ECONOMICS AND POLITICS 0954-1985
Volume 13 July 2001 No. 2

THE POLITICAL ECONOMY OF THE IRS

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This paper tests a multiple principal–agent model of the Internal Revenue Service. Using data for 33 IRS districts over six tax years, 1992–1997, we report evidence that the fraction of individual income tax returns audited is significantly lower in districts that are important to the president electorally and that have representation on key congressional committees. These findings suggest that the IRS is not a rogue government agency, but rather is an effective bureaucratic agent of its political sponsors. "Reforming" the IRS by subjecting it to an independent oversight board appointed by the president would therefore seem to be redundant.

> XI. To make your taxes more odious, more likely to procure resistance, send from your capital a board of officers to superintend the collection, composed of the most indiscreet, ill-bred, and insolent you can find. . . . If any revenue officers are suspected of the least tenderness for the people, discard them. If others are justly complained of, protect and reward them. If any of the under officers behave so as to provoke the people to drub them, promote those to better office. . . .
> Benjamin Franklin, 'Rules by which a great empire may be reduced to a small one'
> (Adams, 1993, p. 301)

1. INTRODUCTION

IN SEPTEMBER 1997 the Committee on Finance of the United States Senate, for the first time in 21 years, held hearings to investigate the practices and procedures of the Internal Revenue Service (IRS). The sentiments expressed at those hearings echoed Benjamin Franklin's colorful description of the tax collectors dispatched by George III to the American colonies. For three days, angry taxpayers told their very real horror stories about stonehearted revenue agents ruthlessly wielding the draconian powers delegated to them by a seemingly unrestrained bureaucracy. The credibility of the testimony was enhanced when current and former IRS employees, shielded by screens to protect their identities, confirmed and corroborated the taxpayers' stories (Cooper, 1998).

The senate hearings touched off widespread criticism of the IRS and energized efforts to restructure and reform the agency. Clearly, the IRS is an easy target. No one wants to pay taxes, and chilling testimony about rogue revenue agents

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running roughshod over vulnerable taxpayers does not inspire confidence in the system for assessing and collecting the taxes that, in the words of Oliver Wendell Holmes, represent the price "we pay for civilized society" (Davis, 1997, p. 19).

Stories like those recounted in the 1997 hearings are not new, of course, and the agents of the IRS are certainly not the first government bureaucrats to be charged with overstepping the boundaries of their authority. But while it is tempting to think that the abuses documented by the Senate Finance Committee are evidence that the IRS is "out of control", building on the seminal work of Niskanen (1971), there is by now a fairly large literature suggesting that, within the limits imposed by informational asymmetries and agency costs, government bureaus are quite responsive to the wishes of Congress. This is especially so for the specialized congressional committees that exercise oversight responsibilities with respect to particular policy areas and which, using their powers to confirm political appointees and to determine agency budgets, are well positioned to reward cooperative (and to punish uncooperative) bureaucratic behavior. Indeed, the evidence of agency complaisance is so strong that one strand of this literature is now known as the congressional dominance model of bureaucracy (e.g., Weingast and Moran, 1983).

Recognizing that more than one principal–agent relationship exists in the so-called iron triangle, later contributions to the literature have brought the president and the courts within the ambit of forces that shape bureaucratic outcomes (Ferejohn and Shipan, 1990). The purpose of this paper is to advance that body of literature by exploring empirically the strength of two channels of political influence on the Internal Revenue Service. More specifically, we investigate the principal–agent relationships that link the IRS and its sponsor committees in the US Senate and House of Representatives, on the one hand, and the IRS and the president on the other. Our results provide evidence of significant presidential influence on agency behavior: other things being the same, the percentage of tax returns audited by the IRS is markedly lower in states that are important to the sitting president's re-election aspirations. We also find that the IRS is responsive to its oversight committees. Taken together, these findings suggest that the IRS is not merely a lawless government agency pursuing its own parochial objectives, but rather is an effective bureaucratic agent of its presidential and congressional sponsors.

The organization of the paper is as follows. Section 2 looks more closely at the political forces that impinge on the Internal Revenue Service. Earlier work on the political control of bureaucratic behavior is summarized in section 3. Section 4 contains a description of our data and empirical model. The empirical results are reported in section 5, and section 6 contains some concluding remarks.

2. THE IRS AND ITS SPONSORS

The stated mission of the IRS is "to collect the proper amount of tax revenue at the least cost to the taxpayers" (US Department of the Treasury, 1995, p. 1). The mission is simple, but the size, scope, and complexity of the tax law make it difficult to operationalize. Ironically, provisions that increase the complexity of the tax code are often justified in the name of "fairness", but this same complexity also reduces compliance: well-meaning taxpayers may not understand the law well enough voluntarily to obey it. Alternatively, more astute taxpayers may exploit the complexity purposefully to evade the law.[1] Indeed, Congress continually enacts new tax legislation, making compliance increasingly more difficult.

> Congress passed legislation in 1997 and 1998 adding more than 1,200 substantive changes to the Internal Revenue Code, which now contains more than 1.5 million words. . . . This nation's tax law is now more than six times longer than Tolstoy's *War and Peace* and considerably harder to parse.
>
> (Graetz, 1999, p. 293)

A fundamental tension thus arises in the relationship between the IRS and its sponsor committees in Congress. While oversight committees having jurisdiction over other policy areas can at least claim to be promoting the general welfare, the members of the IRS oversight committees have a more ambiguous relationship with the taxpaying public. For example, the IRS is a key player in achieving a balanced federal budget, and many members of Congress have invested a great deal of political capital in developing reputations for fiscal responsibility. In order to keep the budget in balance, however, the IRS must collect the requisite tax revenues. Thus, the message from the sponsor committees to the IRS is to be zealous in fulfilling its mission, but to avoid alienating the voters.

This bipolar message creates a dilemma for members of Congress. The more aggressive the IRS becomes in enforcing compliance with the tax law, the greater is the tax revenue that will be collected, but the more unfavorable is the expected reaction from the taxpaying public. On the other hand, the less aggressive the IRS becomes, the less tax revenue is collected, but the more favorable is the reaction from the voters. Congress must therefore remain attuned to the shifting political winds and take steps to moderate the aggressiveness of the IRS's agents whenever the cost in terms of lost voter support threatens to exceed the benefits of raising additional tax revenue.[2]

The members of the IRS oversight committees have a comparative advantage over other members of Congress in striking a balance between taxpayer

[1] Anderson et al. (1987) argue that tax revenues can be increased at the margin by *increasing* the number of tax loopholes. Support for that argument is found in evidence that, other things being the same, personal income tax revenues are higher in states with longer, presumably more complex, and loophole-riddled tax codes. Anderson et al. suggest that this evidence is consistent with the hypothesis that loopholes are a way of buying off opposition to tax increases by politically powerful interest groups.

[2] Consistent with this need for balance and with the reasoning of Anderson et al. (1987), Toma and Toma (1986) find that, as tax breaks increase, Congress provides the IRS with more funding in order to bolster enforcement and offset the revenue loss.

opposition and revenue enhancement. Because the oversight committee members represent only selected districts and states around the country, the members could, in theory, gain political capital by encouraging the agency to be more aggressive with voters residing outside their constituencies and less aggressive with their own constituents (Hunter and Nelson, 1995). Indeed, the pages of oversight committee members posted on the World Wide Web specifically advertise their ability to act on behalf of constituents when they have "problems" with the IRS. When the oversight committee members exercise their political advantage in this way, the IRS can raise the targeted amount of tax revenue without compromising the committee members' re-election chances.

The IRS is an agency of the executive branch of government, residing administratively within the US Department of the Treasury. By virtue of his authority to appoint the Commissioner of Internal Revenue, who reports to the Secretary of the Treasury (likewise a political appointee), the president is also in a position to exercise control over the activities of the IRS. Although the president's constituency is a national one, he is nevertheless subject to the same pressures calling for a balancing of aggressive tax-law enforcement against the need for political support.

There is no lack of anecdotal evidence suggesting that Congress and the president both have used their political influence to bend the IRS to their own partisan purposes. Testifying before the Watergate committee in mid-1973, John Dean ignited a firestorm of controversy by disclosing the existence of an "enemies list" containing the names of 800 mostly left-wing individuals and organizations that President Nixon had singled out for retribution.[3] What was not known at the time, but has since been documented by the IRS's first and only historian, who eventually resigned to protest the agency's systematic destruction of records and its pattern of retaliation against whistleblowers, is that on its own initiative the IRS went far beyond Nixon's call to duty (Davis, 1997, pp. 76–99). Headed by the shadowy figure of career bureaucrat Paul Wright, the IRS assembled a super-secret unit, known as the Special Services Staff, which ultimately compiled a much less selective list of more than 11,000 potential targets of politically inspired tax audits. The agency's zealotry is in part explained by the fact that

> some senators, recognizing a political football perfectly poised to support their claims that they were "doing something" about armed revolutionaries running amok in the streets, began pressuring the IRS to "go after" these subversive organizations that were tearing the country asunder.
>
> (Davis, 1997, p. 83)

[3] More recently, presidential influence may explain "the IRS's unusual audit of Ultrair, a small travel agency in Smyma, Tennessee, that was providing air charter services to the White House Travel Office at the time the Clinton administration fired seven Travel Office employees and tried to shift Travel Office business to a company owned by a longtime Clinton crony" (Davis, 1997, p. 108).

In addition to auditing political enemies, the IRS has been known to go easy on political friends. A report issued by the Merit Systems Protection Board and testimony before a congressional committee point to the conclusion that Frank Santella, who became the head of the IRS's Chicago office in early 1979, intervened to prevent agents from auditing the tax return of a member of the staff of Chicago-area Congressman Frank Annunzio (Davis, 1997, pp. 136–137).

Given that the IRS, like the rest of the machinery of the state, has the power to "selectively help or hurt" various individuals and groups (Stigler, 1971, p. 3), both the president and the Congress have incentives to see that those powers are used in ways that advance their own political interests. Given that its budget and the security of office of its Commissioner are in the hands of the president and the Congress, the IRS has incentives to bend to the will of its political sponsors. But because those sponsors must cater to the demands of different geographical constituencies, the political pressures emanating from the executive and legislative branches may push the IRS in different directions. Moreover, principals and agents must all walk a fine line between raising the revenue that benefits both branches of government and securing the support of the voters from whom the revenue is collected. Whether or not political influence on the IRS is evident when the agency's law enforcement activities are examined more systematically is a question to be explored below.

3. CONGRESS, THE PRESIDENT, AND THE BUREAUCRACY

One of the most fruitful scholarly efforts to place government bureaus within the individualistic postulate of political institutions (Buchanan and Tullock, 1962) focuses on the bureaucracy's interactions with its congressional sponsors. In what has subsequently become known as the congressional dominance model, bureaucrats defer to the policy preferences of oversight committee members – and do so even in the absence of evidence of "active" congressional control. Terry Moe has summarized the theory as follows:

> The committee then becomes a principal, seeking faithful implementation of its policies by the bureaucracy and wielding an array of control mechanisms – oversight, budgets, appointments, threats of new legislation – so formidable that the bureau has overwhelming incentives to comply. Congress dominates. . . . Political scientists misconstrue the facts of congressional oversight – low interest, sporadic and poorly attended hearings – to mean that controls are ineffective. The same facts are observationally equivalent to those associated with strong legislative control: when agencies anticipate sanctions and avoid them through assiduous compliance, there is little need for active oversight, and most of the time nothing would be happening. What appears to be apathy and inattention would arise from successful control.
>
> (Moe, 1997, p. 465)[4]

[4] Wintrobe (1997) provides a complementary summary of this literature.

The congressional dominance model helps explain the apparent lack of attention oversight committees have paid to the IRS in the past 21 years. In other words, the oversight committees do not have to hold public hearings to maintain control over the IRS. Rather, the committee can use less public methods, such as the threat of reduced budgetary appropriations, to compel the agency to follow congressional wishes.[5]

The model has proven to be rich in empirical implications. In 1969, Richard Posner studied the interactions between the Federal Trade Commission (FTC) and its congressional sponsors. Specifically, Posner hypothesized that since the representatives of various districts and states would come to rely on a few key industries for political support, members serving on the FTC's oversight committees would have incentives to intervene to fend off antitrust actions aimed at their constituents. Posner contended that congressional influence would bend FTC investigations to serve the parochial purposes of firms "whose motivation is at best to shift the costs of their private litigation to the taxpayer and at worse to harass competitors" (Posner, 1969, p. 87).

Faith et al. (1982) tested Posner's conjecture. They compared the ratio of dismissals to cases brought by the FTC for states and districts with oversight committee representation and those without. Significantly more of the antitrust complaints issued against firms headquartered in districts represented by the members of oversight committees in the House were found to have been dismissed than was the case for complaints issued against firms not so represented. While the relationship between Senate oversight committee representation and the number of case dismissals was not statistically significant, Faith et al. (1982, p. 342) were still able to conclude that "representation on certain committees is apparently valuable in anti-trust proceedings . . . and that representation matters in determining policy outcomes". Moreover, they found the evidence of House influence on antitrust case outcomes to have become stronger following a series of internal "reforms" implemented by the commission in the late 1960s and early 1970s.

Weingast and Moran (1983) also studied policy changes at the FTC triggered by public criticism of the agency. A period of aggressive antitrust law enforcement and consumer activism followed the publication of reports by the American Bar Association and a Naderite organization in 1969, both of which were highly critical of the commission's policy direction. The increased activism, which included a rule-making initiative to regulate Saturday morning television advertising aimed at children, was viewed by many as an overreaction to the

[5] In 1996, for example, Congressman Jim Lightfoot (R-IA), chairman of the House Treasury, Postal Service and General Government subcommittee of the House Appropriations Committee, angry at the IRS's inability to upgrade its computer systems, introduced a bill that "would slash funding for the IRS by a staggering 11 percent, including a resounding reduction of $270 million targeted specifically at the mismanaged computer modernization project. . . . Lightfoot's bill [also] called for putting the Defense Department in charge of writing contracts for all future IRS computer modernization efforts" (Davis, 1997, p. 49). Although the bill won the approval of the full Appropriations Committee, a floor vote was never taken.

reports and critics derisively referred to the FTC as a "National Nanny" and charged it with being "out of control". By the late 1970s the policies of the FTC had once again changed direction dramatically, becoming much less activist.

While the policy reversals could be explained by bureaucratic reactions to external criticism, Weingast and Moran looked beneath the surface to explore changes in the composition of the FTC's congressional oversight committees. During the early 1970s, members serving on the oversight committees tended to favor an activist policy stance and the commission predictably pursued an activist policy agenda. In the next election cycle, turnover of seats produced a more conservative oversight committee membership and this led to more conservative policies at the FTC.[6]

More recently, Hunter and Nelson (1995) applied the congressional dominance model to the Treasury Department in order to explore the relationship between Congress and the IRS. Based on the estimates of Malangna (1986) that the marginal revenue yield per dollar spent on tax enforcement is $7 for audits and $27 for servicing delinquent accounts, Hunter and Nelson hypothesized that political factors played a role in this efficiency loss.[7] They used efficiency variables, such as type of income reported, and oversight committee representation to explain the percentage of tax returns audited by state over the 1971–1981 period. They found that both the efficiency and political variables were significant in predicting interstate differences in tax return audit rates. Hunter and Nelson concluded that, other things being the same, the IRS tends to allocate tax enforcement resources away from states represented by oversight committee members. These findings point to the conclusion that what appears to be inefficient behavior by the IRS may actually be the result of rational decision-making by self-interested politicians and bureaucrats.

The president also has a stake in controlling the bureaucracy and, indeed, the congressional dominance model has been criticized for ignoring the preferences of the head of the branch of government under which most agencies reside (Moe, 1987). While evidence exists suggesting that presidential politics plays an important role in explaining the distribution of emergency relief funds during the Great Depression (Wright, 1974; Anderson and Tollison, 1991; Couch and Shughart, 1997) and that the president's power of appointment shapes monetary policy outcomes (Grier, 1987; Chappell et al., 1993, 1995), it is only lately that the literature has turned its attention to richer models of political influence on bureaucratic policy-making.

[6] Weingast (1984) later extended this model to study policy changes at the Securities and Exchange Commission. While the anecdotal evidence again pointed to bureaucratic explanations, he was able to link changes in policy to changes in the preferences of the oversight committee members.

[7] In 1985, IRS Commissioner Roscoe Egger estimated that 75,000 additional revenue agents could be added to the agency before the additional budgetary cost would equal the additional tax revenue collected. The staffing shortfall has led to a secular decline in the percentage of tax returns audited. In 1965, 6 percent of returns filed were audited. In 1976, the audit rate had fallen to 2.5 percent, and by 1995 less than 1 percent of returns filed were audited (Graetz, 1997).

Our purpose is to advance that body of literature. Specifically, in the next two sections we explore the influence of key congressional oversight committees and the president on the law enforcement activities of the Internal Revenue Service.

4. EMPIRICAL MODEL

Following Hunter and Nelson (1995), our measure of bureaucratic performance is the percentage of income tax returns audited by IRS agents using data from a more recent time period, 1992–1997. Rather than focusing on audit activity by state, however, our data set is constructed on the basis of the 33 geographic districts the IRS uses for administering its law enforcement activities. Our hypothesis is that oversight committee members will exercise their comparative advantage over other members of Congress to reduce the fraction of tax returns the IRS audits in their home districts and states. We conjecture further that districts important to the sitting president's re-election aspirations will also be treated favorably by IRS auditors. Similar to the approach taken by Faith et al. (1982), we analyze the influence of the House of Representatives and the Senate separately, as well as Congress as a whole.

The hypothesized empirical models are specified as follows:

Congressional Model

$$AUDITPCT = \mathrm{a}_1 - \mathrm{a}_2(TOTAL) - \mathrm{a}_3(TOTALEXP) + \mathrm{a}_4(TOTAL \cdot EXP) - \mathrm{a}_5(EXEC) + \mathrm{a}_6(AUDITORS) - \mathrm{a}_7(INCOMEGAP) + \text{error term;}$$

Senate Model

$$AUDITPCT = \mathrm{b}_1 - \mathrm{b}_2(SENFIN) - \mathrm{b}_3(SENATEXP) + \mathrm{b}_4(SENFIN \cdot EXP) - \mathrm{b}_5(EXEC) + \mathrm{b}_6(AUDITORS) - \mathrm{b}_7(INCOMEGAP) + \text{error term; and}$$

House Model

$$AUDITPCT = \mathrm{c}_1 - \mathrm{c}_2(HOUSE) - \mathrm{c}_3(HOUSEXP) + \mathrm{c}_4(HOUSE \cdot EXP) - \mathrm{c}_5(EXEC) + \mathrm{c}_6(AUDITORS) - \mathrm{c}_7(INCOMEGAP) + \text{error term.}$$

The variables are defined as follows:

AUDITPCT = the percentage of tax returns audited in an IRS district;
TOTAL = number of members of Congress from an IRS district who serve on any of three oversight committees;
SENFIN = number of senators from an IRS district who serve on the Senate Finance Committee;
HOUSE = number of representatives from an IRS district who serve either on the Small Business or the Ways and Means Committee;
TOTALEXP = total number of years members included in *TOTAL* have served in Congress;

SENATEXP	= total number of years senate oversight committee members have served in Congress;
HOUSEXP	= total number of years house oversight committee members have served in Congress;
TOTAL·EXP	= interaction of *TOTAL* and *TOTALEXP*;
SENFIN·EXP	= interaction of *SENFIN* and *SENATEXP*;
HOUSE·EXP	= interaction of *HOUSE* and *HOUSEXP*;
EXEC	= measure of an IRS district's political importance to the president;
AUDITORS	= number of IRS auditors per capita in the district; and
INCOMEGAP	= measure of taxpayer compliance.

4.1 Dependent Variable

The observations on the dependent variable, *AUDITPCT*, were obtained from the Transactional Records Access Clearinghouse (TRAC) at Syracuse University. The time period covered by the data set is from 1992 to 1997, the only years for which data are currently available from TRAC. *AUDITPCT* is defined as the fraction of returns audited within each IRS district for each of the six years in the sample. Although the IRS reduced the number of districts from 63 to 33 in 1996, TRAC has standardized the data to make the years in the sample period comparable. As the dependent variable was measured as the percentage of returns audited per IRS district, all of the independent variables were also measured with respect to IRS districts. (See Appendix A for a list of these districts.) In addition, *AUDITPCT* does not include tax audits conducted by the IRS's regional service centers. Such so-called correspondence audits, which are administered by the service centers and are initiated as a result of a mathematical error or omitted information on a taxpayer's return, are pro forma and not readily subject to the kinds of influences which are this study's concern.

The dependent variable was chosen because of the discretion IRS agents exercise in selecting tax returns for audit. The IRS employs a computer program, called "DIF", to screen returns. DIF contains a database of aggregate historical taxpayer information and includes "reasonableness" measures by which each return is judged. The computer program flags any tax return that reports income or takes deductions outside the normal ranges established by DIF. In addition, the program assigns relative rankings to the returns. Thus, the higher the DIF score the greater is the likelihood that the flagged return will be audited. This program provides an objective means of selecting tax returns for audit and could potentially take audit decisions out of the hands of IRS employees. As a matter of fact, the IRS has emphasized that DIF is responsible for selecting a significant fraction of the returns audited in recent years. In 1995, DIF selected 24.7 percent of the returns that were audited. In 1996, DIF selected 34.3 percent. These percentages imply that the remaining audits – about two-thirds to three-quarters of them – were initiated at the discretion of an IRS agent

(Transactional Records Access Clearinghouse). Hence, the IRS appears to have wide latitude in enforcing taxpayer compliance that could be subject to political influence.

4.2 Oversight Committee Variables

Three congressional committees were identified as having oversight responsibilities with respect to the IRS during the sample period: the House Ways and Means Committee, the House Small Business Committee, and the Senate Finance Committee. These committees were chosen from the list of 16 standing Senate committees and 19 standing House committees based on the descriptions of their jurisdictions in the *Congressional Record*. Specifically, the House Ways and Means Committee and the Senate Finance Committee have "jurisdiction over subjects relating to the Treasury of the United States and the deposit of the public moneys . . ." (US House of Representatives, 1997a, 1997c). Similarly, the House Small Business Committee has the responsibility of supervising "tax policy and its impact on small business" (US House of Representatives, 1997b).

Independent variables are included in the empirical models to test for the direction and magnitude of the influence the members of these three oversight committees may exert on the IRS. Political influence is proxied in two ways. In the congressional model the independent variable *TOTAL* represents the total number of representatives and senators from an IRS district appointed to serve on at least one of the agency's oversight committees. It is hypothesized that if the oversight committees enjoy a strong principal–agency relationship with the IRS the sign of this variable will be negative. That is, the more members on oversight committees there are from a given district, the lower will be the percentage of returns audited of the taxpayers they represent. *TOTALEXP* measures the collective number of years the oversight committee members included in *TOTAL* have served in Congress. This variable was included in the model to account for the effect of seniority on the behavior of the agency. Thus, more senior members of oversight committees are expected to have greater influence over the IRS. The predicted sign of *TOTALEXP* is also negative: the greater the number of years of experience, the lower the percentage of returns audited in the IRS district. An interaction term, *TOTAL·EXP*, is included in the model to control for the combined effect of representation and seniority.

Analogous variables are included when the effects of House and Senate oversight committee representation are estimated separately. *HOUSE* is the total number of members on the Small Business and Ways and Means committees representing voter-taxpayers residing within the boundaries of each IRS district. *HOUSEXP* is the collective number of years the members included in *HOUSE* have served in Congress, and *HOUSE·EXP* is the interaction between committee membership and experience. In the Senate model, *SENFIN* is the total number of members of the Finance Committee representing states located in each IRS district. *SENATEXP* represents the collective number of years the members included in *SENFIN* have served in Congress, and *SENFIN·EXP* is the interaction between oversight committee membership and experience.[8]

Summary statistics for the dependent variable, the percentage of tax returns audited by IRS district, are reported in Table 1. The table shows the mean number of returns audited in each year, 1992–1997, in districts with and without oversight committee representation.

4.3 Other Variables

EXEC captures the influence of presidential politics on the law enforcement activities of the IRS. The variable weights the number of electoral votes at stake in each IRS district by a measure of the competitiveness of presidential races between the Democratic and Republican parties.

EXEC is calculated in two steps (Grier et al., 1995, p. 429). First, a variable *NOTCLOSE* is computed by taking the absolute value of the difference between the percentage of Democratic votes cast in state$_j$ and 50 percent (Scammon et al., 1996). To standardize this measure of electoral competitiveness across years, this difference is divided by the standard deviation of the Democratic vote for president in state$_j$ for election results in years 1972 through 1992. Hence, "political closeness" is defined as follows:

$$NOTCLOSE_j = \frac{|\%VOTE_{Dj} - 50|}{\sigma_j}.$$

Higher values of *NOTCLOSE* are associated with lower levels of party competitiveness in a state (smaller values are associated with more competitive elections). However, the amount of resources a presidential candidate is willing to devote to a politically competitive state will also depend on the number of electoral votes that are at stake. Thus, the second step in calculating *EXEC* is to divide the number of electoral votes assigned to state$_j$ by $NOTCLOSE_j$:[9]

$$EXEC_j = \frac{Electoral\ Votes_j}{NOTCLOSE_j}.$$

Four states contain multiple IRS districts within their borders: California, Florida, New York, and Texas. For each district within those states, the *EXEC* variable was assumed to have the same value as the statewide value. The expected sign of *EXEC* is negative: the more important the IRS district is to the president politically, the lower will be the percentage of returns audited.

AUDITORS is included in the model as a proxy for the amount of law enforcement resources the IRS allocates to each of its districts. The observations

[8] The identities and service records of the members of the various oversight committees were gathered from the relevant *Congressional Directory* (US Senate, 1991–1992, 1993–1994, 1995–1996).

[9] Electoral votes are apportioned on the basis of population and the number of votes cast for president by each state is therefore the same as the number of members of its congressional delegation (i.e., senators plus representatives).

Table 1 Percentage of Tax Returns Audited and Oversight Committee Representation, 1992–1997

Year	Chamber	Districts with representation	Districts without representation
1992	House	Mean = 0.642% Std. Dev. = 0.2115 $N = 30$	Mean = 1.05% Std. Dev. = 0.3424 $N = 3$
	Senate	Mean = 0.611% Std. Dev. = 0.1814 $N = 19$	Mean = 0.774% Std. Dev. = 0.3020 $N = 14$
	House and Senate combined	Mean = 0.642% Std. Dev. = 0.2115 $N = 30$	Mean = 1.05% Std. Dev. = 0.3424 $N = 3$
1993	House	Mean = 0.697% Std. Dev. = 0.2848 $N = 30$	Mean = 0.570% Std. Dev. = 0.1323 $N = 3$
	Senate	Mean = 0.578% Std. Dev. = 0.1797 $N = 16$	Mean = 0.787% Std. Dev. = 0.3149 $N = 17$
	House and Senate combined	Mean = 0.686% Std. Dev. = 0.2800 $N = 32$	Mean = 0.670% Std. Dev. = – $N = 1$
1994	House	Mean = 0.760% Std. Dev. = 0.2573 $N = 30$	Mean = 0.620% Std. Dev. = 0.2022 $N = 3$
	Senate	Mean = 0.671% Std. Dev. = 0.1882 $N = 16$	Mean = 0.820% Std. Dev. = 0.2894 $N = 17$
	House and Senate combined	Mean = 0.749% Std. Dev. = 0.2574 $N = 32$	Mean = 0.700% Std. Dev. = – $N = 1$
1995	House	Mean = 0.679% Std. Dev. = 0.2637 $N = 29$	Mean = 1.06% Std. Dev. = 0.3711 $N = 4$
	Senate	Mean = 0.641% Std. Dev. = 0.1886 $N = 18$	Mean = 0.827% Std. Dev. = 0.3748 $N = 15$
	House and Senate combined	Mean = 0.697% Std. Dev. = 0.2657 $N = 31$	Mean = 1.15% Std. Dev. = – $N = 2$
1996	House	Mean = 0.648% Std. Dev. = 0.2899 $N = 29$	Mean = 0.910% Std. Dev. = 0.4815 $N = 4$
	Senate	Mean = 0.583% Std. Dev. = 0.1313 $N = 18$	Mean = 0.796% Std. Dev. = 0.4331 $N = 15$

(*Continued*)

TABLE 1 *Continued*

Year	Chamber	Districts with representation	Districts without representation
1996	House and Senate combined	Mean = 0.654% Std. Dev. = 0.2810 $N = 31$	Mean = 1.09% Std. Dev. = – $N = 2$
1997	House	Mean = 0.597% Std. Dev. = 0.2485 $N = 29$	Mean = 0.775% Std. Dev. = 0.5252 $N = 4$
	Senate	Mean = 0.580% Std. Dev. = 0.1508 $N = 20$	Mean = 0.677% Std. Dev. = 0.4246 $N = 13$
	House and Senate combined	Mean = 0.600% Std. Dev. = 0.2436 $N = 31$	Mean = 0.900% Std. Dev. = – $N = 2$

on this variable were obtained from the TRAC database. There is an expected positive relationship between *AUDITORS*, which is expressed in per capita terms, and the percentage of tax returns audited within a district. That is, the more auditors there are in a district, the more resources the agency has devoted to the district, and the greater is the expected number of audits.

The final continuous independent variable included in the model, *INCOMEGAP*, is a measure of taxpayer compliance within each IRS district. This variable provides a comprehensive estimate of taxpayer compliance; it was calculated using a formula recommended by the IRS for tax research (Cyr et al., 1994, p. 48). According to this formula, *INCOMEGAP* is the ratio of actual reported taxable income to estimated total household income for the state. The numerator of the ratio was obtained from *Statistics of Income* (US Department of the Treasury, Internal Revenue Service, 1991–1996); the denominator was obtained from the Social Sciences Data Center (1999) at the University of Virginia. As the value of the ratio approaches 1, less potentially taxable income goes unreported. Taxpayer compliance is therefore greater and an IRS guided only by efficiency considerations would be less likely to initiate audits in the district.

Because tax audits generally are not initiated in the year the tax return is filed, the compliance variable was lagged by one year. Thus, observations on *INCOMEGAP* were obtained for the years 1991 through 1996. For states with multiple IRS districts, the statewide value of *INCOMEGAP* was assumed to be the IRS district value. The expected relationship between *INCOMEGAP* and the percentage of returns audited is negative.

To control for the possibility that audit activity varies over time, year dummies are also entered on the right-hand side of the regression equation. The binary variable for 1992 is omitted, so that each of the five estimated coefficients tests whether the fraction of returns audited in a given year is significantly higher or lower than it was at the beginning of the sample.

While this study is motivated by the same theory as the work of Hunter and Nelson (1995), it differs from theirs in three important ways. First, our dependent variable, *AUDITPCT*, is measured at the IRS district level; Hunter and Nelson measured the percentage of audits on a state level. As several states currently contain multiple districts and, conversely, several districts contain two or more states, a district measure of the percentage of returns audited yields a more accurate picture of the geographical distribution of the IRS's law enforcement activities. Second, as measures of efficiency in bureaucratic resource-allocation decisions, the Hunter and Nelson study controlled for the influence of specific income items reported on tax returns by including independent variables for farm income, taxpayers who itemize their deductions, individuals with rental income, and individuals involved in partnerships or sole proprietorships. In this study, the independent variable *INCOMEGAP* is employed to account for all areas of non-compliance. Finally, the only political variables in the Hunter and Nelson study were House and Senate oversight committee representation; the empirical model for this study captures not only congressional influence, but also the influence of presidential politics on IRS audit practices.

5. RESULTS

We pooled the data over time and across IRS districts and estimated the congressional, House, and Senate versions of the model using OLS. The results are reported in Table 2. The estimates suggest that the law enforcement activities of the IRS conform both to the political preferences of its overseers in Congress and the sitting president. In particular, the coefficient on *TOTAL* is significant, and of the expected negative sign. Thus, other things being equal, the percentage of tax returns audited in IRS districts that have representatives on an IRS oversight committee is lower than in IRS districts that do not have such representation. However, while we find that tenure in the Senate appears to influence audit rates significantly, seniority in the House does not.

When the interaction between oversight committee representation and seniority is taken into account for the Congress as a whole, the marginal impact of *TOTAL* on *AUDITPCT* is $-0.07 + 0.00083(32.98) = -0.043$ at the mean value of *TOTALEXP*. The marginal impact is likewise negative at the median value of *TOTALEXP* (32 years). In the Senate regression, where the interaction between representation and seniority is also positive and significant, the marginal impact of *SENFIN* on *AUDITPCT* is $-0.113 + 0.0049(12.04) = -0.054$ at the mean value of *SENATEXP*; the marginal impact is -0.069 at the median of *SENATEXP* (nine years).

In addition to the significance of our oversight variables, as predicted by Hunter and Nelson (1995), we also find evidence of presidential influence on the

TABLE 2 DEPENDENT VARIABLE: PERCENTAGE OF TAX RETURNS AUDITED BY IRS DISTRICT, 1992–1997

	Congress	Senate	House
Constant	2.890	2.722	2.893
TOTAL	−0.0700 (−3.982)**		
TOTALEXP	−0.00291 (−1.584)		
TOTAL·EXP	0.00083 (2.261)**		
SENFIN		−0.113 (−1.942)*	
SENATEXP		−0.0075 (−2.045)**	
SENFIN·EXP		0.0049 (3.603)**	
HOUSE			−0.0497 (−2.828)**
HOUSEXP			0.0012 (0.524)
HOUSE·EXP			−0.000068 (−0.122)
EXEC	−0.000618 (−4.048)**	−0.00056 (−3.587)**	−0.00007 (−4.450)**
AUDITORS	0.00313 (5.138)**	0.0036 (5.699)**	0.0029 (4.733)**
INCOMEGAP	−4.828 (−7.076)**	−4.779 (−3.587)**	−5.054 (−7.226)**
Year 1997	0.05054 (0.868)	0.05602 (0.964)	0.05149 (0.844)
Year 1996	0.03157 (0.560)	0.0134 (0.236)	0.0330 (0.562)
Year 1995	0.02559 (0.447)	−0.00064 (−0.011)	0.02534 (0.428)
Year 1994	0.0409 (0.725)	0.01577 (0.277)	0.0424 (0.727)
Year 1993	0.02211 (0.391)	−0.00647 (−0.115)	0.0279 (0.479)
R^2	0.394	0.380	0.359

Notes: *t*-Statistics in parentheses; asterisks indicate statistical significance at the 5% (**) and 10% (*) levels.

IRS: the estimated coefficient on *EXEC* is negative and significant. Hence, the president does not sit idly by. Audit activity is significantly lower in electorally sensitive IRS districts. Aggressive tax law enforcement is shifted elsewhere in order to further the president's re-election effort.

The results for the efficiency variables are consistent with our a priori predictions. *INCOMEGAP* enters significantly with the expected negative sign, and *AUDITORS* is significant and of the expected positive sign. Other things being the same, more audits occur in districts where taxpayers have greater amounts of unreported income and where the IRS has allocated more resources to tax law enforcement.[10] Lastly, once other factors are taken into account, audit rates in the years 1993 through 1997 seem in general to be higher than they were in 1992, but not significantly so.

Overall, we find that both political and bureaucratic efficiency considerations influence the IRS. Indeed, at the margin, the potential for raising additional tax revenues by examining returns with the largest amounts of unreported taxable income is the single most important determinant of audit activity. It is also true, however, that, other things being the same, the IRS is not only a faithful agent of its oversight committees in Congress, but is also sensitive to the political pressures of the president.

6. CONCLUDING REMARKS

Senate Finance Committee Chairman William Roth (R-DE) opened the September 1997 hearings on the practices and procedures of the IRS with the following statement:

> The threat of an audit, the awesome power of the IRS looms like the Sword of Damocles over the heads of taxpayers. As Chairman of the Senate Finance Committee, I want to know why. I wanted to understand where this fear came from. I wanted to know if it was justified.
>
> (Roth, 1997)

The results of this study shed some light on the chairman's concerns about the power of the IRS. The significance of the political variables included in our analysis suggests that Congress and the president have a shared responsibility for the abuses enumerated in the hearings. In other words, if there really is a "Sword of Damocles over the heads of taxpayers", then the members of congressional oversight committees and the president both have their hands on it.

In response to the hearings, the House and the Senate passed bills to restructure the agency and "get the IRS under control" (US Congress, 1998).

[10] *AUDITORS* is determined by the IRS and the positive coefficient could reflect agency decisions to place more auditors in districts where *INCOMEGAP* is higher and audits are therefore more likely to uncover unreported taxable income. To ensure that the results reported in Table 2 are not biased by the possible endogeneity of *AUDITORS*, we dropped that variable and re-estimated all three models. (One or more years of data would have been lost under the alternative strategy of entering lagged values of *AUDITORS*.) The results of these estimations (available on request), differed in only one respect from those reported in Table 2: the coefficient on *EXEC* in the Senate regression remains negative in sign, but is no longer different from zero at standard levels of statistical significance.

Both versions of the bill call for the establishment of an independent, nine-member oversight board that is accountable to the president. But we find that the IRS is already susceptible to the political pressures of the executive branch: in every year of the sample, audit rates were significantly lower in electoral-vote rich states where presidential contests have historically been "close". An oversight board that answers only to the president therefore appears to be redundant.

The president seems to agree: by law, nominations to the board were due to the Senate in January 1999, but as of May 1999, Clinton had not appointed its members. As evidence of the ongoing competition between the executive and Congress over control of the IRS, Chairman Roth, in a letter to the president, publicly complained:

> I am concerned that you have not timely provided nominees to the Senate as required by law. . . . In view of that fact that the nominations to the Oversight Board are long overdue, no further time should be lost in meeting this obligation. I would greatly appreciate your taking immediate action on this matter.
>
> (US Senate, 1999)

Eventually, one year late, the president nominated seven members to the oversight board (the board also includes the Secretary of the Treasury and the IRS Commissioner). Those nominations were confirmed by the Senate in September 2000 (US Senate, 2000).

Our conclusions must be tempered by two considerations. First, because of the limits on data availability, the sample period only covers six years of IRS law enforcement activities. While our sample spans a relatively stable period in tax policy, the explanatory power of the models may be reduced over a longer time frame. In addition, Bill Clinton occupied the White House for five of the six years of data analyzed. The evidence of executive branch pressure on the IRS may therefore be unique to his first administration. Taken together with the results reported by Hunter and Nelson (1995), however, the evidence of politicization of the IRS by both the Congress and the president seems to be definitive.

APPENDIX A: IRS DISTRICTS

IRS district	State(s)
Arkansas-Oklahoma	Arkansas, Oklahoma
Northern California	California
Central California	California
Los Angeles	California
Southern California	California
Connecticut-Rhode Island	Connecticut, Rhode Island
Delaware-Maryland	Delaware, Maryland
North Florida	Florida
South Florida	Florida
Georgia	Georgia
Gulf Coast	Alabama, Louisiana, Mississippi
Illinois	Illinois
Indiana	Indiana
Kansas-Missouri	Kansas, Missouri
Kentucky-Tennessee	Kentucky, Tennessee
Michigan	Michigan
Midwest	Iowa, Nebraska, Wisconsin
New England	Maine, Massachusetts, New Hampshire, Vermont
New Jersey	New Jersey
Manhattan	New York
Brooklyn	New York
Upstate New York	New York
North Central	Minnesota, North Dakota, South Dakota
North-South Carolina	North Carolina, South Carolina
Ohio	Ohio
Pacific Northwest	Oregon, Alaska, Hawaii, Washington
Pennsylvania	Pennsylvania
Rocky Mountain	Colorado, Idaho, Montana, Utah, Wyoming
Southwest	Arizona, Nevada, New Mexico
North Texas	Texas
South Texas	Texas
Houston	Texas
Virginia-West Virginia	Virginia, West Virginia

Source: TRAC.

ACKNOWLEDGMENTS

An earlier version of this paper was presented at the 1999 meetings of the Public Choice Society in New Orleans, Louisiana. We are grateful for the helpful comments of Shama Gamkhar, Russell Sobel, and an anonymous referee. As is customary, however, we accept full responsibility for any remaining errors.

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