Statement of the Hon. Nancy Killefer,
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Testimony Before the
Subcommittee on Transportation, Treasury and Independent Agencies
of the House Committee on Appropriations

Hearing on Compliance
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Mr. Chairman and members of the Subcommittee, 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. My remarks today will be focused primarily on the Oversight Board's recommendations with respect to compliance.

Let me preface my remarks by saying that the IRS Restructuring and Reform Act (RRA 98) gives the Oversight Board specific responsibilities to review and approve the budget request of the IRS prepared by the Commissioner, and submit this request to the Treasury Department. RRA 98 also provides that the President shall submit the Oversight Board's budget recommendation to the Congress, without revision, together with his own budget request, and gives the Oversight Board the responsibility to ensure that the budget request supports the annual and long-range strategic plans.

In developing its recommendations, the Oversight Board is evaluating first and foremost the needs of taxpayers. The Board wants to ensure that taxpayers get the help they need at both ends of the tax administration spectrum. Up front, do taxpayers receive the education and service they need to understand and meet their tax obligations? Post-filing, do taxpayers believe the tax laws are being enforced fairly so that all taxpayers pay their fair share?

The Oversight Board is cognizant that the present war on terrorism and the budget deficit increase the need to ensure that all federal spending be thoroughly justified and deliver value to taxpayers. Nonetheless, the Oversight Board has statutory responsibilities for IRS governance and must ensure that it makes an honest and independent assessment of the performance levels the IRS must deliver and the budgetary implications of achieving that performance. The Oversight Board worked closely with the IRS, as well as with Treasury and the Office of Management and Budget (OMB) in producing its budget recommendation. The Oversight Board believes that its budget recommendation supports the annual and long-range strategic plans of the IRS, as required by RRA 98.

Moreover, especially in this difficult budgetary time, the Oversight Board believes that there is great value in having the government collect the revenue it is due by ensuring that all taxpayers pay what they honestly owe. Taxpayers expect that this be done, and fairness dictates it.

I will address the Oversight Board's view of the IRS budget from two perspectives. First, I will discuss the challenges the IRS must face as it continues to modernize in accordance with its strategic plan. The IRS' ability to meet these challenges will be affected by resource availability. In a world of scarce resources, the Administration, Congress, and Oversight Board must be conscious of the competitive balance between resources and performance. The Board's role is to provide long-term guidance and direction; it would be remiss not to discuss the long-term funding needed by the IRS to meet its strategic goals.

Secondly, I will present the Oversight Board's FY2004 budget recommendations, and why we made these recommendations. Funding the IRS presents difficult choices, and these decisions should be made in full consideration of the performance levels that various funding alternatives deliver to the public.

Strategic Challenges Over the Next Five Years

RRA 98 set the IRS on a process to transform itself into a modern financial institution that could meet the needs of taxpayers. Five years into that process, the IRS finds itself at a crossroads. The IRS is to be commended for the progress it has achieved since the passage of the landmark RRA 98. With goals of providing better service and ensuring fair treatment under the law for taxpayers, the IRS is striving to meet RRA 98's mandate.

Yet the tax system is still plagued with two long-term conflicting trends: an increased demand on the tax administration system, and a steady decline in IRS resources due to budget constraints. In the past decade, the IRS workload has increased steadily. The number of tax returns continue to grow; particularly complex returns, such as those filed by individuals earning more than $100,000 each year and small corporations.

As the transformation continues, the IRS continues to face challenges. It must close the compliance gap that threatens the integrity of our tax administration system. It must improve customer service that still lags behind what is found in the best private sector companies. It must better manage the modernization of its computer and business systems; and it must show better results that actually benefit taxpayers. It must engage the entire work force – particularly front line managers and employees – in the organization's goals and replace critical talent as employees retire. And it must set clear, long-term goals and find ways to attain them.

To meet these challenges, the Board has called for the IRS to continue to strive for greater efficiencies, and to work harder and smarter to boost its productivity. The Board also called upon Congress and the Administration to support stable and additional funding for the IRS, not only in FY2004, but in the next five years.

Closing the Compliance Gap

There is mounting evidence that some taxpayers are not reporting and paying what they legally owe. The amount of assessed but uncollected taxes, analogous to receivables, is almost $280 billion and growing. Particularly vexing to the Oversight Board is the number of potential examination and collection cases the IRS has identified but cannot pursue due to lack of resources. For many of these cases, the IRS is only assigning resources to approximately 20 to 30 percent of the cases it has identified. In the view of the Oversight Board, the IRS' lack of resources to pursue this many known cases is a serious failure of the IRS to meet taxpayers' needs, and potentially undermines our system of voluntary compliance.

The Oversight Board recognizes the IRS cannot add the resources in a single year to work all identified cases. Adding this many new employees would be impractical, ineffective, and inappropriate. A more practical approach is to add a manageable number of new employees on a steady basis over a long period of time. This is the approach that former Commissioner Rossotti suggested to the Oversight Board in his End-of-Term Report, recommending a steady but slow growth in staff in the range of 2 percent per year for the next five years combined with a 3 percent increase in productivity. The Oversight Board believes that an investment of this scope is what is needed to close the compliance gap.

Boosting Customer Service

The Board believes that making it easier, faster, and more efficient for Americans to meet their tax obligations will pay off in better compliance. In FY2002, taxpayers dialed the IRS' toll-free number almost 100 million times. They visited or called IRS walk-in centers 10 million times. And they wrote 22 million letters. They called to ask honest questions so they could meet their tax obligations.

As the demand for customer service grows each year, so too does the complexity of the tax code. For the past five years, 19 public tax laws were enacted, 293 tax code provisions changed, and 414 alterations were made to forms and instructions. Complexity adds to taxpayers' burdens, and makes it more difficult and expensive for the IRS to enforce the law.

Yet only seven out of ten taxpayers can get help from the IRS over the telephone. Considering the demand for customer service, and its potential to help prevent future non-compliance, it is important to provide taxpayers with more assistance and better access to help them understand their tax obligations.

Committing to the BSM Program

The Business Systems Modernization (BSM) program is another strategic challenge. Much has been written about the state of the IRS' computers, but the sad fact is that no private sector company could remain competitive with computer systems similar to those used by the IRS. These systems prevent IRS employees from obtaining timely and accurate information about taxpayers' accounts and must be modernized.

The BSM program is essential to the transformation of the IRS. Without modern processes and information technology, the IRS cannot meet taxpayers' needs. The Oversight Board, however, has been disappointed in the performance of this critical program, which is still plagued with delays in schedule and cost overruns.

Not only does some of the most difficult development work lie ahead, but the approach to modernization requires that legacy and modernized systems operate in parallel for extended periods of time, possibly five years. These parallel operations will represent an additional cost to the IRS that it is not experiencing today in a major way. The Oversight Board estimates that the IRS has spent approximately $60 million in FY2002 from its operational information systems budget to support the BSM program, and will spend $75 million in FY2003 and approximately $120 million in FY2004 supporting this program. Additionally, modernized systems will have a major impact on business operations, and transitioning to modernized systems will require a major investment in developing modernized processes and training of IRS employees. Managing change must become a way of life for the IRS, and implementing change will present additional cost challenges.

The Oversight Board wants to emphasize two important points about the BSM program:

- The BSM program is a major long-term investment that will require significant ongoing and growing investment
- BSM should be implemented as quickly as possible in order to lower the program's ultimate cost and risk. Funding reductions, while seemingly attractive in the short term, have long-range consequences, which outweigh any short-term savings.

Replenishing Human Capital

As the IRS transforms itself by modernizing its organizational structure and its business and technology systems, it is also important for the IRS to assess its human capital needs. In a modernized environment, people will remain an important enabler of agency performance and will continue to be the IRS' most important asset. Both the Government Accounting Office (GAO) and Treasury Inspector General for Tax Administration (TIGTA) have identified human capital issues among the major challenges facing IRS management.

During the past five years, the IRS has devoted energy and resources towards its structural realignment and its business systems and technology modernization programs, but has placed less attention on strategic human capital planning. During the next five years, the IRS must cope with an aging workforce that is increasingly retirement eligible, build new skills for more complex work in a modernized environment, develop an agency-wide approach to training using modernized technology so it can deliver high quality services to taxpayers, and improve internal communications.

To support its human resources, the IRS has partnered with the General Services Administration to develop a long-term strategic plan to modernize all its campus facilities by the year 2017. The plan includes 83 buildings at 10 campuses, encompassing approximately 9.8 million square feet of space, at a capital cost estimated at $2 billion.

Although one goal of the plan is to replace aging facilities with flexible, modern facilities that align with the IRS new organization, the plan will achieve other objectives as well. The existing facilities average over 35 years in age, and are generally in need of substantial repair. As the IRS modernizes its processes and technology, its facilities must be capable of supporting the modernized environment.

The plan has not yet been approved, but the Oversight Board has no doubt that the need to upgrade IRS facilities over the next 15 years will add an additional strain on already scarce budget resources. The plan's first step is to provide new facilities in Kansas City and Philadelphia. The IRS requested the Board's support to include $72 million in FY2005 budget for these facilities. The Board recognizes the condition of some of the IRS' campuses, but noted that budget restraints will require trade-offs in the future, and that decisions must be placed in this context.

Oversight Board's FY2004 IRS Budget Recommendations

I would now like to present the Oversight Board's FY2004 budget recommendations in the context of the long-range budget challenges just discussed.

Table 1 shows the Oversight Board's FY2004 budget recommendations for each account compared to the FY2003 IRS budget and the Administration's budget request.

Table 1. Comparison of IRS' FY2003 Budget with Administration Request and Oversight Board Recommendations for FY2004 **(All $ in 000s)**

Account	FY2003 IRS Appropriation[1]	Administration FY2004 Budget Request	Oversight Board FY2004 Budget Recommendation	Difference between Administration and Oversight
PAM	$3,930	$4,075	$4,247	**$172**
TLE	$3,705	$3,976	$4,021	**$44**
IS	$1,621	$1,670	$1,670	**-**
BSM	$364[2]	$429	$500	**$71**
EITC	$145	$251	$251	-
HCTC	$70	$35	$35	-
Total	**$9,835**	**$10,437**	**$10,724**	**$287**

[1] FY2003 actual appropriation. Administration FY2003 request was $9,916 million.
[2.] The original FY2003 budget request was $450 million, which was subsequently reduced to $380 million.

Overall, the Oversight Board's recommendation is $889 million higher than the FY2003 IRS appropriation, of which approximately $273 million is due to inflation and $616 million is attributed to growth. This growth includes approximately $100 million for an expanded EITC program and $35 million for the HCTC program.

The Oversight Board's recommended budget is $287 million higher than the Administration's recommended IRS budget of $10,437 million. The Oversight Board recommends an additional 2,120 FTEs over FY2003 levels compared with the Administration request of 238 additional FTEs. An additional 650 FTEs are proposed for the EITC Reform Initiative, which was proposed by the Administration and added by the Board to its budget recommendation.

The Oversight Board has recommended this budget for several reasons. First, and most importantly, it addresses the strategic challenges I identified earlier and is consistent with the Oversight Board's goal of achieving two percent in real growth for a five year period, which it believes is necessary for the IRS to close the workload gap in compliance.

Secondly, it provides for additional investment in the BSM program, which the Oversight Board believes is essential to the transformation of the IRS. Unfortunately, the Oversight Board believes the Administration request will result in the delay of delivery of important benefits to taxpayers.

Third, it restores resources for customer service and enforcement that have been lost in recent years to unexpected costs. Each year, the IRS must cover unexpected costs. These costs reduce the IRS' ability to hire the number of employees (full-time equivalents, or FTEs) planned by both the Administration and the Board in their recommended budgets. Examples of unexpected costs that caused this reduction include:

- $43 million to cover the unfunded increase in the FY2002 annual pay raise from the President's request of 3.6 percent to the enacted 4.6 percent raise;
- $68 million of unfunded increase in the FY2003 annual pay raise from the President's request of 2.6 percent to the enacted 4.1 percent raise.
- $23 million when legislation was not enacted that would have allowed for savings on postage and the Financial Management System payment levy;
- $22 million in postage costs that increased above initial budget projections; and
- $20 million of unfunded increases in security costs after September 11.

In FY2002 and FY2003, unfunded costs resulted in decreases in the number of FTEs requested in the Administration's budget as shown below:

Fiscal Year	**Administration FTE request (less EITC)**	**FTEs Achieved by the IRS (less EITC)**	**Difference**
FY2002	99,116	96,714	-2,402
FY2003	98,727	96,802	-1,925

The stage has already been set for this to happen again, resulting in a lower number of FTEs in FY2004. In the FY2004 budget, the Administration proposed a two percent pay raise for civil service employees and a 4.1 percent raise for military personnel. Pay parity between civilian and military personnel was provided in 15 of the last 17 Treasury Appropriation bills. Furthermore, both the House and Senate versions of the FY2004 budget resolution contain a "sense of the Congress" provision supporting military-civilian pay parity for federal employees. If past years are any indication, Congress will again provide pay parity to military and civilian personnel.

The Board's FY2004 budget proposal, as does the Administration's, assumes a two percent pay increase. The Board urges that Congress provide the necessary funds for any pay raise it may pass in the coming year. Otherwise, as in previous years, the IRS will be forced to freeze future hiring initiatives and cut any discretionary spending such as employee training programs to absorb the impact of an unfunded pay raise.

For three of the six IRS appropriation accounts, there is no difference between the Administration request and the Oversight Board recommendation. Both the Administration and Oversight Board are recommending significant increases to the Tax Law Enforcement account. The Board recommends a slightly higher increase, $316 million versus $272 million. The Board's expanded budget allows approximately 550 additional FTEs for compliance, netting an 8 percent increase in compliance resources.

Processing, Assistance, and Management

The Oversight Board's recommendation for the PAM Account is $172 million higher than the Administration's proposed budget. A common feature of both recommendations is that they contain significant savings from improvements in systems and work processes, specifically a savings of 1,427 FTEs through reengineering in this account.

Although enforcement issues have captured the public's attention, customer service issues are still important, and in many ways can prevent future non-compliance. The demand for customer service grows each year; so too does the complexity of the tax code. Yet service levels need improvement, as evidenced by the fact that only seven out of ten taxpayers can get help from the IRS over the telephone.

The Oversight Board's recommended budget contains the savings from reengineering, but also recommends an additional $172 million for taxpayer assistance that the Board believes is needed to help taxpayers. For example, the Oversight Board's budget provides an additional $45.6 million to improve telephone services to small businesses as well as individual taxpayers who have questions or concerns regarding their taxes, as well as an additional $38 million in pre-filing services to determine the needs and values of taxpayers, identifying whether current or innovative methods are working, and providing education and assistance to taxpayers. Overall, the Oversight Board's additional budget will provide for the following pre-filing and account services:

- Provide a higher level of assistor service (76 percent v. 73 percent), which will result in IRS assistors answering an additional 1,700,000 phone calls from small business owners and other taxpayers who have questions regarding their tax obligation;
- Provide assistance to an additional 630,000 taxpayers through outreach programs and compliance initiatives to combat tax scams and schemes; and
- Provide an additional 38 staff-years of education and out-reach services.

Business Systems Modernization

The Oversight Board's recommendation for the Business Systems Modernization account is $136 million higher than the FY2003 appropriation of $364 million and $71 million higher than the Administration's proposed budget of $429 million.

The Board believes that modernizing the IRS' computer systems is critical to the transformation of the IRS to a modern financial institution.

The Administration's original FY2003 budget request included $450 million for the BSM account, which was approved by both the full House and the Senate Appropriations Committee. In September 2002, $70 million of the FY2003 appropriations for the BSM account was shifted into an account to administer the Health Coverage Tax Credit, passed as part of the 2002 Trade Adjustment Act. As a result, the BSM appropriation request was reduced. Ultimately, the FY2003 appropriation for BSM was reduced further to $364 million, $28 million less than the FY2002 appropriation of $392 million. The Oversight Board is disappointed that funds to meet the new HCTC requirement were taken from such an important strategic program as BSM. Admittedly the BSM program had disappointing results in FY2002, and we are not suggesting that more money should be spent in 2003. However, these are two-year funds. Underfunding the program in the long term only delays the delivery of benefits to taxpayers.

Clearly the program execution needs improvement, and the Oversight Board believes that approval of expenditures must be consistent with the IRS' ability to manage the program. The Oversight Board believes that the current process of having Congress approve the BSM expenditure plan provides safeguards against spending funds on projects the IRS cannot manage.

The Board believes the IRS is beginning to improve its ability to manage the BSM program. If the IRS can demonstrate its ability to manage the program, the funding to move the program forward must be available in FY2004. On the other hand, if the IRS cannot demonstrate its ability to manage the BSM program in an acceptable manner, additional changes must be made prior to starting any new projects.

That concludes my statement. I will be pleased to answer any questions.