IRS OVERSIGHT BOARD

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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 Internal Revenue Service (IRS) Oversight Board and to discuss the IRS' performance and the importance of the IRS Restructuring and Reform Act of 1998 (RRA 98).

On July 22nd we will mark the fifth anniversary of the IRS Restructuring and Reform Act of 1998. At this five-year point, the Board believes it is important to check the true progress of the IRS. Where is the IRS in the transformation process? Is the IRS on track? What are the greatest challenges the IRS faces, and how can they be overcome?

Progress Made Since RRA 98

The American tax system is at a crossroads. Following the enactment of the IRS Restructuring and Reform Act of 1998, the IRS embarked on a ten year modernization program and is now at its mid-point. During the past five years, the IRS made enormous progress in setting the stage to provide better service and ensure fair treatment under the law for taxpayers. The agency has refocused, redefined, and rebuilt itself, with dramatic changes in its mission, organization, management processes, and governance. In the past five years, the IRS:

- Adopted a new mission statement to "Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all."

- Emphasized the specific needs of different taxpayer segments by implementing a modern organizational structure with four major customer-focused operating divisions.
- Held senior executives and organizations accountable for performance by developing and implementing a balanced measures program.
- Integrated a performance and budget plan based upon a sound strategic assessment and planning process.
- Began to transform the IRS into a modern financial services institution with redefined business processes and information technology by designing and implementing a vision and new architecture.
- Implemented modern call routing, so taxpayers get to the right person to answer their questions quickly.
- Promoted electronic tax filing, which continues to grow; so much so that one paper processing pipeline was closed.
- Weaved many services into the internet, so taxpayers can check the status of their refunds, download forms, and get information easily over www.irs.gov.
- Hired executives with private sector backgrounds to bring new business knowledge and practices, while setting processes to ensure the effectiveness of its streamlined critical pay authority.
- Implemented a number of new and/or expanded taxpayer rights, such as the Innocent Spouse program.
- Strengthened advocacy for taxpayer rights through the Taxpayer Advocate Service, which is handling a case load far larger than originally anticipated.
- Began to gather and analyze valuable taxpayer information through the National Research Program. The program's data will help the IRS allocate resources more effectively and fairly, resulting in better compliance.

Strategic Challenges

However, in its 2003 Annual Report to Congress, the Oversight Board reported that the American tax system is still plagued with two long-term conflicting trends: a steady increased demand on tax administration services, 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 filed continues to grow; particularly complex returns, such as those filed by individuals earning more than $100,000 each year and small corporations. The tax revenue stream is now dominated by sources that provide greater opportunities for manipulation and for error.

At the same time, the number of IRS employees continues to shrink, due to budget constraints. From 1992 to 2002, IRS workload increased by 16 percent, while at the same time, the number of full time equivalent employees (FTEs) decreased 16 percent from 115,205 in FY1992 to 96,714 in FY2002. As more resources were needed for the IRS to provide essential services, such as processing returns and answering correspondence, resources were shifted from discretionary operations, such as compliance activities. These trends are creating a huge gap between what taxpayers need and what the IRS can do.

Before he left office, the Board asked Commissioner Charles O. Rossotti to assess the state of the IRS and of the tax system. He reported that the effect of these conflicting trends created a huge gap between the number of taxpayers who are not filing, not reporting, or not paying what they owe, and the IRS' capacity to require them to comply. In addition, the tax revenue stream is now dominated by sources that provide greater opportunities for manipulation by those who wish to take advantage of the decline in IRS compliance resources. According to his report:

- 60 percent of identified tax debts are not pursued
- 75 percent of taxpayers who do not file a tax return are not pursued
- 79 percent of identified taxpayers who use abusive devices (e.g., offshore accounts and abusive tax shelters) to evade tax are not pursued
- 56 percent of identified taxpayers with incomes of $100,000 or more and underreported tax are not pursued
- 78 percent of partnerships and similar document matching are not pursued.

IRS Performance in FY2002

These long-term trends impact the IRS' ability to meet taxpayers' needs. In reviewing the IRS' performance for FY2002, the IRS Oversight Board found that:

- **Customer service showed some improvement, but not enough.** The number of returns filed electronically by individuals rose 16 percent. The IRS also improved its accuracy in correctly answering questions regarding tax law and taxpayer accounts on its toll-free telephone lines. Yet only seven out of ten callers to the IRS toll-free phone line were assisted. This is an improvement from the year before, and may indicate a trend, but this level is not acceptable to the Board. Voluntary compliance is at the heart of the nation's tax system, and the easier it is for taxpayers to meet their tax obligations, the more likely they will be to comply with the law. More resources are needed for the IRS to provide the services taxpayers need.

- **Compliance activities increased, but not enough to close the gap.** In FY2002, collection activities generated $371 million more than the year before – a laudable improvement, but not nearly enough to address the growing compliance gap. The number of levies issued increased nearly 50 percent over the previous year, while the number of liens filed increased by nearly 15 percent. Audits of high-income taxpayers – those earning $100,000 and up – increased by 22 percent from the previous year. The IRS launched a number of initiatives aimed to clamp down on abusive tax shelters and offshore accounts. However, other compliance related measures declined. The gap between new delinquent accounts received and the number closed grew again. The exam coverage rate for large businesses over $10 million declined from 25 percent to 15.5 percent. In areas of high growth in returns filed, such as partnerships and mid-sized businesses filing 1120S returns, coverage rates have also declined dramatically.

While the improvements in both areas are welcome, the Board remains concerned with the overall state of customer service and the IRS' ability to ensure that the tax law is enforced. The National Taxpayer Advocate's 2002 report cited access to the IRS as fundamental to the achievement of universal taxpayer rights. The Board agrees that taxpayer accessibility to the IRS is imperative. The vast majority of taxpayers want to do the right thing in an increasingly complex tax system. They must be able to get help from the IRS, whether it is over the phone, in person, or over the internet. Resources must be made available so the IRS can provide the level of service expected by the public.

Actions Required for Success

The IRS Oversight Board's role is to provide long-term guidance and direction to the IRS. Given the IRS' present situation, we believe that the agency, with the support of the Administration and Congress, must take the following actions if it is to succeed:

- **Close the compliance gap:** The IRS Oversight Board believes that modernizing the IRS and a three percent annual productivity gain alone will not close the compliance gap. In his end-of-term report to the Board, Commissioner Charles O. Rossotti recommended an annual two percent per year staff growth through 2010. The Board fully endorses this approach.
- **Boost customer service:** Millions of taxpayers are filing electronically. Hundreds of millions of forms and publications are downloaded from the IRS web site. Yet the demand for customer service – over the phone, at walk-in centers, and through the mail – grows each year. So too does the complexity of the tax code. Only seven out of ten taxpayers can get help over the phone at tax time given the IRS resource constraints. The IRS has direct contact with more Americans than any other federal agency; the Board believes its customer service must continue to improve to a long-term level agreed upon by Congress and the Administration, and backed up with the resources needed to meet that level.
- **Commit to modernization:** Until both its processes and supporting information systems are modernized, the IRS cannot become a modern financial services institution. The Board is deeply concerned with the progress of this program. Results have been delayed and both the PRIME contractor and the IRS need to continue to improve their management's ability to handle a program of this scope. Despite this, the Board remains committed to the modernization program, and believes it should be accomplished as quickly as possible consistent with the IRS' ability to manage and implement it.
- **Focus on people resources:** As the IRS modernizes, it must recruit, retain and develop employees who have the knowledge and skills needed to do their jobs. The IRS will also face a dramatic loss of institutional knowledge in the next five years when waves of federal employees retire. In the past five years, the IRS has concentrated on business processes and information technology. Now is the time for the IRS to make the most of its people resources by developing a comprehensive, agency-wide strategic human resources initiative.
- **Measure long-term goals:** The IRS made strides in measuring its progress in the past five years with the implementation of an agency-wide balanced measures approach to performance management. The agency and decision-makers now have a much better sense of the IRS' performance. Yet there is no universal consensus on what constitutes the appropriate level of performance in the long-term, for both compliance and customer service. Two efforts are underway to address this. First, at the Board's recommendation, the IRS Executive Steering Committee will propose and seek consensus among key executive branch agencies, Congress, stakeholders, and the public in determining

appropriate levels and strategic goals for IRS long-term performance objectives. The second is the work underway by the National Research Program, which will provide data on taxpayer compliance levels. The Board believes it is necessary for the IRS to set its long-term goals so it can evaluate it progress effectively.

To accomplish all of these things, the IRS needs stable, additional funding. The IRS cannot close the gap or implement a successful modernization effort unless it receives additional and sustained funding over a long period of time. The Board is well aware of the challenges now facing our nation, but believes that short-term solutions to reduce spending will result in larger challenges in tax administration in the future and endanger the source of revenue collection.

FY2004 IRS Budget Recommendations

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.

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.

The Board's recommended budget provides for two percent growth in IRS resources. 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 provides the IRS with resources to address the five strategic actions I described earlier. The proposed budget is also consistent with the Oversight Board's goal of achieving two percent in real growth for a five year period, which it believes is necessary.

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.

Conclusion

Chairman Thomas, before I conclude I would like to add a personal note. Two years ago, on May 8, 2001, GAO, TIGTA, and I testified before you at a Joint Tax Committee hearing on the same subject. You challenged the three organizations to share information and develop common perspectives on the strategic challenges facing the IRS. I'm pleased to say that since that hearing we have responded to your challenge and meet periodically to do just that. The result has been a fruitful and rewarding exchange for all three organizations. I'm confident my fellow panelists would agree.

The Board believes that the IRS has accomplished much, but must do more. We have a tough five years ahead of us. Up to this point, the agency focused on planning and developing major programs. Those programs are now being implemented. The Board intends to work closely with the IRS and its new leadership to provide guidance to improve the implementation process. The Board also will work with the Administration and Congress to do all it can to ensure that the IRS gets the resources needed to succeed.

The future is now. It is time for the IRS to begin to produce the tangible benefits for taxpayers envisioned five years ago.