Statement of the Hon. Karen Hastie Williams,
Member, Internal Revenue Service Oversight Board

Testimony Before the Subcommittee on Oversight
of the House Committee on Ways and Means

Hearing on the 2003 Filing Season and
the IRS FY2004 Budget Request

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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 recommendation for the IRS FY2004 budget.

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.

I would like to 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 scares resources, the Administration, Congress, and Oversight Board must be conscious of the competitive balance between resources and performance. The Oversight Board wants to alert IRS stakeholders, especially the Congress, of the strategic needs the IRS must face in the next five years, and the budgetary demands that meeting these needs will entail.

Secondly, I want to 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. It has made enormous progress in setting the stage to provide better service and ensure fair treatment under the law for taxpayers. During this period, the IRS has refocused, redefined, and rebuilt itself, with dramatic changes in its mission, organization, management processes, and governance.

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, some of which may be more difficult than the ones it has overcome in the last five years. The Oversight Board believes that the following issues present enormous challenges to the IRS, and each will require an investment of resources over multiple years if the IRS is to continue the transformation process:

- Closing a compliance gap that is unfair to honest taxpayers
- Continuing and implementing the Business Systems Modernization program that will modernize its business processes and information technology
- Replenishing its human capital
- Modernizing its facilities

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. The Administration has asked Congress to authorize the IRS to use private collection agencies to help reduce uncollected taxes. The number of promoted abusive tax shelters also is on the rise, and the IRS has developed programs to do more to counter this problem. Both of these issues are serious, but 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, IRS' lack of resources to pursue this many known cases is a serious failure of the IRS to meet taxpayers' needs. Our system of voluntary compliance is based on the premise that taxpayers believe that everyone is paying what they legally owe.

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.

Not only does the large workload gap represent a significant revenue shortfall to the government, taxpayers expect the IRS to enforce the law. Honest taxpayers recognize that they bear the burden for under-enforcement by the IRS. The IRS Oversight Board conducted a public survey in July 2002, in which taxpayers' opinions about the IRS' role in enforcement was questioned. Ninety-three percent of taxpayers said that it was very important or somewhat important to them that the IRS ensures that high income taxpayers, corporations, and small business are honestly paying what they owe. More detailed survey results are in the table below.

How important is it to you, as a taxpayer, that the IRS does each of the following to ensure that all taxpayers honestly pay what they owe?	**Very Important**	**Somewhat Important**	**Not Very Important**	**Not at All Important**	**Don't Know**
1. Ensures low income taxpayers are reporting and paying their taxes honestly	56	28	8	5	3
2. Ensures small businesses are reporting and paying their taxes honestly	68	25	3	3	2
3. Ensures high income taxpayers are reporting and paying their taxes honestly	77	16	1	3	2
4. Ensures corporations are reporting and paying their taxes honestly	83	10	1	3	3

Continuing and Implementing the BSM Program

The Business Systems Modernization (BSM) program is a second strategic area that will require a long-term investment if the IRS is to become a modern financial institution. 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.

Ensuring that IRS employees are engaged in their new organizations and new positions still represents a major challenge for the IRS. Moreover, the reorganization is only the first of many changes the IRS must manage. The introduction of modernized technology has barely begun, and this change will require the IRS to address employees' needs in the modernized environment.

The investment needed to improve the IRS' human capital is not separately identified like the BSM program; it is embedded in all its budget accounts. Historically, budget for human capital improvements such as training are often cut first when the need to reduce expenditures occurs. It is important to that human capital investments be given the attention they deserve, and be more explicitly identified so that decisions on human capital needs be made on an informed basis. Addressing these needs over the next five years will be critical to continuing IRS transformation to a modern financial institution.

Modernizing its facilities

Much like its information technology, the IRS is presently dependent on aging facilities to process paper returns. Commonly known as "pipelines", they are co-located with ten central sites referred to as campuses at which the IRS performs a multitude of centralized tax administration functions. With the level of electronic filing now rising, the IRS is planning to close its first pipeline, located at its Brookhaven campus.

The Brookhaven pipeline closing only represents the start of a program to re-align IRS campus facilities to its new workforce needs. In 2005, the IRS plans to close its pipeline at Kansas City, and in 2007 plans to close the pipeline at its Philadelphia campus.

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. Today's buildings do not provide the functionality needed to house modern office workers who use information technology extensively in their jobs.

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. The FY2004 budget is the first step. It provides for steady improvements in IRS performance, and establishes a level of investment necessary for addressing these challenges.

The Oversight Board is cognizant that the present war on terrorism and the present 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 to taxpayers and the budgetary implications of those needs. 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 Office of Management and Budget (OMB) recommendations.

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	-
HITC	$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 HITC program.

The Oversight Board's recommended budget is $287 million higher than the Administration's recommended IRS budget of $10,437 million. Without the 650 FTEs proposed for the EITC Reform Initiative, which is common to both budgets, the Oversight Board recommends an additional 2,120 FTEs over FY2003 levels compared with the Administration request of 238 additional FTEs.

The Oversight Board's budget recommendation provides for:

- A first step in a five year plan to close the compliance gap;
- An adequate FTE level for the IRS so it can rebuild its human capital to meet its future needs
- Full funding for the IRS's efforts to modernize its processes and information technology ;
- Increased level of telephone service to taxpayers;
- Additional taxpayer outreach and pre-filing assistance to help taxpayers file correctly and prevent problems before they occur, and
- Additional funding for counterterrorism activities.

The Oversight Board has recommended this budget for several reasons. First, and most importantly, it 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. The IRS requires this level of funding if it is to successfully continue its transformation.

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. Unexpected cost increases have caused the IRS to realize a number of Full Time Equivalents (FTEs) that was significantly below the Administration's request. For example, the Administration request for FTEs in FY2002 and FY2003, and the FTE level achieved by the IRS, are:

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

The FY2003 FTE level will likely be lower when the effects of the $64 million across the board cut in the FY2003 appropriation are calculated.

The Oversight Board is concerned that these same problems will be experienced in FY2004. In the FY2004 budget, the Administration proposed a 2 percent raise for civil service employees and a 4.1 percent raise for military personnel. If past years are any indication, Congress will again agree to provide pay parity to military and civilian personnel. 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.

The Board's FY 2004 budget proposal, as does the Administration's, assumes a 2% pay increase. The Board urges that Congress provide the necessary funds to fully fund any pay raise it may pass in the coming year. Otherwise, as in previous years, the IRS will be forced to cut employee training programs, telephone service to taxpayers and freeze future hiring initiatives.

For three of the six IRS appropriation accounts, there is no difference between the Administration and the Oversight Board recommendations. For Tax Law Enforcement, the difference is small, only about 1 percent. Both the Administration and Oversight Board are recommending significant increases to this account. In two accounts, PAM and BSM, the differences are larger. I will only address the difference in these two accounts.

Processing, Assistance, and Management

The Oversight Board's recommendation for the Processing, Assistance, and Management Account is $172 million higher than the Administration's proposed budget. A common feature of both recommendations is that this account should be the source of significant savings resulting from improvements in systems and work processes. Much of the work accomplished in this account relates to assisting taxpayers, processing of tax returns, and management, and the IRS has saved 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 only seven out of ten taxpayers can get help from the IRS over the telephone.

The Oversight Board's recommended budget also contains the savings resulting 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 face-to-face assistance to an additional 492,000 taxpayers through outreach programs and pre-filing compliance alternative treatment initiatives;
- Provide indirect assistance to an additional 138,000 taxpayers through established partnerships with practitioner groups as well as the Volunteer Income Tax Assistance program;
- 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.

Considering the essential nature of the BSM program, the Oversight Board is concerned with the FY 2003 appropriation for the BSM account, and the implications of these actions for future appropriations. The Administration's original FY 2003 budget request included $450 million for the BSM account, which was approved by both the House of Representatives and the Senate Appropriations Committee. However, in September 2002 the IRS was assigned responsibility for implementing a new tax credit, the Health Insurance Tax Credit (HITC), which was passed as part of the 2002 Trade Adjustment Act. In response to this new requirement, the Administration supported a transfer of $70 million from the BSM account to implement the HITC program, creating a separate HITC account and reducing the BSM request to $380 million. This transfer was in lieu of a request for additional funding to cover the costs of the HITC program.

Ultimately, the FY2003 appropriation for BSM was $364 million, $28 million less than the FY 2002 appropriation of $392 million. The Oversight Board is disappointed that funds to meet the requirements of the new HITC requirement were taken from such an important strategic program as BSM. Admittedly the BSM program had disappointing results in FY2002, but 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 and implement 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. 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. Poor performance is not acceptable.

Extension of Filing Deadline for Electronic Filers

One last topic that I would like to address is the proposed extension of the filing deadline to April 30th for taxpayers who file and pay electronically.

I commend this subcommittee for its strong interest in electronic filing. E-filing delivers benefits to taxpayers and is now starting to simplify IRS operations as well. The number of paper returns has now decreased to the point where the IRS is planning to close one of its ten paper processing pipelines in 2004, and is planning to close a second one in 2005.

Last year, in its electronic filing report to Congress, the Oversight Board supported the extension of the filing deadline to April 30th for taxpayers that file electronically. Recently, in response to questions raised at the Oversight Board's public meeting in January, the Board revisited this issue to ensure that this continues to be a sound recommendation. Based on surveys the IRS has made of taxpayers, the Board believes that the proposed due date change would be effective in attracting additional electronically filed returns, and continues to support the proposed extension.

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