HEARING BEFORE THE SUBCOMMITTEE ON FEDERAL WORKFORCE, POSTAL SERVICE AND THE DISTRICT OF COLUMBIA
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM
U.S. HOUSE OF REPRESENTATIVES

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The Honorable J. Russell George
Treasury Inspector General for Tax Administration

STATEMENT OF
THE HONORABLE J. RUSSELL GEORGE
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before the
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Chairman Davis, Ranking Member Marchant, and Members of the Subcommittee, thank you for the opportunity to appear before you today to testify on the Internal Revenue Service's (IRS) pay-for-performance system. Human capital issues are increasingly becoming a serious organizational matter, and none are more far-reaching than the issue of an employee's pay. While many Federal agencies have sought to implement some form of pay for performance, time after time the transition has been met with considerable resistance. The IRS is no exception.

In 2007, the Treasury Inspector General for Tax Administration (TIGTA) conducted a review of the IRS's pay-for-performance system.[1] We concluded that the IRS needed to improve both the design and implementation of the system. The current system may not support the IRS's initiatives to recruit, retain, and motivate future leaders. On the contrary, it may discourage managers from seeking promotions and non-managers from applying for manager positions. We identified several reasons for this, which I will discuss later in my testimony.

The IRS's efforts to implement a pay-for-performance system began with the enactment of the IRS Restructuring and Reform Act of 1998[2] (RRA 98). The RRA 98 gave the IRS the ability to establish one or more pay-for-performance systems to assist in restructuring the agency. In December 2000, pursuant to the RRA 98 directive, the Office of Personnel Management (OPM) provided guidance to the IRS in designing such a pay system.

The IRS implemented its pay-for-performance system in three phases, encompassing all of the agency's managers:

[1] *The Internal Revenue Pay-for-Performance System May Not Support Initiatives to Recruit, Retain, and Motivate Future Leaders* (Reference Number 2007-10-106, dated July 3, 2007).

[2] Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

- The first phase for "Senior Managers" grouped former General Service (GS) grade 14 and 15 mid-level managers and direct reports to executives into one pay band. This phase became effective in March 2001.
- The second phase for "Department Managers" grouped former GS-11 to GS-13 second-level managers[3] in campuses[4] into one pay band. It became effective in November 2001.
- The third phase for "Frontline Managers" maintained the existing 11 pay bands for the former GS-5 to GS-15 Frontline Managers[5] and became effective in September 2005.

Changing to a new pay-for-performance system could not have come at a more critical time for the IRS. According to the IRS, about 66 percent of executives, 50 percent of Senior Managers, 29 percent of Department Managers, and 36 percent of Frontline Managers will be eligible to retire by the end of 2010.[6] In this environment, it is even more important to ensure that managers are satisfied with their jobs and that employees view manager positions favorably. The IRS's ability to meet program requirements and the expectations of external and internal customers depends largely on recruiting and maintaining a highly skilled and motivated workforce.

TIGTA identified several areas in the IRS's pay-for-performance system that needed improvement, involving both the design and implementation of the system.

Design shortcomings

Among our findings, TIGTA identified three major design shortcomings in the IRS pay-for-performance system.

The first involved how the IRS structured the Frontline Manager system. The IRS did not use the RRA 98 flexibilities to improve the existing classification system (General Schedule) in the Frontline Manager system as it had in the Senior Manager and Department Manager systems. Instead, the frontline manager system reflected the existing grade structure for Frontline Managers. There were two contributing factors for this design flaw.

The Human Capital Officer concluded that there were advantages of grouping these GS grades into broad pay bands, but the existing structure had a wide variety of occupations and grades that the IRS indicated were difficult to group. After several attempts, IRS senior management failed to reach an organizational consensus on how to

[3] Second-level managers supervise one or more frontline managers.
[4] The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.
[5] Frontline managers supervise one or more staff (non-managerial) employees.
[6] Human Capital Office internal communication message, dated March 9, 2007.

combine the structure.[7] As a result, the IRS simply brought frontline managers over to the new pay system at their existing grade level, renaming them "pay bands."

In addition, the IRS accelerated its implementation for the frontline manager system by at least a year. Initial plans were to implement it at the beginning of Fiscal Year 2007.[8] However, the IRS decided to implement the Frontline Manager system at the end of Fiscal Year 2005 to minimize the cost of converting the frontline managers to the pay-for-performance system.[9]

The IRS's pay-for-performance structure also did not provide the IRS with the benefits envisioned in the RRA 98, including: 1) the flexibility to assign new or different work; 2) a greater ability to hire more quickly and offer competitive salaries; and 3) providing employees with better opportunities to diversify their knowledge and advance their careers.

The second major design shortcoming involved how annual salary increases for managers were determined. Managers in all three pay systems may receive less than the annual across-the-board salary increase established by the President and given to all employees under the GS pay system. This is a concern to many managers because the across-the-board increase is not tied to performance ratings; instead, it addresses the rising cost of labor based on the Employment Cost Index. Under the RRA 98, the IRS Commissioner has the flexibility to determine the managers' annual salary increases. Therefore, if the Commissioner decides to provide a larger salary increase to managers with higher annual evaluations (e.g., Exceeded Expectations or Outstanding) and a smaller increase to managers with satisfactory evaluations (e.g., Met Expectations), it could result in some managers receiving less than the annual across-the-board salary increase. This could put some managers at a pay disadvantage compared to the approximately 90,000 IRS non-managerial employees who remain in comparable GS pay system grades and will continue to receive the annual across-the-board salary increase.

The third major design shortcoming involved a requirement by the OPM that the lowest and highest salaries for each pay band would be commensurate with the corresponding GS pay system salary ranges and would automatically increase in line with

[7] IRS management advised us during the audit that there were several senior management meetings addressing the frontline manager structure, but they were unable to reach consensus on a different structure for the pay-for-performance system for frontline managers.

[8] IRS management advised us during the audit that the frontline manager system was included as a budget initiative in an earlier version of the Fiscal Year 2007 budget request but was subsequently removed and implemented in the last pay period of Fiscal Year 2005 to save costs.

[9] IRS Policy Number 85, effective in September 2005, stated that, at conversion, managers eligible for a within-grade increase would receive an increase in base pay equal to the prorated value of the manager's time spent toward his or her next GS step increase. Under pay-for-performance, managers would no longer be eligible for step increases or quality step increases.

any across-the-board salary increases.[10] However, this requirement may lead to inequitable salary increases for managers within the same pay band. For example, a manager at either end of a pay band, regardless of their performance ratings, will receive the equivalent of the across-the-board salary increase. Alternatively, a manager in the middle of a pay band who received an Outstanding rating could receive much more than the across-the-board increase, as long as the increase is within the new salary range of the pay band.

Implementation shortcomings

TIGTA found that the IRS did not plan for sufficient time to educate managers on the details of the frontline manager pay system, which resulted in increased opposition and decreased morale for some Frontline Managers. At the time of our review, the frontline manager pay system affected 77 percent of all IRS managers.[11] The IRS needed to provide Frontline Managers with an opportunity to surface questions and concerns about the new pay system to ensure these managers clearly understood the new process for determining salary increases under the pay-for-performance system. This emphasis on communication was especially important because the IRS eliminated its prior policy of providing managers in the pay-for-performance system with the equivalent of the across-the-board annual salary increase. This policy change was effective for managers in all three pay systems.[12] In addition, because the Frontline manager system was implemented at the end of Fiscal Year 2005 and the IRS Deputy Commissioner did not advise managers how much their annual salary increase would be until the beginning of Fiscal Year 2007,[13] managers were left wondering during the entire 2006 rating period what their potential salary increase would be. Predictably, there was significant frustration about the lack of communication on how managers' pay would be affected and how the new pay structure was decided.

IRS Response

In response to our findings, the IRS initiated a third-party evaluation[14] of the IRS's pay-for-performance system. This ongoing evaluation is being conducted in three phases over five years and will determine whether, and how strongly, the IRS's current

[10] As an example, the GS-09 base salary effective January 2007 ranged from $38,824 (Step 1) to $50,470 (Step 10). The pay-for-performance pay band 9 would also have a salary range of $38,824 to $50,470, although there are no steps. In January 2008, the GS-09 base salary increased to $39,795 for Step 1 and $51,738 for Step 10. Accordingly, the pay-for-performance pay band 9 would increase by the same amount to maintain the same salary range.

[11] IRS Workforce report as of June 24, 2006.

[12] IRS presentation in August 2005 explaining the implementation of the frontline manager system in September 2005 and revisions to the senior manager and department manager systems planned for January 2006. The first performance based salary increases would occur in January 2007 for all three systems, and would replace the annual across-the-board salary increase under the GS pay system.

[13] Deputy Commissioner for Operations Support memorandum to all IRS managers, dated October 5, 2006.

[14] In the IRS response to the Draft report, the IRS stated it had initiated a third party evaluation of its pay-for-performance system. A September 25, 2007 news article in Government Executive states "The IRS has hired an outside consultant .....to determine whether it [the system] is helping to recruit, motivate and keep talented employees..... The company also will provide recommendations to strengthen the system."

pay-for-performance system supports its organizational goals to recruit, retain, and motivate future leaders. We are concerned with the length of time the IRS is planning to take to further evaluate its pay-for-performance system. We plan to monitor the IRS's corrective actions and will conduct a follow-up review.

The IRS plans to continue to partner with the management associations[15] representing a number of IRS managers on pay-for-performance issues. The IRS also plans to work with IRS operating divisions and functional stakeholders[16] to determine the best means to communicate information on pay-for-performance updates. Further, the IRS agreed to more effectively communicate with employees before, during, and after implementing any new changes to the IRS's pay-for-performance system.

However, the IRS disagreed with our recommendation to reinstate the policy of providing annual across-the-board adjustments for managers who receive a Satisfactory (Met Expectations) or higher performance rating. The IRS stated that the authority for determining salary increases rests with the IRS Commissioner and that future commissioners need this flexibility to set their own policy. The IRS further stated that this recommendation was not fiscally practicable due to budget implications and constraints.

I recognize that the Commissioner has the authority to set pay increases and am not suggesting that this authority be removed. I also recognize the Commissioner's desire to grant pay raises with meaningful distinctions for highly rated managers. However, I believe that the Commissioner can do both without decreasing the morale of managers who met their performance expectations. The Commissioner could allocate amounts that would have been previously given for within-grade step increases and quality step increases to the higher-rated managers.

IRS Critical Pay Authority

Another personnel flexibility granted to the IRS as part of the RRA 98 was the ability to establish critical pay positions[17] at the IRS, with approval from the Office of Management and Budget. The RRA 98 also gave the IRS streamlined critical pay[18] authority for up to 40 positions for a 10-year period (expiring on July 22, 2008). These streamlined positions were limited to a term of four years and required approval by the Secretary of the Treasury but not from the Office of Management and Budget. These two

[15] The Federal Managers Association and the Professional Managers Association.

[16] Operating division stakeholders include the Large and Mid-Size Business Division, Small Business/Self-Employed Division, Tax Exempt and Government Entities Division, and Wage and Investment Division. Functional stakeholders include various other offices within the IRS, such as those reporting directly to the Commissioner, Deputy Commissioner for Operations Support, or Deputy Commissioner for Services and Enforcement.

[17] For these positions, compensation may be set at a higher rate than the pay of most Federal Government executives, but may not exceed the Vice President's salary (**$221,000 for Calendar Year 2008**).

[18] **During the audit period, several of the IRS Operation Division Commissioners, the Chief Information Officer as well as the Chief Agency-Wide Shared Services were designated as streamlined critical pay employees.**

critical pay personnel flexibilities were intended to provide the Commissioner with the ability to bring in experts and the flexibility to revitalize the current IRS workforce.

In Fiscal Year 2003, we reviewed[19] the IRS's use of streamlined critical pay authority to determine whether the IRS conformed to established laws and regulations, and to analyze the costs associated with the program. We reviewed the salaries for 48 critical pay hires and determined that, in all instances, the salaries plus performance bonuses were computed according to guidelines and did not exceed the salary of the Vice President. As of September 2002, the IRS had incurred costs of approximately $8 million associated with the critical pay authority, including base salary increases, search firm costs, bonuses, and relocation costs. In some cases, the IRS initially designated positions as critical pay positions but subsequently filled them as Senior Executive Service positions. This was done because either qualified outside candidates could not be found or declined the positions, or IRS officials identified an internal candidate who was more highly qualified. The IRS and the IRS Oversight Board agreed to expand the Board's oversight of the critical pay authority by having the Board conduct an annual program review of the authority as a whole.

We recommended that the IRS obtain the Oversight Board's approval for all critical pay positions. The IRS disagreed with this recommendation, saying that it could reduce the intended benefits of the streamlined authority and that the Board's annual assessment should be adequate to determine whether this authority had been used appropriately. However, because the designation of certain positions as streamlined critical indicates a high level of importance to the success of the IRS mission, we believe that the IRS Oversight Board should be a part of the approval process for all streamlined critical pay positions.

TIGTA's Audit Strategy on Human Capital Issues

While pay-for-performance is an important part of the human capital challenge facing many agencies, it is only one aspect. Within the IRS, the term "human capital" represents the philosophy that the linkage of critical human capital assets to business strategies ultimately leads to organizational success.[20] IRS employees are recognized as critical to the attainment of the IRS vision.

Like many other Federal agencies, the IRS has experienced workforce challenges over the past few years. Those challenges include recruiting, training and retraining employees, as well as an increasing number of employees who are eligible to retire. While the IRS has made some progress, the strategic management of human capital remains one of the IRS's major management challenge areas. As a result, TIGTA has developed a cross-cutting audit strategy for Fiscal Year 2008 and beyond that addresses the broader human capital challenge across the IRS.

[19] *Oversight of Streamlined Critical Pay Authority Could Be Improved* (Reference Number 2003-10-116, dated June 2003).

[20] IRS Human Capital Office, *Concept of Operations* (April 2005).

Our audit strategy will align our work with the Human Capital Assessment and Accountability Framework created by the OPM and the Government Accountability Office. This framework consists of five human capital processes that together provide a consistent, comprehensive representation of human capital management for the Federal Government. The framework includes: strategic alignment; leadership and knowledge management; results-oriented performance culture; talent management; and accountability.

Currently, we have ongoing audits in the areas of IRS succession planning activities, retirement and separation estimates, employee skill gaps in key mission-critical occupations, the Workers Compensation Program, and use of sick leave under the Federal Employees Retirement System. We are planning another audit later this year on recruiting strategies.

I hope my discussion of this very important issue will assist the Subcommittee with its consideration of pay-for-performance systems within the Federal Government. Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to provide TIGTA's evaluation of this human capital pay structure. I would be pleased to answer any questions you may have at the appropriate time.