

## POLITICAL INFLUENCE AND THE INTERNAL REVENUE SERVICE

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He has erected a multitude of New Offices, and sent hither swarms of Officers to harass our people, and eat out their substance.

—Declaration of Independence

The Mendoza family was both surprised and alarmed when they received notice from the Internal Revenue Service (IRS) that their home would be confiscated if \$200 in back taxes were not paid, especially in light of the fact that the family had never experienced any previous tax problems. However, it was Patricia Mendoza who was seen on television shouting insults at President Clinton about the deaths of 19 soldiers in Saudi Arabia: “You stink, and those boys died” (*Richmond Times-Dispatch* 1997). Critics of the Clinton administration are convinced, and perhaps for good reason, that the Mendoza’s tax problems are not coincidental.

The Clinton administration has been questioned about its political usage of the IRS. For example, James Adams (1997) reports that, “tax authorities have launched a series of audits into many large organizations which have criticized the [Clinton] administration over the past four years.” Groups targeted for audit include Citizens Against Government Waste, the Heritage Foundation, the National Rifle Association, the Freedom Alliance, and the Western Journalism Center. Two conservative magazines, *The National Review* and the *American Spectator*, are also under audit. On the other hand, left-leaning non-profits and periodicals have escaped such scrutiny (Roeser 1997).

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The publicizing of data collected by the Transactional Records Access Clearinghouse (TRAC) at Syracuse University detailing the rate of returns audited by geographic region has only added to the growing mistrust of the IRS.<sup>1</sup> TRAC results indicate that large variations exist in the percentage of returns audited from a high of 2 percent of Nevada individual returns to only 0.3 percent of Kentucky returns. Examining audit rates by region, the TRAC data reveal an erratic pattern of IRS enforcement. The following questions therefore arise:

Does it appear that the IRS has developed and pursued logical, effective and coherent enforcement strategies? Does it appear that, as required by the United States Constitution, similarly situated taxpayers are being treated in similar ways? Can the IRS managers . . . explain and defend their tax enforcement strategies? [TRAC 1995a.]

This paper investigates these issues and examines whether political considerations play a role in determining IRS enforcement patterns. A statistical analysis of the TRAC data reveals a systematic relation between the rate of tax audits and the percentage of voters casting a ballot for Clinton. It was also found that audit rates within a district are related to the district having congressional representation on a committee charged with IRS oversight.

## The IRS: Its History and Responsibilities

The underpinnings of the IRS can be traced through a series of events in U.S. history. Under authority of the same 1791 law that established an excise tax on whiskey and led to the nation's first tax revolt, Treasury Secretary Alexander Hamilton created the Office of the Commissioner of Revenue—the predecessor of the modern IRS. The first federal income tax was passed as an emergency funding measure during the Civil War. The Office of the Commission of the Internal Revenue Service was established on July 1, 1862 (Bureau of Internal Revenue of the U.S. Treasury) and renamed the Internal Revenue Service in 1953. Its official mission is to collect the proper amount of tax revenue at the least cost to the public and in a manner that warrants the highest degree of public confidence in the IRS's integrity (U.S. Government Manual 1992–1993). Despite calls for the repeal of the income tax and criticism from an unlikely source, the IRS was here to stay. Writing to the U.S. House of Representatives

<sup>1</sup>The TRAC was established in 1989 to provide citizens with accurate information regarding the activities of federal agencies including the IRS.

Committee on Ways and Means in 1871, the commissioner of the IRS stated that he considered the income tax as “the one of all others most obnoxious to the genius of our people, being inquisitorial in its nature, and dragging into public view an exposition of the most private pecuniary affairs of the citizen” (House Misc. Doc. No. 51, 41–3; see <http://hellohanover.com/033197tax.html>).

In 1894, Congress enacted an income tax law that was challenged in the federal courts. In *Pollock v. Farmers’ Loan and Trust Company*, the Supreme Court found the law unconstitutional because it taxed real property without apportionment among the states according to population as required by Article 1, Section 8 of the Constitution.

The efforts for a federal graduated income tax by populists, progressives, and other reformers finally led Congress to submit to the states a constitutional amendment in 1909. On February 25, 1913, the 16th Amendment was ratified. It declared, “The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.” Congress assigned the responsibility of collecting income taxes to the IRS, and required income earners to file accurate and timely tax returns with the IRS. In that first year the rate of the federal income tax was 1 percent on income exceeding \$3,000 for unmarried individuals and \$4,000 for married filers. Today, a taxpayer may pay as much as 39.6 percent of earnings in the form of income taxes.

The IRS increased its ability to raise revenues during World War II. A law was passed requiring employers to withhold from salaries and wages the income taxes that were due the federal government. The wartime government desperately needed cash, but installment payments frequently left taxpayers with obligations that they could not meet. Withholding “meant that workers never even saw or held the money they earned before it was shipped off to Washington” (Davis 1997:196). After the war ended, President Truman held an informal meeting with congressional leaders to determine what to do about withholding. “The Congressmen quietly insisted that they wanted to keep the money coming in for a while” (Davis 1997:197). They wanted to build roads and bridges, schools and hospitals and “we want our names on them” (Davis 1997:197).

The income tax can represent significant costs to taxpayers in multiple forms. First, taxpayers not only are subject to paying high taxes, but they may pay a lot more. When the IRS determines that additional taxes are due, taxpayers are usually required to pay a penalty plus interest on the taxes owed. If the agency suspects that the taxpayer has knowingly evaded taxes, the IRS can even recommend that the

individual be charged with a criminal violation. Second, in addition to the \$7.2 billion needed to operate the IRS, at least \$225 billion (that is \$850 for every man, woman, and child in America) must be added to account for the cost of complying with the tax code ([http://www.fairtax.org/the\\_\\_case/index.html](http://www.fairtax.org/the__case/index.html))—and those dollars come from taxpayers.

As tax rates increased over the years, taxpayers eventually sought ways to avoid some or all of their income taxes. Over time, an underground economy evolved—that is, economic activities hidden from tax authorities through the under reporting of income, or the failure to report income. The size of this economy has been estimated to be as much as 10 percent of U.S. GDP (Marlow 1995: 458). The IRS seeks to lower such tax evasion through enforcement of the tax code.

Some observers point out that political considerations may influence enforcement activities such as audits. The blatant use of the IRS for political purposes is not new. During the Kennedy presidency, a mysterious IRS organization called “The Ideological Organizations Audit Project” was formed to investigate right-leaning groups; among those apparently targeted was Young Americans for Freedom (Davis 1997: 246). The Special Services Staff (SSS) was formed during the Nixon administration to coordinate “all IRS activities involving ideological, militant, subversive, radical, and similar type organizations” (Davis 1997: 88).

The Clinton Politicos, in their own report regarding the Travelgate Scandal (the firing of career travel office employees and their replacement with Clinton cronies), reveals that White House Associate Council William H. Kennedy III pressured the FBI to investigate the travel office and if “the FBI was unable to provide guidance, Mr. Kennedy might have to seek guidance from another agency, such as the IRS” (*Washington Times* 1997). Two days after the travel office workers were fired, three IRS agents visited UltraAir, the airline that handled most White House press travel.

Although accusations have been made that political considerations play a role in who is subjected to audits, IRS spokesperson Frank Keith insists, “agents are not susceptible to manipulation” (Scarborough 1997). Former IRS historian Shelley Davis, however, disagrees. “When you work for the IRS . . . you obey what your superiors at the IRS want you to do. That is the only way to climb the ladder to high level executive status” (Scarborough 1997). And a more politically minded commissioner could not have been found than Clinton appointee, Margaret Milner Richardson. Richardson, a close family friend and a self-described “yellow-dog” Democrat, worked on the 1992 Clinton campaign. Joseph Farah, director of the Western Journalism

Center, explains, “If you wanted to politicize the IRS, she was a great choice” (Adams 1997).

But does the IRS apply its enforcement activities, such as audits, uniformly among taxpayers? Based on recent anecdotal evidence from congressional hearings, and numerous newspaper accounts, we hypothesize that such activities of the IRS tend to be influenced by politics.

## Data and Empirical Results

The research data used to examine this hypothesis come from the TRAC. That database includes data from tax returns and IRS enforcement activities (TRAC 1995b). The data allow us to examine the audits of taxpayers by tax district (63 districts loosely associated with states).<sup>2</sup>

The results cause one to question what truly motivates audits. As Table 1 makes clear, the variations are large and somewhat puzzling. As David Burnham points out, “This kind of erratic enforcement increases cynicism of the public against their government” (*Times Daily* 1997).

Faced with this evidence, the IRS has tried to explain why their enforcement activities vary so widely between districts. One spokesperson suggested that audit rates are higher where the number of taxpayers that cheat are higher: “There are going to be some areas that have a higher noncompliance level” (*Times Daily* 1997). Along these same lines, Ted Brown, the head of the IRS criminal investigations units, adds, “One possible reason for the high number of audits could be the unusually large use of the earned income tax credit [EITC] in . . . relatively poor state[s]” (*Clarion-Ledger* 1997:1). The EITC is often abused and is apparently a so-called “red flag” in the decision to audit. IRS defenders also point out that the location of auditors accounts for a large portion of enforcement activity.

These explanations for enforcement patterns are subjected to empirical scrutiny and an OLS (ordinary least squares) model is used to test the influence of explanatory variables on audits (enforcement activities of the IRS). Taking each of the possible explanations of causation into effect (those offered by the IRS and those hypothesized by the authors), the following model was derived to determine what factors are correlated with the rate of tax returns audited across IRS districts:

<sup>2</sup>Except for a few of the more heavily populated states, IRS district boundaries and state boundaries are the same.

TABLE 1  
 RANK ORDER, ODDS OF DISTRICT TAX AUDIT 1995  
 (PERCENT IS BASED ON INDIVIDUAL RETURNS FILED)

State (Tax District)	Percent Audits	State (Tax District)	Percent Audits
Nevada	2.0	Vermont	0.6
California (Laguna)	1.6	New Mexico	0.6
California (San Francisco)	1.4	South Dakota	0.6
California (Los Angeles)	1.3	Indiana	0.6
Mississippi	1.2	Delaware	0.6
Georgia	1.1	New York	0.6
Idaho	1.1	Minnesota	0.6
Alaska	1.1	Florida (Jacksonville)	0.6
New York (Manhattan)	1.1	North Carolina	0.6
California (Sacramento)	1.1	Illinois (Chicago)	0.6
Texas (Dallas)	1.0	Kansas	0.6
Rhode Island	1.0	Missouri	0.6
Arkansas	0.9	Nebraska	0.5
California (San Jose)	0.9	South Carolina	0.5
Wyoming	0.9	Tennessee	0.5
Louisiana	0.9	Iowa	0.5
North Dakota	0.9	Massachusetts	0.5
Colorado	0.9	Michigan	0.5
Oklahoma	0.8	New York (Buffalo)	0.5
Connecticut	0.8	West Virginia	0.5
Texas (Houston)	0.8	DC/Maryland	0.5
Alabama	0.7	Wisconsin	0.5
Texas (Austin)	0.7	Virginia	0.5
Utah	0.7	Pennsylvania (Philadelphia)	0.4
Arizona	0.7	Illinois (Springfield)	0.4
Florida (Ft. Lauderdale)	0.7	New York (Albany)	0.4
Montana	0.7	New Jersey	0.4
Hawaii	0.7	Pennsylvania (Pittsburgh)	0.4
Maine	0.7	Ohio (Cleveland)	0.3
Oregon	0.7	Ohio (Cincinnati)	0.3
New Hampshire	0.7	Kentucky	0.3
Washington	0.7		

$$(1) \quad \text{Audit Rate} = A + b_1 \text{ POVERTY} + b_2 \text{ AGENTS} \\ + b_3 \text{ GAMBLING} + b_4 \text{ SENATE} \\ + b_5 \text{ HOUSE} + b_6 \text{ CLINTON} + e,$$

where POVERTY is the percentage of persons below the official poverty rate in 1993 and is entered to determine the influence of the EITC on the rate of audits. This variable is found in the *Almanac of the 50 States* (Hornor 1996). AGENTS is the 1995 per capita number of revenue agents in each district and is a part of the TRAC data (TRAC 1995b). It is expected that additional per capita agents will result in additional per capita audits within a particular district.

The decision to evade taxation can be mathematically modeled. Letting  $d$  represent the number of dollars underreported,  $c$  the probability of being caught,  $t$  the marginal income tax rate, and  $P$  the size of the penalty imposed, the optimal amount of evasion is given by the following:

$$(2) \quad td = cP(d),$$

and at the margin:

$$(3) \quad t = cP'.$$

Of course, individuals who are risk averse may wish to avoid such a gamble. Thus, more evaders are expected where a greater number of risk takers reside. To capture the influence of noncompliance, state gambling dollars from parimutual, lottery, casino and devices, bookmaking, card rooms, bingo, and charitable games are included in the model (*U.S. News & World Report* 1996: 57).<sup>3</sup>

Public choice theorists claim that the activities of government are guided, at least in part, by political considerations. CLINTON is included as an independent variable and represents the percentage of total votes within a state cast for Clinton in the 1992 presidential contest. If fewer audits per return were performed in states that gave greater political support to the administration, then the results would suggest that a reelection strategy helped to shape IRS enforcement activity. The variable is found in the *Statistical Abstract of the United States*, 1996.

A number of studies of the determinants of government expenditures have found that the relative power of a state's representatives in Congress plays a role in determining geographically where dollars are spent. The results of one such study suggested that even the

<sup>3</sup>This is admittedly a rough estimate because of cross-state participation in lotteries.

number of soldiers per state put at risk during the Vietnam War was negatively related to the clout of the state's politicians (Goff and Tollison 1987). Thus, it is not unlikely that IRS administrators would be sensitive to congressional power and, in particular, be hesitant to annoy those citizens whose representatives are charged with IRS oversight. Both of the independent variables, SENATE and HOUSE, are entered in this regard.

SENATE is a dummy variable equal to one if the states' senator is a member of the Senate Taxation and IRS Oversight Committee and zero otherwise. HOUSE is likewise a dummy equal to one if the representative within one of the 63 IRS districts was a member of the House Ways and Means Committee, the committee charged with IRS oversight, and zero otherwise. (Committee membership was found in *Congressional Quarterly* 1996.)

The results are presented in Table 2. The model explains nearly 50 percent of the variation of the dependent variable. The variables POVERTY, GAMBLING, and AGENTS are all positive and significant and thus behave as IRS defenders predicted. More agents in a district result in more audits, and the EITC along with gambling dollars attracts the attention of the IRS. Interestingly, our results suggest that gambling activity may serve as a proxy for risk-taking behavior—the kind of behavior exhibited by tax evaders.

The political variables offer explanatory power as well. SENATE was negative and significant at the 10 percent level, indicating that citizens residing in those states whose senators were members of the IRS oversight committee were subjected to fewer audits. Likewise, taxpayers in districts with representatives on the powerful Ways and Means Committee experienced significantly fewer audits. In addition, the variable CLINTON was negative and significant at the 10 percent level of confidence, indicating that greater political support in a state resulted in a lower rate of returns audited. In fact, an increase of 10 percent in the 1992 presidential vote for Clinton led to a 0.1 percent reduction in audits.<sup>4</sup>

Finally, a second equation was used to test for the presence of an endogenous variable—specifically AGENTS. A two-stage least squares model was estimated (see Table 2). During the first stage, the number of agents assigned during President Bush's last term served as an instrumental variable. The findings were similar to those in the simple OLS model above.

<sup>4</sup>Only the explanatory variables CLINTON and POVERTY were significantly correlated at the 5 percent level of confidence with the correlation coefficient equal to 0.27.



TABLE 2  
ACCOUNTING FOR IRS AUDIT ACTIVITY

Independent Variables	Dependent Variable: Percentage of Individual Returns Audited	
	OLS Results	TOLS Results
AGENTS	0.006 (4.99) <sup>***</sup>	—
GAMBLING	0.000006 (5.14) <sup>***</sup>	0.000006 (5.06) <sup>***</sup>
POVERTY	0.023 (2.86) <sup>***</sup>	0.023 (2.79) <sup>***</sup>
SENATE	-0.13 (1.79) <sup>*</sup>	-0.129 (1.75) <sup>*</sup>
HOUSE	-0.14 (2.09) <sup>**</sup>	-0.134 (2.04) <sup>**</sup>
CLINTON	-0.01 (1.87) <sup>*</sup>	-0.01 (1.83) <sup>*</sup>
PREDICTED AGENTS	—	0.006 (4.76) <sup>***</sup>
CONSTANT	0.513 (2.18) <sup>**</sup>	0.26 (0.97)
R <sup>2</sup>	49.9	48.4
F-Statistic	9.12 (0.000)	8.6 (0.000)
Number of Observations	63	63

NOTE: t-statistics in parentheses below estimated coefficients; \* indicates coefficient is statistically significant at the 90 percent confidence level; \*\* indicates coefficient is statistically significant at the 95 percent confidence level; \*\*\* indicates coefficient is statistically significant at the 99 percent confidence level.

Our results suggest that political factors play a role in determining whether taxpayers in a particular state or region are subjected to audit.

## Conclusion

While history is replete with anecdotal evidence concerning the misuse of the Internal Revenue Service, this paper attempts to offer, to our knowledge, the first empirical evidence of systematic political manipulation. Findings reveal that the IRS is more active in states

where noncompliance is more likely, but we also find evidence that political factors help shape enforcement patterns. For example, the IRS audits fewer returns in states whose representatives are members of congressional committees charged with IRS oversight. In addition, taxpayers in those states that gave Clinton greater political support were subjected to significantly fewer audits. Using 1995 audit rate data from the 63 IRS districts across the nation, we find that political factors offer significant explanatory power. In particular, a 10 percent increase in the vote for Clinton in the 1992 presidential election led to a 0.1 percent reduction in returns audited from the state. Thus evidence supports our hypothesis that both public-interest and private-interest motives shape IRS enforcement activity.

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