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

DEPARTMENT OF TAXATION AND FINANCE PRIVATIZATION OF PERSONAL INCOME TAX RETURN PROCESSING

THE COST OF PRIVATIZATION INCLUDING RELOCATION TO KINGSTON

REPORT 98-S-62

H. Carl McCall

Comptroller

State of New York
Office of the State Comptroller

Division of Management Audit and
State Financial Services

Report 98-S-62

Mr. Arthur J. Roth
Commissioner
New York State Department of Taxation and Finance
State Campus, Building 9
Albany, New York 12227

Dear Mr. Roth:

The following is our report addressing the cost of the Department of Taxation and Finance's privatization of personal income tax return processing operations, including the cost of relocation to Kingston.

This audit was performed pursuant to the State Comptroller's authority as set forth in Article V, Section 1 of the State Constitution and Article II, Section 8 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

August 11, 1999

Executive Summary

Department of Taxation and Finance Privatization of Personal Income Tax Return Processing The Cost of Privatization Including Relocation to Kingston

Scope of Audit

In 1995, the Department of Taxation and Finance (Department) began 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 new imaging technology, could cut the cost of tax processing by $76.5 million over the ensuing ten-year period. Other expected benefits included faster taxpayer refunds and more accurate processing of tax returns. In September 1995, the Governor announced a plan to relocate personal income tax return processing operations from the Albany area to vacant IBM buildings in Kingston, New York. Relocation activities began in August 1996 and were completed in August 1997.

Our audit addressed the following questions about the Department's personal income tax return processing operations from the inception of the Fleet contract on January 25, 1994 through September 30, 1998:

- What was the cost of relocating the operations to Kingston, how are the savings projected from the privatization contract affected by the relocation cost, and were all pertinent issues taken into account in the decision to relocate?
- What other adjustments to cost savings estimates from privatization need to be taken into account?
- Did the Department adequately administer the Fleet contract?

Audit Observations and Conclusions

As a result of our prior audit (Report 96-S-45, issued March 16, 1998) and our current audit we continue to conclude that the Department's originally projected cost savings of $76.5 million are not going to be realized. The cost of relocation to Kingston alone accounts for $41.3 million of savings reductions to original estimates. However, in responding to our reports, the Department has identified about $49.7 million of adjustments that would increase savings if correct. While we agree that the underlying concepts for these adjustments are deserving of consideration in determining overall cost savings, we have not been able

to establish an audit value for them because of a lack of sufficient Department documentation, analysis or standard methodologies.

We also found that, in the first three years of the Fleet contract, the expected cost of the contract increased from its 10 year projected total cost of $198 million to an estimated $330 million. In three years the contract, therefore, increased an average of 19 percent a year. While we recognize the successes attributable to the privatization effort and the implementation of state-of-the-art imaging technology, such successes cannot be evaluated independently of the costs incurred in achieving the successes. Accountability for the use of public funds must also be a priority. We found that the Department devoted most of its resources to tax processing operations and devoted relatively few resources to contract administration. (See pp. 5-9)

We believe that, as the contract is moving into its latter years, now is the time for the Department to start focusing on planning for an independently assisted, comprehensive analysis to determine whether it is more cost-effective for the Department to process personal income tax returns in-house with its own imaging technology or whether it is more cost-effective for the Department to continue contracting for these services. Any delay risks time and resource constraints that may leave decision makers with too little time to make informed policy decisions about the future strategic direction of personal income tax return processing. (See pp. 8-9)

In connection with the decision to relocate to Kingston, Department officials did not conduct a comprehensive cost-benefit analysis comparing the advantages and disadvantages of potential alternative sites. When such a study was conducted for a proposed consolidation of State agency data centers in Kingston, the proposal was rejected because it was found to be more economical for the centers to be consolidated in the Albany area. Department officials stated that tax processing operations had to be moved to Kingston because the facilities housing the operations in the Albany area were too small, other suitable facilities were not available in the Albany area, and suitable workers would be difficult to find in the Albany area. The Department did not document why the space needed for processing operations increased from about 132,000 square feet shortly after the contract was awarded to a total of about 382,000 square feet, which matched the amount of space available in Kingston. We also determined that many suitable facilities were available in the Albany area at the time of relocation, and Fleet has been unable to find enough suitable workers in the Kingston area. (See pp. 9-14)

Comments of Officials

Department officials indicate that the privatization of personal income tax return processing is an unprecedented success which continues to have savings to taxpayers. However, they recognize the potential benefits of, and are planning for a comprehensive analysis such as the one we are recommending.

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Introduction

Background

Effective with the 1995 calendar year (1994 tax year), the Department of Taxation and Finance (Department) began a multi-year project to privatize processing of the State's 10 million annual personal income tax returns with a $198 million contract with Fleet Services Corporation (Fleet). The contract privatizes the "front-end" processes, including mail receipt and extraction, remittance deposit, tax return completeness review, and data capture and verification. The Department retains responsibility for all "back office" tax processing functions, including tax return processing and verification, refund processing and accounting, auditing, billing, tax collection and enforcement, tax policy analysis and revenue forecasting. The length of the contract is eight years with a two-year extension option. This effort is the largest privatization initiative in State history and as of March 31, 1998, Fleet had been paid about $104 million.

The project's purpose has been to re-engineer the Department's personal income tax program to improve program efficiency, reduce costs by an estimated $76.5 million over ten years, and enhance services to taxpayers. The project uses new imaging technology that allows Fleet to scan taxpayer submitted returns in computer format for transmission to the Department. Prior to the execution of the contract on December 30, 1994, and to implement new legislation reducing the interest-free refund payment period for personal income tax returns from 90 to 45 days, the Department and Fleet accelerated the new imaging technology from year three to year one of the contract. According to Department officials, Fleet has processed tax returns and deposited tax payments in accordance with contract requirements.

In September 1995, the Governor announced a plan to relocate the Department's personal income tax return processing operations to vacant IBM facilities in Kingston, New York. As part of this relocation, Fleet would shift seasonal employment opportunities and the Department would transfer State positions from the Albany area to the Kingston area. Fleet would lease IBM's facilities and the Department would reimburse Fleet for the lease costs through the contract with Fleet. Any changes to the contract had to be approved by the Office of the State Comptroller (OSC); when Department officials assured OSC that the $76.5 million in expected savings would be preserved even if the operations were relocated to Kingston, OSC approved a contract amendment incorporating the relocation on April 15, 1996.

Audit Scope, Objectives and Methodology

We audited the Department's personal income tax return processing operations from the inception of the Fleet contract on January 25, 1994 through September 30, 1998. Our objectives were to determine; (1) the cost of relocating the operations to Kingston, (2) how these relocation costs affected the savings projected by the Department from the contract with Fleet, (3) whether the Department adequately addressed all pertinent issues when deciding to relocate personal income tax return processing operations to Kingston, (4) what other adjustments to cost savings estimates from privatization need to be taken into account, and (5) whether the Department adequately administered the Fleet contract.

To accomplish our objectives, we interviewed Department, Fleet and Office of General Services (OGS) officials, as well as OSC officials responsible for approving State contracts. We also interviewed officials of Fleet's facility management company (a private company hired by Fleet to manage its properties) and commercial real estate agents. We reviewed the Request for Proposal (RFP) that led to the contract with Fleet, the contract itself, annual contract work statements (which specify the work to be performed by Fleet in the upcoming year and the payments to be made to Fleet for this work), and contract amendments. We also reviewed invoices submitted by Fleet to the Department, vouchers submitted by the Department to OSC authorizing payment to Fleet under the contract, leases and related records from various organizations in the Albany and Kingston areas, and publications about the privatization of government services. We also visited Fleet facilities in the Albany area.

This report is our third in a series of audit reports regarding the Department's privatization of personal income tax return processing operations. Our first audit (Report 96-S-45, which was issued in March 1998) addressed the decision to privatize operations and the expected cost savings and other benefits of the privatization effort, while our second audit (Report 97-S-56, which was issued in August 1998) addressed the Department's administration and monitoring of the contract with Fleet.

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 those 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. We 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 does not address activities that may be functioning properly.

Response of Department Officials to Audit

A draft copy of this report was provided to Department officials for their review and comment. Their comments have been considered in the preparation of this report and are included as Appendix B.

Within 90 days after the 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 Cost of Privatization

The privatization of personal income tax return processing operations was expected to reduce processing costs by $76.5 million over the full ten years of the contract. However, on the basis of our review of the costs incurred to March 31, 1998 and our estimates of likely future costs, the Department's projected savings from the contract with Fleet will not be realized. According to our estimates, the net cost of the Kingston relocation alone will be $41.3 million, and when we examined the justifications offered by the Department for the relocation, we found that a through cost-benefit analysis was not conducted to ensure that the advantages of the relocation outweighed the disadvantages.

We also found that, in the first three years of the Fleet contract, the expected total cost of the contract increased from it's 10 year projected total cost of $198 million to an estimated $330 million. In three years the contract, therefore increased an average of 19 percent a year. In light of the costs that could be incurred by taxpayers under this contract, we recommend that a comprehensive analysis be conducted to determine the appropriate future strategic direction in New York State for personal income tax return processing operations.

Projected Cost Savings

When personal income tax return processing operations were privatized, Department officials reported that New York State taxpayers would realize many benefits as a result of the contract with Fleet, including lower processing costs. According to the officials, processing costs over the full ten years of the contract would be $76.5 million lower than they would have been if the operations had not been privatized and personal income tax returns continued to be processed in-house by Department staff. However, we have determined that about $101.6 million of savings reductions need to be taken into account. While Department officials have agreed with all but $10 million of these savings reductions, they have also proposed significant upwards adjustments to savings. While we agree that the underlying concepts for these adjustments are deserving of consideration in determining overall cost savings, we have not been able to establish an audit value for them because of lack of sufficient documentation, analysis or standard methodologies. These matters are discussed in the following paragraphs.

In our prior audit report 96-S-45, we audited the $76.5 million in savings originally projected by the Department. We audited the personal income tax return processing costs estimated by the Department under the contract

and the in-house processing costs estimated by the Department over the same period. (Both estimates were made before it was announced that personal income tax processing operations would be relocated to Kingston and, accordingly, neither estimate accounted for the cost of the relocation.) We found that the savings projected by the Department were overstated by a total of $32.1 million. We believe the savings were overstated by $15 million as a result of the Department's methodology for estimating processing costs, and were overstated by an additional $17.1 million because actual salary increases for State employees during the first five years of the contract were significantly less than the increases projected by the Department.

When Department officials responded to our prior audit report 96-S-45, they disputed our conclusion that, excluding the cost of relocation, New York State was likely to save $44.4 million as a result of the privatization effort. Of our $32.1 million is savings reductions, officials agreed with only our $5 million adjustment for fringe benefits and cost of living. In addition, Department officials identified an additional $28 million of their own upward adjustments. As a result, Department officials stated that, excluding the cost of relocation, New York State was likely to save $99 million as a result of the privatization effort. In their response to this audit, Department officials have indicated that they are now in agreement with the $17.1 million reduction for salary growth inflation from our prior audit, leaving $10 million of prior reductions still in dispute.

However, Department officials continue to maintain that savings need to be adjusted upwards by $28 million to account for $22 million of incremental depository services costs and $6 million of disaster recovery and contract administration costs that the Department would have incurred without privatization. While we agree in concept that these adjustments have merit, we are not able to establish an audit value for them because of lack of sufficient Department documentation, analysis or established methodologies.

In this audit, we account for the cost of the relocation to Kingston. As is described later in this report, we estimate that processing costs over the full ten years of the contract will be $41.3 million higher than they would have been if the operations had not been relocated to Kingston. Consequently, the savings originally projected by Department officials must be reduced by an additional $41.3 million.

The original savings estimate of $76.5 million was based on the assumption that Fleet would process all personal income tax returns over the ten-year contract period, and the Department would process no personal income tax returns during the period. However, contrary to this assumption, and with the introduction of new imaging technology in the

first year of the contract, the Department has continued to process a significant, diminishing number of personal income tax returns during the contract period. According to Department records, for the 1995, 1996 and 1997 calendar years, Fleet processed only 53 percent, 67 percent and 70 percent, respectively, of the personal income tax returns submitted by New York State taxpayers (excluding certain newly developed tax forms); the remaining returns were processed by the Department. According to Department officials, Fleet was expected to process only 85 percent of the returns for the 1998 calendar year and is not scheduled to process all of the returns until 1999, five years after the start of the contract. On the basis of the in-house processing costs that were estimated by the Department and adjusted by us in our previous audit, we estimate that, between January 1, 1995 and March 31, 1998, it cost the Department about $28.2 million to process the personal income tax returns that were not processed by Fleet (about $20.8 million of these processing costs related to tax returns covered by the original contract scope, and about $7.4 million of these processing costs related to new types of tax returns that were added to the contract scope). Since the Department's savings estimate for the contract anticipated that all original scope tax returns would be processed by Fleet, the Department's cost to process the portion of these returns not handled by Fleet must be subtracted from the savings estimate. In relationship to the Department's original cost savings estimate, new work was expected to be performed by Fleet through the contract change control process. Therefore, these new Department incurred costs must also be subtracted from cost savings.

We note that some of these processing costs ($20.8 million) should have been taken into account in the original savings estimate because, according to Department officials, Fleet originally was not expected to process all personal income tax returns until the third year of the contract. According to the officials, Fleet originally was expected to process only 50 percent of the returns in the first year of the contract and only 75 percent of the returns in the second year of the contract and 100 percent by the third year. Despite these expectations, the original savings estimate was based on the assumption that Fleet would process all the returns throughout the entire contract period.

In response to these findings, department officials have agreed with our estimated incremental cost of $41.3 million from the cost of relocation to Kingston. They have also agreed with our estimate of $28.2 million of Department costs to process returns that were originally intended to be processed by Fleet. However, Department officials also responded that an upwards adjustment to savings of $21.7 million was necessary to account for reduced interest expense associated with late payments of

refunds. While we agree in concept that such an adjustment has merit, we are not able to establish an audit value for it because of lack of sufficient Department documentation, analysis and established methodologies.

We further found that, while the contract was initially expected to cost $198 million over ten years, according to Department estimates developed after the first two years of the contract, the expected ten-year cost was increased to $288 million (including the cost of relocation). Department officials did not provide us with an update to the estimate after the first three years of the contract. Consequently, we performed the update and projected that, as of January 1, 1998, the contract has increased from $198 million to an estimated $330 million with an average rate of growth of almost 19 percent excluding the cost of relocation. We note that this estimate does not take into account additional cost increases that were pending OSC approval at the time of the estimate, including an increase that could be expected to add more than $21 million to the total cost of the contract over the remaining seven years of the contract. Department officials also told us that there are significant additional costs which have not as yet been submitted to OSC for approval. These costs include 1998 calendar year changes.

Considering the extent to which expected contract costs have increased, and considering the possible cost of this increase to State taxpayers, we question whether the continued privatization of these services is in the best interests of the taxpayers. In our prior report 96-S-45, we recommended that the Department, with the assistance of a qualified independent party, conduct a cost-benefit analysis to determine whether it was more cost-effective for the Department to process personal income tax returns in-house with its own imaging technology or whether it was more cost-effective for the Department to continue to contract for these services. In that report we noted that, in deciding to contract for these services, Department officials conducted no such analysis, and as a result, did not address a number of critical issues that should be considered in any privatization effort. Department officials responded that they believed such an analysis would not be a prudent investment of their resources. However, in light of escalating contract costs, we believe such an analysis is urgently needed and should be delayed no longer.

We recommend that, as part of the analysis comparing in-house tax processing to privatized tax processing, Department officials (1) update their estimate of the total expected cost of the Fleet contract, (2) identify the staff resources the Department needs to effectively manage and monitor the Fleet contract, (3) evaluate whether it will be possible in the future to obtain competitive bids for new or emerging technology used in the processing of personal income tax returns, (4) assess whether it is

prudent to allow a single contractor to operate these functions, and (5) identify what would be needed, and at what cost, for the Department to process personal income tax returns in-house using state-of-the-art technology such as imaging. On the basis of this comprehensive analysis, Department officials should determine the appropriate future strategic direction for personal income tax return processing operations.

As was noted in recent testimony before a United States Senate committee on government management, privatization efforts tend to be ineffectively monitored by government agencies. The testimony, which was presented in June 1997 by L. Nye Stevens, Director of the Federal Management and Workforce Issues, noted that privatization contracts must be effectively administered and monitored after they are awarded. In our prior report 97-S-56, we identified many weaknesses in the Department's administration of the Fleet contract. For example, we found that the Department routinely made payments to Fleet without adequately verifying the appropriateness of the amounts, the equipment used in the contract could not be adequately accounted for, and little progress was made in developing the disaster recovery capabilities required by the contract. In light of the increasing contract costs identified by this audit, we question whether the Department can effectively administer the Fleet contract. In general, we have found that Department officials have chosen to devote most of their resources to tax processing operations, and have devoted relatively few resources to contract administration. In the absence of adequate contract administration, costs are more likely to escalate. And while we recognize the successes attributable to the privatization effort and the implementation of state-of-the-art imaging technology, such successes cannot be evaluated independently of the costs incurred in achieving the successes. Accountability for the use of public funds must also be a priority.

The Justification for Relocating to Kingston

The contract with Fleet, and the RFP related to the contract, did not require that personal income tax returns be processed in a specific geographic area or at a specific facility. However, according to contract records prepared by the Department and Fleet, the Albany area was the primary site selected for operations when the contract was awarded, and the RFP specifically stated that disaster recovery capability was to be provided in the Albany area. Although the contract did not specifically prohibit the Department and Fleet from considering relocation elsewhere, the available records did not support a need for Fleet to look for alternative sites outside the Albany area. In our view, had alternatives sites been needed, this need would have been stated in the RFP and the original contract.

To support the decision to relocate tax processing operations to Kingston, Department officials gave the OSC officials responsible for approving the relocation amendment a number of reasons justifying the relocation. When we reviewed these reasons and other information provided by the Department in support of relocation, we found that the Department's justifications for relocation were not consistent with information that was known, or could have been determined, before the decision was made to relocate to Kingston.

For example, Department officials stated that the Albany area did not have enough facility space to accommodate the personal income tax return processing operations, did not have the potential to accommodate any growth in the processing operations, and did not have the potential for new business opportunities. However, when we reviewed commercial real estate records for the Albany area at the time relocation was being considered, we identified at least 36 vacant locations ranging in size from about 11,340 square feet to 125,000 square feet, and together providing more than 1.7 million square feet of available space. In addition, on January 1, 1998, the Commissioner of OGS and the Director of the New York State Office for Technology announced that State agency data centers would be consolidated in Albany because the area had the facilities and the telecommunications infrastructure required for the consolidation. We note that a proposal by the Governor to consolidate these data centers in Kingston was rejected, because a study ordered by the Governor concluded that it would be more economical if the centers were consolidated in the Albany area. No such study was conducted for the relocation of tax processing operations, and the data center study was completed after tax processing operations had been moved to Kingston.

We also found that Department officials were not consistent when they indicated how much space would be needed under the contract for personal income tax processing operations. When the contract was initially awarded, Fleet planned to process personal income tax returns at two Albany area facilities that had a combined total of 113,054 square feet of space. In order to implement the new 45-day refund payment legislation, Fleet officials indicated they would need 18,468 square feet of additional space (for a total of about 132,000 square feet of space in the Albany area). Fleet officials indicated this space requirement in their response to the contract RFP, which indicated that the new refund payment legislation was pending.

However, according to the Department's Strategic Plan, Department officials expected Fleet to add 90,000 square feet of space to implement the new refund payment legislation, and in a March 1996 letter justifying the relocation, Department officials maintained that, in order to meet all the requirements of the contract, including the new refund payment

legislation, Fleet would need about 270,000 additional square feet of space beyond what was already available at the two facilities in the Albany area. Department officials stated that the 270,000 square feet of additional space was needed because personal income tax returns were going to be processed by a single shift of workers, rather than by multiple shifts, as had been done in the past. (The change to a single shift was intended to reduce processing costs, because less equipment, fewer maintenance staff and fewer supervisory personnel would be needed with only one shift.) However, during our post audit review, Department officials did not respond to our repeated requests to discuss these inconsistencies, and did not document the need for the additional 90,000 square feet of space or the additional 270,000 square feet of space. In fact, the amount of space cited in the March 1996 letter (270,000 square feet) was the difference between the amount of vacant space at IBM's Kingston facilities (382,605 square feet) and the amount of space at the two Albany area facilities used by Fleet (113,054 square feet).

Department officials further justified the relocation by stating that labor resources in the Albany area were scarce, and the pay rates in the area were substantially higher than the pay rates in Ulster County (where Kingston is located), where the pay rates were more in line with the rates Fleet had expected to pay. The officials stated that part of the reason labor resources were scarce in the Albany area was that a Post Office data center had just opened in the area, and paid higher wage rates than Fleet.

However, according to an analysis of the Kingston labor market which was conducted for Fleet by a private contractor in August 1995 prior to the announcement of the relocation to Kingston in September 1995, although qualified workers could readily be hired in Kingston at rates 7 to 17 percent lower than the rates in Albany, the large number of employees needed to initiate tax processing operations coupled with the opening of a new Post Office in the Kingston area would likely reduce the size of the relevant labor pool and increase pay rates accordingly. The labor market analysis noted that the Post Office in the Kingston area was hiring 600 part-time and 300 full-time workers at relatively high hourly rates, and the specific availability and cost of seasonal workers in the Kingston area could not be ascertained. (We believe the opening of the Post Office in the Kingston area should have been considered in the decision to relocate the processing to Kingston.)

Moreover, despite an aggressive recruitment program, Fleet has not been able to hire enough staff in the Kingston area to operate in a single (prime) shift and to perform all the required tax processing operations at the Kingston facilities, and accordingly, has continued to perform some functions in the Albany area. To address the labor shortage in the

Kingston area, Fleet and Department officials tried to open a satellite processing center in Poughkeepsie (which is located in Dutchess County), stating that Poughkeepsie contains a broader labor pool than Kingston. Fleet officials further stated that it would be easier to recruit staff for a workplace in Poughkeepsie, because Poughkeepsie is located on the opposite (east) side of the Hudson River from Kingston, and there are more numerous and less costly transportation opportunities on that side of the River. However, a proposed contract amendment for the satellite processing center was rejected by OSC, because the relocation amendment required that tax processing operations be performed in Kingston.

To help justify the relocation, Department officials stated that the estimated savings of $76.5 million would be preserved even if tax processing operations were relocated to Kingston. According to the officials, any costs incurred by the relocation process would be offset by the savings resulting from the change to a single shift of workers in the more spacious Kingston facilities. However, when we asked Department officials for analysis showing how the relocation costs would be offset by savings in processing costs, they were not able to provide any such analysis. Department officials also stated that, to help preserve the $76.5 million in estimated savings, the Kingston facilities would be used to make images of the hard copy tax returns that are maintained at a record center in the Albany area, thereby reducing the Department's need for storage space. However, subsequent to relocation, Department officials abandoned these imaging plans.

We conclude that, in relocating tax processing operations to Kingston, the Department did not adequately analyze the many aspects of the relocation to ensure that the advantages outweighed the disadvantages. The Department did not conduct a comprehensive cost-benefit analysis comparing the advantages and disadvantages of potential alternative sites, and did not use a qualified independent party to assist in the development of such an analysis to help ensure objectivity. As a result, as is explained in the following section of this report, taxpayers are likely to pay about $41.3 million more than they would have paid if personal income tax return processing operations had remained in the Albany area.

The Cost of Relocation

On April 15, 1996, the contract with Fleet was amended to incorporate the relocation of tax processing operations to Kingston. The relocation was begun in August 1996, and as of November 1996, Fleet occupied about 280,000 square feet of space in Kingston. By August 1997, Fleet occupied a total of 382,605 square feet of space in Kingston, and the relocation was completed.

One of the objectives of our audit was to determine the cost of the relocation to Kingston. To accomplish this objective, we had to estimate

the costs that would be incurred by the Department, over the full ten years of the contract, in moving tax processing operations to Kingston and in maintaining those operations in Kingston, and compare these costs to the costs that would have been incurred if the operations had remained in the Albany area.

To provide a basis for estimating the Kingston costs over the ten-year period, we sought to determine how much it had cost the Department to move to and operate in Kingston as of March 31, 1998. According to contract payment records, as of that date, Fleet had been paid $19.1 million to move to and operate in Kingston. On the basis of these payment records as well as other available records (such as the relocation amendment to the contract with Fleet, which indicates the maximum amount Fleet can be paid for various expenses associated with the relocation), we estimate that, as of December 31, 2004, the cost to the Department to move tax processing operations to Kingston and maintain those operations in Kingston will be $51.9 million. The various types of expenses associated with the relocation (such as renovation and rental costs for the facilities in Kingston, the cost of the additional equipment that was needed for these facilities, and the costs already committed to vacated facilities in the Albany area) are shown in Exhibit A. (We note that our estimate does not include the cost of certain services in the additional rent category, such as water and heat, because records of past costs for these services were not available to provide a reliable basis for estimating the costs over the remaining life of the contract.)

If the tax processing operations had not been relocated to Kingston, but had still been contracted to Fleet, we estimate it would have cost the Department about $10.6 million over the contract period to continue processing personal income tax returns in the Albany area. The basis for our estimate follows:

- As part of the relocation to Kingston, Fleet vacated two facilities in the Albany area. If tax returns had continued to be processed in these facilities through December 31, 2004, the Department would have incurred about $7.7 million in basic rent costs for the two facilities. (As in our projection of relocation costs, we could project only the portions of the rents at these two facilities that would have remained fixed over the period; we could not project the portions of the rents that would have varied depending on use, such as the portions relating to water and heat, because records of past costs for these services were not available.)

- At the beginning of the contract period, new legislation became effective requiring personal income tax refunds to be paid within 45 days. Fleet officials informed the Department that they could implement this new requirement with an additional 18,468 square feet of space. On the basis of commercial real estate prices in the Albany area at the time this new legislation became effective, we estimate it would have cost the Department an additional $2.1 million in rent for this amount of additional space over the contract period.

- If personal income tax returns had continued to be processed in the Albany area through December 31, 2004, the facilities in the Albany area would have needed to be renovated in various ways to accommodate processing operations. On the basis of the maximum rate allowed by the contract for such fit-up costs at the Kingston facilities ($45 per square foot), we estimate the Department would have incurred an additional $831,060 for fit-up costs at Albany area facilities.

When the $10.6 million in additional Albany area costs is subtracted from the $51.9 million in Kingston relocation costs, we find that privatized processing costs for personal income tax returns over the full ten years of the contract will be about $41.3 million higher than they would have been if the operations had not been relocated to Kingston. This high cost should be taken into account by Department officials when, in accordance with the recommendations contained at the end of this report, they analyze the costs and benefits of continued privatization for personal income tax return processing operations and determine the appropriate future strategic direction for these operations.

Recommendations

1. With the assistance of a qualified independent party, conduct a comprehensive analysis to determine whether it is feasible and cost-effective for the Department to process personal income tax returns in-house with its own imaging technology, whether it is more cost-effective for the Department to continue to contract for all or part of these services or whether other more cost-effective options exist to continue these operations. In addition to any other significant analysis the Department deems appropriate, the comprehensive analysis should:

   - update the Department's estimate of the total expected cost of the Fleet contract,
   - identify the staff resources the Department needs to effectively manage and monitor the Fleet contract,
   - evaluate whether it will be possible in the future to obtain competitive bids for new or emerging technology used in the processing of personal income tax returns,
   - assess whether it would be prudent to have more than one contractor to operate the privatized function, and
   - identify what would be needed, and at what cost, for the Department to process personal income tax returns in-house using state-of-the-art technology such as imaging.

2. Use the results of the comprehensive analysis recommended by this audit to determine the appropriate future strategic direction for personal income tax return processing operations.

   (Department officials generally agree with recommendation number one and recommendation number two and continue to maintain that the privatization effort is an unprecedented success with original cost savings of at least $35 million continuing for taxpayers. They indicate that rather than using an independent party to assist the analysis, the Department and the Office of the State Comptroller should jointly develop and agree upon the methodology for this effort.)

Recommendations (Cont'd)

Auditors' Comments: As we have stated in our prior audits (Report 96-S-45, issued March 16, 1998 and Report 97-S-56, issued August 24, 1998) we reaffirm the successes of the privatization effort, including the implementation of state-of-the art imaging technology. However, such success cannot be evaluated independently of associated costs. After the first three years of privatization, the contract is experiencing a growth rate of about 19 percent and it is projected to cost about $330 million over its life excluding the cost of relocation.

With only three and one half years remaining on the contract, the time to begin planning for the needed comprehensive analysis is now. Any delay risks time and resource constraints that may leave decision-makers with too little time and insufficient information to make effective policy decisions about future processing of personal income tax returns. We continue to believe that the analysis should be prepared with independent assistance. The Office of the State Comptroller does not have sufficient resources to actively participate in conducting this effort. We also point out that the Department, in addition to completing the comprehensive analysis, must also have a realistic business continuity plan, including contingency plans, to resume personal income tax processing by the Department should the need arise.

DEPARTMENT OF TAXATION AND FINANCE
THE COST OF RELOCATING AND MAINTAINING PERSONAL INCOME TAX RETURN PROCESSING OPERATIONS IN KINGSTON PROJECTED THROUGH DECEMBER 31, 2004

TYPE OF COST (See Schedule A-1 for a more detailed description of each type of cost)	CONTRACT MAXIMUM	SOURCE OF COSTS	ACTUAL RELOCATION PAYMENTS THROUGH MARCH 31, 1998	PROJECTED COST OF RELOCATION THROUGH DECEMBER 31, 2004
Facility Fit-Up	$24,241,853	Actual and Projected Costs	$2,336,891	$18,216,041
Basic Rent	4,924,126	Actual and Projected Costs	819,820	4,840,561
Additional Rent	21,148,491	Actual and Projected Costs	5,114,640	9,410,982
Building 025	600,300	Projected/Maximum	599,400	600,300
Uninterruptible Power	3,000,000	Contract Maximum	898,788	3,000,000
Fleet Facility Management	3,093,750	Projected/Maximum	467,052	3,093,750
Leasehold Improvements	Not Applicable	Reported by Fleet	3,091,988	3,091,988
Equipment	2,602,900	Projected/Maximum	511,665	2,602,900
System/Vendor Costs	250,000	Fleet Reported/Contract Maximum	250,000	250,000
Capital Region Occupied	Not Applicable	Reported by Fleet	1,136,036	1,136,036
Capital Region Unoccupied	Not Applicable	Fleet Reported and Projected	1,423,591	2,120,773
Miscellaneous State Costs	Not Applicable	OGS Reported and Actual	50,000	50,000
Carnevale	Not Applicable	Department Reported and Projected	296,646	445,833
Various Relocation Costs	3,000,000	Contract Maximum	2,107,456	3,000,000
Total	**$62,861,420**		**$19,103,973**	**$51,859,164**

DESCRIPTIONS OF
THE COSTS INCLUDED IN EXHIBIT A

TYPE OF COST	DESCRIPTION
Facility Fit-Up	Construction costs incurred to renovate the Kingston facilities for tax processing operations.
Basic Rent	The portion of the rent cost that remains fixed throughout the lease.
Additional Rent	The portion of the rent cost that will vary depending on use (includes the cost of such services as water, heat, utilities and janitorial services).
Building 025	A building that was leased for only the first year of the contract.
Uninterruptible Power	A supply of power available to support the Department's security requirements, telecommunications equipment and data cabling in the event of a power interruption.
Fleet Facility Management	Fleet's cost to manage the facilities and monitor the delivery of maintenance services.
Leasehold Improvements	Improvements and equipment attached to buildings located in the Albany area and vacated by Fleet during the contract period.
Equipment	Additional equipment needed for operations in Kingston.
System/Vendor Costs	The costs of shutting down computer systems in the Albany area, transporting the systems to Kingston, and terminating the contract with the system vendor.
Capital Region Occupied	The costs incurred by Fleet to process tax returns in Albany area buildings at the same time that it occupied the Kingston facilities.
Capital Region Unoccupied	The lease costs paid by the State for buildings in the Albany area vacated by Fleet. The costs were incurred until the buildings could be leased to other tenants.
Miscellaneous State Costs	Miscellaneous costs incurred by the State, including a construction overage for Building 025.
Carnevale	The cost incurred by the State for an additional processing site located in Albany because Fleet was unable to recruit enough seasonal staff in Kingston.
Various Relocation Costs	Includes employment agency costs, initial training costs, the cost of a temporary management team, and other costs resulting from the relocation.

Major Contributors to This Report

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STATE OF NEW YORK
DEPARTMENT OF TAXATION AND FINANCE
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KEVIN F. MURRAY
EXECUTIVE DEPUTY COMMISSIONER

July 16, 1999

Mr. Jerry Barber
Audit Director
Office of the State Comptroller
A. E. Smith State Office Building
13th Floor
Albany, New York 12236

Dear Mr. Barber:

Thank you for the opportunity to review and comment on your draft audit report (98-S-62) "Privatization of Personal Income Tax Return Processing, The Cost of Privatization: Relocation to Kingston."

The following is our revised response.

I. Success of the Program

The PIT 2000 Program is an unprecedented success, achieving all of its anticipated goals and benefits:

The citizens of New York State are benefitting as follows:

- New York State is achieving savings of at least $35 million over the ten-year duration of the contract with Fleet.
- Interest cost associated with late paid refunds has been reduced by more than $2 million annually.
- Remittances are being deposited on an accelerated basis, improving New York State's cash flow.

Taxpayers of New York State are benefitting as follows:

- The taxpayers of New York State are receiving their Personal Income Tax refunds faster than ever before. Program efficiency has been dramatically improved. The time frame to pay taxpayer refunds interest-free has been reduced from 90 days to 45 days. As a result, in 1998, approximately 4.9 million taxpayers received their refunds 45 days sooner than in 1994.

- Taxpayer problems (e.g., protests) are being resolved via a single, toll-free telephone call rather than written communications, due to the availability of tax return images produced by Fleet. The average time frame to resolve telephone inquiries has been reduced from six-to-eight weeks to one-to-two days.
- The Department's responsiveness to taxpayer inquiries regarding the status of their payments and refunds has dramatically improved.
- Comprehensive monitoring of the Program budget and expenditures (e.g., item level reconciliation of invoices) assures that reimbursement to Fleet (which is subject to OSC review and approval) is consistent with the terms of the PIT 2000 Agreement and taxpayer dollars are being spent prudently.
- On an annual basis, the Department's performance monitoring program evaluates Fleet's compliance with the contractually mandated performance standards. For example, each year a security review is conducted to assure the confidentiality of taxpayer data.

The Department is benefitting as follows:

- Department employees dealing with Personal Income Tax have the tools, information, and empowerment to better serve their customers, the taxpayers of New York State.
- An image enabled environment will streamline other Department operations, such as collection, accounting, and records management, further reducing costs and increasing efficiency.
- More extensive data is captured from all returns upon initial return processing, providing expanded data for audit selection. Previously, multiple data capture passes were required from a small subset of returns to collect data for audit selection.
- The PIT 2000 System includes a comprehensive audit function which records and tracks all changes (both manual and automated) to each data element on each return. This level of history supports manual error resolution and the preparation of descriptive taxpayer explanations.
- Prior to privatization and re-engineering of the Program, the Department's maximum processing capacity was 75,000 returns per day. The PIT 2000 program regularly processes in excess of 110,000 returns per day, capturing more data from each return than ever before.

II. PIT 2000 Projected Savings

The Department's primary objectives of the PIT 2000 privatization were threefold:

- Provide the best possible services to the taxpayers of the State of New York,
- Continually improve Program efficiency; and
- Reduce cost to administer the Program.

The Program has achieved all of these objectives, with savings of at least $35 million for the ten-year duration of the contract.

At the beginning of this privatization in 1995, the Department projected savings of $76.5 million. In their last PIT 2000 audit (96-S-45, The Decision to Privatize PIT Return Processing and the Projected Cost Savings), OSC refuted $32.1 million of the savings for several reasons, primarily as a result of differing methodologies selected by OSC. The Department disagreed with OSC's methodologies in many instances. We used reasonable alternative methodologies specific to the particulars of our business environment to develop the savings projections.

However, the Department did agree that $5 million of adjustments (related primarily to calculation of fringe benefits and cost of living adjustments) to our original savings projection was appropriate. As part of the OSC audit review, the Department also identified other appropriate adjustments to savings. Specifically:

- We determined that the initial calculation of incumbent (depository) processing, which was based on fees contained in expiring agreements was inappropriate. The Department's $22 million adjustment reflects the lowest cost bid to procure these services on a prospective basis.
- Scope adjustments, that is, functionality included in the privatized Program but not included in the Department's costs (e.g., disaster recovery), were appropriate. This necessitated a $6 million adjustment.

Taken together, all the necessary adjustments resulted in an updated savings projection of $99 million in March 1998, exclusive of the impact of relocation.

Since March 1998, the Department has further revised its savings projection to reflect acceptable adjustments identified by OSC during the audit process, including the cost of relocation to the mid-Hudson region and the impact of actual inflation through 1998, resulting in a revised savings projection of at least $35 million.

However, additional sources of savings have been identified by the Department which are not included in the $35 million savings estimate.

Since the Savings Plan compares the Department's cost to perform the Program with the cost of the privatized Program, savings can be realized from either an increase in Department cost to perform the Program and/or a decrease in the cost of the privatized Program. The following two additional areas of increased Department cost to perform the Program, if quantified, would result in additional savings:

- Significant additional resources which would be required for the Department to process refund returns on an accelerated basis due to legislatively mandated reduction in the interest free period from 90 days to 45 days, and
- Additional resources which would be incurred by the Department to process new types of returns which resulted from legislative changes subsequent to the privatization of the Program.

If these factors were quantified, we believe they would significantly increase the estimated savings of $35 million.

*
Note 1

III. Justification for Relocation

As referenced above, the Department accepts OSC's calculation of $41 million as the cost of relocation. However, taking into account the relocation costs, this privatization project still results in significant savings to the taxpayers of New York State.

Prior to the implementation of the Program (but subsequent to the award to Fleet), there were two significant changes which drove the need for substantial additional space to perform the Program: the reduced interest-free period and decision to move to an imaging solution.

The PIT 2000 Program defined in the Department's RFP was based upon the 90-day interest-free period to pay refunds mandated at that time. The RFP did not specify a mandatory solution (e.g., traditional data entry, imaging) to meet the processing requirements.

*
Note 2

Fleet's technical response to the RFP was based upon a traditional data entry solution. Fleet sized the program (i.e., amount of space, equipment, and staffing required) based upon a 90-day window to process returns and pay refunds interest-free. Using the total number of returns received, Fleet determined the daily capacity required in order to complete processing within the 90-day period.

Subsequent to the award of the Program to Fleet, the Legislature mandated a reduction in the interest-free period to pay refunds from 90 to 45 days. This requirement profoundly impacted the resources required to perform the Program timely (i.e., within the new 45-day interest-free period). Fleet would be required to nearly double its processing capacity. Prior to moving forward with Fleet's proposed traditional solution, Fleet and the Department jointly determined that an imaging approach would best serve the needs of the revised Program.

*See State Comptroller's Notes, Appendix C

Since the image solution involved an entirely new approach, neither Fleet nor the Department had a detailed understanding of the space requirement for the full implementation of the program. We jointly agreed to move forward with the originally proposed space, although redesign was necessary to accommodate the image approach.

In the first year of operations Fleet processed about 50 percent of the return volume (i.e., 4.6 million returns), fully utilizing 100 percent of the available PIT 2000 space. It became obvious at that point that significant additional space would be required to fully implement the Program.

Fleet, the Department, and the Office of General Services jointly selected the Kingston site, a world-class facility with sufficient space to accommodate the entire Program and provide the 20 percent growth factor required by the Department's RFP.

OSC approved the Relocation Amendment to the PIT 2000 Agreement, which clearly specified the Kingston site and all costs to fit up and operate the facility, as well as costs for relocation of Fleet's Capital Region-based PIT 2000 Program.

*** Note 3**

The Program was relocated on schedule and without any disruption to Program operations, largely as a result of the efforts of the Office of General Services, Fleet, the Department, and contractors.

Since the initial implementation of the Program, the Legislature has annually mandated changes which have significantly impacted the resources required to perform the Program as well as the complexity of the Program. For example:

- Millions of new two-sided ATT schedules are being processed as a result of expanded requirements for primary forms;
- Expansion of primary returns to include additional data fields for credits and donations (e.g., Breast Cancer, Wildlife, and Lake Placid);
- Redesign of extension forms to include multiple names (IT-370, IT-372, IT-370FP, IT-372FP) for federal conformity;
- Redesign of primary forms to include multiple names for federal conformity;
- Direct deposit for refunds, for taxpayer convenience;
- Redesign of primary forms for the NYC STAR credit;
- Hundreds of thousands of STAR credit (without a primary form) forms are being processed;
- Hundreds of thousands of new primary forms (IT-215, IT-216) for new taxpayer credits are being processed; and
- The electronic filing program has been expanded to include returns with payment.

*See State Comptroller's Notes, Appendix C

Taken together, these changes have significantly increased the resource requirements to perform the Program, including space, equipment, and staffing. Had Fleet and the Department "low balled" the space required in 1996, it is unlikely we would have been able to implement annual legislative mandates such as the Governor's STAR Program (operational in 1999), without either relocating the Program or acquiring another operations site. The Kingston facility provides ample space to absorb this expansion without additional disruption to the Program. For example, we will be able to process the increased volume of refunds due to the STAR program within the 45-day interest-free period.

IV. Response to Recommendations

Recommendation 1:

With the assistance of a qualified independent party, conduct a comprehensive analysis to determine whether it is feasible and cost-effective for the Department to process personal income tax returns in-house with its own imaging technology, whether it is more cost-effective for the Department to continue to contract for all or part of these services or whether other more cost-effective options exist to continue these operations. In addition to any other significant analysis the Department deems appropriate, the cost benefit analysis should:

- update the Department's estimate of the total expected cost of the Fleet contract,
- identify the staff resources the Department needs to effectively manage and monitor the Fleet contract,
- evaluate whether it will be possible in the future to obtain competitive bids for new or emerging technology used in the processing of personal income tax returns,
- assess whether it would be prudent to have more than one contractor to operate the privatized function, and
- identify what would be needed, and at what cost, for the Department to process personal income tax returns in-house using state-of-the-art technology such as imaging.

Response:

The Department agrees to conduct a comprehensive feasibility analysis which addresses OCS's issues. However, we do not agree that the use of a "qualified independent party" is the most effective approach to conduct this analysis. Rather, it is the Department's position that OSC and the Department should jointly develop and agree upon the methodology for this effort.

The first phase of the feasibility analysis will determine the appropriateness (i.e., cost benefit) of extending the PIT 2000 agreement for the final two years of the contract. It is anticipated this analysis will be initiated and completed by the end of year 2000.

The second phase of the analysis will evaluate the feasibility and cost for the Department to implement an advanced technology PIT 2000 Program. The Department's analysis will likely include imaging of paper returns and remittances, electronically filed returns, Internet filed returns, and electronic and credit card payments of tax obligations.

In preparation for a competitive procurement process, the Department will evaluate the competitive field and technologies available as well as the resources required to effectively monitor an outsourced program.

The competitive procurement process, which will include this analysis, must be completed by no later than mid-2002.

Recommendation 2:

Use the results of the comprehensive analysis recommended by this audit to determine the appropriate future strategic direction for personal income tax return processing operations.

Response:

The goals articulated in the Department's RFP for the PIT 2000 Program will continue to guide the Department's strategic direction for all return processing programs (as well as the results of the feasibility analysis). Those goals are:

- Provide the best possible services to the taxpayers of New York State,
- Continually improve Program efficiency, and
- Reduce cost to administer the Program.

Sincerely,

Kevin F. Murray
Executive Deputy Commissioner

STATE COMPTROLLER'S NOTES

1. Our prior audit (Report 96-S-45, issued March 16, 1998) noted shortcomings with the Department's methodology used in establishing the original savings projections of $76.5 million. This methodology compared estimated costs for the Department to continue to process tax returns without adopting new technology, to the estimated costs of the contractor using new technology. Consequently, we have continued to recommend the need for a comprehensive analysis to accurately establish whether privatization is a cost effective option. Although such an analysis has not been completed to date, our audits have examined the original cost savings reported by the Department. Our current and prior audits of privatization of personal income tax return processing have identified $101.6 million of downward adjustments to the original cost savings projection of $76.5 million. The Department has agreed with $91.6 million and has disagreed with $10 million of these adjustments. In addition, during our audits, the Department proposed about $49.7 million of upwards adjustments to the original savings projections. As stated in this report, we find the nature of these adjustments has merit, but we are unable to establish an audit value for them. The agreed to downward adjustments and the upward adjustments proposed by the Department support a Department position that original savings are now projected at about $34.6 million ($76.5 million, less $91.6 million, plus $49.7 million). The Department acknowledges that it has not analyzed the additional savings resulting from 90 to 45 day impacts and expanded scope returns and, therefore, we have no basis for evaluating these potential savings.

2. In a June 1992 letter to the Office of the State Comptroller (OSC), the Department noted that it would take at least three years for technology based tax return filing including the "acquisition, installation and operation of computer facilities and related technologies (imaging systems)" to gain widespread acceptance. Six months prior to the execution of the contract, the Department and Fleet proposed to OSC to move the implementation of imaging technology from the third year of the contract to the first year. Department records, including the RFP which required vendors to estimate the cost of implementing the 90 to 45 day legislation, spell out the intent of the Department to privatize the personal income tax program using imaging technology and the processing of returns within 45 days. To the extent that additional space would have been needed above and beyond the planned capacity, which included 20 percent excess space for growth in the Capital District, we believe there was significant lead time to plan, determine and acquire appropriate space before the contract was approved. In addition, as noted in our report, Department officials have been unable to demonstrate that 382,000 square feet of space was needed at a time when existing Capital District facilities already provided for 20 percent excess space.

3. OSC's Contract Bureau's approval of the relocation amendment was based upon Department representations and assurances that included: preservation of the original projected savings of $76.5 million by, in part, a move to prime shift operations; additional rental revenue for unused space; lower wages in Kingston; a sufficient labor pool, and processing personal income tax returns in Kingston. However, as explained in our report, these objectives were not fully attained.