State of New York
Office of the State Comptroller
Division of Management Audit

DEPARTMENT OF TAXATION AND FINANCE

THE DECISION TO PRIVATIZE PERSONAL INCOME TAX RETURN PROCESSING AND THE PROJECTED COST SAVINGS FROM PRIVATIZATION

REPORT 96-S-45

H. Carl McCall

Comptroller

State of New York
Office of the State Comptroller

Division of Management Audit

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Mr. Michael Urbach
Commissioner
Department of Taxation and Finance
State Campus, Building 9
Albany, New York 12227

Dear Mr. Urbach:

The following is our audit report on the Department of Taxation and Finance's decision to privatize personal income tax return processing and the cost savings projected by the Department from the privatization.

This audit was performed pursuant to the State Comptroller's authority as set forth in Section 1, Article V of the State Constitution and Section 8, Article 2 of the State Finance Law. Major contributors to this report are listed in Appendix A.

Office of the State Comptroller
Division of Management Audit
and State Financial Services

March 16, 1998

Executive Summary

Department Of Taxation And Finance
The Decision To Privatize Personal Income Tax Return Processing And The Projected Cost Savings From Privatization

Scope of Audit

In 1994 the Department of Taxation and Finance (Department) entered into a ten-year contract with Fleet Services Corporation (Fleet) to privatize processing of the State's personal income tax returns. Department officials estimated that the contract, through the use of advanced technology, could cut the cost of tax processing by $76.5 million over the ten-year period. (This estimate was made prior to the decision to move Fleet's tax processing operations from Albany to the Kingston area in September 1996.) Department officials also reported that other benefits would be derived from the privatization effort, including faster taxpayer refunds, more accurate processing of tax returns and improved taxpayer service.

Our audit addressed the following questions about the privatization effort during the period June 1, 1992 through June 30, 1996:

- In deciding whether to privatize tax processing operations, did Department officials adequately address the issues that should be considered when government services are privatized?

- How reasonable are the cost savings from privatization projected by the Department?

Audit Observations and Conclusions

We conclude that Department officials did not thoroughly review all aspects of privatization before taking action to privatize personal income tax return processing. We determined that the original estimated savings of $76.5 million should be reduced by $32.1 million to $44.4 million because of flaws in the procedures used by the Department to estimate these costs and because actual State salary increases during the first five years of the contract were significantly less than projected by the Department. In addition, according to Department officials, estimated savings will be further reduced by $24 million as a result of the relocation of tax processing operations from Albany to Kingston. We have begun a separate audit of the relocation costs to determine the extent to which savings will actually be reduced.

We found that certain critical issues that need to be considered in any privatization effort were not adequately considered by Department officials. For example, the officials began to privatize personal income tax return processing operations without a thorough cost-benefit analysis comparing the

in-house cost of processing tax returns to the cost of contracting for these operations. The cost-benefit analysis used was not based on the same scope of work. Fleet's estimated costs are based on the use of imaging technology to automatically scan information from tax returns, while the Department's estimated in-house costs are based on the manual input of this information. We believe part of the reason certain critical issues were not adequately considered in the Department's privatization decision is that New York State lacks formal guidelines for making privatization decisions. To maximize the benefits of privatization, we recommend such guidelines be established. (See pp. 5-8)

Department officials reported that services would be improved when tax processing operations were privatized. We found that, according to Department reports, some services have improved since the operations were privatized. For example, the reported number of refunds processed before April 15, 1996 nearly doubled. (See p. 9)

According to Department officials, the Department's in-house costs to process personal income tax returns over the ten-year contract period would be $281.5 million, while the cost to the Department for the returns to be processed by Fleet would be $204.9 million. As a result of flaws we identified in the Department's cost savings estimate, we reduced the Department's estimate of in-house costs by $7.1 million to $274.4 million, and increased the estimated contract costs by $8.0 million to $212.9 million. For example, certain rent and utility costs were included in the in-house estimate, even though these costs continued to be incurred after tax processing was privatized. (See pp. 11-16)

Department officials told us that the privatization of personal income tax return processing is an unprecedented success, including saving millions of dollars for New York's taxpayers. However, the Department does not have a system to monitor cost savings to ensure that this primary goal is achieved. Officials told us that the only way to determine if cost savings are achieved is to review their overall budget reductions. Our analysis showed that since the 1993-94 State fiscal year, actual Department expenditures increased overall. (See pp. 17-20)

We recommend that, after the cost of relocating tax processing operations to Kingston is taken into account, Department officials, with the assistance of a qualified independent party, should re-estimate the contract costs and re-estimate the in-house costs (ensuring that these costs include the use of imaging technology), and compare the new estimate of contract costs to the new estimate of in-house costs to determine whether the contract is cost-effective.

Comments of Officials

Officials disagreed with the need for an independent assessment of privatization but agreed to undertake a cost-benefit analysis to assess the feasibility of a cost accounting system. (See also Appendix B and C.)

Contents

Introduction

Background

The Department of Taxation and Finance (Department) administers the State's tax laws. In fulfilling its responsibilities, the Department annually collects over $32 billion in State revenue and over $13 billion in local taxes (such as sales taxes) and New York City and City of Yonkers income taxes.

In 1994 the Department began a multi-year project to privatize processing of the State's personal income tax returns with a contract of $197.96 million with Fleet Services Corporation (Fleet). The length of the contract, which was executed on December 30, 1994, is eight years with a two-year extension option. This project is the largest privatization initiative in State history. According to Department officials, the project's purpose is to re-engineer personal income tax return processing to improve efficiency, reduce costs and enhance services to taxpayers. The paramount goal of this project is to implement electronic filing, magnetic media filing and other technology-based strategies to replace the filing of paper tax returns. The full scope of the project includes:

- quarterly processing of 2.5 million estimated tax returns, including paper and technology-based filings,
- annual processing of 2.5 million personal income tax returns with remittances, including paper, electronic, and magnetic media filings, and
- annual processing of 7.5 million personal income tax returns requiring refunds, including paper, electronic, and magnetic media filings.

To meet the project's goal, the contract privatizes the "front-end" personal income tax processes, including receiving tax returns, depositing remittances, reviewing tax returns for completeness, and capturing and verifying certain data. The Department retains responsibility for all "back office" functions, including processing tax returns, verifying certain data, processing and accounting for refunds, auditing tax returns, billing unpaid taxes, collecting overdue taxes, analyzing tax policy, and forecasting revenue.

Department officials estimated that the privatization contract, through the use of advanced technology, could cut the cost of processing personal income tax returns by $76.5 million over the ten-year contract period. (This estimate was made prior to the decision to move Fleet's tax processing operations to the Kingston area in September 1996; Department officials have stated that the estimated savings will be reduced as a result of this move.) According to Department officials, most of the cost savings would come from eliminating between 1,100 and 4,000 of the part-time workers who are hired between January and June of each year to process personal income tax returns. These

workers would be able to be eliminated because Fleet will use imaging technology to automatically scan information from taxpayers' returns in computer format for transmission to the Department. Prior to the execution of the contract on December 30, 1994, the Department and Fleet accelerated the implementation of the imaging technology from the third year of the contract to the first year of the contract. This change increased Fleet's capability to implement legislation effective June 9, 1994 and applicable to tax years beginning after 1993, which reduced the interest-free payment period for personal income tax returns from 90 to 45 days. Department officials also report that other benefits will be derived from the privatization effort, including faster taxpayer refunds, more accurate processing of returns and improved taxpayer service. The contract with Fleet further provides for disaster recovery operations at a cost of more than $7 million. Under this contract provision, Fleet must quickly recover critical operations that are incapacitated by a disaster. Prior to the contract with Fleet, the Department did not have disaster recovery capability.

Audit Scope, Objectives and Methodology

We audited the process used by the Department in deciding to privatize personal income tax return processing. Our audit focused on the cost savings from privatization that were projected by the Department. The objectives of our audit were to (1) determine whether the Department adequately addressed the issues that should be considered by a government agency when privatizing an existing function, and (2) assess the reasonableness of the projected cost savings. The period covered by our audit was June 1, 1992 through June 30, 1996.

To accomplish our audit objectives, we interviewed Department officials and reviewed Department records. We also interviewed officials in the Office of the State Comptroller (OSC) who were responsible for reviewing the contract between the Department and Fleet. We also reviewed correspondence between the Department and OSC concerning the Department's privatization plans, minutes of certain meetings involving OSC officials, and the Request for Proposal issued by the Department when seeking a contractor to process personal income tax returns. In addition, we reviewed various publications about the privatization of government services. These publications included reports prepared by the Federal Office of Management and Budget (OMB), Louisiana, Massachusetts, New York State, and New York City, and contained guidelines for evaluating privatization proposals.

We conducted our audit in accordance with generally accepted government auditing standards. Such standards require that we plan and perform our audit to adequately assess the operations of the Department which are included within the audit scope. Further, these standards require that we understand the Department's internal control structure and compliance with those laws, rules and regulations that are relevant to the operations which are included in our audit scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in the accounting and operating

records and applying such other auditing procedures as we consider necessary in the circumstances. An audit also includes assessing the estimates, judgments, and decisions made by management. We believe that our audit provides a reasonable basis for our findings, conclusions and recommendations.

We use a risk-based approach to select activities for audit. We therefore focus our audit efforts on those activities we have identified through a preliminary survey as having the greatest probability for needing improvement. Consequently, by design, we use finite audit resources to identify where and how improvements can be made, and devote little audit effort to reviewing operations that may be relatively efficient or effective. As a result, we prepare our audit reports on an "exception basis." This report, therefore, highlights those areas needing improvement and generally does not address activities that may be functioning properly.

Response of Department Officials to Audit

The matters contained in this report were provided to Department officials for their review and comment. Their comments have been considered in preparing this report, and are included as Appendix B.

Within 90 days after final release of this report, as required by Section 170 of the Executive Law, the Commissioner of the Department of Taxation and Finance shall report to the Governor, the State Comptroller and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons therefor.

The Decision To Privatize Personal Income Tax Return Processing

Various publications about the privatization of government services identify several possible advantages and disadvantages to privatization. The possible advantages include reduced costs, greater efficiency, quicker decision-making, better services, fewer barriers to innovation, freeing of government capital for other purposes, private sector job creation, and additional property and income tax revenue. The most frequently used form of privatization in Federal and state governments is to contract for services.

The possible disadvantages of privatization include lower quality services, reduced public access to services, loss of government sovereignty, less protection against conflicts of interest, loss of public accountability, fraudulent and predatory commercial practices, exploitation of part-time workers through low wages and benefits, and difficulty of monitoring and administering contracts. In addition, any cost savings from privatization may consist almost entirely of wage differences between organized public employees and unorganized and often part-time or temporary employees of private sector contractors.

If a government agency is considering privatizing its services, it should carefully analyze the prospect to ensure the advantages of privatization outweigh the disadvantages. In our review of publications about the privatization of government services, we found no established criteria or methodology for evaluating the advantages and disadvantages of privatization. However, reports prepared by the Federal OMB (issued in 1966 and revised through 1996), Louisiana (issued February 1995), Massachusetts (issued November 1993), New York State (issued June 1995), and New York City (issued September 1994) describe various methodologies for evaluating privatization proposals. While Department officials stated that they did not have the benefit of these privatization reports during the preparation of their analysis in 1992 and 1993, three of these reports were available before and during the Department's contract development process. When we compared these methodologies, we found they generally agree that the following critical issues need to be considered in any privatization effort:

- State governments need to accurately determine the cost of delivering a service.

- An independent consultant or a private accounting firm should assist in the calculation of the in-house costs of providing government

services, because such external assessments tend to be more objective.

- The government agency's in-house estimate of the cost of providing services and the cost estimates prepared by the prospective private contractors must be based upon the same scope of work and the same performance standards.

- In-house costs should be compared to contract costs before a decision is made to privatize operations. Moreover, according to the Federal OMB, privatization should not be chosen on the basis of cost savings if the savings do not equal at least 10 percent of the in-house costs.

We examined the process used by Department officials in deciding to privatize personal income tax return processing to determine whether these critical issues were adequately considered. We found that these critical issues were not adequately considered by Department officials in their decision to privatize personal income tax return processing, as follows:

- Department officials did not obtain the assistance of an independent party when determining the in-house costs of personal income tax return processing and, as is described later in this report, the Department's estimate of in-house costs was not accurate.

- When Department officials compared their in-house costs to Fleet's costs, they did not base the comparison on the same scope of work. Fleet's estimated costs include the use of imaging technology to automatically scan information from taxpayer returns, while the Department's estimated costs do not include the use of imaging technology. Rather, in their estimate of in-house costs, Department staff would continue to manually input information from taxpayer returns. Department officials told us that, because of operational and financial constraints, the Department could not implement imaging technology. However, the officials could not provide us with documentation of these constraints. For example, Department officials could not provide any evidence which would indicate the State Legislature would not have made available sufficient funding for personal income tax return processing as part of New York State's Capital Budget Plan.

- The chronology of events shows that Department officials began to privatize personal income tax return processing without a thorough cost-benefit analysis comparing in-house costs to contract costs. In a June 23, 1992 letter to OSC, a Deputy Commissioner of the

Department informed OSC officials that the Department planned to privatize personal income tax return processing. However, the Department's estimate of in-house costs was not completed until November 1993, well after the Department had already issued its Request for Proposal (RFP) for contracted services in January 1993. Moreover, the Department began to privatize personal income tax return processing in February 1994, eleven months before the contract was approved by OSC.

We also note that the privatization cost-benefit analysis prepared by the Department did not consider the potential disadvantages of privatization, such as exploitation of part-time workers through low wages and benefits, the difficulty of monitoring and administering contracts and the loss of government sovereignty. We therefore conclude that Department officials did not thoroughly review all aspects of privatization before beginning to privatize personal income tax return processing.

In our judgement, part of the reason the critical issues were not adequately considered in the Department's privatization decision is that New York State lacks formal guidelines for making such decisions. Since privatization may be an option for a number of services provided by State agencies, we believe such guidelines should be developed. In the absence of such guidelines, the privatization decisions that are made are less likely to be in the best interests of New York State.

Department officials contend that their exhaustive research and comparison of all viable options was the basis for their final decision to privatize personal income tax return processing. Our audit shows that Department officials were strongly pre-disposed in favor of privatizing personal income tax return processing before they conducted their exhaustive research. For example, the Department's June 1992 letter to OSC not only states the intent of the Department to privatize personal income tax return processing, but documents the services required to be made part of the contract and was accompanied by an attachment justifying the contract length. It is evident to us the Department performed a significant amount of work in developing this letter to inform OSC of its intent to privatize personal income tax return processing before performing its research. Moreover, in response to OSC's follow-up letter, dated October 6, 1992, requesting additional information for 13 critical issues including the availability of technology, prospective bidders, contract length and the cost and estimated savings from this privatization effort, Department officials responded on October 15, 1992 that most or all of the issues would be addressed by the RFP which was not yet complete.

Department officials also told us that the models used by the other states in evaluating privatization methodologies and the treatment of privatization costs were for business functions dissimilar to tax processing operations and were therefore inappropriate. However, we note that the Federal OMB requires Federal agencies to use their guidelines for privatizing hundreds of different Federal government functions including social and health services, equipment maintenance, research and development, automated data processing and other manufacturing and non-manufacturing functions.

Department officials further stated that the models used by the other states were not consistent in their treatment of certain privatization costs. However, contrary to this assertion, our analysis shows that these models were consistent with one another in their treatment of most privatization costs.

Recommendation

To the Governor

1. Establish via legislation or executive order, procedural guidelines to be followed by State agencies when deciding whether or not to privatize or outsource State services or activities. Such guidelines should emphasize the need to:

   - consider the advantages and disadvantages of privatization including those discussed in this audit report;
   - conduct a comprehensive cost-benefit analysis before taking steps to privatize services;
   - engage affected stakeholders on the potential impact; and
   - utilize a qualified independent party in the development of the cost-benefit analysis.

Benefits of Privatization

According to Department officials, as a result of privatization, taxpayers will receive their refunds sooner, tax returns will be processed more accurately, and taxpayers will receive better service. For the 1995 processing year, the Department reported that Fleet received 10 million 1994 personal income tax returns, accelerated the deposit of 2 million personal income tax remittances valued at $1 billion, deposited in a timely manner 2 million estimated income tax remittances valued at $3.5 billion, and processed in a timely manner more than 5 million IT-201 long tax forms and attachments. According to Department officials, because Fleet absorbed additional work beyond the scope of the original contract (and was compensated for this work through a contract amendment), the Department was able to pay 804,000 tax refunds valued at $441 million 45 days earlier than the previous year, in accordance with new legislation.

In addition, during the 1995 processing year, the Department reportedly processed 50,000 more refunds than in the 1994 processing year, and paid $2.75 million less interest than in 1994. For the 1996 processing year, the Department reported that it had nearly doubled the number of refunds processed before April 15 and had processed more tax returns overall. Department officials attributed these successes to Fleet and its high technology imaging system.

The Department reported the following back-office tax processing operation enhancements and benefits are being implemented:

- Department auditors will access images rather than require paper returns, expediting audit activity. By making auditors more efficient, additional revenue will be generated.

- Processing specialists will access images rather than require paper returns to resolve protests and correct exceptions. By making processing specialists more efficient, taxpayer problems will be resolved more timely, interest on late paid refunds will be avoided and assessments will be issued and collected more timely.

- OSC pre-audit staff will make use of images beginning with the 1998 processing year to perform their review of personal income tax refunds. This will significantly and positively impact OSC's ability to timely perform their reviews, since they will no longer have to wait for paper returns to be retrieved and transported.

Cost Savings

The privatization of personal income tax return processing began during the 1994-95 State fiscal year. If the Department's contract with Fleet runs through the two option years, it will extend into the 2004-05 fiscal year. To determine the full cost of this contract for this ten-year period, we requested Department officials to estimate the costs of developing the contract RFP and administering and monitoring the contract, and added these costs to the projected contract payments to Fleet, for a total of $204.9 million. To determine the in-house costs over the ten-year period if personal income tax return processing were not privatized, Department officials projected 1991-92 costs (the most recent data available at the time) to the 1994-95 fiscal year (the first year of the contract), and multiplied these costs by an annual inflation factor over the remaining nine years of the contract, for a total of $281.5 million. As a result of these calculations, Department officials estimated that privatizing personal income tax return processing would save $76.5 million over the ten-year period.

However, we found that the cost estimates developed by the Department could have been more reasonable. When we adjusted the estimates to make them more reasonable, we determined that the original estimated savings of $76.5 should be reduced by $15 million to $61.5 million because of flaws in the procedures used by the Department to estimate these costs. We also determined that savings were reduced further by $17.1 million because actual State salary increases during the first five years of the contract were significantly less than projected by the Department. As a result, savings are reduced to $44.4 million. In addition, according to Department officials, estimated savings will be further reduced by $24 million as a result of the relocation of tax processing operations from Albany to Kingston. We will separately audit these relocation costs to determine the extent to which savings will actually be reduced.

Projected In-House Costs

We asked Department officials to provide us with supporting documentation for their estimate of the in-house costs for personal income tax return processing over the ten-year contract period. In response to our request, the officials provided us with a cost schedule from the Fall of 1993 totaling $234.8 million. However, because of various errors we identified, this schedule had to be revised, and in November 1996, the officials provided us with a revised cost schedule totaling $282.8 million. However, this schedule also had to be revised because of errors we identified, and in December 1996, the officials provided us with a third cost schedule totaling $281.5 million. The officials could not explain many of the variances in the different cost schedules; they told us that the employees who developed the original in-house cost estimate may have been able to explain the variances, but these

employees were no longer employed by the Department. We examined the third cost schedule amounting to $281.5 million, which is summarized in Exhibit A, and attempted to verify the reasonableness of the estimated costs.

According to Department officials, the estimated in-house costs for the first year of the contract were based on actual Department costs for the 1991-92 fiscal year. Because the Department's accounting system does not allocate costs among the various Department functions, e.g., personal income tax, sales tax, corporation tax, etc., Department officials based their projection of in-house personal service costs on interviews with Department managers, who were asked to estimate the portion of their staff's personal service costs that related specifically to personal income tax processing. In the absence of a cost accounting system, this overall estimation process used by the Department appears reasonable. However, we believe the Department should develop a cost accounting system that accurately allocates all costs among the various Department functions.

The estimated in-house costs for the second through the tenth year of the contract were based on the estimated in-house costs for the first year of the contract as multiplied by an annual inflation factor. The same inflation factor was applied to both personal service costs and non-personal service costs. For the second year of the contract, the inflation factor was 5.25 percent; for the remaining eight years of the contract, the inflation factor was 5 percent.

The Department required Fleet to escalate its proposed $197.96 million contract cost (which is considered a non-personal service cost) using the consumer price index for urban areas, which was 4.1 percent at the time. We believe it would have been fairer and more reasonable to expect the Department's non-personal service costs to increase by this same 4.1 percent each year during the contract period, rather than by personal service rates of 5.25 or 5 percent. In addition, since certain kinds of non-personal service costs normally do not increase each year (in the Department's estimate, such costs consisted of amortized equipment costs and travel mileage costs), we believe the inflation factor should not be applied to these costs. However, Department officials applied the inflation factor to both amortized equipment costs and travel mileage costs. We therefore adjusted the Department's estimate of in-house costs by applying no inflation factor to amortized equipment costs and travel mileage costs, and by applying the 4.1 percent inflation factor to the remaining non-personal service costs. As shown in Exhibit A, this adjustment was a factor in decreasing the Department's estimated non-personal service costs during the contract period by $.9 million.

We also believe the inflation factors applied to Department personal service costs (5.25 percent and 5 percent) are excessive. These percentages were used by Department officials at the instruction of officials from the Division of the Budget, who based the percentages on the annual rate of increase in

State employee paychecks as calculated by the OSC Employee Retirement System for actuarial purposes. However, these calculations, which are based on 22 years of data, include periods of high inflation and large increases in State employee pay rates during the 1970s and 1980s. According to State employee contracts, between 1985 and 1995, State employee pay rates increased by an average of 4 percent a year.

To determine a more reasonable inflation factor for Department personal service costs, we applied a weighted average forecasting technique to the annual cost-of-living increases in State employee pay rates between April 1, 1985 and March 31, 1995. This forecasting technique places more weight on recent occurrences because such occurrences tend to be more predictive of the future. Using this technique, we calculated possible annual inflation rates of 2.94 percent, 3.45 percent or 3.72 percent. Adopting a more conservative approach, we selected the 3.72 percent rate.

We therefore adjusted the Department's estimate of in-house costs by applying the 3.72 percent annual inflation rate to the Department's personal service costs during the contract period. As shown in Exhibit A, this adjustment was a factor in reducing the Department's estimated personal service costs during the contract period by $7.8 million.

Department officials initially contested our alternative computation because it covered the ten-year period through 1995 and thus, this information was not available to them at the time of their cost savings calculation. We note that this information was available to officials in the Spring of 1993 when State employee contracts which cover the period through March 31, 1995 were approved by the State legislature. Consequently, Department officials accepted our methodology and also stated that, if our alternative computation were to be accepted, the inflation factor should be increased from 3.72 percent to 3.9 percent to account for two lump sum bonus payments that were made to Department employees as part of the collective bargaining agreements between the State and its employees. We disagree. The two bonus payments were not added to the OSC calculation of 3.72 percent, because they were incurred prior to the base year. Therefore, such costs would not be part of annual inflationary increases over the projected ten-year period.

We also identified other errors in the Department's estimate of in-house costs for the contract period, including the following:

- We identified errors that were made by Department staff in their calculation of the estimated employee fringe benefit costs for the contract period. As shown in Exhibit A, these errors understated fringe benefit costs by $3.4 million.

- Department officials estimated that, if personal income tax returns were processed in-house, the Department would pay $9.8 million in rent and utilities. However, the Department continued to pay the same rent and utilities after personal income tax return processing was privatized. Therefore, the $9.8 million in rent and utility costs was to be incurred regardless of privatization, and should not have been considered in the comparison between in-house and contract costs. As shown in Exhibit A, this error overstated the estimated in-house costs by $9.8 million.

- If personal income tax return processing were privatized, the Department would continue to pay certain staff until they were assigned to other Department functions or until they left State service (the cost of paying these employees is called the layoff avoidance cost). Since employees are not laid off unless personal income tax return processing is privatized, layoff avoidance costs should be associated with the cost of the contract with Fleet. However, Department officials did not add layoff avoidance costs to the estimated cost of the contract with Fleet; rather, to account for layoff avoidance costs, they subtracted these costs from the estimated in-house costs for the contract period. While subtracting layoff avoidance costs from in-house costs has the same monetary effect as adding the costs to contract costs, this approach distorts the cost estimates by understating in-house costs and contract costs by the same amount. Therefore, as shown in Exhibit A, we removed the layoff avoidance costs from the estimated in-house costs and added layoff avoidance costs to the estimated contract cost. Moreover, as a result of certain calculation errors as well as various other factors, we increased the layoff avoidance costs from $2.9 million to $4.0 million.

- If personal income tax returns were processed in-house, the Department would hire many temporary employees to help process the returns. However, the Department's original estimate of in-house costs did not include the payroll taxes that must be paid for these temporary employees. As shown in Exhibit A, this error understated the estimated in-house costs by about $5 million.

We adjusted the Department's estimated in-house costs for these errors. As shown in Exhibit A, as a result of all our adjustments, the Department's reported in-house costs for the contract period of $281.5 million were reduced by $7.1 million to $274.4 million.

Department officials disagree with most of our $9.8 million adjustment to projected in-house rent and utility costs. While they acknowledge that all $9.8 million in costs continue to be incurred after the privatization of personal

income tax return processing, they stated their belief that, in the future, $7.8 million of these rent and utility costs may be used for functions other than personal income tax processing. They therefore contend this $7.8 million should be used in determining privatization savings. We cannot accept the Department's position, because the possible use of the space for other functions is not described in detail, is not documented, and has not been justified as necessary for other functions. For example, it is possible that new or expanded functions could be implemented within existing space even if personal income tax return processing had not been privatized. In addition, the 1983 OMB and 1994 New York City guidelines clearly indicate such rent and utility costs are unavoidable costs and should not be included in the cost analysis.

In addition, as shown in Exhibit A, the Department projected a ten-year cost of $39.15 million for incumbent processing, which represents existing in-house costs under a separate Fleet contract for personal income tax receipt and deposit functions. The Department derived these costs from historical data, adjusting the contract amount for the partial State fiscal year 1994-95, holding constant the cost for the 1995-96 State fiscal year and escalating the cost by 4.1 percent for the remaining contract years. We concluded that the Department's methodology was reasonable and correct; therefore, we accepted the $39.15 million cost.

However, in September 1997, in response to our preliminary findings, the Department sought to add $22 million to its estimate of incumbent processing costs. The new estimate of $61.2 million for incumbent processing included about $42.9 million for the receipt and deposit functions, $13.6 million for program development and implementation, and $4.7 million for disaster recovery. We cannot accept this additional $22 million in estimated costs because, according to Department officials, disaster recovery functions and program development and implementation functions were already included in the existing $39.15 million contract with Fleet. Moreover, in response to our request for an estimate of the contract costs incurred through January 1997, the Department provided us with an updated estimate of the in-house costs for the ten-year contract period, including additional work that had been added to the original contract. According to this January 1997 update, and throughout the fieldwork stage of this audit, the Department continued to estimate that incumbent processing (the receipt and deposit functions) would cost $39.15 million.

In responding to our preliminary findings, Department officials also sought to further increase the estimated in-house costs by adding $7.3 million to provide disaster recovery services (in addition to the $4.7 million claimed for incumbent processing disaster recovery services) and $2.7 million to continue to administer and monitor Fleet's contract for the receipt and deposit functions. Department officials could not provide any reason why these costs

were not included in their original estimate of in-house costs, and when we examined these additional costs, we found that they could not be supported.

The $7.3 million for additional in-house disaster recovery costs is not based on a documented analysis of costs; rather, Department officials assume it would cost the Department about the same as Fleet to develop disaster recovery capabilities. We therefore cannot accept these additional estimated costs. Although we acknowledge that the Department would have incurred some disaster recovery costs for personal income tax return processing, in the absence of a cost analysis we cannot determine how much should have been included in the in-house costs.

Similarly, the estimate of an additional $2.7 million for contract administration and monitoring is not based on a documented analysis of costs; rather, Department officials assume that the costs of administering the Fleet contract for the receipt and deposit functions would be incurred at the same rate as the costs of administering the full privatization contract. However, regardless of the appropriateness of this assumption, we believe the costs of administering the receipt and deposit contract were already included in the Department's initial estimate of in-house costs, since this estimate was based on management's allocation of staff time to personal income tax return processing activities. Since the receipt and deposit functions were personal income tax return processing activities, it is reasonable to conclude staff involvement in these activities would have been accounted for. In the absence of documentation showing that the cost of administering this contract was excluded from the Department's initial estimate of in-house costs, we cannot accept the Department's claim that this expense should be added to the Department's estimated in-house costs.

Projected Contract Costs

Department officials initially reported that the cost of privatizing personal income tax return processing would be about $200 million. This amount should have included the contract payments to Fleet during the contract period, the costs incurred by the Department to develop the contract RFP before the contract period, and the costs incurred by the Department to administer and monitor the contract during the contract period. We asked Department officials to provide us with supporting documentation for this estimate, which included $195.5 million for contract payments to Fleet and about $4 million for unspecified costs incurred by Department staff. In response to our request, Department officials told us they were unable to support the $4 million in Department costs. When the officials created detailed schedules to account for the estimated costs of RFP development, contract administration and contract monitoring, the costs totaled $9.4 million. As a result, the Department's total estimate for the cost of privatization

increased to $204.9 million. We attempted to verify the reasonableness of this estimate.

When we examined the $9.4 million in costs to be incurred by Department staff for RFP development, contract administration and contract monitoring, we identified many of the same issues that we found in our examination of the Department's estimate of in-house costs for the contract period: personal service costs for contract administration and contract monitoring were overstated to the extent they were based on annual inflation factors of 5.25 or 5 percent rather than a more reasonable annual inflation factor of 3.72 percent; non-personal service costs for contract administration and contract monitoring were overstated to the extent they were based on annual inflation factors of 5.25 or 5 percent rather than an annual inflation factor of 4.1 percent; and employee fringe benefit costs were overstated as a result of numerous errors. We therefore adjusted the Department's estimate of these costs. As shown in Exhibit A, these adjustments increased the estimate of RFP development, contract administration and contract monitoring costs by a net total of $1.5 million.

In addition, as was the case in our examination of the Department's estimate of in-house costs if personal income tax return processing were not privatized, the estimate of personal service costs for RFP development, contract administration and contract monitoring is based on the amount of Department staff time that was allocated to these activities. Since these allocations are based on estimates made by Department managers, rather than on a formal system for allocating staff time among different activities, the allocations may not be as accurate as possible. However, since the overall estimation process used by the Department appears reasonable, we accept the Department's estimated contract costs for the first year of the contract.

Department officials stated their belief that RFP development costs should be included as both an in-house program cost and a cost of privatization. We cannot accept this approach, because such costs are clearly a contract related cost. The three reports from Massachusetts, New York City and OSC all agree such costs are part of the cost of contracting for services.

When we examined the $195.5 million in estimated contract payments to Fleet, we identified one error. Fleet is to receive more than $21 million, plus interest, in personal income tax return processing development fees over the course of the contract (these fees repay Fleet for funds that Fleet borrowed to purchase equipment and to develop personal income tax return processing). However, the interest ($2.4 million) was not included in the estimate of contract costs. Therefore, as shown in Exhibit A, we increased the estimate of contract costs by $2.4 million. As a result of all of our adjustments, the Department's reported contract cost of $204.9 million was increased by $8.0 million to $212.9 million.

Projected Cost Savings

According to the cost estimates developed by Department officials (an estimated $204.9 million in contract costs compared to an estimated $281.5 million in in-house costs), privatizing personal income tax return processing would save $76.5 million over the ten-year contract period. However, according to our adjusted cost estimates (an estimated $212.9 million in contract costs compared to an estimated $274.4 million in in-house costs), privatizing personal income tax return processing would save $61.5 million over this period, a reduction of $15 million in estimated savings.

According to Department officials, once personal income tax return processing was privatized, the Department would need to make less use of the temporary workers who are hired between January and June of each year to process personal income tax returns. In fact, Department officials expected most of the privatization savings to come from this reduced reliance on temporary workers. We tried to determine whether personal income tax return processing has made less use of temporary workers since privatization began. Since the Department does not have a system for allocating staff time among different Department functions, we could not readily analyze the use of temporary workers for personal income tax return processing. However, we were able to identify the use of temporary workers by the Department as a whole, as follows:

State Fiscal Year	***Cost of Temporary Personal Services***
1993-1994	$1,900,965
1994-1995	1,099,127
1995-1996	740,693
1996-1997	1,379,050

As shown above, the Department made much less use of temporary workers during the first two years personal income tax return processing was privatized (the 1994-95 and 1995-96 fiscal years). However, during the 1996-97 fiscal year, the Department's use of temporary workers increased significantly.

We also note that the Department's overtime payments to regular workers have increased significantly since personal income tax return processing was privatized, as follows:

State Fiscal Year	*Regular Personal Service Overtime*
1993-1994	$649,628
1994-1995	682,589
1995-1996	1,367,522
1996-1997	1,478,561

In the absence of detailed records relating personal service costs to specific Department functions, we cannot determine whether this increase in overtime payments, or the increase in temporary service costs, is attributable to the privatization of personal income tax return processing.

Department officials stated that temporary staff are used for special projects of varying duration and to support ongoing Department operations for specific time periods. Depending on the need and initiatives the Department must support (e.g., Tax Amnesty, etc.), the use of temporary staff may vary widely from year to year. We note that in January 1994, Department officials reported that all (personal income tax return processing) part-time and seasonal jobs would be eliminated in 1995. The Department appears to imply that such increased temporary and overtime costs are for other than personal income tax return processing related costs and that special projects and initiatives have dramatically increased in the last few years, but provided no data or financial analysis to support this position.

We asked Department officials if they tracked cost savings as part of their effort to determine if their cost savings goal was being achieved. Officials told us they do not track costs savings to determine whether their goal was being achieved. Because personal service costs represent 70 percent of the Department's in-house costs, we reviewed actual increases in State employees' salaries for the first five years of the Fleet contract to determine how these increases compared to the increases projected by the Department. We found that State employee salaries increased by an average of 2.1 percent over the period, compared to the 5.25 and 5 percent increases projected by the Department and the 3.72 percent increase projected by us. As a result, we determined the estimated cost savings from privatization would be further reduced by $17.1 million.

Department officials stated that the privatization of personal income tax return processing has been an unprecedented success, achieving all of its objectives, and costs to perform personal income tax return processing have been reduced significantly, saving millions of dollars for the taxpayers of New York State. We question the Department's basis for stating that the privatization

effort has saved millions of dollars for New York's taxpayers. Department officials were unable to provide us with updated cost savings data because they do not monitor savings to determine if one of their primary contract goals is being achieved.

Department officials acknowledge that there is no internal process to determine whether projected cost savings will be achieved. However, the officials stated their belief that certain Department budget reductions clearly demonstrate approximately $18 million in annual savings have been achieved during the State fiscal years 1993-94 through 1997-98 and that privatization savings are significant.

We disagree with Department officials. In the absence of a system to track, monitor and capture the actual effects and costs of privatization, the officials cannot demonstrate that any budget reductions are the result of privatization. For instance, for the 1996-97 State fiscal year, the Department reports that the State Division of the Budget made a non-specific reduction to the Department's budget of about $6.5 million and indicated the reduction included privatization impacts. Department officials provided no evidence showing that Division of the Budget officials had analyzed internal Department operations and costs and then determined that such budget reductions were directly related to privatization. We also note that the Department wide State expenditures for the State fiscal years 1993-94 through 1996-97 increased from about $260 million to about $292 million.

Department officials also stated their belief that, because of privatization, personal income tax refunds are processed quicker. When refunds are processed quicker, less interest is paid to taxpayers for late refunds. Department officials estimate the interest expense for late refunds will be reduced by $21.6 million, and believe privatization should be credited with this savings. To the extent that these cost savings can be substantiated, some savings, net of contract costs, may be realized.

Department officials also disagree with the need for an independent assessment of privatization and believe it would not be a prudent investment of resources. However, the officials have agreed to undertake a cost-benefit analysis to assess the feasibility of a cost accounting system.

Recommendations

To the Department:

2. With the assistance of a qualified independent party, recalculate the estimated contract costs and the estimated in-house costs of operating personal income tax return processing during the contract period. Ensure that the estimate of in-house costs includes the use of imaging technology, the other estimation errors identified by our audit are addressed, and the relocation to Kingston is taken into account. Compare the new estimate of contract costs to the new estimate of in-house costs to determine whether the contract is cost-effective.

3. Develop a cost accounting system that accurately allocates all Department costs among the various Department functions.

PRIVATIZATION OF PERSONAL INCOME TAX RETURN PROCESSING
ADJUSTED PROJECTED IN-HOUSE COSTS VS. ADJUSTED PROJECTED CONTRACT COSTS
JANUARY 1, 1995 - DECEMBER 31, 2004

COST ITEM	*DESCRIPTION*	*REPORTED COSTS*	*ADJUSTED COSTS*	ADJUSTMENTS
PROJECTED DEPARTMENT IN-HOUSE COSTS				
Personal Service	Employee Wages	$197,566,344	$189,722,020	$7,844,324
Employee Fringe Benefits	Employee Fringe Benefits	38,199,201	41,570,605	(3,371,404)
Payroll Taxes	Social Security, Unemployment, Worker's Compensation for temporary staff and State employee longevity awards.	0	5,040,001	(5,040,001)
Other Than Personal Service	Equipment, Supplies, Maintenance Agreements	8,702,375	7,769,452	932,923
Costs Prior to January 1995	In-House Costs Prior to January 1995	(9,075,432)	(8,870,501)	(204,931)
Layoff Avoidance	Personal Service Costs Incurred Before Employees Are Assigned to Other Department Functions	(2,895,914)	0	(2,895,914)
Incumbent Processing	Existing Functions Contracted With Fleet	39,146,678	39,146,678	0
Space	Rent and Utilities for State Campus Facilities	9,821,451	0	9,821,451
TOTAL		$281,464,703	$274,378,255	$7,086,448
PROJECTED CONTRACT COSTS				
Contract Cost	Projected Contract Payments to Fleet	$195,540,000	$197,960,000	($2,420,000)
RFP Development	Department Costs	2,054,232	2,177,677	(123,445)
Contract Administration	Department Costs	2,508,505	3,522,002	(1,013,497)
Program Monitoring	Department Costs	4,838,931	5,248,553	(409,622)
Layoff Avoidance	Personal Service Costs Incurred Before Employees Assigned to Other Department Functions	0	4,016,547	(4,016,547)
TOTAL		$204,941,668	$212,924,779	($7,983,111)

DIFERENCES BETWEEN PROJECTED IN-HOUSE AND CONTRACT COST	$61,453,476	
LESS ADJUSTED FOR STATE SALARY INCREASES	($17,083,237)	
ADJUSTED PROJECTED SAVINGS FROM PRIVATIZATION EXCLUDING RELOCATION COSTS	$44,370,239	

Exhibit A

Major Contributors to This Report

Jerry Barber
Frank Houston
Kevin McClune
Marvin Loewy
Arthur F. Smith
William Hughes
Maureen Costello
Michele Foley
Michael Muth
Sandy Prabhu
Mark Radley
Dana Newhouse

RESPONSE OF DEPARTMENT OFFICIALS TO THE AUDIT

Officials disagreed with the need for an independent assessment of privatization and stated their belief that it would not be a prudent investment of resources. The officials have agreed to undertake a cost-benefit analysis to assess the feasibility of a cost accounting system.

In response to our draft report, Department officials make numerous representations and assertions which, when fully evaluated, cannot be supported by the records, conditions or facts which existed when the Department considered privatizing personal income tax return processing. The cost savings analysis used by the Department was a significant component of its effort to publicly justify privatizing this operation. As a result of our audit, Department officials are now seeking to add millions of dollars in unsupported costs to their estimate of in-house costs in order to give the appearance of substantial savings from the privatization of personal income tax return processing. Officials now represent savings to be more than $99 million. Our audit documents that the original estimated savings of $76.5 million should be reduced by $32.1 million to $44.4 million because of flaws in the procedures used by the Department to estimate these costs and because actual State salary increases during the first five years of the contract were significantly less than projected by the Department. Additionally, our audit clearly demonstrates that the Department did not thoroughly assess or evaluate the effects of privatization, and that officials began to privatize personal income tax return processing before conducting the thorough research necessary to support this decision.

STATE OF NEW YORK
DEPARTMENT OF TAXATION AND FINANCE
W. A. HARRIMAN CAMPUS
ALBANY, NY 12227

MICHAEL H. URBACH
COMMISSIONER OF TAXATION AND FINANCE

March 3, 1998

Mr. Kevin M. McClune
Office of the State Comptroller
Alfred E. Smith State Office Building
13th Floor
Albany, New York 12236

Dear Mr. McClune:

Thank you for the opportunity to comment on the draft audit findings "Cost Savings and Benefits" relating to your examination of the Department's privatization of the Personal Income Tax Program with Fleet Services Corporation.

Our comments are split into two sections: (1) this letter, which summarizes our response to the draft audit report, and (2) a Detailed Audit Response, which is conveyed as an attachment. We realize that providing the Detailed Audit Response attachment is unprecedented. However, the nature of this audit and the significant disagreement between the auditors and the Department warrants the inclusion of this additional detail.

Goals of Privatization

The PIT 2000 Program is an unprecedented privatization success, achieving all of its goals, which include:

-- Enhanced services to taxpayers,

-- Improved program efficiency, and

-- Reduction in costs.

Clear, measurable achievements of these goals includes the following:

-- Taxpayers are receiving their refunds faster than before. In 1994, prior to privatization, 3.6 million taxpayers received their refunds by June 1, 1994. In contrast, in 1996, 4.7 million taxpayers received their refunds by June 1, 1996.

-- Interest cost resulting from late paid refunds has been reduced dramatically. In 1996, over $2 million was saved in interest payments for late refund checks compared to 1994. This is even more significant when considering that the deadline for interest free payment was 45 days earlier in 1996.

-- Remittances are being deposited on an accelerated basis, improving the State's cash flow.

-- Responsiveness to taxpayer inquiries and problems has dramatically improved, based upon the availability of automated tax return images produced by Fleet.

-- The State is achieving savings consistent with the PIT 2000 savings plan.

The Decision to Privatize

The Office of the State Comptroller's conclusion that the Department did not conduct a thorough analysis when making the privatization decision is incorrect. The Department implemented a comprehensive, structured approach that examined the critical issues pertinent to this procurement. Specifically, the Department:

-- Conducted a detailed functional analysis of the Department's program;

-- Conducted a detailed cost analysis of the Department's program;

-- Developed a comprehensive RFP (Request for Proposal), in excess of 1500 pages, to evaluate the cost-benefit of privatization;

-- Developed a Department alternative to privatization (Alternate Program Plan) which satisfied the RFP functional requirements (not including deposit services); and

-- Conducted a comprehensive evaluation of bidder proposals by Fleet and Chemical Bank (now Chase).

This exhaustive research and comparison of all viable options was the basis of the decision to privatize. Furthermore, this well-documented approach demonstrates that the Department made the final decision to privatize at the conclusion of the process, not prior to the RFP process, as stated by the auditors.

* Note 1

*See State Comptroller's Notes, Appendix C

Measurement of Savings and Cost: Savings for the State

Reductions have been taken in the Department's budget as the result of privatization. The auditors disagree with the Department by citing two examples. The first is that the $6.5 million "non-specific" 1996-97 reduction could not be tied directly to privatization. The report says that we could not provide evidence showing that the Division of the Budget had analyzed internal Department operations and costs and determined that budget reductions were directly related to privatization. The second is that the Department's overall budget increased from $700 million in 1993-94 to more than $1 billion in 1996-97.

While there may not be a specific reference to the 1996-97 budget reduction, the auditors fail to acknowledge that both the 1994-95 and 1995-96 Executive Budgets specifically reference reductions based on implementation of PIT 2000. We also disagree with the auditors that the Division of the Budget did not determine that budget reductions were directly related to privatization. In fact, in preparation of our appropriation requirements and the Division of the Budget's analysis of those requirements, adjustments were made in our appropriations for the years 1994-95 through 1996-97.

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Note
2

We do not know why the report states that there was an increase in the Department's budget from $700 million to $1 billion. The Department's overall available operating funding in 1993-94 was $273.0 million, and in 1996-97 it was $268.8 million. More specifically, the Revenue Information Management (RIM) funding for those years was $93.4 million and $86.9 million respectively.

*
Note
3

OSC and the Department both agree that the PIT 2000 Program should generate significant savings; however, there is disagreement on the reasonableness of methodology and, therefore, the resulting savings projection. The Department is projecting $99.75 million of savings while OSC is projecting $61.48 million of savings.

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Note
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Substantial agreement has been reached on the value of the savings for the majority of the categories included in the Department's 10-Year Savings Plan. As a result of differing methodologies selected by the Department and OSC, there is disagreement in three areas, valued at approximately $31 million:

-- The Department revalued incumbent processing (depository services) based on the lowest bid proposal, submitted by Fleet Bank. The auditors continue to value this service based on historical,

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Note
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*See State Comptroller's Notes, Appendix C

expired fees that are no longer applicable. This discrepancy accounts for approximately $22 million of the variance in savings.

-- Space (rent and utilities), which accounts for approximately $7.5 million of the discrepancy, is treated differently by the auditors and the Department. The Department included savings for space for the period the space is not being used by PIT 2000. We disagree with OSC's position that disallows any savings attributable to non-PIT 2000 use of space.

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Note
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-- The Department considers it inappropriate to include the cost of the RFP (approximately $2 million of the discrepancy) as a cost of privatization since these costs would have been incurred in the absence of a successful bidder. The auditors rejected the Department's proposed alternative methodology, which allows for this cost to be included both as a cost of privatization and a Department cost to perform the Program.

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Note
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Based upon the achievement of the broad range of programmatic and fiscal goals established for this privatization initiative, PIT 2000 is an unprecedented success.

The result is a win for everyone. Taxpayers are better served, the State saves taxpayer dollars, and the private sector has expanded business opportunities, resulting in increased tax revenue for New York State.

Response to the Recommendations

Recommendation 1: This recommendation was directed to the Governor. Therefore, we have not provided a response.

Recommendation 2: With the assistance of a qualified independent party, recalculate the estimated contract costs and the estimated in-house costs of operating the personal income tax return processing during the contract period....

Response: The Department does not agree that an independent assessment of program costs would be a prudent investment of our resources. Rather, the Department will continue to focus on achieving the full scope of Program goals which define the unprecedented success of PIT 2000.

*See State Comptroller's Notes, Appendix C

Recommendation 3: Develop a cost accounting system that accurately allocates all Department costs among the various Department functions.

Response: The Department will undertake a cost-benefit analysis to assess the feasibility of the cost accounting system recommended by OSC.

Very truly yours,

Michael H. Urbach

Michael H. Urbach
Commissioner

Attachments

Attachment: Detailed Response to the Audit Findings

A. History of Privatization

The Department has used the private sector for front-end tax processing and depository services for more than 30 years. During this time, Department staff developed extensive expertise in the management of privatized services. In recent years, prior to the Personal Income Tax (PIT) procurement, successful competitive procurements were conducted for several services, including Withholding Tax and Wage Reporting, Estate Tax, Gift Tax, Personal Income Tax Controlled Disbursement, International Fuel Tax Agreement (IFTA), and PrompTax (electronic funds transfer program). As a result of the Withholding/Wage Reporting procurement, costs to perform the Wage Reporting program were reduced; the same is true of the PrompTax procurement.

This extensive history of successful implementation and performance of these services within the banking industry, including the application of advanced technologies to tax processing services (e.g., electronic funds transfer), was the context within which the Department considered privatizing the PIT Program. PIT was the last remaining front-end tax processing program performed by the Department.

B. The Department's Goals for PIT 2000 Program

As is often the case, OSC's exception based reporting gives a narrow view of the program under audit. The only issues considered critical by OSC (p.5 of report) are financial in nature. As evidenced by the Program goals stated in the Personal Income Tax RFP, the Department's critical issues were much broader in scope and are essential considerations to assure the on-going success of the Program.

The Request for Proposal for Personal Income Tax Processing articulated the following strategic Program goals (Section III-2):

-- Improving the accuracy, completeness and timeliness of the initial processing of tax returns including data capture, data completeness and correctness and data management;

-- Capturing sufficient tax return data to provide taxpayers with more understandable explanations of assessments and adjusted refunds;

-- Capturing sufficient tax return data to enhance Department operations such as audit, revenue forecasting, statistical modeling and tax enforcement;

-- Reducing the cost to administer the program;

-- Enhancing the timeliness of deposit of remittances and payment of refunds;

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Note
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*See State Comptroller's Notes, Appendix C

-- Providing sufficient redundancy in the program to assure minimum impact in the event of processing site disruption; and

-- Enhancing services to taxpayers, such as faster responses to taxpayer inquiries regarding the status of refunds.

Building on the foundation established in the RFP and Fleet's proposal, the Department and Fleet jointly negotiated a contract which ensures the goals of the Program are achieved and maintained on an on-going basis.

While the Department did not have the benefit of privatization guidelines, our process considered the broad range of privatization issues and concerns, and has resulted in a successful Program.

C. The Privatization Process

In June 1992, the Department proposed undertaking a competitive procurement to evaluate the potential programmatic benefits and negative impacts of privatizing the front-end processing of Personal Income Tax. The audit report takes the June 1992 letter from the Department's Deputy Commissioner to OSC out of context. That letter was not intended to convey that the Department had made the decision to privatize the entire PIT Program. Rather, the purpose of that communication, (as well as discussions with the Division of the Budget) was to ensure critical control agency support if the Department determined that, based on the RFP and bidder proposals, privatization beyond depository services was the appropriate decision. This was a necessary and prudent preliminary step in the process of evaluating privatization.

With the approval of OSC and the Division of the Budget (DOB) the Department issued the PIT Request for Proposal (RFP) in January 1993 to assess interest in the banking community to perform this service and understand the cost to the Department. After analysis of two viable bids and comparing an Alternate Program Plan for the Department to implement a program consistent with RFP requirements, it was determined that it would be beneficial to privatize the PIT 2000 Program with Fleet Bank.

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Note
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The Department's first step in the PIT procurement process included a detailed analysis of the functions involved in Department's front-end processing program, as well as analysis of the Department's cost to perform this program. These analyses served two purposes. They formed the basis of the functional requirements for the RFP and the Department's Alternate Program Plan and provided the basis for the cost evaluation for privatization. The Alternate Program Plan satisfied the RFP's functional requirements (not including deposit services). The RFP functional requirements did not mandate imaging or any other specific technology. Therefore, the Department's Alternate Program Plan addressed the same scope (i.e., breadth) as Fleet's proposal.

*See State Comptroller's Notes, Appendix C

Department implementation of imaging was not considered feasible primarily due to the lack of technical expertise and limited ability to invest large amounts of capital in facilities improvements and equipment. This limitation was discussed with OSC and DOB as early as 1992. OSC's assessment of the potential for the Department to develop an imaging program internally is not realistic. During the time frame that the Department prepared its Alternate Program Plan, imaging technology had not matured sufficiently to be applicable to our program. Department experts evaluated Maryland's pilot imaging program for tax processing and reviewed IRS efforts at imaging. If an imaging Alternate Program Plan had been determined to be feasible, it would have included the services of a systems integrator to design and implement the hardware platform; design, code, and test the software; and implement the system and maintain it until the Department developed adequate expertise to do so independently.

During the time frame that bidders were developing responses to the RFP, the Department prepared its Alternate Program Plan, including the corresponding cost analysis. This process was completed prior to the opening of any proposals (consistent with the Federal Office of Management and Budget (OMB) circular A-76). Upon determination that bidder technical proposals were acceptable, financial proposals were compared with the Alternate Program Plan cost. The evaluation summary chart "Comparison of Projected Ten Year Development and Operations Costs" documents that the Department considered its Alternate Program Plan as part of the selection process. The final determination to privatize the Program to Fleet Bank was the result of this comparison.

*** Note 10**

OSC's findings failed to recognize that the RFP process was a critical component of the analysis that led to the decision to privatize; the decision to privatize did not occur prior to the RFP. The Personal Income Tax RFP prominently acknowledged that the Program would not be privatized if the Department determined that proposals were not cost effective. Specifically:

*** Note 1**

"The award of modules beyond those services already performed by depository banks would be largely dependent on the cost benefit of the solution proposed." (Section I-8)

and

"With respect to contracting for services currently provided by the Department we will consider awarding these modules, or part thereof, only if the proposal were to prove cost beneficial compared with our operational costs and our evaluation concluded that the quality of services would equal or surpass existing Department operations." (Section I-9)

Prior to awarding the Program to Fleet Bank, the Department had prepared a comparison of the projected Department cost to perform the current program with Fleet's cost. These

***See State Comptroller's Notes, Appendix C**

costs were projected over the ten year duration of the contract. The Savings Plan was a projection only, because the Program changes constantly over the ten year life of the contract. Our projection included all direct Program costs, including personal service, fringe benefits, equipment, space, and utilities to perform the Program based upon the 90 day interest free refund cycle, which was still in effect at the time. It also recognized the cost to retain permanent employees (i.e., avoid layoffs) until reassigned to other programs. It did not include indirect costs, such as general administrative costs and certain Program support costs (e.g., contract monitoring).

Privatization costs included the value of the Fleet contract, certain contract monitoring costs, and implementation costs.

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We did not include Department costs associated with the RFP process, since these costs would have been incurred even if the Program was not outsourced.

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Note
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The Department's cost projection was prepared during 1992 - 1993, and the privatization cost projection was completed upon analysis of the proposals. The Department did not consider an independent party in preparing cost projections, since the Department's Program experts were most knowledgeable of our Program and its associated cost. At this point, estimated savings of approximately $75 million was projected over the ten year contract duration. This savings projection was the basis of appropriation reductions to the budget for the Office of Revenue and Information Management.

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Note
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This exhaustive research and comparison of all viable options was the basis of the decision to privatize. Therefore, the comprehensive analysis resulted in the strategic decision to privatize the Program with Fleet Bank, not the reverse as asserted by OSC.

Upon award of the Program, Fleet and the Department immediately began the development and implementation effort, irrespective of the status of contract negotiations. This approach was critical in order to assure that the Program would be implemented timely for the 1995 processing year. Had Fleet and the Department not proceeded immediately, implementation of the Program would have been delayed until the 1996 processing year. Fleet's willingness to invest millions of dollars in the development effort without benefit of an approved contract reflects Fleet's commitment to the strategic partnership which is a cornerstone of the success of PIT 2000.

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Note
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D. The Cost Savings Plan

1. Overview

The Department did not have the benefit of the "models" referenced by OSC in the Report when preparing its analysis (1992 - 1993), since all of the "models" were published subsequent to the analysis. Furthermore, none of the State "models" or the

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Note
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*See State Comptroller's Notes, Appendix C

New York City "model" are for business functions similar to our tax processing services. The methodologies chosen by the Department were reasonable and appropriate to the particulars of our business environment.

The specific methodologies applied by the Department included:

-- Personal Service: Actual salaries of staff directly involved in providing the services to be privatized.

-- Fringe Benefits: Blended rate reflecting the mix of permanent and temporary staff receiving various levels of benefits, and using the most recent annual fringe benefit rate as the initial base.

-- Equipment: Estimated cost for outright purchase of the data entry environment. Financing was not assumed, since the financing cost was not considered significant. The Department conservatively assumed a five year replacement cycle.

-- Layoff Avoidance: Projected annual salaries and fringe benefits to retain staff until attrition and turnover allowed reassignment of this staff to other Department programs. The rate of turnover and attrition was based on the Department's historical experience.

-- Incumbent (Depository) Processing: Projected based upon fees specified in expiring agreements (which would be replaced by the proposed contract) applied to projected volumes.

-- Space: Projected based upon actual square footage utilized for those portions of the Program being privatized, since the space would be available for other purposes. The cost per square foot was provided by the Office of General Services. This cost includes utilities.

-- Inflation Factor: The Division of the Budget provided the annual inflation adjustment to be applied to State costs. The factor was based upon the growth factor for the Employee Retirement System, which is based upon extensive historical experience and accounts for changing economic conditions. Since the contract is long term, this approach is appropriate.

2. Topics of Substantial Agreement

The Department identified errors in OSC's original Cost Saving Schedule, calculated on the basis of their alternative methodologies. The Schedule was provided in a preliminary audit report. As a result of the recalculations presented by the

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Note
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*See State Comptroller's Notes, Appendix C

Department, and the revised savings presented by OSC in the report, the Department agrees that certain of OSC's methodologies (and associated calculations) are reasonable alternatives to the reasonable methodologies adopted by the Department. This agreement was communicated to OSC but is acknowledged in the audit report.

Specifically:

-- Department Costs:
- Personal Service
- Fringe Benefits/Payroll Taxes
- Other than Personal Service Costs
- In-House Cost Prior to January 1995 Conversion
- Layoff Avoidance

The difference between OSC and Department estimates is approximately $90,000.

Note: While the Department acknowledges that some minor errors occurred in the calculation of fringe benefits, OSC's initial computation of the personal service cost, including fringe benefits, based on the application of the actual fringe benefit rate, failed to include the applicable fringe benefit component for entry level temporary employees. The Department's response to OSC's preliminary report identified this error and OSC subsequently made the appropriate adjustments.

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Note
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-- Privatization Costs:
- Contract Costs
- Contract Administration
- Program Monitoring

The difference in costs between OSC and Department estimates is approximately $500,000, with the major portion attributable to the inflation factor used for contract costs.

3. Topics of Disagreement

We disagree with OSC on the following issues:

-- Incumbent (Depository) Processing

The initial calculation of the incumbent processing costs was based upon a fee structure associated with expiring agreements. The Department acknowledges that this approach was not appropriate, since as part of the PIT RFP, bidders were required to submit proposals for this service (since the Department

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Note
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*See State Comptroller's Notes, Appendix C

reserved the right to award only deposit services). The lowest bid, submitted by Fleet Bank, totaled more than $60 million for the ten year contract term. Hence, the $39 million originally projected for depository services, which would be required if the Department did not privatize the entire front-end Program, was understated by about $22 million.

The increase in fees for this service compared to incumbent costs is at least in part attributable to new functionality required by the RFP (not previously included with the incumbent services) including disaster recovery capability, verification of header records with the Department's extract file, review of W-2s and capturing social security numbers.

The development cost associated with these modules (which the auditors consider excessive) in part reflects the initial investment associated with the proposed imaging solution for deposit processing. By leveraging the imaging investment to the entire Program (i.e., returns processing), the State has benefitted from the economies of scale.

Based on Fleet's low bid and acceptable technical proposal, this service would have been awarded to Fleet if the entire Program had not been outsourced. The chart entitled "Comparison of Projected Ten Year Development and Operations Costs", prepared as part of the final bid evaluation documentation, clearly includes the bid amount of more than $60 million as the cost to be incurred had the Department outsourced only depository services. Therefore, it is reasonable and appropriate to include Fleet's bid amount as the ongoing cost for incumbent processing.

-- Request for Proposal (Procurement) Costs

RFP cost is not an appropriate cost of privatization for the Department and has not been included in the savings projections prepared by the Department. These costs would have been incurred in the absence of a successful bidder. Had this been the outcome of the RFP, privatization would not have occurred. Therefore, alternatively, it would be appropriate to include it as both a cost of privatization and a Department cost to perform the Program.

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-- Space (Rent and Utilities)

The cost associated with maintaining space should not be excluded from the Department's projected savings. However, until full implementation is achieved, we accept that a portion of the space costs should be treated as conversion cost, consistent with the New York City "model" referenced by OSC. In support of this position, the Department retained full space cost as a

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*See State Comptroller's Notes, Appendix C

projected savings, but included the projected cost for space during the implementation period in the Projected Privatization Costs. However, even during this period, this space has been available for other Department activities. It has been and will continue to be used as "swing space" during Department renovations. Were these facilities not available, other space would be acquired at additional cost to the State.

-- Inflation Factor

OSC's assertion that the Department initially accepted OSC's inflation factor of 3.72% is incorrect. In fact, the Department accepted OSC's methodology as a reasonable alternative to our approach but not OSC's calculation. The Department recalculated its cost based on OSC's proposed methodology. However, the cost of the lump sum payments should be included for the year in which they occurred. The Department's calculation did **not** include these payments in the base used for defining the escalation rate. Despite the Department's repeated attempts, OSC has failed to comprehend this fact.

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E. Scope Issues

The Department's savings projection was not a true "apples to apples" comparison with the privatized cost, since the Fleet contract value includes functionality (i.e., disaster recovery, contract monitoring) not reflected in Department costs.

OSC quotes Federal OMB Circular A-76, which outlines the general cost comparison process, as follows "*....an agency should ensure that the government's in-house cost estimate and the other offers are based upon the same scope of work and performance standards".* The Department's cost comparison was intended to project actual savings based on the program performed by the Department prior to privatization. In order to achieve the comparable scope of work goal stated in the OSC report, two strategic adjustments to the Department's cost are required. This information was reported to the auditors, but they chose to exclude these costs from their analysis, violating the Federal OMB A-76 rule of comparable scope which OSC had previously determined to be appropriate.

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Adjustments for scope, that is, functionality included in the Fleet contract cost of $197.4 million, but not included in the auditors' presentation of Department costs are:

-- Disaster Recovery ..... -/+$3.3 million

-- Contract Administration and Monitoring for Incumbent Processing .... $2.7 million

*See State Comptroller's Notes, Appendix C

The Fleet contract value includes disaster recovery services. Since the Department's program did not provide any disaster recovery capability, it is necessary to project additional cost for the Department to acquire this capability. Since we had not developed detailed disaster recovery plans and associated costs, we assumed the same costs as the Fleet proposal (net of the Disaster Recovery fee included in Incumbent Processing for Depository Services). This approach likely understates the cost, since Fleet's fees are based on redundant operating facilities, whereas the Department would have to secure a new site for this purpose. While the Department understands the auditors' unwillingness to accept Fleet's fee as a valid cost, OSC should acknowledge that this issue is appropriate to include for scope comparability purposes.

The auditors are incorrect in assuming that Program monitoring and administration costs are included in the Department's cost analysis. The source documentation of Department costs to perform the Program clearly does not include any Revenue Services staff costs, the organization responsible for Program monitoring and contract administration.

As a result of additions for added scope, incumbent processing and methodological/ mathematical adjustments, the projected ten-year savings is approximately $99.75 million.

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The Savings Plan did not consider "back office" savings which would result from improved front end processing. Therefore, the Savings Plan does not reflect reduced interest expense for late paid refunds. Prior to privatization, annual interest for late paid Personal Income Tax refunds averaged $5.4 million. As a result of privatization, interest expense is now approximately $2.5 million. Projected over the contract duration, additional savings of $21.6 million will be achieved in addition to savings projected in the Savings Plan. The accomplishment is significant given the reduced time frame to pay refunds interest free.

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Enhancements to Department operations are currently being implemented as a result of the availability of images. Specifically:

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-- Auditors will access images rather than require paper returns, expediting audit activity. By making our auditors more efficient, additional revenue will be generated.

-- Processing specialists will access images rather than require paper returns to resolve protests and correct exceptions (i.e., errors). By making our processing specialists more efficient, taxpayer problems will be resolved more timely, interest on late paid refunds will be avoided and assessments will be issued and collected more timely.

-- OSC pre-audit staff will make use of images beginning with the 1998 processing year to perform their reviews of PIT refunds. This will significantly and positively impact OSC's ability to timely perform their reviews, since they will no longer have to wait for paper returns to be retrieved and transported.

*See State Comptroller's Notes, Appendix C

F. Tracking Costs and Savings

The Department acknowledges that there is no internal process in place to differentiate costs associated with PIT front-end tax processing functions performed by the Department.

The expenditure data detailed in the audit report reflects Department temporary service and overtime for various special projects and initiatives. In 1996-97 the Department conducted an Amnesty Program and a Highway Use Tax permit renewal project, incurring temporary service costs of approximately $700,000 (accounting for the 1996-97 increase in cost referenced by OSC). Increases in overtime costs in 1996-97 are related to these projects, as well as many other initiatives which require overtime (e.g., annual systems development and testing cycle for Corporation Tax). However, the funding availablefor the Office of Revenue and Information Management from 1994-95 through 1996-97 demonstrates reductions.

G. Conclusion

The Department's primary objectives of the PIT 2000 privatization (as stated in the RFP) may be summarized as follows:

-- Enhance Services to Taxpayers

-- Improve Program Efficiency

-- Reduce Costs

The PIT 2000 Program is an unprecedented privatization success, achieving all of its stated goals:

-- Taxpayers are receiving their refunds faster than ever before. Program efficiency has been dramatically improved, such that the Department was able to achieve the legislative mandate which reduced the interest free refund cycle from 90 days to 45 days. At the same time, interest cost resulting from late paid refunds has been reduced dramatically.

-- Remittances are being deposited on an accelerated basis, improving the State's cash flow.

-- The Department's responsiveness to taxpayer inquiries regarding the status of their payments and refunds has dramatically improved.

-- In the near future, for Personal Income Tax, taxpayer problems will be resolved via a single, toll free telephone call rather than written communication, based upon the availability of tax return images produced by Fleet. The Department is currently re-engineering back office operations for this purpose.

-- In the near future, images will be utilized to increase the efficiency of the audit process.

In addition, an image enabled environment will streamline other Department operations, such as collection, accounting, and records management, further reducing costs and increasing efficiency.

STATE COMPTROLLER'S NOTES

1. The Department's assertions cannot be supported by the records, conditions or facts which existed when the Department considered privatizing personal income tax return processing. As stated on page 7 of our report, the chronology of events shows that Department officials began to privatize personal income tax return processing without a thorough cost-benefit analysis comparing in-house costs to contract costs. The Department's June 1992 letter to OSC not only stated the intent of the Department to privatize personal income tax return processing, but documented the services that were to be made part of the contract. The Department's initial estimate of in-house costs was not completed until November 1993, well after the Department had already issued its Request for Proposal (RFP) for contracted services in January 1993. The Department began to privatize personal income tax return processing in February 1994, eleven months before the contract was approved.

2. Budget adjustments based on the success or needs of an agency function or program must be based upon quantified and/or verifiable information. As stated on page 22 of our report, using the 1996-97 State fiscal year as an example, Department officials provided no evidence showing that Division of the Budget officials had analyzed internal Department operations and costs and determined that such budget reductions were directly related to privatization. By the Department's own admission, officials do not monitor cost savings internally to determine if this goal is being achieved.

3. We have made corrections to the final report to reflect Department wide State expenditures as reported by the State's accounting system. Expenditures by the Department increased from about $260 million in 1993-94 to about $292 million in 1996-97.

4. Department officials make an assertion that OSC agrees that the PIT 2000 privatization effort should generate significant savings. This is not correct. Our report concludes that the Department's original savings estimate of $76.5 million should be reduced by $15 million to $61.5 million because of errors and flaws in the procedures used by the Department in calculating its projection and by $17.1 million more to $44.4 million because actual State salary increases during the first five years of the contract were significantly less than projected by the Department. Savings will be reduced further as a result of the relocation of tax operations to Kingston. We will issue a separate audit report addressing the extent to which savings will be reduced as a result of the Kingston relocation.

5. As stated on page 18 of our report, the Department provided us with an updated estimate of in-house costs in January 1997. Throughout the field work stage of this audit, the Department continued to estimate that incumbent processing (deposit function) would cost $39.15 million. In response to our preliminary audit findings, officials sought to add additional costs of $22 million to their original estimate for receipt and deposit functions, program development and implementation, and for disaster recovery. We cannot accept these costs, since according to Department officials, disaster recovery functions and program development and implementation functions were already included in the existing $39.15 million contract with Fleet.

6. As stated on page 17 of our report, officials acknowledged that all $9.8 million in costs continue to be incurred after the privatization of personal tax return processing. We cannot accept the Department's position, because the possible use of the space for other functions is not described in detail, is not documented, and has not been justified as necessary for other functions. Privatization guidelines clearly

indicate that such rent and utility costs are unavoidable costs and should not be included in the cost analysis. As a result, savings can not be recognized at this time.

7. In response to our preliminary audit findings, officials contended the RFP development cost was not an appropriate contract cost. Subsequently, officials changed their position regarding the treatment of RFP development costs. They now suggest such costs should be included as both an in-house program cost and a cost of privatization. We cannot accept this alternative. RFP development costs are a contract related cost.

8. Department officials state that our exception based report gives a narrow view of the program under audit, and the only issues we consider critical are financial in nature. Department officials cite several strategic program goals including improved accuracy, completeness and timeliness of personal income tax return processing and capturing sufficient tax return data to provide taxpayers with more information. We acknowledge in the report that the PIT 2000 project is the largest privatization initiative in the State's history, with many critical components. On pages 11 and 12 of the report, we cite some of the benefits of privatization. However, we also state on page 2 of the report that we audited the process used by the Department in deciding to privatize personal income tax return processing and that our focus was on the cost savings from privatization that were projected by the Department. Hence, we report on these issues, and not on issues outside the scope of our audit.

9. As stated on page 7 of our report, the chronology of events shows that Department officials began to privatize personal income tax return processing before they completed a thorough analysis of in-house costs and contract costs. The Department's June 1992 letter to OSC not only states the intent of the Department to privatize personal income tax return processing, but documents the services required to be made part of the contract and was accompanied by an attachment justifying the contract length. Furthermore, Department officials maintain that the first step in their procurement process included a detailed functional analysis of the Department's front-end processing program, as well as analysis of the Department's cost to perform the program. They stated that these analyses served two purposes: they formed the basis of the functional requirements for the RFP and the Alternative Program Proposal and provided the basis for cost comparison for privatization. Department officials also contend that the Alternative Program Proposal was consistent with the RFP.

   However, the RFP did not mandate imaging or any other specific technology. More importantly, the Alternative Program Proposal stated that the "major objectives of PIT 2000 could not be addressed due to current operational, systems and financial limitations." The Alternative Program Proposal also states that it "does not incorporate use of advanced technologies to support 'front end' or 'back end' returns processing." Officials further stated that imaging was not considered feasible due to the lack of technical expertise and limited ability to invest a large amount of capital.

   While the Alternative Program Proposal may have met the intent of the RFP, in our judgement, it did not meet the intent or paramount goal of this privatization effort which was to implement electronic filing, magnetic media filing and other technology based strategies to replace the filing of paper tax returns. The Department officials were also unable to provide support for the stated limitations, or provide us with any evidence which would indicate that they would have been unable to employ personnel with the technical expertise to implement advanced technology systems.

10. As part of the Department's decision to privatize personal income tax return processing, officials compared two bids submitted by Fleet and Chemical Bank with two different Department in-house bids. The in-house bids were based upon the Department's existing manual process and a potentially improved manual process (Alternate Program Proposal). Officials stated that it was determined after comparing the two viable bids and the Department's Alternative Program Proposal, that it would be cost effective to privatize personal income tax return processing with Fleet Bank. However, the Department's cost savings analysis that was used to estimate savings from privatization of $76.5 million, was not based on the Alternative Program Proposal but upon the manual process which was not in conformance with the RFP.

11. Per page 19 of our audit report, Department officials were unable to support that any contract related administrative costs were considered in their cost-benefit analysis.

12. As indicated on pages 13 and 14 of our audit report, at the time of our audit, officials were unable to provide us with an original cost savings schedule.

13. We believe the Department's decision to move quickly on this contract is in part responsible for the weaknesses cited in this report. Had the Department taken adequate time to properly plan for this privatization effort, many of the weaknesses discussed in this report may have been avoided.

14. As indicated on page 5 of our audit report, three privatization reports were available to Department officials before and during their contract development effort.

15. Department officials indicate they identified errors in our preliminary calculations of estimated savings. In those instances where the Department provided us with sufficient documentation, we revised our preliminary calculations.

16. Our audit showed there were at least 13 major fringe benefit calculation errors in the Department's analysis which resulted in $3.3 million in fringe benefit adjustments and $5 million in adjustments for payroll taxes for temporary employees. During the course of our audit, our auditors noted the Department exclusion of payroll costs and made adjustments to the in-house cost schedule. Subsequent adjustments were made based on the Department's response to our preliminary audit findings.

17. Department officials stated that the Fleet bid of more than $60 million for incumbent processing (deposit function) should have been included in their original in-house cost estimate. Officials stated that part of this $60 million reflects the initial investment associated with the proposed imaging solution. Officials also stated that if the entire contract was not awarded, the deposit function would have been awarded to Fleet. Officials further contend that by leveraging the imaging investment of the entire imaging program for the deposit function, the State benefitted from economies of scale. As stated in note 5, throughout the course of our audit field work, Department officials continued to estimate that incumbent processing would cost $39 million. It was not until they responded to our preliminary audit findings that they sought to add about $22 million to their in-house estimate of the costs of incumbent processing, which included the receipt and deposit functions, program development and implementation, and disaster recovery. Additionally, we note that this $22 million cost is an integral part of the larger privatization contract and can not stand alone. If the Department awarded a contract only for the deposit function, the deposit function would not immediately benefit from imaging capabilities, because these capabilities were developed as part of the larger privatization contract, and would not have existed.

18. During our audit, Department officials contended that about $2 million of the space costs should be allocated to the contract cost (i.e., conversion costs) for disaster recovery because State space was provided as a backup site during our audit scope period. We note that the contract provides more than $7 million for the development and maintenance of a disaster recovery plan, including the maintenance of a back-up site(s). Furthermore, this $2 million would become a reimbursable cost to the Department by Fleet from funds received from the contract. The Department's suggestion to add $2 million to the contract for disaster recovery would inflate the existing disaster recovery contract cost component and the entire contract amount. We cannot accept the Department's position, because the possible use of the space for other functions is not described in detail, is not documented, and has not been justified as necessary for other functions. (See also State Comptroller's note 6)

19. Officials responded to our preliminary audit findings and draft audit report that they accepted our methodology but they believed our calculation was in error. We agree that the cost of the lump sum payments should be included for the year in which they occur. However, as stated of pages 15 and 16 of our report, these lump sum payments were incurred before the contract was approved on December 30, 1994 and were made prior to the 1995 base year. Therefore, such payments would not have been a chargeable expense to the base year nor subject to escalation.

20. Our audit report reflects that the contract would have provided disaster recovery services, a function which the department did not have. In the absence of a cost analysis, officials first maintained it would be reasonable to add the same disaster recovery contract costs of more than $7 million to in-house costs. However, they added an additional $4.4 million of disaster recovery costs as part of the deposit function and also added $2 million to the contract costs because State space was claimed to have been provided as a disaster recovery back-up site. When we pointed this out to officials, they changed their position and suggested adding $3.3 million to in-house costs and $2 million for space to the contract cost. In the absence of a cost analysis, we cannot accept these additions but we recognize some costs would have been incurred.

21. The Department's newest projected savings estimate of $99.75 million is not supported by reliable information, additional facts or detailed cost analyses. By the Department's own admission, they do not monitor cost savings to ensure the savings goal is achieved. Officials now believe that the savings estimate should be increased by $38 million to adjust for Department costs they did not consider in their original estimate. The Department's new $99.75 million cost savings estimate does not reflect reductions in cost savings of $17 million from lower than projected State employee salary increases. Audited savings to date of $44.4 million will be reduced further for the cost of the move to Kingston. The Department estimates this cost to reduce savings by an additional $24 million.

22. We have addressed Department officials' projected $21.6 million in "back office" savings on page 23 of our report. To the extent that these costs savings can be substantiated, some savings, net of contract costs, may be realized.

23. We direct Department officials to pages 11-12 of our report. We acknowledged these benefits.