget. Federal support, however, may come in the form of exclusions or credits in the tax code. It may come in the form of direct loans or loan guarantees. It may come in the design of regulations. Yet none of these tools should be ignored if we are to get a true picture of federal activity in an area. So, for example, if we are evaluating federal support for health care we need to look not only at spending, but also at tax preferences. Figure 8 shows federal activity in health care and Medicare budget functions in FY 2003: \$48 billion in discretionary BA, \$419 billion in entitlement outlays, \$177 million in loan guarantees, and \$129 billion in tax expenditures.<sup>54</sup>

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<sup>53</sup> U.S. Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2004* (Washington, DC: Government Printing Office) 2003.

<sup>54</sup> This represents the sum of a number of different tax provisions.

**Figure 8: Relative Reliance on Policy Tools in the Health Care Budget Functions (FY 2003)**



Source: GAO analysis of data from the Office of Management and Budget.

Note: Loan guarantees account for about \$177 million or 0.03 percent of the approximately \$597 billion in total federal health care resources.

## CONCLUDING REMARKS

There is a Chinese curse that goes “May you live in interesting times.” We clearly do. I would prefer to see this not as a curse—but as a challenge and an opportunity.

Tackling areas at risk for fraud, waste, abuse, and mismanagement will require determination, persistence and sustained attention by both agency managers and Congressional committees. Large and complex federal agencies must effectively use a mixture of critical resources and improved processes to improve their economy, efficiency, and effectiveness, Congressional oversight will be key.

We should be striving to maintain a government that is effective and relevant to a changing society—a government that is as free as possible of outmoded commitments and operations that can inappropriately encumber the future. The difference between “wants,” “needs,” and overall “affordability” and long-term “sustainability” is an important consideration when setting overall priorities and allocating limited resources.

Government must operate in the context of broader trends shaping the United States and its place in the world. These include:

- National and global response to terrorism and other threats to personal and national security;

- Increasing interdependence of enterprises, economies, civil society, and national governments—also known as globalization;
- The shift to market-oriented, knowledge-based economies;
- An aging and more diverse U.S. population;
- Advances in science & technology and the opportunities & challenges created by these changes;
- Challenges and opportunities to maintain & improve the quality of life for the nation, communities, families & individuals; and
- The increasingly diverse nature of governance structures and tools.

In addition to the above trends, large and growing fiscal challenges at the federal, state, and local levels are of great concern. Furthermore, known demographic trends, and rising health care costs and other health care related challenges (e.g., access, quality) are of growing concern crossing all sectors of the economy and all geopolitical boundaries.

Government leaders are responsible and accountable for making needed changes to position the federal government to take advantage of emerging opportunities and to meet future challenges. Focusing on accountable, results-oriented management can help the federal government operate effectively within a broad network that includes other governmental organizations, nongovernmental organizations, and the private sector.

In view of the broad trends and large and growing fiscal challenges facing the nation, there is a need to fundamentally review, reassess, and reprioritize the proper role of the federal government, how the government should do business in the future, and—in some instances—who should do the government’s business in the 21<sup>st</sup> century. It is also increasingly important that federal programs use properly designed and aligned tools to manage effectively across boundaries work with individual citizens, other levels of government, and other sectors. Evaluating the role of government and the programs it delivers is key in considering how best to address the nation’s most pressing priorities. Existing programs, policies and activities cannot be taken as “givens.” We need to look at “the base” across the board—mandatory and discretionary spending and tax preferences/incentives. Such periodic reviews of programs can prompt not only a healthy reassessment of our priorities but also changes needed in program design, resources and management to get the results we collectively decide we want from government.

Needless to say, we at GAO are pleased to help Congress in this very important work.

## **CONTACTS AND ACKNOWLEDGMENTS**

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Irving, Director for Federal Budget Analysis, Strategic Issues, at (202) 512-9142 or [irvings@gao.gov](mailto:irvings@gao.gov) regarding general budget and oversight issues in this testimony.

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Attachment I: GAO's 2003 High-Risk List

2003 High-Risk Areas	Year Designated High Risk
<b>Addressing Challenges In Broad-based Transformations</b>	
• Strategic Human Capital Management*	2001
• U.S. Postal Service Transformation Efforts and Long-Term Outlook*	2001
• Protecting Information Systems Supporting the Federal Government and the Nation's Critical Infrastructures	1997
• Implementing and Transforming the New Department of Homeland Security	2003
• Modernizing Federal Disability Programs*	2003
• Federal Real Property*	2003
<b>Ensuring Major Technology Investments Improve Services</b>	
• FAA Air Traffic Control Modernization	1995
• IRS Business Systems Modernization	1995
• DOD Systems Modernization	1995
<b>Providing Basic Financial Accountability</b>	
• DOD Financial Management	1995
• Forest Service Financial Management	1999
• FAA Financial Management	1999
• IRS Financial Management	1995
<b>Reducing Inordinate Program Management Risks</b>	
• Medicare Program*	1990
• Medicaid Program*	2003
• Earned Income Credit Noncompliance	1995
• Collection of Unpaid Taxes	1990
• DOD Support Infrastructure Management	1997
• DOD Inventory Management	1990
• HUD Single-Family Mortgage Insurance and Rental Assistance Programs	1994
• Student Financial Aid Programs	1990
<b>Managing Large Procurement Operations More Efficiently</b>	
• DOD Weapon Systems Acquisition	1990
• DOD Contract Management	1992
• Department of Energy Contract Management	1990
• NASA Contract Management	1990

Source: GAO

\*Additional authorizing legislation is likely to be required as one element of addressing this high-risk area.



## Attachment II: Selected Reports Regarding Specific Areas in Testimony

### Overall

*Federal Budget: Opportunities for Oversight and Improved Use of Taxpayer Funds.* GAO-03-922T. Washington, D.C.: June 18, 2003.

### Social Security Programs

*Social Security Administration: Revision to the Government Pension Offset Exemption Should Be Reconsidered.* GAO-02-950, Washington, D.C.: August 15, 2002.

*Social Security: Congress Should Consider Revising the Government Pension Offset “Loophole.”* GAO-03-498T. Washington, D.C.: February 27, 2002.

*Supplemental Security Income: SSA Could Enhance Its Ability to Detect Residency Violations.* GAO-03-724. Washington, D.C.: July 31, 2003.

*Social Security: Issues Relating to Noncoverage of Public Employees.* GAO-03-710T. Washington, D.C.: May 1, 2003.

*Major Management Challenges and Program Risks: Social Security Administration.* GAO-03-117. Washington, D.C.: January 2003.

*High Risk Series: An Update.* GAO-03-119. Washington, D.C.: January 2003.

*Supplemental Security Income: Progress Made in Detecting and Recovering Overpayments, but Management Attention Should Continue.* GAO-02-849. Washington, D.C.: September 16, 2002.

*Social Security Administration: Agency Must Position Itself Now to Meet Profound Challenges.* GAO-02-289T. Washington, D.C.: May 2, 2002.

*SSA and VA Disability Programs: Re-Examination of Disability Criteria Needed to Help Ensure Program Integrity.* GAO-02-597. Washington, D.C.: August 9, 2002.

*Social Security Disability: Efforts to Improve Claims Process Have Fallen Short and Further Action is Needed.* GAO-02-826T. Washington, D.C.: June 11, 2002.

*SSA Disability: Other Programs May Provide Lessons for Improving Return-to-Work Efforts.* GAO-01-153. Washington, D.C.: January 12, 2001.

*Supplemental Security Income: Action Needed on Long-Standing Problems Affecting Program Integrity.* GAO/HEHS-98-158. Washington, D.C.: September 14, 1998.

*Social Security: Better Payment Controls for Benefit Reduction Provisions Could Save Millions.* GAO/HEHS-98-76. Washington, D.C.: Apr. 30, 1998.

*SSA Disability: Return-to-Work Strategies From Other Systems May Improve Federal Programs.* GAO/HEHS-96-133. Washington, D.C.: July 11, 1996.

*SSA Disability: Program Redesign Necessary to Encourage Return to Work.* GAO/HEHS-96-62. Washington, D.C.: April 24, 1996.

## **Unemployment Insurance**

*Unemployment Insurance: Increased Focus on Program Integrity Could Reduce Billions in Overpayments.* GAO-02-697. Washington, D.C.: July 12, 2002.

## **Medicare**

*Medicare: Financial Challenges and Considerations for Reform.* GAO-03-577T. Washington, D.C.: April 10, 2003.

*Medicare: Observations on Program Sustainability and Strategies to Control Spending on Any Proposed Drug Benefit.* GAO-03-650T. Washington, D.C.: April 9, 2003.

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