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Testimony Before the Joint Committee on Taxation

Joint Hearing on the Strategic Plans and Budget of the IRS

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Mr. Chairman, and members of the Joint Committee, thank you for holding this hearing and inviting me to testify. It is an honor for me to appear before your committee today on behalf of the IRS Oversight Board and to discuss the IRS' performance and the importance of the IRS Restructuring and Reform Act of 1998 (RRA 98).

On June 25th we will mark the fifth anniversary of the report of the National Commission on Restructuring the IRS, *A Vision for a New IRS*. This report led directly to the passage of RRA 98, which has changed the IRS for the better in many important ways. Let me offer the following examples:

- Commissioner Rossotti will complete the first five-year term for an IRS Commissioner in November 2002. This term, specified by RRA 98, has added stability to the position of IRS Commissioner.
- The IRS has been reorganized into four divisions, each of which is responsible for a specific segment of taxpayers, as specified in RRA 98.
- The IRS has brought over 30 outside hires with private sector experience into its executive ranks as a result of personnel flexibilities provided by RRA 98
- The IRS Oversight Board was established in September 2000 and is bringing stability, expertise, and accountability into the governance of the IRS. The Board's most significant challenges still lie ahead, however.
- Thanks to the goals established in RRA 98 for the electronic filing of tax returns, almost one of three Form 1040s was filed electronically during the last tax season.
- Taxpayers have enjoyed new rights in many areas, including innocent spouse protections, offers in compromise, and collection due process.
- The role of the National Taxpayer Advocate has been strengthened considerably.
- Low-Income Tax Clinics have been promoted to help the most needy of taxpayers seek relief from their tax problems.

Overall, RRA 98 has brought an excellent record of accomplishment towards establishing the vision for the new IRS articulated by the IRS Restructuring Commission. However, although RRA 98 has started us down the right path, let me caution that there is still a long way to go. The vision is in place, the IRS has developed a strategic plan to achieve the vision, but implementation is still in its infancy and the IRS faces some formidable challenges to fully implement its plan.

Mr. Chairman, the IRS is far from a perfect agency, but it is making progress in improving itself. What is particularly important is that the IRS is beginning to use best practices that will enable it to continue to make progress if it can successfully implement what it is planning. Let me briefly summarize the current state of the IRS.

In its 2001 Annual Report, the Oversight Board reported that the IRS is still not effectively and efficiently serving the needs of the American taxpayers, although it has made significant progress since 1997. Customer service, although improved, has not risen to desired levels and enforcement activity has fallen for many years. These problems are compounded by outmoded computer systems that handicap IRS workers and prevent the delivery of effective service. It is not surprising that this environment has resulted in dissatisfied taxpayers, inadequate job satisfaction among IRS employees and difficulty in achieving improved performance.

On the positive side, the IRS is making progress and has put in place several key elements that establish a foundation for further progress. Under Commissioner Rossotti's leadership, the IRS has made major strides in the last few years. A well-formulated, high quality strategic management and planning process has been put in place. The Board has high praise for the IRS strategic assessment process implemented as part of the budget and performance plan formulation activities. Balanced measures are also being implemented across the IRS. Other key elements that form the foundation for further progress include a major reorganization designed to better focus on customer needs and provide clear accountability, a strengthened senior management team, and a business systems modernization program that will eventually provide modern business processes and tools for employees and taxpayers. The entire modernization effort is being conducted in accordance with a strategic plan that has been approved by the Oversight Board, and monitored by balanced performance measures that will provide Congress, the Administration, the Oversight Board and other stakeholders a quantitative means to evaluate progress.

The RRA 98 assigns the Oversight Board the responsibility for overseeing the IRS in its administration, management, conduct, direction and supervision of the execution and application of the internal revenue laws. These duties closely resemble those of a corporate board of directors, but tailored to fit a public sector organization.

Carrying out these duties in light of the IRS' many challenges requires that the Oversight Board focus its attention on key strategic issues that can really make a difference in the long term. I would characterize the Oversight governance efforts into three major categories: strategic planning, budgeting, and performance monitoring.

Strategic Planning

RRA 98 assigns the IRS Oversight Board responsibility to review and approve the IRS strategic plans, and ensuring that IRS budget requests support its annual and long range strategic plans. In 2001 the Oversight Board reviewed the IRS' Strategic Plan and, to obtain an independent review, held a public meeting in March 2001 with IRS external stakeholders to obtain their comments on the Strategic Plan. Subsequently, the Oversight Board approved the IRS' Strategic Plan.

However, the strategic planning process is more extensive then the approval of a formal Strategic Plan. The Board is focused on establishing a strategic planning process and discipline linked to critical functions such as budget formulation, executive evaluation, performance management, and operational planning. Ensuring the appropriate linkages and alignment among these efforts is critical to successful implementation of the Strategic Plan. By its nature, the value of the strategic plan is to guide overall efforts, so the Oversight Board concentrates on ensuring that IRS programs are consistent with the strategic plan. This is analogous to the way a corporate board of directors functions in the private sector.

The Oversight Board is currently participating in the IRS' annual strategic assessment process, which provides an annual assessment on IRS' strategic needs. This activity leads to resource allocation among IRS functions and formulation of the FY2004 budget request.

Another function of strategic planning is executive succession planning. The most important task the Oversight Board must perform this year is to help identify candidates to replace Commissioner Rossotti.

RRA 98 requires the Oversight Board to recommend candidates to the President for the position of IRS Commissioner. The Oversight Board has exercised this responsibility by partnering with the Treasury Department to develop a Position and Candidate Specification describing the qualifications needed and hiring a search firm to identify qualified candidates.

The Oversight Board believes the next Commissioner must have the experience and competence necessary to ensure that the IRS continues its transformation to an organization focused on customer service driven by quantity and quality measures, and must be able to chart a steady course to balance calls for increased compliance and additional customer service, all within limited resources.

Qualified candidates must be CEO caliber executives with relevant operational experience, preferably gained within an intensive information processing and customer-service environment. Candidates must understand the leadership challenges of managing a 100,000 person organization. Qualified candidates must also possess credibility and stature, with a reputation for being a strong leader and manager, and having been an effective change agent. Additionally, candidates must be broad-based functionally, and be particularly adept at providing operational and technology leadership.

Budgeting

Mr. Chairman, last year I reported to the Joint Committee that the Oversight Board concluded that the President's Fiscal Year 2002 budget did not adequately support the IRS Strategic Plan and failed to provide enough funding for technology modernization and other vital operations. The Oversight Board based this conclusion on its collective business and professional expertise, drawn from years of managing major corporations, small businesses, and information technology programs.

Although much of the difference in budget requests was related to systems modernization, there was a difference of $138 million for IRS operations. This funding would have provided for 1300 additional FTEs that would have been applied to the Staffing Tax Administration for Balance and Equity (STABLE) program, and would have directly impacted the IRS' ability to implement its strategy of immediately improving customer service and enforcement levels.

In retrospect, I believe our judgement was correct. Neither the IRS nor the Oversight Board is satisfied with the state of the IRS' performance as reported in the Oversight Board's 2001 Annual Report. As I mentioned earlier, enforcement activity has fallen for many years, while at the same time, several areas of noncompliance are troublesome and need attention. Let me provide some examples. The IRS is just starting to match pass-through income reported on Form K-1 to individual tax returns. The IRS estimates that perhaps $100 billion of pass-through income is unreported every year. Another example of an emerging compliance problem is offshore credit cards, which can be used to hide spending and income from the IRS. While programs are now being introduced to identify these problems, the Board does not believe that the IRS will have adequate resources to follow up on many of the cases that are identified.

During the formulation of the FY2003 budget, the Board worked very closely with the Department of Treasury. The Board's recommended FY2003 budget is $92 million higher then the Administration's proposed budget.

Because of emerging issues, the Oversight Board is now concerned that the Administration's proposed FY2003 budget will not allow the IRS to make the progress in enforcement activity that was envisioned when the Oversight Board approved this budget in August 2001. Several factors cause this growing concern:

- The cost of postage in FY2003 will be $41 million more than was originally planned.
- Additional security measures have been implemented at an expense of $19.5 million for guard services and $15 million for campus security because of needs to provide for greater security for IRS offices and especially our mail handling centers in the aftermath of the 9/11 tragedy.
- The unfunded portion of the calendar year 2002 pay raise for federal civilian employees will add $43.5 million in costs in FY2003.

The greatest concern, however, is a potential $70 million negative adjustment to the IRS budget for a 4.1 percent pay raise in calendar year 2003 for federal civilian employees. If the IRS must absorb the difference between the proposed 2.6 percent pay raise and the higher pay raise Congress is considering, the impact will be to prevent the IRS from hiring 800 enforcement personnel at a time when enforcement resources are faced with many challenges. The Oversight Board urges Congress to fund any pay raise over the 2.6 percent proposed in the President's budget. These negative impacts virtually eliminate any FTE gains envisioned as part of the STABLE initiative.

The impact of these reductions affects enforcement in a very direct way. The IRS budget is labor-intensive, with 70 percent of its budget for people. Moreover, its processes are also labor-intensive, and encompass a range of activity from processing every business and individual return filed each tax year, to the identification and resolution of individual cases. Some of this activity, such as processing of all returns, is mandatory. Discretionary activity is primarily the identification and resolution of individual cases. When resources are tight, it is the discretionary activity that suffers—audit rates fall and collection activity decreases.

Collecting taxes is a thankless job, and stories of falling resources at the IRS seem to strike a sympathetic ear among taxpayers. However, the reality is much different. Honest taxpayers across the country, and they are in the vast majority, must pick up the tab for those taxpayers that cheat. An IRS that can enforce the tax laws fairly for all serves honest taxpayers by ensuring all taxpayers are paying what they owe in accordance with the tax laws passed by Congress. I don't believe that Congress wants some taxpayers helping themselves to a de facto tax cut by cheating.

Performance Monitoring

The bottom line for the Oversight Board, as is the case for private sector boards of directors, is improved performance of the organization it is governing. As such, the Oversight Board has the responsibility of helping the IRS improve its performance. There are two aspects of this process, organizational performance and executive performance, and one objective of the Oversight Board is to ensure they are linked.

The Board has recently implemented quarterly reviews of IRS performance that focuses on three dimensions of improvement: productivity (including timeliness and quality), customer satisfaction, and employee satisfaction. In our annual report, the Board noted the deficiencies in telephone service. Progress is being made in this area and the IRS is beginning to see positive results. For example, we have seen some significant improvements in timeliness and quality of IRS telephone service over the last few years, particularly in the opening months of the 2002 filing season. Although progress is being made, it is slower in some areas. In some cases, the full range of balanced measures are in the development stage. Others have only recently established baselines. Quality levels at IRS walk-in sites are just being baselined and need attention. Because of the link between employee and taxpayer satisfaction, employee satisfaction levels for these and other operations also need improvement.

The Oversight Board is concerned that the broad decline in enforcement activity increases our reliance on voluntary compliance, and fears that the public's attitude towards voluntary compliance is beginning to erode. Because of this concern, the Oversight Board initiated a survey to obtain data on taxpayers' attitudes regarding their obligations to report and pay their fair share of taxes. The survey, taken in August 2001, asked two questions from an earlier 1999 IRS survey and three new questions.

The survey results are included in the annual report, but the most troubling result was in response to a question that asked how much, if any, do you think is an acceptable amount to cheat on your income taxes. In 1999, 87 percent of the respondents replied "not at all." In 2001, the percentage of respondents who selected that answer fell to 76 percent. In short, one fourth of US citizens believe it is okay to cheat on their taxes. The Oversight Board intends to repeat the survey in 2002 using the same questions.

The other part of performance monitoring is reviewing the performance of IRS executives. The Oversight Board has established a process for reviewing the selection, evaluation, and compensation of senior IRS executives. It initiated this activity in October 2001 by developing a process and reviewing the proposed evaluation and compensation of senior IRS executives for FY2001. It is now extending that process to a more general process that will be used in FY2002 and subsequent years. This process will review IRS executive performance agreements and year-end evaluations and compensation to ensure they are aligned with the performance plans and results of the operating divisions managed by the reviewed executives.

The long-range solution to improve the IRS' performance is to modernize its business processes and information technology. The IRS' Business Systems Modernization (BSM) program is designed to transform both IRS' business processes and information technology into modern, efficient processes and systems that incorporate world-class best practices. The BSM program has been progressing slowly, limited primarily by the IRS' capacity to manage the program. Efforts from inception to date have focused on establishing an enterprise life cycle, a standard architecture, and low-risk projects. In 2002, however, several major deliverables are scheduled, and the upcoming year will be a test of the IRS' ability to manage this program.

The longer it takes the IRS to modernize, the longer taxpayers will be deprived of the benefits of improved IRS processes and systems, and be forced to endure the inadequacies of the antiquated systems in place today. Even under the best of circumstances, it will take the IRS far too long to complete its modernization program. The Oversight Board recommends that BSM be accomplished as quickly as possible, consistent with the IRS' ability to manage the program and absorb change. The private sector has already learned that accomplishing programs in as short a period as practical actually lessens overall cost and risk. To successfully implement the modernization program, all organizations involved in BSM must do a better job. The Oversight Board's recommendations for key organizations include:

- The IRS must improve its program management ability, work more effectively with the PRIME Contractor, and manage/implement change more effectively.

- The PRIME Contractor must understand and achieve its responsibilities to deliver business results within budget and on schedule and improve its breadth and depth of skills.

- The Administration must understand the importance and critical nature of the situation, support the long-term plan, including increased investment levels, and hold the IRS responsible for meeting the plan.

- The Congress must accomplish the same tasks as the Administration, and, in addition, speed up the process for review and release of BSM funding.

The Oversight Board recognizes that the IRS still has a long way to go to reach the level of performance envisioned by both the IRS Restructuring Commission and the IRS Restructuring and Reform Act. However, failure to provide adequate funding will deprive the IRS of resources it needs to make improvements in customer service and compliance.

Let me conclude my testimony by recognizing the contribution of Commissioner Charles Rossotti. During his five-year tenure Commissioner Rossotti has provided the IRS with the leadership it needed as it went through the most dramatic change in its history. The changes he implemented while Commissioner will have a positive impact on the IRS for many years into the future. His accomplishments have placed the IRS on the right track to provide top-quality service and fairness to all taxpayers, and he should be commended for what he has done to transform the IRS into a performance-based organization. We believe the country owes him a debt of gratitude for the public service he has given us in the last five years.