JOINT REVIEW OF THE STRATEGIC PLANS AND BUDGET OF THE INTERNAL REVENUE SERVICE, 2001

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
COMMITTEE ON APPROPRIATIONS
COMMITTEE ON GOVERNMENT REFORM
HOUSE OF REPRESENTATIVES

AND THE

COMMITTEE ON FINANCE
COMMITTEE ON APPROPRIATIONS
COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

MAY 8, 2001

JCS–2–02

Printed for the use of the Joint Committee on Taxation

JOINT REVIEW OF THE STRATEGIC PLANS AND BUDGET OF THE INTERNAL REVENUE SERVICE, 2001

JOINT REVIEW OF THE STRATEGIC PLANS AND BUDGET OF THE INTERNAL REVENUE SERVICE, 2001

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
COMMITTEE ON APPROPRIATIONS
COMMITTEE ON GOVERNMENT REFORM
HOUSE OF REPRESENTATIVES

AND THE

COMMITTEE ON FINANCE
COMMITTEE ON APPROPRIATIONS
COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

MAY 8, 2001

JCS–2–02

Printed for the use of the Joint Committee on Taxation

U.S. GOVERNMENT PRINTING OFFICE

77–620 WASHINGTON : 2002

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON WAYS AND MEANS

WILLIAM M. THOMAS, California, *Chairman*	CHARLES B. RANGEL, New York

COMMITTEE ON APPROPRIATIONS

C. W. BILL YOUNG, Florida, *Chairman*	DAVID R. OBEY, Wisconsin

COMMITTEE ON GOVERNMENT REFORM

DAN BURTON, Indiana, *Chairman*	HENRY A. WAXMAN, California

COMMITTEE ON FINANCE

CHARLES E. GRASSLEY, Iowa, *Chairman*	MAX BAUCUS, Montana

COMMITTEE ON APPROPRIATIONS

TED STEVENS, Alaska, *Chairman*	ROBERT C. BYRD, West Virginia

COMMITTEE ON GOVERNMENTAL AFFAIRS

FRED THOMPSON, Tennessee, *Chairman*	JOSEPH I. LIEBERMAN, Connecticut

CONTENTS

JOINT REVIEW OF THE INTERNAL REVENUE SERVICE, 2001

TUESDAY, MAY 8, 2001

The joint review met, pursuant to notice, at 9:00 a.m., in room 1100 Longworth House Office Building, Honorable William M. Thomas, presiding.

[The press release announcing the hearing follows:]

JOINT COMMITTEE ON TAXATION PRESS RELEASE

JCT Press Release: 02-01
For Immediate Release: April 25, 2001
For Further Information, Contact: Michael Boren (202) 225-3621
Michael.Boren@mail.house.gov

The Internal Revenue Service Restructuring and Reform Act of 1998 (the "IRS Reform Act") requires the chairman of the Joint Committee on Taxation to convene a joint review of the strategic plans and budget of the IRS. The joint review is to be held before June 1 of calendar years 1999 through 2003. The joint review is to include two Members of the majority and one Member of the minority from each of the House Committees on Ways and Means, Appropriations, and Government Reform, and the Senate Committees on Finance, Appropriations, and Governmental Affairs.

Pursuant to the IRS Reform Act, Congressman Bill Thomas, Chairman, Joint Committee on Taxation, has scheduled a joint review of the IRS strategic plans and fiscal year 2002 budget for **Tuesday, May 8, 2001, in room 1100 of the Longworth House Office Building beginning at 9:00 a.m.** The joint review will be open to the public.

Witness List

A Panel Consisting of:

The Honorable Charles O. Rossotti, Commissioner of Internal Revenue, Washington, D.C.

A Panel Consisting of:

The Honorable Larry Levitan, Chairman, IRS Oversight Board Washington, D.C.

A Panel Consisting of:

The Honorable David C. Williams, Treasury Inspector General for Tax Administration, Washington, D.C.

Mr. James R. White, Director, Tax Issues, United States General Accounting Office, Washington, D.C.

JOINT REVIEW OF THE STRATEGIC PLANS AND BUDGET OF THE INTERNAL REVENUE SERVICE, AS REQUIRED BY THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998

TUESDAY, MAY 8, 2001

U.S. HOUSE OF REPRESENTATIVES,
UNITED STATES SENATE,
JOINT COMMITTEE ON TAXATION,
Washington, DC.

The joint review met, pursuant to notice, at 9:02 a.m., in room 1100, Longworth House Office Building, Hon. Bill Thomas (chairman of the Joint Committee) presiding.

Representatives present: Thomas, Houghton and Coyne.

Senators present: Grassley.

Chairman THOMAS. The joint review hearing will come to order.

We are here this morning pursuant to legislation on ongoing follow-up and focus on the Internal Revenue Service. The joint review, by statute, is to include two members of the majority and one member of the minority of the relevant committees, namely, the Committee on Ways and Means, Appropriations, and Government Reform in the House of Representatives, and the Senate Committee on Finance, Appropriations and Governmental Affairs.

The chair has an opening statement and would place it in the record and would request any other members who have opening statements to have them placed in the record.

[The opening statements follow:]

Opening Statement of Representative William M. Thomas,
Chairman of the Joint Committee on Taxation
Before the Joint Review of the
Internal Revenue Service
May 8, 2001

This hearing is the third joint review of the strategic plans and goals of the IRS mandated under the IRS Restructuring and Reform Act of 1998. The purpose of the joint review is to ensure that the Congress conducts a coordinated review and oversight of IRS operations. To that end, we will hear testimony today from four witnesses: Charles O. Rossotti, Commissioner of Internal Revenue; Larry Levitan, Chairman of the IRS Oversight Board; David Williams, Treasury Inspector General for Tax Administration; and James White, Director of Tax Issues, General Accounting Office.

It has been almost three years since the IRS Restructuring and Reform Act of 1998 was signed into law. In that time, the IRS has overhauled its organizational structure, which now features four operating units devoted to groups of taxpayers with similar needs, and has taken other steps to improve its service to taxpayers. While the IRS has made significant progress toward reform, several challenges remain. The decline in collection activity raises questions about tax compliance and fairness to the majority of taxpayers who pay all their taxes. Taxpayer service has not reached optimal levels. There continues to be a backlog of thousands of innocent spouse cases. The General Accounting Office and Treasury Inspector General for Tax Administration report that IRS employees, while now more polite and courteous, are often giving out the wrong answers to taxpayers seeking assistance.

We also have questions about the level of funding for the IRS, particularly the funding for modernizing the IRS's outdated computer systems. For example, the IRS Oversight Board has requested that an additional $550 million of funding for fiscal year 2003 be released now. Regarding technology modernization, the General Accounting Office has noted that, while the IRS has developed a massive modernization effort, this effort will likely take more than a decade to complete, as the IRS remains just as challenged as it was at the time when the IRS Reform Act was passed by the Congress.

The IRS has had a successful 2001 tax filing season. Electronic filing has increased, although the rate of increase is below expectations and may not be fast enough to reach the 80-percent electronic filing goal by 2007, as mandated by the IRS Reform Act. The Treasury Inspector General for Tax Administration, David C. Williams, has noted that the IRS has experienced success in processing tax returns and issuing refunds, and continues to provide substantive information on its Web site. The Treasury Inspector General for Tax Administration has indicated, however, that improvements are needed in customer service. For example, success with the IRS's modernization efforts can provide taxpayers with more accurate access to tax help, account information, expanded electronic filing capabilities, and expanded self-service over the telephone or on the Internet.

To protect the integrity of the tax system, the IRS must carry out its responsibilities (both compliance and service) to the fullest extent. IRS employees need to be trained in the law they help to administer. Congress must provide the IRS with the appropriate level of funding to carry out its duties, but we also must assure ourselves that the money is being spent appropriately and in a manner that will best serve the tax system.

I look forward to the witnesses' testimony.

Opening Statement
The Honorable Amo Houghton
2001 Joint Review of the Internal Revenue Service
Tuesday, May 8, 2001

This is the third of five scheduled annual reviews of the Internal Revenue Service to be held by Members of relevant committees of Congress. The Restructuring and Reform Act of 1998 proposed these reviews to enable Congress to better coordinate our oversight of the IRS.

As Chairman of the Ways and Means Oversight Subcommittee I find it particularly important that vigorous review be done on the activities of the IRS. With a budget of over $9 billion, nearly 100,000 employees, and the responsibility for bringing in over $2 trillion in revenue, the IRS is an agency of vital importance.

Unfortunately, the past track record of IRS performance has not always been adequate. There have been failures in the computer modernization efforts and a decline in staff productivity and moral. The Restructuring Act provided the groundwork for better IRS management, as well as establishing a variety of taxpayer protections.

The Oversight Subcommittee has conducted annual reviews of the performance of the IRS during tax filing season and continues to review the specific activities of the IRS that are designed to meet its strategic objectives. I look forward to the assistance of my colleagues on the Appropriations and Government Reform Committees with this effort.

Chairman THOMAS. With that, does the gentleman from Iowa, the Chairman of the Senate Finance Committee, have any opening comment?

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, SENATOR FROM IOWA

Senator GRASSLEY. I want to comment on two topics, worker productivity at the IRS, and financial management at the agency.

On worker productivity, the General Accounting Office, in its testimony today, states that the IRS cannot provide a valid explanation of why the productivity has declined at the IRS. I want to suggest two factors for this decrease in productivity that comes from the Treasury Inspector General.

The Inspector General, in written reports, states that there has been significant misuse by the IRS employees of Internet and e-mail. The IG states that over half of the Internet activity was for nonbusiness purposes, including even looking at filth.

During just one seven-day period, IRS employees spent over half their time on the Internet for nonbusiness purposes. The amount of time spent on the Internet by IRS for nonbusiness purposes was 8,250 hours in just one week, equal to 429,000 hours a year that would be wasted. That translates into about 238 people at the IRS who do nothing all year except "surf" the Internet, shopping, looking at filth, and joining "chat rooms".

Now, are taxpayers sitting on hold while the IRS employees are surfing the Internet instead of answering the phone? Of course, we hope not. And this waste doesn't include the time spent by IRS employees on thousands of non-business e-mails every day. The IG, in this case, says that e-mails significantly impact productivity. It's tough for me to hear a Federal agency talk about needing more money when it's wasting money they've already got.

I would like to make one note regarding a letter that I received from Commissioner Rossotti. There has been much in the news about the drop in employees at the IRS, but in response to my questions, the Commissioner's letter admits that at the same time the number of IRS employees has gone down, the amount of money spent on contract employees has skyrocketed. The IRS has gone from $444 million in contract spending to nearly $1.3 billion in the year 2000. So, to talk about the number of IRS employees without mentioning a huge increase in money spent on contract employees is not providing a full picture to Congress.

I would now like to turn to the financial management at the IRS. I have a longer statement and questions on this matter that I will submit for the record. But I want to say quickly that I'm concerned that there is a double standard in auditing at the IRS, a very strict standard for taxpayers and a lax standard at the agency.

When the IRS audits a tax return, everything had better be in order. But the same standards I think should also apply to the agency. So we have the Chief Financial Officers Act of 1990 requiring that every agency must prepare a financial statement every year. These statements are then subjected to independent audit by the General Accounting Office or the Inspector General.

While the General Accounting Office gave an unqualified opinion to the IRS this year, it still had a lot of "ifs, ands or buts", the main one being that an IRS-paid accounting firm, KPMG, performed a work-around. KPMG had to manually reconstruct the records and fill in the gaps. Billions of dollars in unrecorded transactions had to be backed into the general ledger. The General Accounting Office characterized this as a "monumental, labor intensive, ad hoc effort."

Unfortunately, this work-around is not sustainable and is not in keeping with the goals of the Chief Financial Officers Act. The goal is to produce accurate financial information as a basis for sound decisions. The IRS needs to clean up the books, fix the problems as soon as possible, and I would ask that my statement and questions be placed in the record.

I would like to say in closing that these comments may be strong, but they aren't really any stronger than I would make to the Department of Defense on an annual basis, when the General Accounting Office reports that their books are not in order. What I am concerned about in the case of the IRS is that you cannot be the only one "pulling the wagon".

I would appreciate any thoughts you may have on my comments about low productivity, the IRS waste of taxpayers' money, or financial management.

Chairman THOMAS. I thank the chairman for the statement.

I will turn now to our first witness, the Honorable Charles O. Rossotti, Commissioner of Internal Revenue. I would tell the Commissioner that his written statement will be made a part of the record and he can address us in the time he has in any way he sees fit.

OPENING STATEMENT OF HON. CHARLES O. ROSSOTTI, COMMISSIONER, INTERNAL REVENUE SERVICE

Commissioner ROSSOTTI. Thank you very much, Mr. Chairman. Let me thank all the members of the Joint Review Committee, as well as the President and Secretary O'Neill, for their continued support of the IRS modernization program.

Even before RRA'98 became law, it was clear to the members of the Presidential commission that preceded the law that a long-term commitment was required to fix the IRS. The changes that were triggered by the Act, together with the need to modernize the IRS' archaic computer systems, probably are of unprecedented magnitude for any government agency.

Since the RRA's enactment, the IRS has a new mission and goals. We have changed the entire way that success is valued at the agency, both individually and collectively. We have implemented and are administering 71 new taxpayer rights provisions that represent a new way of doing business for all of our 100,000 employees.

We have also inaugurated a new, more taxpayer-focused organization, eliminating a 50-year-old structure of District service centers, regions and national office staffs. Tens of thousands of IRS managers and employees have new jobs and many old jobs were abolished. We are now in the process of redesigning nearly every business process and system, the way examinations are planned and conducted and the way phone calls are answered.

We are making these changes while achieving our first clean financial opinion from the GAO, stopping the drop in enforcement revenues in fiscal year 2000, and managing an extremely difficult Y2K program in three consecutive successful filing seasons. In 2001, the filing season just ended, new records were set for electronic filing and web site use, and although the phone service is still not adequate, more taxpayers are getting through on the phones and they are getting more accurate responses.

We know that we are still not providing the level and quality of service that taxpayers desire, nor are we collecting all the taxes due as efficiently as we could. Nor are we keeping our books and records in the most completely effective way consistent with the CFO Act. However, we are setting the stage for year-by-year improvements in performance and for implementation of fundamental improvement enabled by our business systems modernization program.

Our new strategic plan spells out what we must do to solve these problems, to improve taxpayer service and meet our compliance goals, while continuing to shrink the size of the agency in relation to the economy.

We think that this strategic plan, together with the implementation of major parts of the reorganization and our other RRA provisions, means that there is one very important difference between the IRS situation today and even that of a year ago; that is, that the level of uncertainty about the future is reduced. We still have much to do, but we think we know more clearly how to do it and have put the foundation for doing it in place.

The fiscal year 2002 budget request of $9.28 billion will enable us to continue to maintain current operations and provide crucial investments for our longer-term business systems modernization program. It will address the highest priority gaps in our ability to meet our mission and goals, and focus on areas that will need more resources, even while modernization continues.

I think it is very important to note the time that it takes to see practical effects from changes in IRS resources and from our initiatives. For example, through the STABLE initiative, the IRS requested some additional staff resources to cope with the RRA workload and responsibilities. That request was formulated in calendar '99 for the 2001 budget request, which was submitted to Congress last year. The resources were appropriated and made available by the Congress this year, 2001, and they will really produce significant results in 2002, and the statistics will be reported in 2003. So there are significant time lags to see the effects of modernization, and that makes it all the more important to sustain the effort over a period of time.

In terms of responsibility for this sustained effort, we believe it is shared by the IRS, the Treasury, the Oversight Board, and Congress. We think the greatest responsibility does fall on us, the IRS management, to make the necessary improvements and to identify essential resources and other support. Treasury and the Oversight Board are providing essential guidance and oversight and, of course, the Congress has the critical role in providing resources through the appropriations process, oversight and guidance through the oversight committees, and legislative changes through the tax-writing committees.

Mr. Chairman, I am frequently asked, and I was last year at this hearing, if there are changes to RRA that we would recommend. Now, based on almost three years of experience, I believe there are some modifications that would help us implement the Act's intent more effectively.

With this hearing, I would like to begin a dialogue with Congress about certain changes. These would include a modification to section 1203 that would continue to provide the IRS the authority to terminate employees for the listed offenses, but would reduce the impact of unsubstantiated allegations.

Another would be technical changes to the collection provisions that would provide the IRS more flexibility to settle debts with taxpayers, and to simplify procedures for court appeals and collection due process cases. Still other provisions would be a measure to reduce the impact of the frivolous use of collection due process, offers and compromise and taxpayer advocate protections. I believe these changes would be fully consistent with RRA's intent and will allow us to implement it more successfully.

In conclusion, Mr. Chairman, I think we have laid out a plan and we have demonstrated the ability to make some short-term improvements in service, but more importantly, I think we have the path ahead of us laid out that will guide our efforts and allow us to raise the performance of this agency to the level that the public has a right to expect.

Thank you, Mr. Chairman.

[The statement of Mr. Rossotti follows:]

Statement of

Charles O. Rossotti

COMMISSIONER
INTERNAL REVENUE SERVICE

Before the

ANNUAL RRA'98
JOINT HEARING ON IRS PROGRESS

CONVENED BY THE
JOINT COMMITTEE ON TAXATION

IRS
Department of the Treasury
Internal Revenue Service
www.irs.gov

May 8, 2001

**PREPARED TESTIMONY OF
COMMISSIONER OF INTERNAL REVENUE
CHARLES O. ROSSOTTI
BEFORE THE
ANNUAL JOINT REVIEW OF
THE IRS RESTRUCTURING AND REFORM ACT OF 1998
CONVENED BY THE
JOINT COMMITTEE ON TAXATION
MAY 8, 2001**

INTRODUCTION

Mr. Chairman, as we approach the third anniversary of the passage of the IRS Restructuring and Reform Act of 1998 (RRA 98), it is appropriate that we step back and examine the progress the IRS has made towards achieving the mandates contained in the legislation. And let me take this opportunity to thank all of the Members of the Annual Joint Review for their continued leadership and support of IRS modernization. I also want to extend my appreciation to the IRS Oversight Board – which RRA 98 created – for its thoughtful recommendations and support of our change program.

Even before RRA 98 became law, it was clear that a long-term commitment was required to fix the IRS. The barriers to better taxpayer service, fair and uniform administration of the tax law and greater productivity would not yield to short term fixes. Progress would be hard won and the victories would be small at first.

Mr. Chairman, the changes triggered by the passage of RRA 98, together with the need to modernize IRS's archaic computer systems, are extremely pervasive and probably unprecedented in magnitude for any government agency. It is perhaps only now that we have begun to implement some of the larger changes to our organization and business systems that we all fully appreciate the enormity of the challenge we have undertaken in partnership with Congress, the Administration and America's taxpayers. And that challenge is modernizing the IRS while still administering the largest tax administration system in the world.

From my own perspective, I have tried to describe this process in a number of different ways, such as overhauling a passenger plane in mid-flight. I have also likened our Business Systems Modernization plan to reconstructing New York City from the bottom up without disturbing anyone and still accommodating growth and change. The mathematician and philosopher Alfred North Whitehead once wrote that, "the art of progress is to preserve order amid change and to preserve change amid order." And that sums up both the promise and challenge of making progress on modernization.

But any metaphor I could suggest would not do justice to the magnitude and pervasiveness of the change that has occurred at the IRS and will take place for the rest of this decade. This is by no means a comprehensive list, but let me provide the Committee a representative sample of some of these changes.

Since the enactment of RRA 98, the IRS has a new mission and strategic goals. We changed the entire way we value success at the Agency, both individually and collectively. We invented a means to quantitatively measure success in a tax administration agency without considering dollars collected. We implemented and are administering the 71 new taxpayer rights provisions. Many of these taxpayer rights provisions, such as innocent spouse protection, due process in collections and offers in compromise, would individually be considered major change projects. Collectively, they represent a challenge of learning new ways of doing business for nearly every one of our 100,000 employees.

We also inaugurated the new customer-focused organization structure in October 2000, eliminating a 50-year old structure of districts, service centers, regions and national office staffs. Tens of thousands of IRS managers and employees have new jobs and many old jobs were abolished. We are now redesigning nearly every business process and system in the Agency, from the way examinations are planned and conducted, to the way phone calls are answered and the way facilities repairs are ordered. As part of this change, the distribution of workload in processing returns, answering phone calls and processing cases is being consolidated and redistributed.

Just as importantly, we are making these changes while carrying out increasingly successful filing seasons for three straight years, achieving our first clean financial opinion from the GAO, and managing an extremely difficult and complex Y2K program. In FY 2000, we were also able to stop the drop in enforcement revenue.

These changes set the stage for year-by-year improvements in performance and for implementation of even more fundamental improvement that will be enabled by the Business Systems Modernization program. These improvements are carefully mapped out in a new strategic plan that spells out what the Agency must do as an organization to improve taxpayer service and meet compliance goals while shrinking in size relative to the economy.

This strategic plan, together with the implementation of the major parts of the reorganization and of other RRA provisions, means that there is one very important difference between the IRS situation today and the IRS situation even a year ago: namely that the level of uncertainty about the future is greatly reduced. We still have much to do, but we know more clearly how to do it and have put the foundation for doing it in place.

Mr. Chairman, it is also very important to understand the time that it takes to see the practical effect of changes from IRS resources and initiatives. For example, through the STABLE initiative, the IRS requested additional staff resources to cope with some of the additional workload and responsibilities under RRA 98. The request was formulated in Calendar Year 1999 for the FY 2001 budget request, which was first submitted to Congress in early CY 2000. The resources appropriated were made available to the IRS in 2001. They will produce significant results in 2002 and the statistics will be reported in early 2003. The time lags to see the effects of modernization are at least as long, usually several years. And they make it all the more important to maintain a sustained and consistent approach to addressing the problems of the IRS, many of which were very longstanding in their creation.

This sustained effort will be required of the IRS, Treasury, the Oversight Board and the Congress. The greatest responsibility falls on IRS management to make the necessary improvements in management, business process and systems and to identify the essential resources and other support needed to be successful. The Treasury Department and the Oversight Board have an essential role in providing guidance and oversight. And Congress has a critical role in providing resources through the appropriations process; oversight and guidance through the oversight committees; and legislative changes through the tax writing committees, when necessary. Our strategic plan and budget submission represent our request to the Congress for resources and our plan for how we plan to use these resources to improve the performance of the agency.

SERIOUS PROBLEMS REMAIN

Mr. Chairman, in spite of the progress the IRS has made since the enactment of RRA 98, it is clear that we are still not providing the level and quality of service that taxpayers deserve, nor are we collecting the taxes due as efficiently as we could.

In an interim report recently submitted to the Congress and other interested stakeholders, the IRS Oversight Board reached a similar conclusion: "The IRS is not meeting any of the goals and objectives demanded by Congress and American taxpayers. Service to taxpayers is inadequate, and enforcement activities have dropped to a dangerous level, giving the impression that it is easy to get away with cheating. The agency's computer systems are completely outdated, while the number of IRS employees continues to drop while the workload increases."

The IRS certainly does not take issue with the Board's basic conclusion. It is correct. Although we are moving steadily in the right direction, we have not reached the point where we can achieve our three strategic goals of service to each taxpayer, service to all taxpayers and productivity through a quality work environment.

The facts speak for themselves. The level of phone service – while improving – is still not on a level with what taxpayers receive in the private sector. We cannot provide taxpayers with up-to-date information on their accounts, resulting in enormous frustration for both taxpayers and the IRS employees who want to help them. In fact, nearly all of our business processes operate too slowly, inaccurately and inefficiently. Many of our notices are still confusing and poorly written. Achieving the 80 percent electronic filing goal by 2007 will be very difficult. While we can receive returns electronically, we cannot follow up to answer taxpayers questions and adjust their accounts electronically because we do not yet have adequate security systems in place.

The IRS is also deeply concerned about the continued drop in audit and collection activity. Clearly, the declines we have witnessed in the past few years must stop or the fairness and effectiveness of our tax system will be undermined. The risks of these declines are not simply the dollar value of the taxes left uncollected. The greatest risk is that the average taxpayer who honestly pays taxes loses confidence if the IRS fails to act effectively and efficiently to collect from those who do not pay what they owe.

To help address these problems, the President's budget includes follow-on funding for the STABLE initiative, begun earlier this year. (Please *see Appendix A for discussion of stabilization of compliance activities.*)

Mr. Chairman, the drop in exam and collection activity in FY 2000 was caused by several factors, including the long-term decline in staffing, the need to assign compliance staff to customer service duties during the filing season, and added RRA 98 responsibilities.

Between FY 1992 and 2000, the Agency's workforce fell by 17 percent while the number of tax returns filed (including supplemental documents, such as Forms 1040X, 4868, 2688, 1120X and 7004) increased 13 percent to 230 million. RRA 98 also created very significant additional resource demands on the IRS Exam and Collection staffs. Expanded programs, such as the innocent spouse provisions, offers in compromise and due process in collection required more that 4,200 IRS staff annually for administration. Other provisions, such as the requirements for notifications of third parties, tacked on more time to complete each exam and collection case. Many more steps have been added to the completion of an exam. *(Please see Appendix B.)*

RRA 98 also had some very profound indirect impacts on IRS operations. Two provisions, in particular, have greatly affected the time required to conduct many activities. They are: Section 1203, commonly known as the "ten deadly sins" provision, and Section 1204, which broadly prohibited use of enforcement statistics in setting goals or making personnel evaluations at any level in the IRS.

Section 1203 caused a great deal of concern, caution, and hesitation among front-line employees and their managers with respect to taking enforcement action. And Section 1204, prohibiting use of enforcement statistics, caused a great deal of confusion and hesitation among managers to use any quantitative data to evaluate operations or to direct employees with respect to matters of time and efficiency. The effect of Section 1204 has been magnified by the extensive number of investigations and disciplinary actions of managers that was undertaken in 1998 and 1999 for misuse of statistics. In addition, uncertainty over the reorganization, which flattened the organization and eliminated management layers, caused some temporary loss of focus. The effect of all these factors was to increase the time it takes to complete cases, reducing the number of cases completed per FTE by 20 to 30 percent.

In its March 2001 financial audit of the IRS' Fiscal Year 2000 Financial Statements, the GAO pointed out the continued problem with the IRS' management of unpaid tax assessments. The GAO found that the IRS' "inability to actively pursue significant amounts in outstanding taxes owed to the federal government continue to hinder IRS's ability to effectively manage unpaid assessments."

The GAO report pointed to a much larger and fundamental weakness that threatens the IRS' mission: the pressing need to overhaul IRS' systems and processes. The IRS core data systems that record taxpayers' tax accounts are fundamentally deficient. The IRS will never be able to perform its mission without replacing these systems. The solution to these problems is not simply to do more of everything in the way it has always been done. Instead the solution is to modernize the IRS to do things more efficiently and effectively.

Replacing virtually the entire technology infrastructure in the next 10 years, while also delivering short-term service improvements demanded by taxpayers, employees, and the Congress, remains an enormous challenge fraught with risk. But we have no choice; we must move ahead for the good of America's taxpayers and the good of our Nation. The President's budget includes close to $400 million in investments to modernize the IRS' outdated computer systems. This multi-year project will provide the IRS with the modern tools needed both to deliver first class customer service to America's taxpayers and to ensure that compliance programs are administered efficiently.

Mr. Chairman, there have also been some questions as to whether the "audit rate" as publicly reported by the IRS understates the ability of the IRS to verify the accuracy of individual tax returns. It is true that simply focusing on the audit rate does substantially understate the IRS' capacity to find errors in returns, especially in certain kinds of returns. In my many press interviews in the past few years in which this topic has come up, I have consistently made this point, often citing our computer matching program as an example of a technique that the IRS uses in addition to traditional audits.

While audits alone are not a sole measure of compliance activity, this does not mean we should not be very concerned about the drop in out compliance activities, including audits. First, all measures of compliance activity are down substantially, including document matching. For example, the number of document matching cases in FY 2000 was down 72 percent from the high point in FY 1991. Second, document matching, even if expanded to the maximum, cannot address major areas of potentially underreported income. The type of income not covered by document matching is concentrated in upper income individuals, raising a major concern about fairness as well as collections if these forms of income are not verified.

The IRS has for many years relied on a range of techniques to verify certain items on tax returns. Each of these techniques is appropriate for particular classes or types of potential errors. With respect to Information Returns Processing, or document matching as it has often been called, this technique is very effective for verifying income items reported by third parties, including wages, interest, dividends and miscellaneous payments. It can also be used to verify gross sales of assets, but cannot be used to verify the gain or loss on such sales since we have no third-party reporting on the cost basis of assets. It is also of limited value in verifying some deductions, such as mortgage interest.

Document matching is not useful for verifying business income, gain or loss on asset sales, or most itemized deductions. We estimate that the total personal income that cannot be verified by document matching represented about $1.2 trillion in FY 1998, or 19.7 percent of total reported personal income. An important role of audits is to verify these major categories of income and deductions.

The significance of verifying income and deduction items through audits is illustrated by the fact that the average in-person audit of an individual return results in an assessment of approximately $9,540, while the average assessment from a document matching case is $1,506. In FY 2000, the IRS closed 277,212 in-person audits of individual returns and assessed $2.4 billion from this program; in the document matching program in FY 2000, the IRS closed 1,353,545 cases and assessed $2.1 billion.

One of my real concerns about the decline in audits is fairness to the majority of taxpayers whose income is reported and can be readily verified. It is relatively easy for the IRS to verify the returns and reported income of taxpayers whose income results from wages, interest and dividends and who take the standard deduction, whom comprise the majority of taxpayers. It is harder, and often requires audits, to verify the income of taxpayers with other forms of income and deductions or more complex returns, who are often higher income taxpayers.

The proportion of income that cannot be verified through document matching is 10 percent for taxpayers with income under $100,000, as compared with 35 percent for taxpayers over $100,000. Also, 91 percent of returns reporting income over $100,000 itemize deductions, compared to 26 percent of those below $100,000, and most itemized deductions cannot be verified through document matching. To the extent that the IRS uses more and more document matching and less and less auditing, the effect may be perceived as, and will in fact be unfair because higher income taxpayers will not have their returns verified to the same degree as middle income taxpayers.

Another concern with respect to both tax revenues and fairness is the income reported by corporations and partnerships. While the IRS continues to audit the 1,100 largest corporations every year, the audit rate for all other corporations has declined from 3.0 percent in 1992 to 1.1 percent today. A particular source of concern is the growing number of entities, such as partnerships, trusts and S-corporations, which pay no income tax at the business level but pass their net income on to their shareholders or partners. In 2000, these "passthrough" entities filed 7.4 million returns, reported $5.0 trillion of gross revenues and $680 billion of income. However, the IRS audited only 29,057 of these entities, or only 1 of every 256 returns - .39 percent. We do plan to begin a program to match income reported on K-1 forms from these entities to individual tax returns. However, this technique will not provide any verification of the income reported by the business entity itself, which requires an audit.

Our strategic plan attempts to reconcile all these factors with the objective of increasing the IRS's ability to achieve our second strategic goal, which is service to all taxpayers through fair and uniform application of the tax law. If our modernization program is successful, we believe we can do this while continuing to shrink the size of the IRS in relation to the economy.

The plan sets forth an approach in the short run to stabilize our level of traditional compliance activities, such as individual audits, at above current levels and to focus them on the areas where they are most required. In the long run, we will rely on our business systems modernization program to increase the effectiveness and efficiency of these activities, which will enable us to increase coverage from audits and other income verification techniques with modest increases in staff as provided through the STABLE initiative.

A CLEAR PLAN – A DUAL APPROACH

Last year when I came before the Joint Review, I said we had a clear direction and had taken some important steps to improve the IRS. Now, for the first time I can tell you that we have a real plan that lays out how we will build on the foundation we have created to make the IRS everything the American public has a right to expect it to be.

On January 30, 2001, the IRS Oversight Board approved the IRS Strategic Plan. It follows closely the letter and spirit of RRA 98 and reflects the new and modernized IRS. The strategic plan shows how the IRS can dramatically improve service to taxpayers and ensure fairness and compliance with our tax laws. Moreover, the Agency will meet these goals while continuing to shrink in size relative to the economy.

The greatest challenge presented by the IRS strategic plan is that we must continue to administer the world's largest and most complex tax system while simultaneously reengineering and improving how the Agency works at its most basic level. In other words, we must operate effectively and modernize at the same time.

Mr. Chairman, I want to emphasize the importance of this two-pronged, or dual approach of strategies to improve performance over the next two years while modernizing the Agency in the longer term.

In conjunction with our mission and goals, we developed 10 major strategies, all tied to RRA 98's goals, such as meeting the needs of taxpayers, reducing taxpayer burden, broadening the use of electronic interactions and addressing key areas of non-compliance. For each of these strategies, operational priorities and improvement projects for FY 2001 and 2002 were defined and responsibilities assigned for carrying them out.

We have seen this dual approach of short- and long-term improvements, already at work this filing season as the IRS provided taxpayers with enhanced services and immediate burden relief. Let me briefly illustrate how this approach operates. A detailed description of the filing season and Electronic Tax initiatives and progress can be found in Appendix C.

We are making some important short-term gains on the 80 percent electronic-filing mandate contained in RRA 98. On-line filing from home computers was 34 percent ahead of last year's pace; we expect to exceeded last year's total volume by 722,000 returns. In total, we expect to receive about 42.3 million electronic returns this year. And there are reasons for this. For the 2001 filing season, we added 23 additional forms to the 1040-*e-file* program. We plan to roll out the remaining 38 forms and schedules for the 2002 filing season. This means we will open *e-file* eligibility to 99.1 percent of all taxpayers. We also made electronic filing truly paperless by eliminating the requirement for a separate paper signature document with the e-file return. And for the first time ever, taxpayers who needed an extension to file could do so with a simple phone call – no paper involved.

Our web site has received almost 1.8 billion hits this fiscal year. Through February 28, 2001, there have been over 103 million downloads as compared to 51.5 million for the same period in 2000 – an increase of almost 100 percent. On April 16, 2001, Reuters reported the following observation on our web site by Sean Kaldor, vice president eCommerce, Net Ratings, "IRS.gov has become the go-to online resource for timely and useful tax information. . . It strays from the stereotype of a typical government Web site, reaching out to the average taxpayer with well organized content, providing assistance and support, and helping decrease the tax season burden."

We also launched the new "Small Business and Self-Employed Community" web page intended to benefit the millions of small business owners, the self-employed and start-up businesses that often confront more complex tax issues than taxpayers who have their taxes withheld by an employer.

This year, we are conducting an exciting new pilot program to test our new Internet-based application for businesses to pay federal taxes on line. EFTPS-OnLine, allows businesses to enroll in the system, securely make federal tax payments and check their electronic payment history over the Internet. Using EFTPS-OnLine, businesses will be able to schedule future payments through the Internet and cancel payments if necessary.

Our short-term efforts also include reducing the number of taxpayers required to file specific forms as well as simplifying or eliminating forms and notices altogether. For example, millions of taxpayers no longer have to file the 54-line Schedule D Capital Gains and Losses form. They can now use a much shorter and easier to understand form.

In two years, the IRS has also increased the threshold from $500 to $2,500 for required employment tax deposits. Through our continued efforts, we estimate that between 70-80 percent of small businesses can be relieved of the burden of making as many as 12 deposits annually.

Of great importance, in April 2000, the IRS issued a revenue procedure that permits qualifying taxpayers with average annual gross receipts of $1,000,000 or less to use the cash method of accounting. The new procedure has an enormous impact on lessening burden for small businesses who could use the much simpler, easier to understand and usually advantageous cash method of accounting. By our calculations, we have exempted the vast majority of small business taxpayers who otherwise would have been required to use an accrual method.

Due to a licensing agreement between the IRS and the U.S. Postal Service, taxpayers who move after filing their tax returns will have their addresses automatically updated, even if they do not notify us by filing Form 8822, Change of Address. And following RRA 98's directions, the IRS also continues it effort to improve its correspondence to taxpayers. This year, the IRS began sending out six redesigned notices, including those dealing with math errors, balance due, overpayments and offsets. These notices affect both individual and business taxpayers. The new notices should: (1) reduce the number of times taxpayers need to contact the IRS; (2) be easier to understand; and (3) facilitate resolution of inquiries. The combined yearly volume of these six notices is about 10.5 million.

Over the past year, the IRS also made incremental progress on three key modernization programs. In response to RRA 98, the new customer focused organization is currently being implemented and a top management team is in place for each of the four Operating Divisions. We also approved balanced measures for much of the new organization and have slated approval of measure for the remaining organizational units for the current fiscal year. Both of these programs should start delivering benefits now *(Please See Appendix D)*.

The third piece of modernization, the Business Systems Modernization program (BSM) is off to an excellent start. The Enterprise Architecture plan, which is the roadmap for modernizing the Agency's business systems and supporting information technology networks, was approved earlier this year. BSM is just beginning to deliver tangible improvements; it will deliver a growing number of benefits with each succeeding year for the remainder of the decade.

Mr. Chairman, I want to stress that this dual approach will require sustained support from the Congress and the public, as the change will take time and will inevitably include setbacks along the way. It will also require investments, especially for business systems modernization, and adequate funding for current operations, such as customer service and compliance.

And as the Oversight Board stated in its report, "Accomplishing this plan will be a long and difficult process. It will require significant work by the IRS and its advisors and contractors. As importantly, it will require the continuous oversight and support of the many stakeholders that are impacted by and work with the IRS, in particular the Administration and Congress."

TURNING THE CORNER

If we continue to build on these initial successes, taxpayers and our tax administration system can begin to realize the benefits of modernization. By taking full advantage of proven best business practices and new technology, we can greatly improve performance on all three of our strategic goals. The IRS can improve service to taxpayers and reduce their burden. The IRS can improve compliance and its collection activities, ensuring that the tax laws are fairly administered. And we can do this with limited increases in staff resources. Taxpayers will reap the benefits in a number of key areas, such as speed, access and accuracy. Let me briefly illustrate how this works in each of these three areas.

Nearly all taxpayers will be able to file and pay electronically, regardless of the type of form or tax. Taxpayers filing electronically and having correct returns would receive refunds in their bank accounts within 2 to 3 days.

We will emulate the best business practice of providing service to customers at times and through channels convenient to them, whether it is by phone, letter or on-line.

The level of phone service would increase to 90 percent. (Level of service measures the relative success rate of taxpayers who call the IRS through toll-free services and wish to speak to an operator. It excludes calls routed to automated systems.) We would expand web-based services to include exchange of information and resolution of accounts through the Internet. First time resolution of account inquires would increase to 80 percent. Taxpayers would receive consistent and accurate answers to their questions regardless of the communications channel they chose. IRS employees would also have access to comprehensive taxpayer histories, thereby increasing the accuracy of the information and the transactions contained in them.

We also will provide more ways for taxpayers to resolve some issues by themselves, without requiring assistance from IRS staff. At the same time as we create the ability for taxpayers to check on such things as the status of their refunds and tax deposits through the automated systems on the telephone or the Internet, some in-person service requirements may be reduced. We are already beginning this process through such exciting initiatives as the previously described EFTPS-OnLine program.

The effect on our compliance activities would also be profound. Third party matching data would be made available earlier. Assembling all available data about a taxpayer case for our employees will avoid the need to get duplicate data from taxpayers. With the advent of many new best private sector practices, such as risk-based compliance techniques, the IRS also has the opportunity to allocate its compliance resources more efficiently, both in specific cases and around patterns of non-compliance. And when intervention is called for, we can use analytically-based techniques to assist in determining the appropriate action.

Most individual tax returns would be selected for audit within the same year and those audits will be completed more rapidly. "No change" determinations would be cut substantially.

The collection time for outstanding balances would be reduced to an average of six months. Improved systems will allow us to identify much more quickly which taxpayer accounts need attention from either telephone or in-person collectors. They will provide much more complete and accurate information to the collectors before they even deal with the taxpayer, and computer tools will assist them in closing cases.

These changes will also greatly increase our ability to "leverage" staff and use them more effectively and efficiently, while reducing the amount of time we take from taxpayers.

Our ability to ensure protection of taxpayer rights will be increased by building into the computer tools used by our employees the correct notifications and other protections prescribed by law.

The Solution

As I discussed in the introduction to my testimony, we are making substantial progress on the short-term improvement projects that support our major strategies. The second part of that dual approach is the Business Systems Modernization (BSM) program. It was established to take the IRS to the next level and make longer term, fundamental changes to our business processes and practices while managing the inherent risks of the process. Over the remainder of this decade, it will deliver the major benefits to taxpayers and our tax administration system that modernization and RRA 98 are all about. And that process has already begun.

Earlier this fiscal year, the IRS Executive Steering Committee approved the Enterprise Architecture. It is the roadmap for modernizing the Agency's business systems and supporting information technology networks. The Enterprise Architecture (Version 1.0) will guide the agency's business and technology improvements in the coming years. The approval of the architecture marks a major milestone in our progress towards the goals of Business Systems Modernization and will enable us to design and build new business and technology projects that will be the backbone of the modernized IRS.

The IRS previously published a blueprint in 1997. It was the first comprehensive view of modernized tax systems and guided the IRS in efforts to update technology. The new Enterprise Architecture reflects the lessons learned since 1997 and incorporates elements of the IRS reorganization into the four new customer-oriented operating divisions. It is an evolving document designed for constant use, with updates scheduled for spring and fall 2001 and regular updates thereafter. This new blueprint will ensure that IRS business systems' technology is compatible. And it will enable IRS employees to do their jobs better and provide taxpayers better service.

Because of the scale, complexity and risk of BSM, we can only carry out the plan by defining manageable projects, which are subject to a disciplined methodology. Each of these projects will be carried out through a step-by-step "enterprise life-cycle" in which successively greater amounts of detail are defined. The process requires that a vision and strategy phase be completed as a first step, prior to commencing tasks such as infrastructure development, information systems delivery, or process-reengineering. The final milestone in the cycle is an initial "deployment" of a project as an operational system. The IRS' Enterprise Program Management Office manages this process.

Also key to BSM's success, is the Tax Administration/Internal Management Vision and Strategy Project. Through the project, we have instituted a practice that ensures the Operating Division Commissioners and staff develop and take ownership of a process and systems modernization approach that is consistent and integrated with the overall vision of the future IRS. The project's ultimate goal is to create an enterprise-wide view of tax administration that is reflected in BSM.

The Business Systems Modernization Organization (BSMO) has now identified all the major initiatives for the next several years that link directly to our major strategies. Moreover, BSMO defined the major dependencies between and among projects and created a sequencing plan for their initiation, development, and deployment. It has also made rough estimates at a high level of the costs associated with each initiative and developed multi-year spending estimates consistent with this program.

This high-level cost and schedule estimates serve as general guide for planning and setting overall priorities, but are not intended to be used to make specific spending or schedule commitments. No spending is actually authorized except with respect to specific milestones in which more reliable cost and schedule estimates are made. In short, the IRS now has a strategy for achieving the major goals of business systems modernization.

In addition to the strategy and planning for business systems modernization, much emphasis has been placed on building an adequate program management and product acquisition capacity for this huge program. In the 21 months that this program has been underway, considerable progress has been made in building this capacity. However, management capacity can only mature with experience, and much more can and will be done to improve it.

The risks of business systems modernization are undeniably substantial. Any large and complex modernization program involves substantial risk, and by any measure, the IRS program is large and complex. However, the unique aspect of this program, as compared with any other business systems modernization program in the public or private sectors, is the exceptionally old and fragile base of existing installed systems on which the IRS totally depends for current operations.

Virtually every one of the IRS' 100,000 employees depends on these old, inefficient, inconsistent systems to perform their everyday job. There is little, if any, precedent for making a transition of an entire base of such large-scale installed systems on an enterprise-wide basis for an organization the size of the IRS. This unique situation, as undesirable as it is, also creates the necessity for the modernization program. There is no practical alternative to total replacement of this base of installed systems.

Although the risks of modernization are high, this does not mean that the program is destined to fail. With intense and effective management, the risks can be identified and addressed and appropriate corrections made. However, the nature of this risk means that it is to be expected that frequent adjustments to plans and schedules will be made to reflect experience. Delays and even failures of some initiatives and projects will occur, but if properly managed these problems can be identified early enough to correct them with reasonable adjustments in costs and schedules and without undermining the overall success of the program.

FY 2002 BUDGET REQUEST

Mr. Chairman, I want to take this opportunity to thank the President, and in particular, Treasury Secretary O'Neill, for their support of the IRS and its critical mission. I am especially grateful that the 6.7 percent increase contained in the IRS budget request is above what many other Agencies are proposed to receive for the coming fiscal year. The President's FY 2002 budget request of $9.28 billion for the IRS will enable us to continue to maintain current operations and provide the crucial investments needed for our longer-term Business Systems Modernization program.

The budget includes close to $400 million in investments to modernize the IRS' outdated computer systems. This multi-year project will provide the IRS with the modern tools needed both to deliver first class customer service to America's taxpayers and to ensure that compliance programs are administered efficiently.

In addition to our Congressional Justification, we have also provided the subcommittee our Annual Performance Plan. It is a direct result of the new IRS Strategic Planning process and complements our budget submission and supports the FY 2000-2005 Strategic Plan.

The resources provided by the FY 2002 budget request will be used to address the highest priority gaps in our ability to meet our mission and goals and will be focused on areas that we know will need more resources even while modernization continues. Taxpayers seeking to comply with tax laws must receive the assistance they expect; unpaid tax debts should be collected; and non-filing and underreporting must be addressed and corrected. The IRS is falling seriously short in all these areas, in part because of resource limitations.

In addition, we must continue to support key programs mandated by RRA 98, including Electronic Tax Administration, and must reduce the case backlog in programs such as Offers in Compromise, Innocent Spouse and Collection Due Process. Information services delivery must improve toward established benchmark levels, thereby boosting productivity throughout the organization, including the service and compliance programs. Progress on correcting security and financial control weaknesses must be made and we must fully implement some of the technical training programs, including those for essential occupations such as exam and customer service.

Finally, modernization itself places major demands on the IRS operating organizations. The Business Systems Modernization Program, which is funded by the Business Systems Modernization Account (formerly the Information Technology

Investment Account or ITIA), provides only for outside contract services, not for internal IRS staff required for these programs. These internal demands are increasing rapidly.

Our plan to meet the demands of these key drivers will not be accomplished in FY 2002; however, we will make a significant start towards meeting those goals. We will address the following strategies as one of the significant steps on the road to IRS modernization.

Fill New Front-line Pre-Filing and Taxpayer Assistance Positions in the Organizational Design.

In order to provide better service to compliant taxpayers, we must complete the staffing of our pre-filing organization that aids taxpayers in filing correct returns, as well as resolving issues with payments and correction of tax returns. The need for this service was highlighted during Congressional hearings and through the success of our "Problem Solving Days." Once our in-person taxpayer assistance offices are adequately staffed, we will be also able to reduce our reliance on work details from the compliance function during the filing season – a necessary, but inefficient practice. This will enable us to provide more effective compliance coverage.

Increase the Level of Service (LOS) Access for Telephone Service.

The strategy for increasing LOS for toll-free telephone is two-fold: (1) increase staffing slightly and (2) install management, process and technology changes to increase the effectiveness and efficiency of telephone operations; these changes include both technology changes and improved management specialization and training of assistors. With these changes, the IRS has set an aggressive goal to improve the level of service – the success rate for callers connecting to an IRS representative – to 71 percent. System and productivity improvements will raise Toll-Free Level-Of-Service the equivalent of hiring 1,474 additional live assistors.

Replace Attrition in Front-line Compliance Positions.

External factors, however, are affecting our ability to meet this plan. In FY 2001, the IRS is experiencing a higher than normal attrition rate of 6.05 percent versus the 4.5 percent average annual rate. This rise is due to a number of factors, including an aging workforce. Since much of this attrition is among our senior front-line staff, our productivity measures in FY 2001 and 2002 may be affected. Replacement of staff lost to attrition with qualified personnel will be a major challenge over the next several years.

Increase Front-Line Compliance Services Staffing for Document Matching and Telephone Collections.

In FY 2001, sixteen Electronic Collection sites will be divided between W&I and SB/SE. At those sites, Customer Service Representatives (CSR) will answer specific calls based on the taxpayer's needs. In FY 2002, calls will be routed to CSRs based on additional characteristics. For example, a specialty site will be in place for taxpayers who have defaulted on installment agreements. These and other service improvement efforts will be enhanced with the addition of staff from the STABLE (Staffing Tax Administration for Balance and Equity) initiative.

Also, in FY 2001, six Automated Underreporter (AUR) sites will be divided between W&I and SB/SE. In FY 2002, specialized service will be provided to target groups identified through feedback from compliance audits. Through both of these approaches, taxpayers will receive better service that addresses their specific tax problems and provides a basis for more efficient tax administration.

Reduce the Number of Compliance FTE Diverted to Filing Season Details, Thereby Increasing Net FTE for Compliance

In recent years, the IRS has detailed approximately 1,200 FTE from Examination and Collection duties to Customer Service to meet filing season workload peaks in the Toll-Free Telephone and Walk-In assistance programs. The STABLE initiative was designed, in part, to reduce by 50 percent the Customer Service reliance on short-term details of compliance staff. By reducing the diversion of revenue agents, tax auditors and revenue officers from enforcement casework, audit coverage and collection effectiveness are expected to increase.

Centralize Processing of Most Offers in Compromise (OIC) to Reduce the Drain on Front-Line Collections Staff

Over the past several years, the Offer in Compromise program continued to show an increase in its over-age inventory even while resources used have continued to increase. Recent tests proved that using a bulk processing methodology to process low-dollar cases resulted in productivity gains. OIC Centralized processing will be divided between two SB/SE sites responsible for processing determinations and case building. This centralization will allow Revenue Officers to concentrate on collecting overdue accounts while improving the timeliness of processing OICs.

Move Most Innocent Spouse Cases to W&I to Reduce the Drain on Front-Line SB/SE Exam Staff.

To improve efficiency, the "Innocent Spouse" program has been centralized at one W&I service center location. SB/SE field staff will continue to work through their current inventory, but most new cases will be resolved in the W&I service center or taxpayer assistance centers. New cases forwarded to field compliance staff are expected to decline in FY 2001. With the shift of work to W&I, there will be a reduction of Field Compliance resources in SB/SE dedicated to Innocent Spouse activity allowing a redirection of these resources to compliance activities.

Fill Out the TEGE Government Entities Organizational Design

TEGE designed its Government Entities (GE) organization to reach taxpayer segments that have been historically underserved: Tax-Exempt Bond-Issuers, Federal, State and Local Governments (FSLG) and Indian Tribal Governments. The size and complexity of the tax-exempt bond market requires ongoing attention to address emerging economic issues. Indian Tribal government gaming and related economic development are expanding rapidly nationwide. For FSLG, the objective is to identify emerging employment tax issues and provide guidance.

Initiate Document Matching for K-1s

Trust and partnership return filings have steadily grown since 1995, increasing 7.4 percent and 26.2 percent respectively. Trust return filings constitute the largest business filing population at 3.5 million filers, while partnerships surpassed two million filers in FY 2000. Research suggests that up to 20 percent of pass-through income is not being reported. And it is further estimated that unmatched K-1s equate to up to $500 billion in pass-through income.

These pass-throughs are not being identified by IRS and therefore are not available for compliance reviews. Abusive tax shelters are taking advantage of IRS' inability to match, regulate or analyze this information. Over 350 FTE are to be hired from the STABLE initiative in FY 2001 to ensure that greater effort is placed on this problem. These FTE will provide for the essential data entry, not the actual casework to follow up on matches.

Improve Operational Efficiency Through Modernized Business Systems Coming On Line

In its FY 2001 budget request, the IRS stated: "Our modernization program relies on improved management, business practices and technology. Because the basic IRS strategy is to meet increased workload and service demands by reengineering business practices and technology, freeing up positions through business systems investment is a critical requirement. By investing in technology and improved business practices, the FY 2001 budget request avoids the traditional staff increases that would otherwise be required." And in FY 2002, we will begin to deliver on that promise.

Operational efficiencies and improved customer service will be evident as early as FY 2002 in two programs. The first, Electronic Tax Administration, will make submission processing more efficient through electronic filing. The second program, Customer Communications 2001, will provide increased toll-free telephone service to taxpayers. Let me describe these initiatives in greater detail.

- The *e*-Services project will foster easy-to-use electronic products and services. It is targeted at specific practitioner segments that inform, educate, and provide service to taxpayers. In addition, *e*-Services will provide the foundation for providing safe and secure electronic customer account management capabilities to all businesses, individuals, and other customers. This project will help the IRS meet the congressionally-mandated goal of 80 percent of tax returns and information filed by electronic means by 2007, while achieving a 90 percent customer and employee satisfaction rate.

Research has shown that third party preparers filing complex returns have been slower to adopt electronic filing. In conjunction with our efforts to allow all forms and schedules to be filed electronically, the e-Services 2002 release is designed primarily to encourage paid preparers to e-file on behalf of their clients.

- The Customer Communications 2001 project will improve the efficiency and effectiveness of IRS' systems for responding to taxpayer calls on our toll free lines. Hardware and software improvements will be made to the telephone system that is used to receive, route, and answer more than 95 million taxpayer telephone calls each year. The efficiencies derived through modernizing will allow the IRS to improve its level of service without commensurate increases in the number of FTE handling calls. This project will not only deliver direct benefits by increasing the number of calls that can be answered with available staff, but will also be a critical foundation element for subsequent projects, since virtually all major systems require communication with taxpayers.

Plan for Normal Workload Increases

In FY 2001, the IRS will handle a total workload – greatly increased by an expanding economy – with 15,000 fewer FTE than in FY 1993. Staff reductions since FY 1993 are due to downsizing efforts and internal reprogramming to meet essential non-labor needs. We estimate that the IRS overall workload increases at the rate of approximately 1.8 percent per year, slightly greater than the rate of growth of returns filed. At the same time, RRA 98 created very significant additional resource demands. Expanded programs such as the innocent spouse provisions, offers in compromise and due process in collection required more than 4,200 IRS staff annually to administer.

FY 2002 RESOURCE REQUEST AND OBJECTIVES

To ensure that we meet these requirements, the IRS requires a minimal increase in funding in FY 2002, as set forth in the President's budget. With the new organization in place, new technology improvements beginning to come on line, and the staffing provided by the STABLE initiative, the declines in compliance activities, such audit and collection actions, will stabilize while customer service indicators will continue to improve.

In fact, as demonstrated in the performance and workload measures included throughout our Congressional Justification document, we expect some improvement in performance over FY 2000. For example, service improvements can be seen in the expected level increase to 71 percent in toll-free telephone service. In addition, while still low by historical standards, the number of returns audited is projected to rise by 28 percent. Equally important, key areas of non-compliance, such as trusts and passthroughs, higher income returns, corporate returns and employment tax collections will receive more focus. The quantitative goals in our performance plan represent aggressive near term goals. We may not achieve all of these goals as quickly as projected, but we are confident the trend is in the right direction.

The FY 2002 request is $9.276 billion (without the Earned Income Tax Credit Account), $580 million more than the FY 2001 appropriated level of $8.696 billion. Most of this increase, $325 million, maintains the momentum needed for the Business Systems Modernization technology effort underway at IRS.

Let me stress Mr. Chairman, that the $325 million increase will be used to replenish the Business Systems Modernization Account (formerly ITIA) which has been drawn down as the IRS begins to deliver on the BSM program benefits. In FY 2001, in addition to the $72 million in the FY2001 appropriation, the IRS had use of $305 million in ITIA funds carried over from prior years' appropriations. Thus, the total BSMA funds requested for FY 2002 of approximately $397 million represent a net increase in actual funds available to the program of $20 million or 5.3 percent even though the requested increase in appropriations is $325 million.

Apart from this technology investment, the remaining increase is only 2.9 percent greater than FY 2001 and is necessary to maintain current operations.

Program Changes

Our budget request has two broad categories: Maintaining Current Operations and Modernization. Program increases to maintain current operational levels include FTE for the STABLE initiative and the Counter Terrorism Initiative. Decreases in our operational levels include program offsets in costs for non-labor resources that support activities of the IRS. Modernization includes increases for our investments in new technology to continue the momentum of business systems modernization and decreases in funds for organization modernization that are no longer needed.

Maintaining Current Operations

Modernization of the IRS includes modernizing the organization structure as well as the technological base. On October 1, 2000, the structural reorganization of the IRS was completed with the standup of the final operating units. However, there will be a period of adjustment over the next two years as the new business units assume their new roles and responsibilities. In particular, the service improvements in telephone operations and compliance depend on further workload redistribution and increased specialization will require varying degrees of retraining of approximately 4,000-6,000 employees in Accounts Management and Compliance Services programs.

The IRS is also requesting $325 million to fund the estimated cost of non-pay inflation and statutory pay and benefit increases. The IRS is a labor-intensive organization. Our mission is accomplished through people, and stabilization of the workforce is critical. To maintain current operations, protect the integrity of the filing season, oversee tax administration programs and implemented organization modernization, the IRS must have the resources to pay for the increased costs associated with statutory pay increases.

Congress provided funding in FY 2001 for the STABLE and Counter Terrorism Initiatives. The STABLE initiative was designed to stabilize and strengthen tax compliance and customer service programs. In addition, the annualization of the Counter Terrorism Initiative will complete funding for the IRS Criminal Investigation portion of the National Counter Terrorism Initiative.

There are program offsets too – $57 million in projected inflation for non-pay expenditures, as well as a variety of other non-discretionary cost increases that are not funded. It is believed that such costs can be offset through improved resource management.

Modernization

Most of the costs to America's taxpayers of administering our tax system are not in the IRS budget. Each taxpayer must invest time and money in preparing a return and must bear the intangible cost of dealing with an agency that attempts to help using extraordinarily old and poorly integrated systems. The IRS has been endeavoring to reengineer the entire way it does business to ensure that its customer, the American taxpayer, receives world class service.

Business Systems Modernization

For FY 2002, we are requesting $397 million to continue to invest in the modern technology necessary to improve customer service delivery. Compared to FY 2001, this represents a net increase in available funds of $20 million, taking into account funds available in FY 2001 that were carried over from prior years. A specific list and description of the projects to be funded from this request are contained in our Congressional Justification; a summary of these can be found in the Appendix to our testimony. Funding to improve these Core Business Systems is necessary for full compliance with RRA 98 mandates. Full funding will allow for the following benefits:

Short Term: Improved access to IRS support, information and tax data through multiple, easy-to-use channels; more accurate information provided by IRS; greater speed of response to taxpayers; and improved timeliness of IRS-initiated actions;

Mid-Term: A set of business systems and practices more nearly on a par with the private sector, and that provides a single point of access to all information relating to taxpayer account information for both taxpayers and IRS employees;

Long-Term: A flexible and adaptable environment that meets the Nation's tax administration requirements and taxpayer needs in the ever-changing technological landscape of the future.

Organization Modernization Non-Recur

Funds have been requested in the past three years to cover special costs that are related to IRS modernization. Some of these resources were for design work, space alterations and contract movers to physically realign employees with their new operating divisions. The remaining funds were for employee buyouts, recruitment, relocations, employee training, equipment, services and supplies, telecommunication moves and installations, and modification of information systems to the new organizational structure. Costs for organizational modernization are peaking in FY 2001, and will decline by $101 million in FY 2002 and end in FY 2003. In FY 2002, the $101 million non-recur reflects reduced costs for modification of information systems, employee buyouts and moving expenses, and some contracts, training and operating travel.

CONCLUSION

Mr. Chairman, in conclusion, I believe that the IRS is on the right track. We have demonstrated both the ability to make some short-term improvements in service, and more importantly, the ability to produce a viable and cogent strategic plan that will guide our efforts to make changes in the entire way we do business and provide service to taxpayers. With your continued support and the support of the American people, I am convinced more than ever that we can succeed.

APPENDIX A – STABILIZATION OF COMPLIANCE ACTIVITIES

Earlier this year, Congress approved the staffing plan for the STABLE (Staffing Tax Administration for Balance and Equity) initiative. The funding was included in the Fiscal 2001 Appropriations bills.

The STABLE staffing plan reflects the new modernized IRS and represents a careful judgment as to how these additional resources, together with our internal management improvements, can best be used to improve our service to taxpayers and compliance effectiveness.

The two principles that guided the budget request were, first, allocate incremental resources directly to staffing front line positions. Second, these additional resources will provide a balanced improvement between service and compliance programs. With the increased staffing levels, we expect the IRS to be able to slightly increase levels of service and to stabilize the level of exam and collection activity while complying with the taxpayer rights provisions of the RRA.

Our overarching goal is to achieve the greatest possible improvements in both taxpayer service and compliance efforts by determining how best to use the STABLE resources in conjunction with the base FY 2001 budget request. We believe that STABLE achieves this goal.

In our reorganization effort over the last two years, we have carefully studied the use of nearly every position in the IRS. One of the key findings in this analysis is that the use of compliance personnel such as revenue agents and revenue officers on "details" to taxpayer service duties during the filing season is not efficient. This practice, while necessary as a short term solution to inadequate service, takes highly trained and high graded personnel away from important exam and collection casework during a substantial part of the year, causing reduced levels of productivity and delays in completing cases.

Another key finding of the study is that the IRS provided very minimal levels of activity in assisting taxpayers to understand their tax obligations and avoid mistakes in filing, especially in the small business areas. Many stakeholders groups have stressed that this problem causes errors later in the process, which are expensive for both taxpayers and the IRS.

In our new structure, instead of increasing the number of expensive and scarce compliance personnel, we have provided for additional positions in taxpayer service and education. A significant portion of the STABLE resources will be used to fill these positions. By hiring staff to perform these service and educational functions, we can avoid the need to use more expensive compliance personnel on details during the filing season, thus allowing us to accomplish two objectives efficiently: increase our level of taxpayer education and taxpayer service and increase the number of staff years actually applied to exam and collection casework.

With this approach to the STABLE staffing, together with our reorganization and technology improvements, we have set goals for measurable improvements in our key programs in FY 2001. Because of the time required to hire and train people, we will not achieve the full impact until FY 2002. Some of the improvement goals we have set in key areas in FY 2001 are:

- Increase the level of service on our toll free telephone service from approximately 59.1 percent in FY 2000 to approximately 63.4 percent in FY 2001, while also improving our quality measures.

- Reverse the downtrend of the last five years in compliance, increasing the number of overdue accounts closed by our telephone and field collectors by 8.6 percent.

- Increasing the number of exams of individuals conducted in person by about 6.2 percent, while also improving quality.

In examination, we will focus on the areas with the greatest risk of underreporting of income. For example, the number of exams of higher income individuals and corporations will increase more rapidly than the average.

This additional staffing will allow us more quickly to resolve innocent spouse claims, offers in compromise cases and collection due process cases we completed – key taxpayer rights included in RRA 98. We will also increase our commitment to pre-filing assistance to taxpayers through communication and education programs and pre-filing agreement programs. These areas are of particular importance and concern for the small business community.

Targeting Our Resources

We must promote fairness by combating key areas of non-compliance. To this end, the IRS must apply its limited resources where they will be of the most value. Some of the special problem compliance areas include: underreporting, non-filing and abuse of trusts and passthroughs; abusive corporate tax shelters; accumulations of unpaid trust fund taxes; and erroneous refund claims.

Abusive corporate tax shelters continue to be an important compliance initiative for the IRS. From the information that IRS and Treasury receives from a variety of internal and external sources, we know that there are a significant number of transactions that have no legitimate business or economic purpose other than reducing taxes.

These abusive corporate tax shelters could seriously undermine the tax system if all corporations believe they must engage in these transactions to keep up with the competition.

We have a coordinated effort with Treasury to deal with this problem and our Office of Tax Shelter Analysis (OTSA) plays an important role in it. The IRS does not want to impede normal tax planning, and through the OTSA, we have available a means to separate the real problems from quite legitimate transactions. In addition, a "Tax Shelter Hotline" and our commitment to issue more guidance in this area will help us respond to abusive transactions on a more timely basis.

Promoters of abusive tax shelters are also using offshore tax entities in their tax schemes to unlawfully reduce or eliminate taxes. Last month, in the largest IRS enforcement action ever taken, law enforcement authorities in multiple states executed over three dozen search warrants and made four arrests as part of a series of investigations of alleged illegal offshore trust programs involving the diversion of millions of dollars of income for hundreds of clients.

I want once again to express my appreciation for the fine work done by our Criminal Investigation Division, the United States Attorneys offices in Boston and San Francisco, the Tax Division of the Department of Justice, and the Costa Rican law enforcement authorities. Last week's historic enforcement activities send an unmistakable signal about IRS' commitment to pursue investigations of promoters and their clients who would try to move money off-shore to evade taxes.

It further represents the IRS' continuing efforts to combat tax compliance problems caused by those who promote and participate in the use of trusts and offshore schemes designed to evade U.S. taxes.

Frauds Alerts: Buyer Beware

In February 2001, The Internal Revenue Service issued a nationwide alert to taxpayers, warning them not to fall victim to a number of tax scams that are being promoted. These schemes take several shapes, ranging from promises of special tax refunds to illegal ways of "untaxing" yourself. Taxpayers were told that they could report suspected tax fraud to the IRS by calling 1-800-829-0433.

One of these illegal tax schemes involves telling employers that they do not have to withhold federal income tax or employment taxes from the wages paid to their employees. Using a bogus interpretation of the Tax Code, the con artists are selling the unsuspecting and the unscrupulous a phony and illegal scheme that in the long run will cost these employers a huge tax bill that can include stiff penalties and jail time.

In addition to this warning, the IRS devoted a special consumer alert to this problem. We told working men and women that if they have concerns that their employer is failing to withhold these taxes to call our toll-free number at 1-800-829-1040. We are also asking our stakeholder groups to help us get the word out about this problem.

Taxpayers can get more information on how the IRS is combating this bogus withholding scheme by going to our web site at www.irs.gov and clicking on the "Small Business and Self Employed Community" page. From there, taxpayers can click on "tax schemes" and get all the necessary information. Taxpayers can also link to the IRS' Criminal Investigation home page and get a very detailed description of its employment tax enforcement program, including a breakdown of cases and a number of significant convictions of those who thought they could get away with evading their tax responsibilities.

I want to stress that IRS Criminal Investigation works closely with all parts of the Agency to investigate and refer for prosecution individuals and companies who have willfully failed to file or pay employment taxes. In the past three years, 127 individuals were sent to federal prison, a halfway house or home detention on employment tax issues. Nearly 86 percent of those sentenced for evading employment taxes served an average of 17 months in confinement and were ordered to make restitution to the government for the taxes evaded plus interest and penalties.

Revenue Protection Strategy

The IRS revenue protection efforts in 2001 will again identify and look at certain tax returns before issuing refunds. In addition to identifying questionable refunds, the IRS will continue its emphasis on improving compliance with the Earned Income Tax Credit (EITC) provisions of the Internal Revenue Code, including the use of our dependent database to identify questionable issues relating to incorrect claims on dependent exemptions, filing status and EITC credits.

The Earned Income Tax Credit Preparer Outreach Program will also continue. As part of this program, IRS revenue agents will visit tax professionals nationwide prior to January 2001, to provide individual assistance and to answer any questions about EITC. Some of the visits will also include a review of files to determine if due diligence requirements for the preparation of EITC have been met.

APPENDIX B – ADMINISTRATION OF RRA 98 TAXPAYER RIGHTS PROVISIONS

Due Process in Collection Provisions

RRA 98's collection due process provisions presented the IRS with great hurdles that have been difficult to overcome. However, as we develop the necessary expertise and case law experience for dealing with new technical issues, we are confident that we will be better able to meet these challenges.

Initially, we could not predict the number of due process cases and therefore, the impact that they would have on Appeals. When the due process provisions went into effect in January 1999, Appeals had approximately 60 settlement officers to handle collection issues. However, once it became evident that additional staffing was needed to handle the due process work, Appeals undertook a major retraining program of its appeals officers, who typically handle examination work. By the end of May 2001, an additional 250 appeals officers will be trained to handle due process cases. In addition, Appeals will then have 475 officials capable of working due process cases.

The due process provisions have also raised the need for resources at our Automated Collection System (ACS) sites. Before the implementation of RRA 98, many of our levy actions were systematic and required minimal staff intervention. Now, staff must review the facts and circumstances of each case before we take a lien or levy action. In addition, once the hearing request is received, ACS is required to prepare the case for referral to Appeals. ACS staff is being redirected to handle the processing of Collection Due Process (CDP) requests.

To ensure that we maximize staffing resources, we are examining our internal operations and workflow to identify opportunities to streamline and improve our handling of these accounts. Last summer, an executive level task force was convened to review the due process program. The task force issued its report in late September with its recommendations for improving the process. An implementation team is in place to take appropriate actions. Some of the initiatives underway include:

- The establishment of an ongoing due process program review requirement in Appeals.
- The development of a Best Practices and Case Management Guide for managers.
- The adoption of a standardized Appeals referral form that will clearly identify the issues being raised by the taxpayer and assist Appeals in determining its initial case analysis workload.
- The establishment of special purpose job aids and an internal CDP web-site to provide quick reference materials.

- The development of abbreviated Notices of Determination and Appeals Case Memos to streamline the hearing process in some situations where the taxpayer and the Service have reached agreement.
- The establishment of a procedure that provides time for the collecting office to work with the taxpayer after a hearing request has been made, but before the case is referred to Appeals
- The establishment of an inventory tracking system that will assist in assessing and predicting due process workload needs.
- The examination of criteria for lien filing and systemically proposed levies.
- The development of a pilot where employees familiar with ACS processing are assigned to Appeals to assist in due process hearing requests received from that function.

Offers In Compromise (OIC)

RRA 98 added additional requirements that lengthened the offer-in-compromise process. The law mandated a separate, independent administrative review before the Service could reject an offer in compromise, or return the offer for failure to provide financial information. It also expanded the bases for compromise to allow compromise would promote effective tax administration. In cases where taxpayers seek to compromise under this expanded authority, the IRS must undertake additional investigations.

Also, in an effort to add flexibility to the program and to open the offer process to more taxpayers, we no longer automatically return offers which do not contain all information needed to complete an evaluation. While this change has reduced taxpayer burden, it has increased IRS processing time and has caused our inventories to increase. We must now spend more time perfecting offers, which we would have returned immediately to the taxpayer in the past.

Evaluating and processing offers in compromise requires numerous processing steps that currently must be performed manually. Future automation could alleviate some of the case building and financial verification aspects, saving costs and processing time.

In FY 2000, we completed processing 83 percent of the offers in compromise received within one year of the offer's submission. We resolved 38 percent of these cases within the first six-months and the remaining 45 percent by the end of the year. Through January 2001, we resolved 32 percent of the offers in compromise submitted within the first six-months. This is a decline from the same period in fiscal 2000.

To shorten the time frames for processing offers in compromise, we realigned field resources to increase the number of staff assigned to that task. In FY 2000 we increased the revenue officer, paraprofessional, and clerical staff assigned from 762 to 1,140 FTEs, and we project an increase to 1,239 by the end of fiscal 2001. We also reviewed our processes and procedures in an effort to shorten processing timeframes. As part of that effort, we will be addressing the backlog in inventory and providing additional recommendations to redesign the Offers in Compromise (OIC) process.

To address the increasing workload in the OIC program, we conducted a pilot project in two service centers to test the feasibility of processing offer in compromise cases of less than $50,000 in a centralized environment. Based on the results of the test, we expect centralized bulk processing of OICs to lessen both our staffing requirements and time per case closure. Beginning in July 2001, all new OIC receipts will be sent to one of two service centers, depending on where the taxpayer resides. A staged implementation is planned between July and November, with actual casework beginning in August 2001.

Innocent Spouse

The IRS is making steady progress to deal with the backlog of innocent spouse claims. As of March 1, 2001, the IRS had 40,278 innocent spouse claims, affecting 21,198 taxpayers, where we have not notified the taxpayer of a determination. In FY 2000, we exceeded projections, processing 42,546 innocent spouse claims, despite a 22 percent increase in receipts from the prior year. This meant that of the 111,243 claims (affecting 58,549 taxpayers) received since July 1998, we had not notified 21,136 taxpayers of our determination by the end of the fiscal year.

To achieve this reduction in cases and promote more efficiency in administering future case, we have taken or will take the following steps.

- By May 2001, we will have increased the staffing at the Centralized Site by 50 positions during FY 2001, an increase of over 46 percent from the 107 employees in FY 2000. Thirty of the new positions are temporary in nature, created to deal specifically with the current backlog of inventory. We also upgraded the tax examiner position, increasing the number of examiners who make determinations on claims that are more complex.

- In January 2001, we developed and implemented an Integrated Case Processing (ICP) application in the Centralized Site. This computer workstation application embeds the algorithm for working an innocent spouse case that leads the examiner through the complex decision-making process, creating a workpaper trail to document the decision. We believe this application will allow us to increase productivity and provide a consistent application of the law. Additional phases of ICP will include account research and screening phases of the process.

- In January 2001, we implemented a new automated Master File account used for recording and maintaining information relating to separate spousal account transactions. It replaces the manual Automated Non-Master File system.

- Early in FY 2001 we detailed Appeals officers to 120-day assignments in local field quality review sites to assist with backlogs in that stage of the process in the field.

We believe the above initiatives will help us make significant progress toward achieving our goal of processing claims within prescribed timeframes. By December 31, 2001, we predict that our inventory level will be at a point where we can process claims received after that date without significant delays on the part of the Service.

We further believe that with the staffing increases already accomplished and implementation of the recent computer-based decision-making tool, we have sufficient staff to process claims within acceptable time periods.

APPENDIX C – 2001 FILING SEASON

The IRS delivered on a very successful filing season as it continues to meet the mandates that Congress set forth in RRA 98 and the challenges of modernization.

By continually managing this change and risk in an orderly and integrated fashion, I am pleased to report that as we approach the home stretch, the 2001 tax filing season has been smooth and almost error free. The 2001 filing season continues to demonstrate how we can build on positive trends in service to taxpayers, especially as our major technology and organizational initiatives take effect.

Projected net collections for FY 2001 will exceed $2.0 trillion. During FY 2001, we also project to receive 232.1 million returns, including over 130.3 million individual returns, and expect to issue over 97 million individual refunds. As of April 13, 2001, the average dollar amount per refund is up over 5 percent over last year, and the average refund is $1,728.

Electronic Tax Administration

Mr. Chairman, RRA 98 mandated that at least 80 percent of returns be filed electronically by 2007. Reaching this and the other Electronic Tax Administration (ETA) goals is an enormous challenge, but well worth the effort.

The IRS' overarching goal is to conduct most of its internal and external transactions by electronic means. To meet this objective, we must make it not only technologically possible, but also attractive to the public to make a permanent change from paper to electronic means. Indeed, a robust ETA system helps form the foundation of a modernized IRS. It is key to easing taxpayer burden and can provide multiple benefits to taxpayers, practitioners and our tax administration system.

Let me also stress that during the past year, the IRS completed a sweeping set of changes and upgrades to add an extra layer of protection for the millions of taxpayers using the *e*-file program. We have strengthened our system's security and we will remain vigilant to keep our *e*-filing processes the safest possible.

The 2001 filing season statistics continue to demonstrate that an increasing number of taxpayers are taking advantage of these initiatives and filing taxes electronically. Through April 13, 2001, over 36.5 million individual taxpayers filed using one of the three *e-file* options; a 11.9 percent increase over the same period last year.

- Over 26.7 million taxpayers *e-filed* their tax returns electronically through an IRS-authorized Electronic Return Originator (ERO), a 13.3 percent increase over the same period last year.

- Approximately 5.7 million taxpayers filed their tax returns on-line via their home computer through a third party transmitter. On-line filing is running 34.1 percent ahead of last year and has surpassed the FY 2000 total volume of 5 million.

- Over 4 million taxpayers filed their returns over the telephone using the award winning TeleFile system. Oklahoma and Georgia joined Kentucky and Indiana in the Federal/State TeleFile option.

- Almost 13.9 million taxpayers chose to file both their federal and state tax returns simultaneously in a single electronic transmission. This year, 35 states and the District of Columbia are participating in the program.

Mr. Chairman, let me also note that paper and electronic return preparation and filing are also offered through IRS local offices as well as Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites. Taxpayers who cannot afford either to pay a professional tax preparer or buy a personal computer and tax software may also go to local IRS offices to have their returns prepared. The tax software we use in our offices is competitively procured in the open market. Through this method, the IRS both electronically prepares and files simpler returns for lower-income taxpayers at their request.

New in ETA for the 2001 Filing Season

In order to improve our ETA program and ease taxpayer burden, the IRS listened to taxpayers, industry and practitioners. We heard that we must make electronic filing more attractive and remove barriers. Let me briefly discuss our efforts this filing season to meet these concerns.

First, the IRS is working to address the frustration that taxpayers and practitioners experience when they find they cannot file some forms electronically. For the 2001 filing season, we added 23 additional forms to the 1040-*e-file* program. These include Form 2106-EZ for un-reimbursed employee business expenses; the Form 2688 application for additional extension of time to file; and Form 8379 for injured spouse claims.

We plan to roll out the remaining 38 forms and schedules for the 2002 filing season. This means we will open *e-file* eligibility to 99.1 percent of all taxpayers, potentially adding 3.8 million new *e-filers* to the growing rolls. Equally important, it means that preparers will be able to go essentially 100 percent electronic for all of their customers by 2002.

Second, the IRS is making electronic filing paperless by eliminating the requirement for a separate paper document with the *e-file* return. In 2000, the IRS successfully tested the use of a Personal Identification Number (PIN) code as the taxpayer's signature, eliminating the need to file the paper *jurat*. This year's program extended the option to taxpayers nationwide, with some exceptions, and permits them to select a PIN, and then file electronically without any paper. So far, 4.2 million taxpayers have chosen this option.

Third, this filing season, more electronic payments options have been made available to taxpayers, such as accepting debit payments through TeleFile and accepting credit cards for Forms 1040ES, estimated tax payments, and Forms 4868, extensions of time to file. For the fiscal year, 144,731 payments averaging $2,745 were made via credit card and another 251,015 payments averaging $2,170 were made by Automated Clearing House (ACH) Direct Debit where taxpayers can authorize either their checking or savings account to be debited.

Fourth, our e-Services project under BSM will help us conduct most transactions with taxpayers and their representatives in an electronic format. By 2002, the e-Services' goals are to: (1) provide the capability to register new electronic return originators over the Internet; (2) permit delivery of transcripts to authorized parties electronically; and (3) allow third parties who are required to provide certain forms 1099 and information returns to check the taxpayer identification numbers for accuracy before submission.

Fifth, contributing to this year's successful *e*-filing season is IRS' new marketing campaign, "40 Million People Already Know *e-file* is the Way to Go." In conjunction with its advertising agency, and as authorized by RRA 98, the IRS developed a fully integrated campaign with TV, radio and print advertising. As the *e-file* program matures, our data- and market-driven marketing campaign is shifting away from merely promoting awareness of *e-file* to emphasizing its value, such as saving taxpayers time.

ETA Also Easing Business Taxpayer Burden in 2001

A strong ETA program must embrace the needs and expectations of all taxpayers, including business taxpayers. In 2001, the IRS continues to make progress serving the electronic tax administration needs of this important sector.

For example, beginning last April, employers could file their Form 941 on line, saving time and paperwork. And for the first time, companies and payroll service providers will be able to file both the Quarterly 941 and Annual 940 (*Employer's Annual Federal Unemployment Tax Record*) electronically. A direct debit payment was also made available through Form 941 TeleFile.

Another major ETA initiative eases the information-reporting burden for employers. Providers of certain information statements, including W-2s, now have the option of giving taxpayers the information electronically, instead of on paper.

These new rules were a direct response to requests we received from lenders, educational institutions, employers and stakeholders who wanted the option to deliver these statements in an electronic format. Under the new option, providers will save the cost of processing, printing and mailing paper statements. And recipients will receive the information faster and more efficiently without the worry of mailing delays or lost statements.

The Electronic Federal Tax Payment System (EFTPS) also continues to be a runaway success. In 2000, EFTPS topped all of its 1999 numbers for new enrollments, dollars and transactions. It processed more than 63 million federal tax payments – a 14 percent increase over the previous year. And EFTPS also received a staggering $1.5 trillion – a 15 percent increase over the previous year. Payroll companies, tax practitioners and financial institutions have been instrumental in helping us grow this program and the use of electronic payments.

Why has EFTPS been so successful? Over the years, EFTPS has delivered a high level of service and accuracy. It consistently exceeds industry standards, and delivers a 99.9 percent accuracy rate for payments appropriately applied.

We developed the system with a focus on being able to handle significant volume with accuracy, integrating checks and balances to make sure information is correct and verified at each step of the process. EFTPS delivers a level of precision that can be compared to stringent banking and financial transaction standards for accuracy.

This year, we are conducting an exciting new pilot program to test our new Internet- based application for businesses to pay federal taxes on line. This new feature, EFTPS-OnLine, allows businesses to enroll in the system, securely make federal tax payments and check their electronic payment history over the Internet. Using EFTPS-OnLine, businesses will be able to schedule future payments through the Internet and cancel payments if necessary. They will also have access to on-line help and "how-to" pages with step-by-step instructions.

One of our primary EFTPS priorities is security and it continues with our new Internet feature. EFTPS-OnLine uses the strongest available security and encryption technology to ensure taxpayer privacy and protection. After evaluating the pilot results, we plan to make EFTPS-OnLine available to all business taxpayers and to individual taxpayers who are required to make estimated quarterly payments.

There are currently more than 3 million taxpayers enrolled in EFTPS and with the addition of the new Internet feature, we expect that number to continue to grow.

Web-Based Help

The Internet continues to offer exciting new opportunities for easing taxpayer burden and improving service. The IRS web site, the *Digital Daily (www.irs.gov)*, has already received almost 1.8 billion hits this fiscal year. According to the "Lycos 50", since almost the beginning of the year, the IRS has consistently ranked among the top 10 user searches. As of April 14, 2001, it came in as Number 2.

Anyone with Internet access can receive: tax forms, instructions, and publications; the latest tax information and tax law changes; tax tables and rate schedules; and hypertext versions of all taxpayer information publications, including the very popular Publication 17, "Your Federal Income Tax"; all TeleTax topics; answers to the most frequently asked tax questions; a library of tax regulations; and the weekly Internal Revenue Bulletin that contains all the latest revenue rulings, revenue procedures, notices, announcements, proposed regulations and final regulations. However, to ensure that taxpayer privacy is protected, our web site will not provide or receive individual taxpayer data until adequate safeguards are in place.

Since coming on line in January 1996, taxpayers have downloaded over 412.9 million forms, publications and products. Through February 2001, there have been over 103 million downloads as compared to 51.5 million for the same period in 2000 – an increase of almost 100 percent.

The IRS web site also has a W-4 Calculator in its "Tax Info for You" section. In addition, the expanded use of online customer service technologies provides greater taxpayer access to IRS' help while on the *Digital Daily*.

Earlier this year, the IRS launched its new user-friendly "Small Business and Self-Employed Community" web page that can be accessed from our web site. It was developed by our Small Business/Self-Employed Operating Division specifically to benefit the millions of small business owners, the self-employed and start-up businesses who often confront more complex tax issues than taxpayers who have their taxes withheld by an employer.

This convenient "one-stop shopping" for assistance can provide most, if not all, of the immediate products and services that a small businessperson needs, such as a section on common problems, a calendar of important tax deadlines, helpful tax hints, forms and publications and a direct link to stakeholder sites, such as the National Association of Home Builders and the National Restaurant Association.

I mention these two associations because for the first time ever, the IRS is providing industry-specific tax information for the construction and restaurant industries. For example, if a food server wants to know the deadline for reporting tips, he or she can go to our site and in two clicks, learn that Form 4070 should be filled out and turned into the employer by February 12.

In the near future, we will add more of these targeted areas to the web site, such as for the automotive, oil, and gas industries. We will also add a Smart Q&A Wizard that will make it easier for taxpayers to search our growing database of frequently asked questions and get the information they need.

The IRS web site will continue to evolve and improve in design, content and features. The biggest leap in the future will be from its current state as an information source to include a transactional-based portal.

CD-ROMs

The Federal Tax Forms CD-ROM contains more than 600 tax forms and instructions for the current tax year, an archive of forms and instructions dating back to 1992 and some 3,000 pages of topic-oriented tax information. Users can electronically search, view-on-screen, or print any of the items contained on the CDs. The two-issue subscription is conveniently available through the *Digital Daily* for $21. If ordered by fax, mail, or telephone, the cost is $26 (includes postage and handling).

In conjunction with the Small Business Administration, the IRS also produced the latest edition of the joint small business CD-ROM, "Small Business Resource Guide: What You Need to Know About Taxes and Other Topics." It has consistently received highly favorable reviews from small businesses and external stakeholders. The Year 2001 version of the CD-ROM is being made available free of charge, one-per-customer, by calling our toll-free number at 1-800-TAX-FORM. It can also be ordered on the IRS web site.

The CD-ROM provides an array of helpful information for business operators, including actions to take before going into business and tax filing and reporting responsibilities when starting, expanding, closing and selling a business. In addition, it includes all of the business tax forms, publications and instructions for *e-filing*. The CD-ROM also allows users with Internet access to link to other helpful federal and state web sites.

Telephone Assistance

Throughout the 2001 filing season, the IRS will provide telephone assistance 24 hours a day/7 days a week at 1-800-829-1040. After April 16, we continue to offer around-the-clock service for refund and account callers, and service will be available for tax law assistance Monday through Saturday from 7:00 AM until 11 PM.

For the filing season through April 14, approximately 67 percent of the taxpayers who wanted to talk to a customer service representative got through, compared to 62.2 percent last year at this time. In addition, 44.4 million of taxpayers used our automated services to get information such as refund status, an increase of 25 percent since last year, and the trend has been upward. In the last four weeks, the level of service averaged 67.7 percent. The upward trend in phone service is encouraging and shows that our investments in training, management and technology are beginning to pay dividends.

The IRS will continue to implement many process and systems enhancements to improve both the convenience and the quality of telephone communications. These changes are major, affecting approximately 14,000-15,000 employees in more than 20 locations around the country. With the benefit of new call routing technology and new software planning tools, we are realigning the work assignments and training of many of these assistors so that the employees will have the right specialized training and knowledge to answer taxpayers inquiries efficiently and accurately. We will make increasing use of the technology to direct taxpayer calls more accurately to the right assistor, and enable taxpayers in many cases to make uses of "self-service" applications, either through the phone or the Internet.

As these changes take place, the average complexity of calls answered by the Customer Service Representatives (CSRs) will continue to increase as: more of the simpler calls are routed to automated services; alternative language services are expanded; and CSRs handle topics previously referred to compliance personnel.

During FY 2001, the IRS will introduce and test a new series of measures consistent with industry standards to improve monitoring of the delivery of the service experience and utilization of resources. The current measurement system will be maintained concurrent with this new effort through 2002 to allow IRS to solicit external expertise to validate and assess the new measures and develop an implementation plan. IRS will solicit external expertise to validate and assess the new measures and develop an implementation plan.

Earlier this year, the IRS also inaugurated its San Patricio, Puerto Rico call site. Now that the center is fully operational, it will be able to take the majority of the Spanish-speaking traffic. Our Spanish-speaking customer service representatives in the States will still play a critical role, but creating this center will allow us to make the best use of all of our bilingual assistors. By staffing this call site, we have made real progress in reducing the current deficit of Spanish speaking customer service representatives.

Forms By Fax and Phone

Taxpayers can receive more than 150 frequently used tax forms 7 days a week, 24-hours-a-day from IRS TaxFax. Taxpayers can request up to three items per-call. Taxpayers use their fax machine to dial the service at 703-368-9694. The only cost to the taxpayer is the cost of the call. Taxpayers can also request forms and publications by calling 1-800-TAX-FORM.

Recorded Tax Information

TeleTax has 148 topics available 24 hours a day using a Touch-tone phone. Taxpayers can call (toll-free) 1-800-829-4477 to hear recorded information on tax subjects such as earned income credit, child care/elderly credit, and dependents or other topics, such as electronic filing, which form to use, or what to do if you cannot pay your taxes. As of April 14, 2001, over 3.5 million have taken advantage of the service so far this filing season.

Automated Refund Information

For the period January 1 to April 14, 2001, over 38.8 million taxpayers used the Automated Refund Information system on TeleTax to check on the issuance of their refund checks. This is up over 87 percent from the 21.1 million at this same point last year. Taxpayers may call 1-800-829-4477 to check on their refund status Monday through Friday from 7:00 AM to 11:00 PM if using a touch-tone phone, or 7:30 AM to 5:30 PM for rotary or pulse service.

Taxpayer Assistance Centers

While many taxpayers prefer to use the telephone and the Internet to communicate with the IRS, our modernization studies and experience with the highly successful "Problem Solving Days" showed that some taxpayers need to meet in person with IRS representatives to get the assistance they need.

For those taxpayers who prefer to visit an IRS office, walk-in service is available at more than 400 locations nationwide. At many sites, walk-in service will be offered on 12 Saturdays between January 27 and April 14. So far this filing season, we have served over 4.9 million taxpayers at all Taxpayer Assistance Centers – an 11 percent decrease from last year.

The Saturday Service sites were selected based on their weekend accessibility, year-round operational status, and high traffic volume. They include non-traditional locations, such as shopping malls, community centers and post offices.

With the help of the additional personnel provided for by the STABLE initiative, we are broadening the services available in our local offices so that taxpayers who wish to come in person will be able to resolve most tax account issues. We have defined a new job category called Tax Resolution Representatives. These employees will have the training and authority to provide "one-stop service" for a broad range of issues ranging from answering tax questions to resolving payment problems.

We also believe that by energizing the VITA return preparation program and co-locating these activities at the Taxpayer Assistance Centers, the IRS will be able to focus on simple account and collection issues. In 2001, the Stakeholder Partnership, Education and Communications (SPEC) branch of our Wage and Investment Operating Division will work with more than 17,000 volunteer sites across the country to assist an estimated 4.7 million taxpayers. We will also work to better track the impact and benefits of the volunteer program.

APPENDIX D – ORGANIZATIONAL MODERNIZATION AND BALANCED MEASURES

A New Customer-Focused Organization

Following RRA 98's directions, the IRS designed and has made substantial progress in implementing a new organizational structure. It closely resembles the private sector model of organizing around customers with similar needs. The IRS created four customer-focused operating divisions to best serve taxpayers: Wage and Investment, Small Business and Self-Employed, Large and Mid-Size Business, and Tax Exempt and Government Entities. There are also a number of functional units, including Appeals, the Taxpayer Advocate Service, Criminal Investigation, and Communication and Liaison.

The modernized IRS organization was officially inaugurated, or "stood up", on October 1, 2000 and a top management team is in place for each of the operating divisions and business units. However, many challenges and much hard work remain as the different parts of the new organization are staffed and trained. The final stages of implementation, including the redistribution of workload, will require another two years through FY 2002.

In the short-term, the reorganization should be largely invisible to taxpayers and tax practitioners. In the long-term, they will see the positive changes that modernization is intended to produce. The new organization will place a greater emphasis on pre-filing services and early resolution of complex issues. More resources will be devoted to pre-filing activities, such as education and outreach to help taxpayers comply with the tax law and get their tax returns right the first time. Post-filing activities will be geared to problem prevention with targeted enforcement activities for non-compliance. Most importantly, the focus and clear assignment of responsibility will result in faster action to fix problems and improve the way that business is done.

Establishing a Balanced Measurement System

All federal agencies must have appropriate quantitative performance measures. They are required by the Government Performance and Results Act (GPRA) and are essential to any large organization's proper operation. An integral part of our overall modernization program is establishing balanced performance measures that support and reinforce the IRS' mission and strategic goals. However, because of past IRS experience with measurements and RRA 98 requirements (Section 1204), developing appropriate measures is an especially sensitive and difficult task.

Critical to our efforts was establishing measurements based on what we needed and wanted to measure, rather than using what is most easily measured. Our balanced measurement system was designed to measure the progress we are making to achieve our three strategic goals: (1) service to each taxpayer; (2) service to all taxpayers and (3) productivity through a quality work environment.

Also critical is ensuring that measures are aligned at all levels, from the top of the organization to the front-line employee. This does not mean that all of the organization's levels and components have precisely the same measurements. Obviously, this would be impossible. Rather, it means that the measures or evaluations are aimed at encouraging the type of behavior that will advance the organization's overall strategic goals, and do not encourage inappropriate behavior.

In developing measures for each organizational level, it is important that each component of the balanced measurement system reflect responsibility at that level. At the top of the organization, management has control over strategies and allocation of resources. However, at the mid-level, managers have less control over these variables, but do exercise control over the effectiveness of training, coaching and guidance of employees. And at the individual level, each employee has control over his or her work and self-development.

In the balanced measures system being implemented, there will be quantitative measurements keyed to each of the three strategic goals (service to each taxpayer; service to all taxpayers and productivity through a quality work environment) at both the strategic level and the operational level. In general, quantitative measures will not be used at the individual employee level.

In September 1999, we issued a Balanced Measures Regulation to formally establish our new performance management system. The publication of the regulation, which followed a public comment period, set forth our structure for measuring organizational and employee performance.

At the strategic level, our measures are designed to gauge overall performance on accomplishing the mission and strategic goals. This level is meaningful for the IRS as a whole, or for those parts of it that are responsible for providing a full range of services to large sets of taxpayers.

We began identifying specific strategic measures in FY 2000 and will refine and finalize these measures in FY 2001. Experience has shown that the development of good performance measures is an evolving process that improves with time. Accordingly, we anticipate there may be changes to the specific measures. We expect, however, that the strategic intent behind these measures will remain firm.

At the operational management level, our measures are focused on successfully executing our core business functions within the organizational units. At this level, we derive the balanced measures of organizational performance as follows: customer satisfaction, business results and employee satisfaction. This can be easily contrasted with measuring at the individual level.

All quantitative measurements assess organizational performance, not individual performances. It is impossible to capture in any quantitative measurement system all that is important in evaluating an individual. As of January 2000, we redefined the system for setting and measuring performance expectations for nearly all managers and executives to align with the balanced measurement system.

For front-line employees, we do not use quantitative measurements to evaluate performance, except in certain submissions processing functions. In most cases, it is not practical to quantify the performance of an individual employee in a meaningful and appropriate way. Instead, we incorporate the desired activities and behavior consistent with the strategic goals into the "critical elements" of each employee's position description.

We began to implement the balanced measures system at the operational level in 1999, starting with the three functions, Customer Service, Examination, and Collection, that most directly affected large numbers of taxpayers and employees. We implemented the operational measures for these functions within the existing organizational structure and have now transferred these measures to the new organization.

Since that time, we approved additional balanced measures for Large and Mid-Size Business, Tax Exempt and Government Entities, Taxpayer Advocate Service, Information Systems, Criminal Investigation, Appeals, and for additional Submission Processing and Customer Service product lines within the Wage and Investment and Small Business/ Self Employed Operating Divisions. We have slated balanced measures for the remaining organizational units for approval in fiscal year 2001. In the interim, we are using 64 indicative measures and workload indicators in our annual performance plan as we complete our measures development.

However, we still have work to do. We must agree on a final set of Agency-wide strategic measures and then begin implementing a comprehensive suite of strategic measures covering all taxpayer segments. Most importantly, we must continue to learn how to use balanced measures as a tool to achieve a high level of performance for all three of our strategic goals.

Development of the balanced measurement system and, even more so, learning the new ways of working will take years. By focusing our attention on what is important for achieving our strategic goals, we will stay on the right path and continue our progress.

APPENDIX E – BUSINESS SYSTEMS MODERNIZATION PROJECTS

The Business Systems Modernization Organization (BSMO) has now identified all the major initiatives for the next several years that link directly to our major strategies. Moreover, BSMO defined the major dependencies between and among projects and created a sequencing plan for their initiation, development, and deployment. It has also estimated the costs associated with each initiative and developed multi-year spending estimates consistent with this program. It now has a strategy for achieving the major goals of business systems modernization. The following are some of the key projects we will be working on during the next three years and beyond.

- **Deployment of the Customer Communications 2001 Project** – The Customer Communications Project is the first deployment of a business capability under the BSM effort. It is now in final testing before deployment in the third fiscal quarter. The IRS will greatly improve the efficiency and effectiveness of IRS' Automated Call Distributors (ACDs) and provide customer service levels on a par with the private sector. Hardware and software improvements will be made to the telephone system that is used to receive, route and answer more than 150 million taxpayer telephone calls each year. At a later date, Internet access capabilities will be added. This project will deliver direct benefits by increasing the number of calls that can be answered with available staff and will be a critical foundation element for subsequent projects, since virtually all major systems require communication with taxpayers.

- **Development of the Customer Relationship Management Exam (CRM Exam) Project** – Development has already begun. Through CRM, the IRS tackles some of the most complex tax calculations, including carryback/ carryforward, the Alternative Minimum Tax, and Foreign Tax Credit. This initiative will enhance the revenue agent's capabilities, reduce exam time, produce consistent results and reduce the burden on taxpayers who must deal with the IRS on these complex tax issues.

- **Development of the Security and Technology Infrastructure Releases (STIR)** – The design for STIR was approved and development was initiated. This project provides the essential underlying security infrastructure for the planned project deployments of the Customer Account Data Engine (CADE), Customer Communications (2002), and e-Services and Customer Account Management System. Development, testing and first release are expected in time to support the business applications projects to be deployed in 2002.

- **The Customer Account Data Engine.** (CADE) is the cornerstone of the data infrastructure. It is designed to provide a modern system for storing, managing, and accessing records of taxpayer accounts. CADE will create applications for daily posting, settlement, maintenance, refunds processing, and issue detection for taxpayer accounts and return data. The database and applications developed by CADE will also enable the development of subsequent modernized systems.

CADE is scheduled to be released in stages, beginning first with simple tax returns being moved into the new CADE system, followed by increasingly complex taxpayer returns. As more taxpayer account information is moved into the new CADE system through these staggered releases, other modernized applications will be put in place to provide the interfaces necessary for IRS employees, and affected taxpayers, to access and carry out transactions. System development, testing and initial deployment of some returns is expected to be completed during 2002.

- **Development of the Enterprise Data Warehouse/Custodial Accounting Project (EDW/CAP)** – Today, the IRS has a variety of dedicated research databases, and also uses its operational databases for operations research/analysis. The timeliness, consistency and standardization of the data in these separate systems do not support integrated analysis and corporate-wide decision making. The inconsistent and redundant data in stovepipe systems can result in inconsistent management and reporting data.

  Through EDW/CAP project, the IRS will develop an integrated enterprise data warehouse to support organizational data needs, such as those that are critical to managing our new compliance initiatives. For example, it will provide a single integrated data repository of taxpayer account and payment/deposit information, fully integrated with the general ledger. And it will identify payment and deposit information at the point of receipt. The operating divisions will be given access to pertinent revenue, assessment, disbursement, and seized asset information. In addition, it will provide the IRS with the capability to maintain financial controls over the $2 trillion of tax revenue received annually.

- The **e-Services** project will support our ability to meet the overall goal of conducting most transactions with taxpayers and their representatives in electronic format, as required by RRA 98. By 2002, the e-Services will: (1) provide the capability to register new electronic return originators over the Internet; (2) permit delivery of transcripts to authorized parties electronically; and (3) allow third parties who are required to provide certain forms 1099 and information returns to check the taxpayer identification numbers for accuracy before submission.

  An important aspect of e-Services project is that it will be one of the first projects to provide a practical and limited application to define and test the design of our critical security infrastructure for sending and receiving taxpayer data internally and externally.

- **Customer Account Management (Individual Assistance and Self-Assistance Operating Models).** In today's environment, taxpayers are often unable to receive timely and accurate responses to requests and inquiries. These operating models will provide improved technology and business processes that will enable the IRS to: better manage customer service functions; maintain and utilize customer data to improve taxpayer interactions with the IRS; provide comprehensive account and tax law assistance to taxpayers and practitioners; and manage the case work flow of customer inquiries. There is a separate release strategy for each of the operating models based on the customer segment that benefits the most from the new capabilities.

- **Tax Education (Direct and Indirect) Operating Models.** These models address improving business processes and operational systems within the pre-filing business area (*i.e.* before a return is filed). In the past, there has been minimal investment in pre-filing activities, such as making educational materials, information and forms more readily available. With the organizational modernization, pre-filing activities will become more prominent. The Tax Education Operating Models will help taxpayers reduce or eliminate errors before they become compliance problems by developing proactive and targeted educational materials that are available 24/7 in various formats from web-based products to published documents. Utilizing third-party partnerships, the IRS will develop and make available in plain language reliable educational information, guidance and advice.

- **Individual Assistance Operating Model for Reporting Compliance.** The current compliance environment has produced a number of problems, such as extended cycle times, reduced coverage and decreased customer and employee satisfaction. This project will have a significant impact on the present Reporting Compliance operational environment by providing: (1) robust, issue driven compliance planning that utilizes outcome-based improvement to ensure fair and effective selection of cases; (2) highly automated decision engines for risk-based case selection, treatment assignment and resource allocation to decrease cycle time; (3) electronic case files with pre-identified issues to support productivity gains and increased coverage; (4) case working tools, workflow management and remote access to critical data; and (5) new technology and processes to establish collectability, secure payments and facilitate payment agreements at the closure of cases.

- **Filing and Payment Compliance Operating Model**. This is an end-to-end strategy to resolve collection issues quickly and fairly. It augments, refines and replaces existing processes and technology to enable the IRS to interact with taxpayers in a seamless and efficient manner. Protection of taxpayer rights at all times is an important component of this strategy. Taxpayers who are able to resolve their cases with no direct IRS contact are provided various self-correct options. Field or Collection Call center staff will assist taxpayers who need help to resolve their delinquent tax cases. They will have access to real-time data to ensure that appropriate actions are taken and taxpayer rights are protected. The operating model will decrease cycle time to approximately six months.

Chairman THOMAS. Thank you very much, Commissioner.

There are a lot of questions that can be asked, and my hope would be that, given the limited time that we have, both for the questioning and the response, that, where appropriate, we could get written answers so that we can more fully appreciate the positions that are taken.

Commissioner ROSSOTTI. Yes, sir.

Chairman THOMAS. I applaud you for going right back in and examining legislation. One of the things I hope we do not do in this particular relationship is stick to whatever posited goals or results we thought we could get prior to actually getting in and looking at the situation, and then having a series of hearings in which basically not enough money has been funded and that the rationale for not meeting whatever percentage you throw on out, the 80 percent of electronic returns, for particular reasons, and never going back and examining the goals that were originally established to determine whether or not they were realistic.

I think this effort is one in which I wouldn't mind at all reviewing the previously stated goals, examining them to determine whether or not they were really realistic in the light of what we know now, and adjusting them so that we can have some measurable but achievable objectives. I have been through too many of these review hearings in which there is a failure to communicate in terms of "it's not our fault" and "these are the reasons why." The reasons why are almost always not enough money.

We can posit at the beginning there is never going to be enough money. What I want is a clear understanding of priorities within the amount of money that we have. What goals are achievable? What goals are not achievable, and where we need to adjust those goals so that neither one of us is frustrated at the next review and we repeat that cycle over and over and over.

So in the brief time that I'm able to stay on top of shepherding this legislation, I would be very much concerned in creating a goal structure which is achievable upon agreement and, where we fail, we analyze why we failed and readjust our goals.

In that light, Commissioner, what goals that were established initially do you believe are either not realistic and that you would like to reexamine adjustment of those, and what would be that readjustment? I know my time is brief, so that if you want to follow up with written statements, I would be more than willing to accept that.

Commissioner ROSSOTTI. Mr. Chairman, first of all, I really welcome the way that you phrased that. I think we do have three years of experience now with this Act. We have learned a lot. I think there are, as I mentioned in my statement, some modifications to some provisions.

I would say, though—and I will follow up——

Chairman THOMAS. If I might, just on those items that you mentioned, most of those are fine-tuning and adjustments from a management point of view.

Commissioner ROSSOTTI. Right.

Chairman THOMAS. Most people who will be concerned about achievement of goals are looking at those broader interactions between the government and the individual and the follow up. For example, the initial statement of the Chairman of the Finance Committee, the larger picture goals, whereby we're measured, if not by each other, at least by the press.

Commissioner ROSSOTTI. Yes, and let me go directly to that. I will follow up with a more lengthy written statement, because I think it's an extremely important question you have asked.

But to summarize it this way, my personal belief—and I really took this job because I believed in the goals that were set in this Act—I believe that those goals, in the broad sense, are achievable. I guess I would describe them as being able to satisfy the reasonable expectations of the average taxpayer and how they deal with the agency, while still collecting the tax. I mean, those are the two basic goals, and the Act sets forth a lot of specific ways that that's supposed to be done. Most of them, by the way, are not quantitatively set forth in the Act, with the exception of the electronic filing goal. So I think we can achieve those goals.

I will say there's been skepticism by many parties about whether there was some conflict inherent in tax collection that you couldn't treat people correctly and protect taxpayers' rights and still be effective in tax collection. Notwithstanding the difficulties, my belief is that it can be done. It is, however, a process that is going to take some time.

I think the main issue that I would comment on is the question of time. I believe that if we sustain this effort over a period of another three, four, five years, I believe we will be able to raise the agency's performance very, very significantly.

Now, some of the items in the bill that were specifically designed for the protection of taxpayer rights and setting forth certain procedures, we have found costly and difficult to implement. We have some suggestions about how to modify those. By the way, those don't involve any money. They just involve ways of improving.

Let me finish with just a comment about the money, and I will give a more detailed written statement. I believe that if we were to attempt to meet all the goals broadly defined in the Act by continuing to do business—I'll call it "the same old way"—it would be extraordinarily expensive. There would be a requirement to add very significant numbers of staff to answer phones and collect debts, the way it's been done, and to do many other things that are required.

We have not proposed that kind of a plan. What we have proposed are some limited increases in the operational resources and some significant investments in modernization. Modernization encompasses especially the computer technology, but also the ways of doing business.

So my proposal is that we achieve those goals over a period of time by investing and improving the way we do business, primarily, rather than simply throwing money at the problem, to make everything bigger and address all the problems. That does mean we have to tolerate some deficiencies for a period of years as we gradually proceed towards our goals.

Chairman THOMAS. I thank the Commissioner.

My concern will be that we evaluate periodically the goals, and that where they were overly ambitious, we refocus them so that the hearing would be on supposedly achievable goals, those we've met and those we haven't, and why we haven't, and how we have adjust those goals to reach achievable goals. To me, that's the only way we can move forward in this extremely difficult and complex area.

We can beat each other up any day of the week over any one of these points that we're trying to deal with. The intent of Congress in providing this structure with the Oversight Board was to, in fact, move forward on achievable goals. I look forward to the written follow up on those statements.

The gentleman from Iowa, the Chairman of the Finance Committee.

Senator GRASSLEY. First of all, I want to acknowledge that I appreciate very much your opening statement, where you talked about possible changes that will increase IRS productivity.

Do you agree that we can achieve both the protection of taxpayers rights and improve IRS productivity?

Commissioner ROSSOTTI. Yes, Mr. Chairman, I do. I think that's the sort of crystallizing question of the Reform Act. I have to say that I wouldn't be sitting in this chair if I didn't believe that. That's why I really took this job.

I don't think that it's an easy thing to do, because there is a propensity to view those goals as being either/or. Either you provide good service and protect rights, or you collect money. It's my belief that you do both. One of the main reasons is that most taxpayers are honest taxpayers.

I do think, as I have said in here, there are some taxpayers who are taking advantage of some—I'll call them loopholes—in the way some of these provisions are written, and I believe if we could work together with Congress to make some adjustments in those, we can eliminate that problem. But I consider those more fine-tunings of how the process works than anything that would be a deviation from the basic direction that the Congress set in the Restructuring Act.

Senator GRASSLEY. Ways and Means and the Senate Finance Committee recently received a major report from the Joint Tax Committee on simplification of the Tax Code, with 150 suggestions, and I think the people doing the study would characterize this as obviously not necessarily an easy simplification, but simplification that is very obvious and not going in the direction that a lot of people would suggest simplification of throwing the Tax Code out and starting over.

But based upon that study, and whether you know all 150 recommendations or not, my question would be very general to you. How much will simplification of the Tax Code make the IRS' job easier and within the general approach of the study that was given to us?

Commissioner ROSSOTTI. Yes, Mr. Chairman, I have had a chance to read—I have to say I've read the executive summary. I haven't read all the three volumes yet. But I thought it was a very excellent layout. Some of these points have been made by others, including our own complexity report, and yes, they would definitely make our job easier.

I think what might be even more important is that they would make the taxpayers' job easier, because we do need to remember that for every dollar that the IRS spends on its administrative budget, taxpayers spend somewhere between 10 and 20 times that amount of money—and, by the way, we're getting a good study of that number and we'll give it to you when we have it. But it is much greater. The taxpayers, in terms of their own time and the money they outlay to practitioners, is very great.

I think that if the recommendations that were in the Joint Committee report were adopted, many of them, they would definitely reduce that burden on the taxpayers and would also make the IRS's job easier.

I can give you a practical example. We strive mightily to answer questions that taxpayers pose to us over the telephone. During the filing season, we get about 100 million questions, or calls. Many of them, about 30 percent of them, are questions about the tax law. Some of those can be quite complex to answer, even though they seem simple. Like if you ask the question, "Can I take my niece or nephew as a dependent", it seems like a fairly straightforward question. When you penetrate down, you find that there are a lot of sub-questions that you have to ask. In the Joint Committee report, they laid that out pretty carefully. And then you go on and on into the alternative minimum tax and all these other things.

If those provisions were changed along the lines of what the Joint Committee said, I believe that it would reduce the burden on taxpayers and simplify the IRS's job.

I do need to point out a qualification. A lot of what the IRS does is not so much keyed to the specific provisions of the Code, as just the process of collecting and processing and following up on two trillion dollars. When you have that many transactions, there's a lot of work to do. Even if the Code was simpler, there is a lot of work that has to do with the processing and the accounting and the follow up for people who don't pay in full and all those sorts of things. So that part of it would not be changed. But the actual filling out of the returns and the accuracy of the returns would probably increase significantly.

Senator GRASSLEY. My time is just about up.

My last point would be—and your response may be short now, but I would encourage you to write longer answers in your reaction to my comments in my opening statement, particularly the misuse of the Internet and just to put things in perspective, so that you don't think we're just looking at the IRS.

Within the last short period of time, I have heard about employees at the U.S. Department of Agriculture watching soap operas all afternoon. So we have a major problem throughout government here. We aren't just looking at the IRS. But we do have the IRS Inspector General speaking to these, and I would think that would be an authoritative voice within the Treasury on this issue.

Commissioner ROSSOTTI. There is no question that the Internet, as he said in his report, is a tremendously powerful tool that we want to give to our employees, because they do use it to look up information that they need to process taxpayer cases. But, of course, it is difficult.

Even in business, I remember in my previous firm we had an issue and people had access to the Internet, and some people would use it for nonbusiness uses. It is hard to filter those things.

Since that report was done, we have put some additional policies in place, but I will concede that it is a challenging issue, the use of the Internet, and making sure that it's used for business purposes. Of course, ultimately, it's a management issue. We need to have our managers making sure they understand what our employees are doing and following up on that.

Could I comment on your other one, on the financial statements, Mr. Chairman, because that was your other opening point?

We have been working very hard on these financial statements. I think you know that, for the first time ever, the IRS did get a clean opinion. It did require a tremendous effort. Most of that effort was actually put in by IRS employees who were working very hard, as was the GAO, by the way, they were working very hard with us, and we did have some support from our contractors.

Many of the things that were done in fiscal 2000 to get that clean opinion were not limited to getting the statements done for that year. They have also been aimed at making the process better for next year. What we are basically doing is having a plan year-by-year to make that process more efficient, so that we will continue to get a clean opinion. But we will also do it in a more orderly way and in a more systematic way.

Part of the solution does involve upgrade of the computer systems. We are using very, very old computer systems to process data, about two trillion dollars worth of tax money. That is not the only problem, but it is certainly at the root of many of the problems having to do with our accounting and financial management.

Senator GRASSLEY. Thank you.

Chairman THOMAS. I thank the Chairman.

I would just tell the Commissioner that his last statement is one I'm concerned about, because we're slipping back into the argument that the reason we aren't able to do something is because of a well-known fact when we began the process of reform. We need to factor in when and how we update computers to address the problems that we see, rather than to simply state that our computers aren't up-to-date.

It has been a decade-long attempt, and will be an additional decade-long attempt. I would rather create measurable milestones to determine whether or not we're moving in the direction that we need to move.

Commissioner ROSSOTTI. Yes, sir.

Chairman THOMAS. I thank the chair.

Does the gentleman from New York, the Chairman of the Oversight Committee of Ways and Means, wish to inquire?

Mr. HOUGHTON. Yes, Mr. Chairman, I would.

First of all, thank you, and also, Commissioner Rossotti, thank you very much for being here, and thanks for the job you're doing for the IRS and for the country.

You quoted in your testimony something about Alfred North Whitehead, who was sort of a hero of mine, about producing change amid order and order amid change.

It seems to me that you've got two issues here. One, you have the short-term issue of trying to fulfill the objectives that you set out and the IRS is required to produce in terms of its everyday activities. The other thing is long term, the business systems modernization program.

Where should we be most concerned? With both, or with one of those?

Commissioner ROSSOTTI. Well, I think we have to pay attention to both of them, Mr. Chairman. I think the most difficult challenge that we have—and it really goes exactly to what Chairman Thomas said—is that we have to operate every year. We have to do a filing season; we have to make progress. And yet, we know we're not going to reach fully the goals that we are striving for until we've made some more fundamental changes, and especially in the computer systems. So I couldn't agree more with the Chairman's approach.

I think we need to make step-by-step progress in both service and compliance at the same time we're performing these more fundamental issues. That is really the most difficult thing about this whole job. I mean, I often joke that if we could just shut down the IRS for two or three years and rebuild the systems and start over, it would be an easier job. Of course, that's not practical or possible. So we have to do both at the same time.

That's really what our whole plan attempts to do. We try to balance long-term progress and short-term progress at the same time.

Mr. HOUGHTON. Yeah, but where's the biggest problem?

Commissioner ROSSOTTI. What is the biggest problem? The biggest problem is really trying to do them both at the same time. I think that is really the most challenging problem, balancing——

Mr. HOUGHTON. But this happens in any business. It happens in any institution. You don't shut down a business that has problems.

Commissioner ROSSOTTI. Right.

Mr. HOUGHTON. You try to fix them and then look forward to the future. But it would seem to me that one of the reasons that you came into this job was to do this very basic systems modernization program.

Commissioner ROSSOTTI. Right.

Mr. HOUGHTON. Is this something we should be concerned about? Is it on track?

Commissioner ROSSOTTI. Well, first let me say that I think, no matter what else we do, if we don't succeed in the business systems modernization program, we will never reach the goals that the Congress has set, because the thing that is unique compared to other businesses, Mr. Chairman—yes, all businesses have these problems—but I don't know there's any large business that I was ever aware of—and I was in it 28 years—that got this far behind in its systems. Because if they were that far behind, they would have been acquired by a competitor or someone else. So it's really a unique situation. This, I believe, is honestly an accurate situation, that we still have——

Mr. HOUGHTON. Maybe we should sell it to the Bundestag or something like that.

Commissioner ROSSOTTI. That's what makes it unique. Every business has to upgrade its systems, but not in the extreme that we have. So it is absolutely essential, and it is a risky situation.

Are we on track? I believe that we are making progress. I think, if you get your testimony later from GAO, you will note that they see some weaknesses still, some improvements that we have to make in our management capacity—and we are fully in accord with that.

What we are doing is trying to build our management capacity, our ability to manage this really complex program. At the same time we make progress in the program, we can't just make progress in management without actually applying that to real work. Every once in a while we make adjustments, you know, in the speed with which we go forward, or the speed with which we, in some cases, slow down a bit, to make sure our management is caught up.

But I believe that in the less than two years we've been in this, we have done some very significant things. Over the next few months we will be delivering our first actual operational projects, that will improve business results this year. We have put a program management office in place that has put in some discipline procedures. They're not fully at the level we would like, but they have matured a great deal. We have laid out a long-term plan in architecture, and there's more work to be done. But it is dramatically more substantial than it was even six months ago. And we have, over the next 18 months, a significant amount of additional practical results that we hope to deliver. I think that's quite a bit.

So are we on track? I believe we are on a positive path. I think we can succeed. Have we addressed every issue? No, we have more work we need to do in terms of management and organization.

Mr. HOUGHTON. In other words, you have not lost confidence in the opportunity for doing these things you wanted to do in the first place?

Commissioner ROSSOTTI. I have definitely not lost confidence. While I often say this is a very risky program, I sometimes have to correct a misimpression I give, that I'm saying I think it's going to fail, that it's not going to work. I don't believe it's going to fail. I believe it's going to succeed. I believe it is succeeding, but not without twists and turns in the road and, you know, occasional delays. Our management responsibility is to adjust to those as quickly as possible and not let them get too far off track before we correct any problems we find.

Mr. HOUGHTON. Thank you, Mr. Chairman.

Chairman THOMAS. I thank the gentleman.

Does the gentleman from Pennsylvania, Mr. Coyne, wish to inquire?

Mr. COYNE. Thank you, Mr. Chairman.

Commissioner, what is the administration's position relative to the Oversight Board's recommendation of a $10.3 billion funding for fiscal year 2002?

Commissioner ROSSOTTI. Well, I think the administration's position is reflected in the President's budget request, which lays out the specific budget—I believe it's $9.276 billion, if I have the number correct—that is requested. So, obviously, there are some difference between that number and what the Oversight Board has suggested.

Mr. COYNE. Is that going to result in some diminution of service as a result of not getting the request that the Board wanted?

Commissioner ROSSOTTI. Well, as in any agency that has pressing needs, if we had more resources, we could do more in terms of delivering service and perhaps moving some of the modernization forward more quickly. But I believe that, with the budget that the administration has proposed, we will be able to continue to make progress on our operations as well as on our modernization program. I think those are the twin things that we really need to do in this agency.

Mr. COYNE. Well, in future years, when the Oversight Board comes and makes a recommendation for a budget, are they going to be taken seriously in the recommendations they make?

Commissioner ROSSOTTI. Well, I hope so. One thing to note is that the Oversight Board was getting in business at the same time the new administration was getting in business. It was a very short period of time for the administration to put the budget together. There were conversations, but I think it was a limited period of time.

I know Mr. Levitan is going to testify later, and I'm sure he'll be able to comment on his views on that. But I think we all have a goal of making this process work cooperatively between the IRS, the Oversight Board, and the administration.

Mr. COYNE. But one could make the case that, without the funding that they recommend after a close examination, that some of the services will not be provided?

Commissioner ROSSOTTI. Certainly, I mean, if we had more funding, we could accelerate the improvement of service.

Mr. COYNE. Thank you.

Chairman THOMAS. Thank you very much, Commissioner.

With that, we will ask our next panel to come forward, the Honorable Larry Levitan, the Chairman of the Internal Revenue Service Oversight Board; the Honorable David C. Williams, Inspector General, Tax Administration, U.S. Department of the Treasury; and James R. White, Director, Tax Issues, U.S. General Accounting Office.

Thank you, gentlemen. Any written statement you may have will be part of the record, and you may address us in any way you see fit in the time that you have.

I will start with Chairman Levitan and then move across the panel.

OPENING STATEMENT OF LARRY R. LEVITAN, CHAIRMAN, IRS OVERSIGHT BOARD

Mr. LEVITAN. Chairman Thomas, members of the committee, I appreciate the opportunity to appear before you today. I am proud to represent the IRS Oversight Board and to discuss our role of improving the operations of the IRS.

I would like to take this opportunity to also recognize two other Board members that are here, Steve Nichols and Chuck Kolbe.

Mr. Chairman, one obvious but powerful way to summarize the challenges the IRS faces is to tell you what the IRS is failing to do. The IRS is not meeting any of the three strategic goals and objectives defined in its own strategic plan:

The IRS does not provide top-quality service to each taxpayer in every interaction. For example, phone calls frequently go unanswered and notices to taxpayers are often difficult to understand.

The IRS does not provide top-quality service to all taxpayers through fair and uniform application of the law. For example, the level of audits and other enforcement activities have fallen to an unreasonably low level.

The IRS does not provide productivity through a quality work environment. Because of outdated technology, the work environment is completely inconsistent with efficient and modern practices.

These problems are well understood by Congress, by Treasury, and by the IRS. They were the subject of congressional hearings and led directly to the IRS Restructuring Commission and the passage of the IRS Restructuring and Reform Act of 1988. The passage of RRA '98 was landmark legislation that pointed the IRS in a new, long-overdue direction. The IRS oversight Board believes that with this legislation in place, with new management on the job, with a modernization program back on track, the IRS is on the right course now, but much work still remains in order to turn around years of neglect.

Mr. Chairman, as you know, one of our statutory responsibilities is to review and approve the IRS budget each year. The statute requires the Board to submit its own budget proposal, which rides in tandem with the President's budget submission to Congress.

Much of our efforts since we went into business last September focused on reviewing and approving the IRS strategic plan and putting together a budget that supports the goals and objectives outlined by Congress. Mr. Chairman, our conclusion is that the President's fiscal year 2002 budget does not adequately support the IRS strategic plan and fails to provide enough funding for technology modernization and other vital operations.

The administration claims that their budget provides a 6.6 percent increase over 2001. While this statement is technically accurate, the Board believes it is misleading, since the IRS had an additional $256 million of available funds in 2001 in ITIA carryover from previous years. Therefore, the real, spendable, increase in the President's budget is 3.4 percent, not 6.6 percent.

The IRS Oversight Board reviewed the budget recommended by the President very carefully. We applied our judgment and we looked at it carefully and independently. To illustrate our budget recommendations, let me quickly outline a number of the major differences between our budget and the President's budget.

The Board recommends full funding of the STABLE program that will end a decade-long reduction of IRS personnel and provide approximately 3,800 new employees to improve service and enforcement capabilities. The administration also claims to fully fund STABLE. This statement is also technically accurate, but misleading. While the STABLE line item in the budget is fully funded, the President's budget eliminates funding for $137 million of real costs that the IRS will have to fund by eliminating approximately 1,300 positions.

The Board recommends an expenditure of $54 million to start to replace out-of-date laptop and desktop computers that will not support the new software—that is available today and improving daily—that will improve security and make IRS employees more effective. The President's budget provides no funding for this program. It makes no sense to the Oversight Board to spend hundreds of millions of dollars on new software and then not provide the necessary computer equipment to run the software.

The Board recommends providing the ITIA with an additional year of expenditures, $550 million for 2003, to ensure that projects that cross fiscal years will not have to experience inefficient delays and slowdowns. This multi-year funding of the investment account was part of the original strategy for the fund, and this will be the first year since the fund was set up that it will drop to a zero balance. The President's budget does not recognize the importance of multi-year funding for ITIA, which the Board believes is a critically important concept.

The Oversight Board believes that the IRS is at a critical juncture. The IRS has begun an aggressive program of modernization that has the first real chance in many years to create a new and greatly improved system of tax administration and an agency that can finally provide the kind of service and responsiveness that the American taxpayers deserve.

Mr. Chairman, thank you for the opportunity to be here today. The newly restructured and modernized IRS is very much a work in progress. The IRS Oversight Board is proud of its important role in this process.

I appreciate this opportunity to report on our activities and our views on these critical matters, and would be pleased to answer any questions that you may have.

[The statement of Mr. Levitan follows:]

Testimony of Larry R. Levitan
Chairman
IRS Oversight Board
Before the Joint Committee on Taxation

May 8, 2001

Chairman Thomas, members of the Committee, I appreciate the opportunity to appear before you today and I am proud to represent the IRS Oversight Board and discuss our role in improving the operations of the IRS. As you know, the IRS Oversight Board was established by the IRS Restructuring and Reform Act of 1998.

In the fall of last year, the Senate confirmed the seven private citizen members of the Board. We held our first meeting in September of 2000 and meet for two days every two months. While we are still a new organization and still have a lot to learn, we believe that we have gained a good understanding of many of the issues and challenges that the IRS faces.

Mr. Chairman, one obvious but powerful way to summarize the challenges the IRS faces is to tell you what the IRS is failing to do. The IRS is not meeting any of the three strategic goals and objectives defined in it's own Strategic Plan:

The IRS does not *"provide top-quality service to each taxpayer in every interaction"*- for example, phone calls frequently go unanswered and notices to taxpayers are often difficult to understand.

The IRS does not *"provide top-quality service to all taxpayers through fair and uniform application of the law"* – for example, the level of audits and other enforcement activities have fallen to an unreasonably low level.

The IRS does not *"Provide productivity through a quality work environment"* – because of outdated technology, the work environment is completely inconsistent with efficient and modern practices.

These problems are well understood by Congress, by Treasury, and by the IRS. They were the subject of congressional hearings and led directly to the IRS Restructuring Commission and the passage of the IRS Restructuring and Reform Act of 1998. The passage of RRA '98 was landmark legislation that pointed the IRS in a new, long-overdue direction. The IRS Oversight Board believes that with this legislation in place, with new management on the job, with a modernization program back on track, the IRS is now on the right course. But much work still remains in order to turn around years of neglect, mismanagement, and spotty "feast or famine" funding and oversight.

To give the Committee an idea of how we have spent much of our time since being appointed this past September, let me take a few minutes to describe our analysis and recommendations on the IRS budget for 2002. As you know, one of our statutory responsibilities is to review and approve the IRS budget each year. The statute requires the Board to submit its own budget proposal, which rides in tandem with the President's budget submission to Congress. Our early meetings were focused on reviewing and approving the IRS Strategic Plan and putting together a budget that supports the goals and objectives outlined by Congress.

Mr. Chairman, our conclusion is that the President's Fiscal Year 2002 budget does not adequately support the IRS Strategic Plan and fails to provide enough funding for technology modernization and other vital operations. The Administration claims that their budget provides a 6.6% increase over 2001. While this statement is technically accurate, the Board believes that it is misleading since the IRS had an additional $256 million of available funds in 2001 in ITIA carryover from previous years. Therefore, the real (spendable) increase in the President's budget is 3.4%, not 6.6%.

The IRS Oversight Board reviewed the budget recommended by the President very carefully. We applied our collective business and professional expertise, drawn from years of managing major corporations, small businesses, and information technology programs. Let me just emphasize that we did not accept every argument offered by the IRS. We believe that it was the intention of the Congress and the President and in the interest of America's taxpayers that we operate as an independent voice in this process, that we apply our own metrics and common sense, and provide both the Congress and the President with our best, most carefully considered opinion on what we believe the IRS needs to meet its obligations to you and to America's taxpayers.

To illustrate our budget recommendation, let me quickly outline the major differences between the budget for the IRS recommended by the Board and the President's budget:

- The Board recommends full funding of the STABLE program that will end a decade long reduction of IRS personnel and provide approximately 3,800 new employees to improve service and enforcement capabilities. The Administration also claims to fully fund STABLE. This statement is also technically accurate but misleading. While the STABLE line item in the budget is fully funded, the President's budget eliminates funding for $137 million of real costs that the IRS will have to fund by eliminating approximately 1,300 STABLE positions.

- The Board recommends an expenditure of $54 million to start to replace out-of-date laptop and desktop computers that will not support new software that will improve security and make IRS employees more effective. The President's budget provides no funding for this program. It makes no sense to the Oversight Board to spend hundreds of millions of dollars on new software and then not provide the necessary computer equipment to run the software.

- The Board recommends funding the Information Technology Investment Account with $450 million during 2002 to continue the critically important technology modernization program.

This amount is based on a carefully developed plan that the Board has reviewed and strongly supports. The President's budget recommends funding the investment account at $397 million. The impact of this gap between the President's budget and our recommendation will be to slow down a critical program that is already taking far too long to complete.

- Further, the Board recommends providing ITIA with an additional year of expenditures, $550 million for 2003, to insure that projects that cross fiscal years will not have to experience inefficient delays and slowdowns. This multi-year funding of the investment account was part of the original strategy for the fund and this will be the first year since the fund was set up that it will drop to a zero balance. The President's budget does not recognize the importance of multi-year funding for ITIA, which the Board believes is a critically important concept as the IRS moves forward in developing and implementing these highly complex information systems over multiple years.

The Oversight Board believes the IRS is at a critical juncture. The IRS has begun an aggressive program of modernization that has the first real chance in many years to create a new and greatly improved system of tax administration and an agency that can finally provide the kind of service and responsiveness America's taxpayers deserve.

Mr. Chairman, I have submitted to the Committee as part of my testimony a formal report on the IRS Strategic Plan and our 2002 budget recommendation. This paper provides additional background on my remarks and I would ask that it be included in the official record as part of my testimony.

In closing, one obvious problem faced by the IRS and America's taxpayers is one I know the Congress continues to struggle with. While this problem is clearly outside the scope of the Board's responsibility, we believe the complexity of the tax code continues to create burdens to sound tax administration. As long as the tax code is as complex as it is today, the operations of the IRS and the service it provides to taxpayers will be negatively impacted.

Mr. Chairman, thank you for the opportunity to be here today. The newly restructured and modernized IRS is very much a work in progress. The IRS Oversight Board is proud of its important role in this process, providing oversight and guidance as the IRS moves toward the goal of meeting its strategic objectives, creating an IRS which truly provides top-quality service to America's taxpayers. I appreciate this opportunity to report on our activities and our views on these critical matters and would be pleased to answer any questions that you may have.

x x x

INTERNAL REVENUE SERVICE OVERSIGHT BOARD

The IRS Budget
Fiscal Year 2002

ANALYSIS AND RECOMMENDATIONS

Interim Report
Spring 2001

The IRS Budget
Fiscal Year 2002

ANALYSIS AND RECOMMENDATIONS

Interim Report

Spring 2001

Table of Contents

Executive Summary

The IRS is not meeting any of the goals and objectives demanded by Congress and American taxpayers. Service to taxpayers is inadequate, and enforcement activities have dropped to a dangerous level, giving the impression that it is easy to get away with cheating. The agency's computer systems are completely outdated, while the number of IRS employees continues to drop while the workload increases.

The IRS does not *"provide top-quality service to each taxpayer in every interaction."*

The IRS does not *"provide top-quality service to all taxpayers through fair and uniform application of the law."*

The IRS does not *"provide productivity through a quality work environment."*

The newly created IRS Oversight Board studied this situation carefully for the past five months and is recommending a budget that supports the creation of a new IRS that is able to provide the kind of taxpayers' service that is demanded.

This situation is well understood by both Congress and the IRS. An aggressive program to address these issues has been developed and significant progress is being made. This program embodies short-term improvements that will immediately improve service to taxpayers and a longer term modernization program that will create a new, better and more efficient IRS.

The IRS Oversight Board's recommended 2002 budget, which is 8.9% higher then the Administration's budget, fully supports this program of modernization and improvement. **The Administration's 2002 budget does not adequately support the IRS Strategic Plan and provides inadequate support for technology modernization.**

The Board's recommendation allocates resources into services to benefit more taxpayers more quickly. It calls for a modest increase in operations and a substantial longer-term investment in modernization and improvement.

- The operations budget is directly linked to the strategic goals of the IRS and represents a 6% increase over FY'01. About 25% of the budget is dedicated to providing better service to each taxpayer, such as making filing easier, and providing prompt, professional taxpayer service. Forty percent of the budget is focused on providing quality service to all taxpayers, particularly on ensuring fairness of compliance. About 36% percent of the budget is designed to achieve productivity through a quality work environment.

- The Board believes that an important initiative included in the operations budget is full-funding for the Staffing Tax Administration for Balance and Equity (STABLE), begun in 2001.

- The IRS Oversight Board is concerned that for the first time, the Information Technology Investment Account (ITIA) will have a zero balance by the end of Fiscal Year 2001. This is a dangerous situation that could result in projects being inefficiently stopped and started or unnecessarily slowed down.

- The $1 billion recommended appropriation for Fiscal Year 2002 represents a plan to release $450 million in 2002 and $550 million in 2003. The Board believes that funding the ITIA with two years of planned releases ensures that the program can move ahead as planned, without inefficient slowdowns or stops and starts.

I. Introduction

The IRS Oversight Board was established by the IRS Restructuring and Reform Act of 1998 with three primary objectives:

- Strengthen governance through independent oversight;
- Provide continuity through five year staggered terms; and
- Bring business-oriented input to the agency's operations.

During 2000, the seven private citizen members of the Board were nominated by President Clinton and confirmed by the US Senate. The Board was sworn in and held its first meeting in September, 2000. Since then, the Board has met every two months. Since September, the focus of the Board's activities has been:

- Learning more about IRS operations;
- Reviewing and approving the IRS Strategic Plan;
- Developing a recommended IRS budget for Fiscal Year 2002;
- Actively participating in the evaluation of candidates for the Taxpayer Advocate position and advising the Secretary of the Treasury on this appointment;
- Participating in the selection of a new Chief Information Officer; and
- Beginning to build a professional staff for the Board.

The Board also established three committees that focus on the important areas of:

- Modernization
- Personnel and Organization
- Performance Management

In March of this year, the Board held its first public meeting and heard statements from groups that regularly work with and advise the IRS. The Board asked for the groups' views on the IRS' Strategic Plan and the 2002 budget recommended by the Board.

While the Board is a new organization and has much to learn, it has gained a good understanding of many of the issues and challenges that the IRS faces.

The Board is required to report annually to the President and Congress on its activities, findings and recommendations. The Board decided to prepare this interim report to provide our perspective on important decisions that will be made over the next few months on the IRS 2002 budget.

II. IRS Problems

The IRS is not effectively and efficiently serving the needs of American taxpayers.

The problems faced by the IRS are too numerous to list. The Board is aware that it has not yet identified all of these problems, even though the Commissioner and other senior executives have been very forthcoming in discussing many important issues. Some of the more pressing issues that have come to the Board's attention:

Despite management focus and certain improvements, customer service is still inadequate.

- Approximately 35% of the calls made to the IRS for assistance are not answered.
- Many customer service representatives do not have the training or do not have access to the right information to respond to more complex questions.
- Many of the walk-in customer service centers are only open during hours that most people are at work and require taxpayers to come in to the centers to make appointments.
- Notices to taxpayers are frequently unclear or difficult to understand.

The level of enforcement activities has fallen consistently for many years, raising questions about tax compliance and fairness to the vast majority of citizens who pay all their taxes.

- The level of virtually all enforcement activities (levies, liens, installment agreements) has dropped dramatically since the mid-90's. There is no question that congressional hearings and certain portions of the IRS Restructuring and Reform Act of 1998 had a chilling effect on the IRS, despite no desire to reduce necessary and appropriate activities.

- Audits, and in particular, field examinations, have also declined dramatically. The coverage rate in 1997 was .65% and by 2000 it had dropped to .23%, a 64% reduction. While many tax returns are checked using computerized methods, audits are the only way to verify many items on tax returns, particularly for high-income taxpayers.

- The IRS has not been able to measure reporting compliance since 1988. It is not clear what percentage of taxpayers are making honest mistakes on their tax returns or how many are attempting to cheat. The approach used to measure this important factor prior to the late-80's was considered to be too time consuming, inefficient and intrusive. In the meantime, no other measurement technique has been put in place to determine this critical factor of compliance effectiveness.

The IRS computer systems are outdated, resulting in a work environment that is completely inconsistent with efficient and modern practices. Many of these systems were developed more than thirty years ago. Not enough data is captured from the tax returns, and the databases are inconsistent and certainly not up-to-date. This limits the ability for service personnel to adequately respond to taxpayer questions or efficiently perform other critical tasks.

IRS employee morale and job satisfaction are not adequate.

After meeting with IRS employee groups, the Board found that:

- Many employees believe that they are performing tasks that are inconsistent with their experience and skill level.
- There is a general belief that training is inadequate and often inappropriate.
- While they see many changes, some employees have little confidence that the changes will continue or have any real impact. A "this too shall pass" attitude is not uncommon.

The number of IRS employees has declined for the past decade. During this period, headcount has declined 17 percent while the workload has increased significantly by any measure. This has affected almost all of the other issues the IRS faces; particularly those discussed above.

III. Progress & Direction

In 1997, Congress began holding public hearings focusing on the IRS' performance. The agency was sharply rebuked for failing to serve taxpayers fairly for many years and for many reasons, ranging from poor management to a faulty method to measure success.

Congress created the IRS Restructuring Commission to establish a plan of improvement and create legislation to address these issues. Other organizations shared their views on ways to rebuild the IRS, with a focus upon taxpayers' rights and needs. The following year, the IRS Restructuring and Reform Act of 1998 was enacted into law.

The passage of RRA '98 was an important step in pointing the IRS in the right direction. Since then, the IRS has reorganized and many changes have been made in the administration of the tax code to protect taxpayers' rights. The most important changes include:

- Interaction between the IRS and the American taxpayers was put on a fairer footing.
- A five-year term was established for the Commissioner of the IRS, providing for improved continuity of leadership.
- The IRS Oversight Board was created to strengthen governance, provide additional management continuity and establish independent, business oriented input to the agency's operations.

In addition, operational changes at the IRS are addressing many issues facing the IRS:

- During 1999 and 2000, the IRS was reorganized from a geographic structure to one built upon specific taxpayer needs. This should provide the basis for building more specialized skills and improving service.
- Steps were taken to improve the rights of taxpayers, including:
  - ✓ The Office of the National Taxpayer Advocate was strengthened.
  - ✓ New rules and regulations was put in place.
  - ✓ IRS employees received extensive training.
- The organization was strengthened by bringing in new managers from private enterprise and other government agencies.
- During 2000, the IRS drafted its first Strategic Plan in many years. This plan establishes a blueprint and a sequence of steps to operate and improve the agency over the next five years. The Fiscal Year 2002 budget request was developed to support this plan.

- Steps have been taken to improve the communication and relationships between the IRS and Congress, the Treasury Department, GAO and other public stakeholders.

- For the first time, the IRS received a clean opinion on their FY'00 financial statements from the GAO.

- An aggressive program to dramatically increase the level of electronic filing was put in place and is showing real results. A well-designed web site to support both taxpayers and tax return preparers is in place and is one of the most widely used sites on the Internet.

The technology modernization program was started in 1997 and real progress is evident.

- The entire IRS leadership team is fully engaged and has taken ownership of this program.

- The program was designed to include not just new technology but improved business processes and new skills for IRS employees.

- A management governance program was put in place to help ensure that appropriate decisions are made at the right time by the right people and that funding is effectively managed. In addition to IRS management, this program includes GAO, OMB and congressional oversight.

- A new business system modernization blueprint that defines what work will be done was approved this year and provides a sequenced plan for the entire program.

- A systems development life cycle methodology was put in place to support and link governance of the program and how the work is conducted.

- Technology management was consolidated under the leadership of a strong CIO with extensive and relevant private sector experience.

- A technology consolidation program was recently completed, reducing the number of data centers and mainframe computers. In addition, steps are underway to standardize the technology infrastructure across the entire agency and to improve data security.

IV. The IRS Strategic Plan

During this past year, the IRS has spent a significant amount of time and effort developing a Strategic Plan for Fiscal Years 2000-2005. The plan, which was released in final form in February 2001, provides a logical and thorough road map for how the IRS will go about improving its operations and the services it provides to the taxpayers of this country. The IRS received input and assistance from its many stakeholders in completing the plan. The IRS Oversight Board, as required by the IRS Restructuring and Reform Act of 1998, thoroughly reviewed the plan. The Board discussed it at two Board meetings and approved it on January 30, 2001.

The plan attempts to address the many concerns expressed by taxpayers, Congress and numerous organizations that work with the IRS. It defines an approach for creating a new IRS that supports and serves all taxpayers as well as ensuring that all appropriate taxes are collected. This is embodied in the new IRS mission statement:

> *Provide American 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.*

In support of this mission, three broad strategic goals were formulated:

- *Top-quality service to each taxpayer in every interaction*
- *Top-quality service to all taxpayers through fair and uniform application of the law*
- *Productivity through a quality work environment*

There is no argument that the IRS is not meeting these strategic goals at the present time. The plan therefore goes on to define guiding principles and major strategies for accomplishing these goals. The strategies define short-term steps that can be quickly implemented to address immediate needs. The plan also describes longer-term strategies, particularly systems and process modernization, that will take longer to implement but are necessary to create the kind of IRS that the public and Congress demand.

The IRS Oversight Board strongly supports the mission statement and strategic goals defined in the plan. Further, the Board believes that the strategies described in the plan provide a logical and appropriate approach to accomplishing these goals. Accomplishing this plan will be a long and difficult process. It will require significant work by the IRS and its advisors and contractors. As importantly, it will require the continuous oversight and support of the many stakeholders that are impacted by and work with the IRS, in particular the Administration and Congress.

At almost every well-managed business, the annual budget is fully linked and totally supportive of the long-term business strategy. This is not just "best practice," it is necessary and required practice. Unfortunately, this has not been the case at the IRS. Why? To begin with, prior to this year, the IRS has not had a strategic plan. In addition, the IRS budget has frequently been driven by short-term requirements, such as Y2K, and funding limitations that did not recognize the need to provide high-quality service to the American taxpayer. A key example is the 15 percent reduction in IRS headcount during the past decade while the workload required to serve taxpayers increased significantly.

The IRS Oversight Board's budget recommendation for Fiscal Year 2002 is directly linked and completely supportive of the IRS Strategic Plan. The recommendation allocates resources into services to benefit more taxpayers more quickly. It calls for a modest increase in IRS operations, and a substantial longer-term investment in modernization and improvement.

V. The IRS Operations Budget

The IRS operations budget should be increased to account for inflation, mandatory cost increases, normal salary increases and promotions, boosting funding about six percent over Fiscal Year 2001.

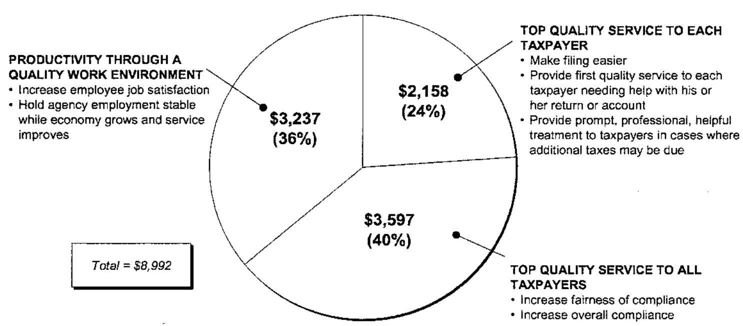
OPERATIONS BUDGET SUMMARY
(MILLIONS OF DOLLARS)

	FY2001	FY2002	% CHANGE
Operations Budget	$ 8, 497*	$ 8,992*	6%

* *Includes EITC of $145 million for FY 2001 and $146 million for FY 2002; excludes user fees*

The operations budget is directly linked to the strategic goals of the IRS. About one quarter of the budget is dedicated to providing better service to each taxpayer, such as making filing easier, and providing prompt, professional taxpayer service. This represents a substantial increase in funding over previous years. Forty percent of the budget is focused on providing quality service to all taxpayers, particularly on ensuring fairness of compliance. And, about thirty-six percent of the budget is designed to achieve productivity through a quality work environment.

FY'02 OPERATIONS BUDGET TO IMPROVE CURRENT SERVICE LEVELS
(MILLIONS OF DOLLARS)



The best way to understand how the IRS operations budget is linked to its strategic goals is to analyze changes between years. The Fiscal Year 2002 budget significantly shifts resources and funding to activities that provide quality service to each taxpayer. Specifically, pre-filing services (such as taxpayer education and walk-in sites) and filing and account services (including phone customer service) are increasing by approximately 13 percent over Fiscal Year 2001 levels. The Boar believes that resources should go where taxpayers need help.

The budget for compliance activities, shared services, and information systems programs are increasing at five to seven percent. These activities support the IRS' efforts to provide fairness in compliance, and in making improvements in productivity and quality in the workplace. Finally, several areas decreased or have below average increases. These include general management and administration, research, statistics of income and tax return processing. Increases in electronic filing is driving certain budget decreases, while simultaneously helping to improve the quality of service that the IRS provides taxpayers.

The Board believes that an important initiative included in the operations budget is full-funding foı the Staffing Tax Administration for Balance and Equity (STABLE), begun in 2001. These funds wi allow the completion of the hiring of approximately 3,800 staff and will enable the IRS to begin addressing the decline in taxpayer service, audits, and other compliance programs that have occurre during the past few years.

CHANGES IN OPERATIONS BUDGET FROM FY'01 TO FY'02

CHANGE IN BUDGET	DESCRIPTION	% CHANGE (FY'01 TO FY'02)
SIGNIFICANT INCREASE	• Prefiling Services ① • Filing & Account Services ①	13%
AVERAGE INCREASE	• Payment, Filing & Reporting Compliance ② • Shared Services Programs ③ • Information Systems Programs ③	5 to 7%
BELOW AVERAGE INCREASE OR DECREASE	• General Management & Administration ③ • Research & Statistics of Income ③ • Tax Return Processing & Information Reporting ①	(2%) to 4%
Overall Change in IRS Operations Budget		**6%**

STRATEGIC GOALS
- ① *Service to each taxpayer*
- ② *Service to all taxpayers*
- ③ *Productivity through a quality work environment*

FY'02 OPERATIONS BUDGET DETAIL
(MILLIONS OF DOLLARS)

STRATEGIC GOALS AND OBJECTIVES	MAJOR STRATEGIES	FY'02 BUDGET REQUIREMENT		
SERVICE TO EACH TAXPAYER • Make filing easier • Provide first quality service to each taxpayer needing help with his or her return or account • Provide prompt, professional, helpful treatment to taxpayers in cases where additional taxes may be due	• Meet the needs of the taxpayers • Reduce taxpayer burden • Broaden the use of electronic interactions • Meet the special needs of the tax-exempt community	Prefiling Services Filing & Account Services Tax Return Processing & Information Reporting Other TOTAL	$ 359 910 866 23 $ 2,158	2
SERVICE TO ALL TAXPAYERS • Increase fairness of compliance • Increase overall compliance	• Address key areas of noncompliance • Stabilize traditional compliance activities • Deal effectively with the global economy	Payment, Filing & Reporting Compliance[1] TOTAL	$ 3,597 $ 3,597	4
PRODUCTIVITY THROUGH A QUALITY WORK ENVIRONMENT • Increase employee job satisfaction • Hold agency employment stable while economy grows and service improves	• Recruit, develop and train a qualified workforce • Provide high-quality, efficient and responsive Information Systems Services and Shared Support Services • Promote effective asset and information stewardship	Tax Administration Training Shared Services Programs Information Systems Programs[2] General Management & Administration Research and Statistics of Income TOTAL	$ 64 1,121 1,593 358 101 $ 3,237	3
TOTAL			$ 8,992	1(

1) Includes EITC of $146 million
2) Includes mandated IS special pay increases of $9 million; excludes Modernization and Improvement projects

VI. The Information Technology Investment Account (ITIA)

The Information Technology Investment Account (ITIA) was established in 1998 as a mechanism to fund the massive Business Systems Modernization Program that was started in 1999. ITIA has several objectives. First, it provides for oversight and approvals that are necessary because of the size and complexity of this program and prior failures by the IRS in implementing major new systems. Accordingly, while funds are appropriated to ITIA during the annual budget process, they are only released to specific projects after review and approval by OMB, the GAO and Congress. A second and very important objective of ITIA is to provide a consistent level of funding that supports projects that go beyond one fiscal year. The history of the ITIA is as follows:

ITIA HISTORY
(MILLIONS OF DOLLARS)

FISCAL YEAR	APPROPRIATED	RELEASED	YEAR END BALANCE
1998	$ 294	$ -	$ 294
1999	211	35	470
2000	-	214	256
2001	72	328*	0*
2002	1,000**	450**	550**

** Projected based on current plans*
*** Recommended by IRS Oversight Board*

The IRS Oversight Board is concerned that for the first time, the ITIA will have a zero balance by the end of Fiscal Year 2001. This is a dangerous situation that could result in projects being inefficiently stopped and started or unnecessarily slowed down.

PROJECTS UNDERWAY AND FUNDED BY ITIA

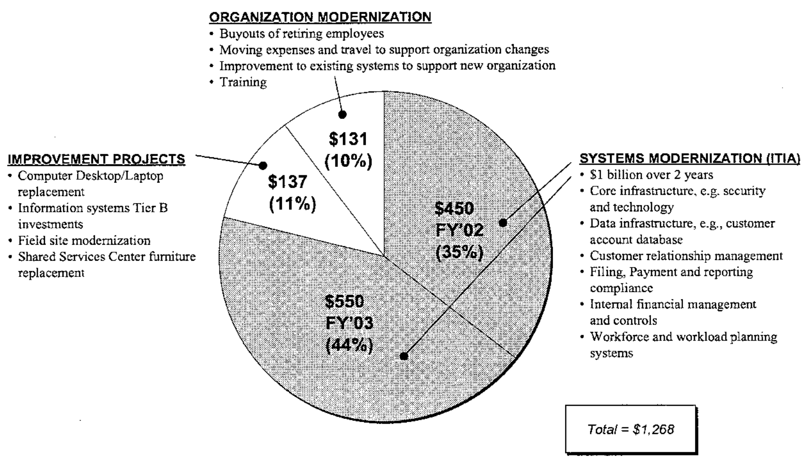
PROJECTS	TAXPAYER BENEFITS
Customer Communications	• Improved telephone system to handle 150 million taxpayer phone calls per year • Extended internet capabilities
Customer Relationship Management – Examination (CRM-EXAM)	Improved software that will provide more accurate processing and review of corporate income tax returns, saving time and money
e-Services	Allow for electronic transactions that yield better accuracy and efficiency
Customer Account Data Engine (CADE)	Modern system for storing, managing and accessing taxpayer records will provide better accessibility, accuracy and faster refund processing
Custodial Accounting	Financial management system will provide necessary control over taxpayer dollars
Infrastructure	Programs dealing with: • Security • Efficient voice and data transfer • Timely help desk assistance • Flexibility to address changes efficiently

VII. IRS Modernization & Improvement Programs

The IRS Oversight Board also recommends funding in Fiscal Year 2002 for Modernization and Improvement Programs of $1.268 billion.

In Fiscal Year 2002, the majority ($1 billion) of the funding relates to systems modernization through the Information Technology Investment Account (ITIA). The final implementation of organization modernization ($131 million) and other improvement projects ($137 million) account for the balance of the budget.

FY'02 BUDGET FOR MODERNIZATION AND IMPROVEMENT PROGRAMS
(MILLIONS OF DOLLARS)



The $1 billion recommended appropriation for Fiscal Year 2002 represents a plan to release $450 million in 2002 and $550 million in 2003. The Board believes that funding the ITIA with two years of planned releases ensures that the program can move ahead as planned, without inefficient slowdowns or stops and starts.

Analyzing the changes in budget between fiscal years indicates that the organization modernization program budget is decreasing by $101 million. The remaining budget amount of $131 million reflects buyouts for retiring employees, moving expenses, and improvements to existing systems to support the new organization.

There is a recommended increase in budget of $97 million for other improvement programs. This includes computer desktop and laptop replacements, improvements in existing systems, field site renovations and shared services center furniture replacement.

A program of periodic upgrades to desktop and laptop computers to support the rollout of standardized software will provide improved functionality for IRS employees and enhanced security. Without this program, the enhanced software could not be delivered to or utilized by many IRS employees.

Enhancements and additions to existing systems and certain new systems are necessary to support the new IRS organization structure that was put in place in 2000. The ability to manage this new organization and support the work of its employees will be significantly impacted without this program.

CHANGES IN MODERNIZATION AND IMPROVEMENT PROGRAMS
BUDGET FROM FY'01 TO FY'02
(MILLIONS OF DOLLARS)

	DESCRIPTION	FY2001	FY2002
Systems Modernization	• Security, technology and data Infrastructure • Customer relationship management • Filing, Payment and reporting compliance • Internal financial management • Workforce and workload planning	$ 72*	$ 1,000**
Organization Modernization	• Buyouts of retiring employees • Moving expenses and travel to support organization changes • Improvement to existing systems to support new organization • Training	232	131
Improvement Projects	• Desktop/Laptop replacement (2002) • Information systems Tier B investments (2001 and 2002) • Field site modernization (2002) • Shared Services Center furniture replacement (2002)	40	137
Total Modernization and Improvement Budget		**$ 344**	**$ 1,268**

* *In addition to this amount, $256 million of carryover from FY2000 will be released in FY2001*
** *Includes $450 million for FY'02 and $550 million for FY'03*

The Board believes that the modernization program is absolutely necessary to support the longer-term strategies and objectives defined in the IRS Strategic Plan. The $450 million release plan for Fiscal Year 2002 and the $550 million plan for Fiscal Year 2003 are based on a detailed technology blueprint that also supports the plan. The technology blueprint's objective is to implement new systems as quickly as possible, consistent with the IRS' ability to manage both the change involved and the scale of the program. As described in the strategic plan, the implementation of the modernization program will clearly support meeting the goals and objectives of the IRS and the funds necessary to support this program are a necessary investment.

FY'02 MODERNIZATION AND IMPROVEMENT PROGRAMS BUDGET DETAIL
(MILLIONS OF DOLLARS)

PROGRAM	DESCRIPTION	FY'02 BUDGET
Systems Modernization	• Business Systems Modernization (BSM) – Core infrastructure, e.g. security and technology – Data infrastructure, e.g., customer account database • Tax Administration Vision & Strategy (TAVS) – Customer relationship management – Filing, Payment and reporting compliance • Internal Management Vision & Strategy (IMVS) – Internal financial management and controls – Workforce and workload planning systems	$ 1,000 for 2 year commitment FY'02 = $450 FY'03 = $550
Organization Modernization	• Buyouts of retiring employees ($30) • Moving expenses and travel to support organization changes ($13) • Improvement to existing systems to support new organization ($25) • Training ($15) • Projects to support implementation of new organization ($48)	$ 131
Improvement Projects	• Computer Desktop/Laptop replacements ($54) • Information Systems Tier B investments ($60) • Field site modernization ($15) • Shared Services Center furniture replacement ($8)	$ 137
TOTAL		**$ 1,268**

VIII. Comparison to Administration Budget & Conclusion

The Administration's 2002 budget request does not adequately support the IRS Strategic Plan and provides inadequate support for technology modernization. The IRS Oversight Board's budget request should be adopted.

The IRS Oversight Board is recommending a budget for Fiscal Year 2002 that is completely consistent with the IRS Strategic Plan and is 8.9% higher then the Administration's budget.

COMPARISON BETWEEN IRS OVERSIGHT BOARD AND ADMINISTRATION BUDGETS

	IRS OVERSIGHT BOARD BUDGET (in millions)	ADMINISTRATION BUDGET (in millions)	% DIFFERENCE
Operations Budget	**$8,992**	**$8,854**	1.5
Modernization & Improvement Budget			
Organization Modernization	$131	$131	
Improvement Projects	137	40	242.5
Systems Modernization/ITIA	1,000	397	151.9
Total Modernization	**$1,268**	**$568**	**123.2%**
Total FY'02 Budget	**$10,260**	**$9,422**	**8.9%**

An important part of the operations budget is the Staffing Tax Administration for Balance and Equity program (STABLE). This program was begun in 2001 and funds the hiring of approximately 3,800 new staff that will enable the IRS to begin addressing the decline in taxpayer service, audits and other enforcement programs that have occurred during the past few years. While the Administration's budget blueprint says that this program is fully supported in their budget, this statement is misleading. While the line item for stable is funded in their budget, the following cost items, which cannot be eliminated, are not funded:

OPM mandated pay raises for technology professionals	\$9million
Non-labor inflation costs @OMB rates	63 million
Higher costs of an older work force	65 million
Total	**\$137 million**

The impact of this difference is that headcount supported by the Administration's budget will be approximately 1,300 less then under the Board's budget. Most of these reductions will come from STABLE. This would directly impact the IRS' ability to implement its strategy of immediately improving customer service and enforcement levels.

As indicated above, the Administration is recommending \$40 million for what the Board is calling improvement projects, while the Board is recommending \$137 million, a difference of \$97 million.

- The most critical difference is \$54 million for a program of periodic upgrades to desktop and laptop computers to support the rollout of standardized software that will provide improved functionality for IRS employees and enhanced security. It seems ridiculous to develop new software that will make the IRS more effective and then not to be able to deliver it to many IRS employees because their desktop and laptop computers are old technology.

- The Board is recommending \$20 million more then the Administration (\$60 million versus \$40 million) for what are called "Tier B software projects." These necessary projects will add the functionality to support the immediate needs of the new IRS organization structure that was implemented recently.

- The Board is recommending \$15 million (the Administration nothing) for the expansion and renovation of field assistance sites. These sites are necessary to provide walk-in support for taxpayers, primarily low-income taxpayers that need assistance.

- The board is recommending \$8 million (the Administration nothing) for the replacement of antiquated furniture at three IRS service centers. The plan is to replace the furniture in all ten of the service centers over a three-year period.

The biggest difference between the Board and Administration budgets is for systems modernization (ITIA), where the Board is recommending an appropriation of \$1 billion and the Administration is recommending \$397 million. As described in a previous section of this report, the Board is recommending that ITIA be funded with two years of expenditures, \$450 million in 2002 and \$550 million in 2003. This multi-year funding is consistent with the early history of the ITIA and the objective to provide consistent commitment and financial support for this critical long-term investment. This approach should eliminate the inefficient stopping and starting of projects that can impact multi-year projects. The Administration is only recommending one year of funding.

The final difference between the Board and Administration budget is \$53 million for ITIA funding in 2002 (\$450 million versus \$397 million). The Board's recommendation is based on a comprehensive development plan that has the objective of completing modernization as quickly as possible, consistent with the IRS' abilities to manage the program. The impact of accepting the Administrations budget would be to slow down a program that is already taking far too long.

Conclusion

One of the most important responsibilities of the IRS Oversight Board is to review and approve the IRS Strategic Plan and budget. Since its inception in September 2000, the Board has spent a significant amount of its time and efforts on this objective. We are convinced that the strategic plan lays out as logical and realistic approach for addressing the many issues and challenges that the IRS faces. While many of the problems identified by Congress still exist, significant progress has been made and the strategic plan defines a way forward. The Fiscal Year 2002 budget recommended by the Board supports this plan. Taxpayers demand an IRS that supports their needs and administers the tax code fairly and fully. The programs and activities that are funded by the 2002 budget move the IRS toward that goal.

Chairman THOMAS. Thank you very much.
Mr. Williams.

OPENING STATEMENT OF DAVID C. WILLIAMS, INSPECTOR GENERAL, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, U.S. DEPARTMENT OF THE TREASURY

Mr. WILLIAMS. Mr. Chairman and members of the House and Senate committees, I appreciate this opportunity to appear before you to discuss the progress that the IRS has made in implementing the IRS Restructuring and Reform Act of 1998.

In my testimony before you last year, I committed TIGTA to timely and accurate reporting on the IRS reforms and making recommendations to improve the direction and pace of the progress. Today, I will report to you on the results of our work involving taxpayer protection and rights, systems modernization, and organizational restructuring.

Since July, 1998, when the RRA '98 was enacted, the IRS has involved itself deeply in implementing the law's 11 major components, with considerable emphasis on the 71 provisions for taxpayer protection and rights.

Our audit work for the provisions that TIGTA is required to review has shown that the IRS has made substantial progress in protecting taxpayer rights, but it still needs to complete its efforts to comply with the following areas: providing proper and timely notices for all Federal tax liens, timely consideration of innocent spouse relief claims, and fully eliminating the use of illegal tax protester designations.

With respect to systems modernization, the IRS has completed major foundational aspects, including overall architecture and program management processes, to guide the modernization. However, most of the projects have taken longer and cost more than originally planned. These delays are of concern because the seriously needed improvements in IRS operations are heavily dependent on the success of the projects.

Some of the expected benefits the taxpayers will receive are: quicker access to more accurate tax help, readily available, correct, and current account information, more electronic filing capabilities, refunds in days instead of weeks, and expanded self-service options over the telephone and Internet.

The other major component of the IRS modernization involves organizational restructuring. The IRS has made significant progress over the past three years in its restructuring efforts. For example, on October 1, 2000, the IRS substantially completed the stand up of its four customer-focused business units.

Although the organizational standup was an important first step, the next phase of IRS reengineering needs to address management and operational issues that relate to designing management information systems to support the new organizational structure, improving taxpayer access to walk-in and toll-free telephone services, increasing accuracy of responses provided to taxpayers, hiring, training and retaining a qualified workforce, and eliminating computer security weaknesses.

Through October 27th, the IRS has had a successful 2001 filing season, but a great deal of work is still needed to achieve its primary goal of providing quality customer service as the key to improving tax compliance. As of this date, approximately 39.6 million of the 118 million individual income tax returns have been filed electronically, which is a 13 percent increase over last year. Similarly, the number of refunds deposited directly into bank accounts increased by almost 15 percent. In addition, the IRS Web site recorded over 1.5 billion accesses, which is a 57 percent increase over last year.

In contrast to these successes, the IRS has experienced a drop in its examination and collection activity. From fiscal year 1996 to 2000, revenues attributed to compliance activities have declined by $4.2 billion, to $33.8 billion, and unpaid assessments have increased by 22 percent.

Finally, the IRS customer service statistics continue to show the need to improve dramatically. It may take some time before we have conclusive evidence of the totality of IRS efforts to better protect taxpayer rights, modernize its systems and organization, and achieve a higher level of customer service. In this regard, my office will continue to review the progress made and problems encountered in implementing RRA '98.

This concludes my statement and I would be pleased to respond to any questions that you have at the appropriate time.

[The statement of Mr. Williams follows:]

IMPLEMENTATION OF THE IRS RESTRUCTURING AND REFORM
ACT OF 1998

JOINT HEARING BEFORE COMMITTEES OF THE
UNITED STATES SENATE
AND
UNITED STATES HOUSE OF REPRESENTATIVES

MAY 8, 2001

STATEMENT FOR THE RECORD

DAVID C. WILLIAMS
INSPECTOR GENERAL
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Mr. Chairman and distinguished members of the House and Senate Committees, I appreciate this opportunity to appear before you to discuss the progress the Internal Revenue Service (IRS) has made in implementing the IRS Restructuring and Reform Act of 1998 (RRA 98). In last year's testimony, I committed my organization to timely and accurately reporting on the IRS reforms and making recommendations to improve the direction and pace of progress. Today, I will report to you on the results of our work.

Internal Revenue Service Challenges and Accomplishments

Three of the more significant challenges for the IRS involve restructuring the organization, modernizing computer systems, and improving customer service. The RRA 98 requires the IRS Commissioner to reorganize the IRS around groups of taxpayers with similar needs and to place a greater emphasis on serving taxpayers and meeting their needs. The IRS' modernization process includes both restructuring the organization to better meet taxpayer needs and developing new technology to replace deficient and obsolete systems. Although this is a long-term effort, there is broad consensus for the IRS' plan to transform itself, while continuing to implement tax law changes, collect approximately $2.1 trillion in tax revenue, and improve customer service.

Since July 1998 when the RRA 98 was enacted, the IRS has involved itself deeply in modernizing its operations and procedures and has made progress in its restructuring efforts. For example, as of October 1, 2000, the IRS substantially completed the stand-up of its four customer-focused business units. In addition, considerable emphasis has been given to protecting taxpayers' rights and, as a result, the IRS is either in full compliance or is taking action to become compliant in the specific taxpayer rights provisions that the Treasury Inspector General for Tax Administration (TIGTA) is required to report on annually.

In the RRA 98, the Congress stated that the IRS should have a plan to increase electronic filing and also established a goal that at least 80 percent of all federal tax and information returns should be filed electronically by 2007. To help achieve this goal, the IRS continues to increase the number of tax forms that taxpayers can file electronically. More than 20 new forms (for electronic filing) were added in 2001, with an additional 38 to be added in 2002. The number of returns filed electronically and refunds deposited directly into back accounts have both increased during the 2001 filing season. In addition, the IRS began accepting electronic partnership returns in February 2001.

Although the number of electronic returns filed continues to increase, the IRS faces a significant challenge to meet the goal of 80 percent electronic filing by 2007. To achieve this goal, the IRS must increase the use of electronic filing an average of 19 percent per year for individual returns over the next several years. Despite IRS efforts to increase the number of returns filed electronically, the IRS is projecting annual increases ranging from only 7.4 to 2.8 percent for years 2004 through 2007.

The IRS must continue to address these challenges as well as other issues that surface in its organizational restructuring to provide first-rate customer service and ensure compliance with the tax laws.

Organizational Restructuring

As stated previously, on October 1, 2000, the IRS achieved a significant milestone toward modernization by putting into effect (or standing up) a new organizational structure. The four major components of the new IRS are the Wage and Investment (W&I) Division, the Small Business/Self-Employed (SB/SE) Division, the Large and Mid-Size Business (LMSB) Division and the Tax Exempt and Government Entities (TE/GE) Division.

The stand-up of the new business unit structure was an important step in the IRS' restructuring, though it is far from the last step of this long-term endeavor. The next phase must continue to address management and operational issues surrounding its organizational restructuring, such as revised management information systems designed to support the new organizational structure; taxpayer access to walk-in and toll-free telephone services; accuracy of responses provided to taxpayers; the ability to hire, train, and retain a qualified workforce; and the decline in enforcement rates.

TIGTA audits showed that all four business units substantially completed the five critical elements needed for standing up. Specifically, most key management positions were filled, most employees were realigned, finance offices and budgets were established, many delegations of authority were revised, and detailed plans of workarounds were developed. However, additional actions were needed in the area of staffing unfilled positions in the W&I Division, enhancing the TE/GE Division's oversight and control of its modernization initiatives, and coordinating a long-term strategy to place remaining SB/SE Division's transition employees in permanent positions.

In addition to these four new operating divisions, the IRS' Criminal Investigation (CI) function substantially completed the requirements for operation when it stood up on July 2, 2000. The CI function has also made significant progress in completing the recommendations in the report of Judge William Webster's Review of the Criminal Investigation Division (Webster Review). However, the CI function still needs to take additional steps to ensure all Webster Review initiatives are implemented, that special agent search warrant activities are appropriately monitored, and resources are effectively shifted to legal source tax violations (as opposed to illegal source violations, such as narcotics).

The IRS' Taxpayer Advocate Service, which assists taxpayers in resolving problems with the IRS that cannot be resolved through normal systemic processes, stood up on March 12, 2000. Local taxpayer advocates now report directly to the National Taxpayer Advocate and are independent of any local IRS official. In January 2001, the IRS expanded caseworkers' delegated authorities to include account adjustments, which should enable them to resolve issues rather than referring such matters to other functions in the IRS.

The IRS Appeals function, which is the alternative dispute resolution program for taxpayers contesting a compliance action taken by the IRS, stood up on August 13, 2000. The Appeals function reorganized its staffing into operating units that align with the larger IRS operating divisions.

Despite the successful stand-up, the transition to the new operating divisions and the process changes required to implement certain taxpayer rights provisions of the RRA 98 have adversely impacted the IRS. For example, for the taxpayer rights provisions we reviewed, new procedures were written, new forms and notices were prepared, and training provided, often extending past the effective date of the provisions. The average Internal Revenue Manual change took over 9 months. In the interim, some employees did not have adequate procedures to follow to ensure compliance with the law. Additionally, new procedures were not always adequately tested with field personnel before implementation to determine the impact on casework processing. These problems caused confusion and delayed processing.

In addition, the transition to the new operating divisions and the implementation of the required process changes delayed some enforcement actions. The overall decline in enforcement actions has been primarily attributed to a long-term decline in enforcement staffing, to redirection of the staff to customer service functions during the filing season, and to IRS employees' concerns over the mandatory termination provision in Section 1203 of the RRA 98.

Moreover, current information technology systems have not been reprogrammed to provide IRS executives the management information they need to make decisions in the IRS' new operating environment, which focuses on serving distinct taxpayer market segments. For example, IRS compliance management information systems will not fully reflect the new organizational structure in the SB/SE Division until at least early in 2002. The IRS' Master File does not segment tax account data by operating division, nor will this capability be provided in the foreseeable future. Executives rely on the information generated from these systems to plan, execute, and evaluate programs. Until this realignment of management information is achieved, executives may not have all the data they need to effectively manage resources and evaluate whether taxpayers are receiving the best service possible.

Systems Modernization

The IRS' modernization concept and plans are heavily dependent on new technology to update its computer systems. The IRS has made significant progress towards establishing its governance structure and processes to support and oversee the modernization of its computer systems. The Business Systems Modernization Office was created to manage modernization efforts and the risks inherent with an undertaking of this size and complexity. Although there were initial difficulties, the IRS has addressed them by clarifying the roles and responsibilities for both the IRS and the PRIME contractor. The IRS is primarily responsible for acquisition and oversight of the contractor, and the PRIME contractor is responsible for building and delivering the systems that meet the IRS' needs and requirements. The IRS also adopted a performance-based contracting process, which includes plans to provide incentives for the contractor to deliver quality products on time and within budget.

Another major accomplishment is the completion of the first version of the enterprise architecture, known as Blueprint 2000. The purpose of the enterprise vision and of the architecture is to set forth a high-level, complete picture of how the future business systems will operate and how they will fit together. The IRS also finalized a disciplined process to be followed in developing modernized systems, called the Enterprise Life Cycle (ELC). The definition of the future architecture (Blueprint) and the ELC processes are essential if the IRS is to fully succeed in modernizing its systems.

To further enhance IRS operations, TIGTA has recommended to IRS management the need for all systems development activities to be consolidated and monitored under the Chief Information Officer (CIO). TIGTA believes that managing systems development initiatives outside the CIO's organization increases the risk of inconsistent and ineffective project management processes and fragmented systems modernization initiatives, which could lead to delays, cost overruns, and rework. The IRS has stated that the consolidation of all systems staff in the field under the CIO is scheduled for completion by October 1, 2001.

About $400 million has been spent on the current systems modernization initiative since it began about 2 years ago. While significant progress has been made, thus far, most of the ongoing systems modernization projects have taken longer and cost more than originally planned. Some contributing factors are that the IRS is in a steep learning curve in its systems modernization effort and that the roles and responsibilities of the IRS and the PRIME contractor were inadequately defined during the early phases of the modernization.

Because of these delays, the intended benefits to taxpayers have yet to be realized. For example, the IRS plans to dramatically improve the volume and routing of telephone calls received on its toll-free telephone service and to provide Internet access to determine refund and filing status. These benefits were originally scheduled to be implemented for the 2001 filing season. However, they will not be fully implemented until the 2002 filing season or later. To meet the revised implementation dates, the IRS must define and complete a substantial amount of critical design requirements and development work.

The IRS will continue to face risks throughout the life of its technology modernization projects, and TIGTA will continue to assess the IRS' efforts. Thus far, TIGTA has identified six areas of concern that could have serious implications on the success of computer modernization efforts, if they are not properly managed. These areas are:

- Potential funding problems.
- Problems implementing key systems development processes, such as the ELC, project management, configuration management, and risk management.
- Inappropriate sequencing of projects, e.g., projects are progressing towards development without having key foundational development efforts established to provide needed direction.
- Projects being over budget and behind schedule.
- Business needs not always being well defined.
- A lack of substantial tangible benefits delivered to taxpayers.

An example of a project that has experienced delays is the Customer Account Data Engine (CADE) project. The CADE project will incrementally replace the IRS' current taxpayer databases with new technology, applications, and databases. The new "data engine" provided by the CADE will lay a foundation for modernizing IRS systems and business processes. The CADE will allow employees to post transactions and update taxpayer account and return data from their desks. Updates will be immediately available to anyone who accesses data, which should enable the system to provide a complete, timely, and accurate account of the taxpayer's information.

The CADE project team was initially supposed to complete its planning phases in December 2000 for the initial release of the CADE project, which will store simple individual tax returns. This was later moved to March 2001, and has recently been moved again to an estimated completion date of May 15, 2001. As a result, this project will likely be delayed beyond the scheduled January 2002 release date.

Computer Security

The IRS maintains a significant amount of valuable and sensitive information. As such, computer security will continue to be a risk for the IRS. There are risks from within (e.g., unethical employees who have improperly viewed and manipulated taxpayer records) as well as external threats (e.g., potential incidents such as defacement of public web pages, manipulation of computer software coding, and the theft of taxpayer account information). In response to these risks, TIGTA maintains an approach to overseeing the IRS' computer security efforts that addresses detection and prevention activities.

Over the past several years, TIGTA has recommended that the IRS improve controls in its computer systems to safeguard confidential taxpayer information from unauthorized employee accesses because the IRS continues to have difficulty protecting such information from misuse. Recent TIGTA audits have identified significant security weaknesses in other areas, such as:

- Intrusion detection.
- Disaster recovery.
- Physical security of facilities and systems.
- Certification of security controls for sensitive systems.

To address unauthorized access to taxpayer information by employees, TIGTA uses computer technology and forensic data analysis techniques to investigate unauthorized access leads identified by detection criteria and complaints received by field special agents. Since 1997, the number of unauthorized access to tax information (UNAX) violations identified and investigated has continued to remain relatively constant, although the number of resignations and terminations has increased each year. TIGTA has initiated 1,546 investigations since 1997 for apparent UNAX violations, which have resulted in 448 resignations or removals and 74 successful criminal prosecutions.

TIGTA is also working closely with the IRS to develop a cadre of computer specialists and criminal investigators who will rapidly respond to computer intrusion incidents, investigate IRS network problems when indicators of intentional disruption are present, and conduct recurring systems penetration tests to detect new vulnerabilities.

<u>2001 Filing Season</u>

The filing season impacts every American taxpayer and is, therefore, always a highly critical program for the IRS. Many programs, activities, and resources have to be planned and managed effectively for the filing season to be successful. The processing changes for the 2001 filing season included the Third Party Authorization Initiative, which provides a checkbox on individual returns to allow the designation of limited power of attorney.

Through April 27, 2001, the IRS has had a successful 2001 filing season. As of this date, approximately 118 million individual income tax returns were filed, and over 88 million of those were processed. Approximately 39.6 million (34 percent) of these returns were filed electronically, which is a 13 percent increase from last year. While this represents a significant increase, the IRS did not achieve its goal of 19.5 percent for this filing season. The average dollar amount of refunds issued was $1,711, up from an average refund of $1,624 last year. In addition, the number of refunds deposited directly into taxpayers' bank accounts increased by almost 15 percent from last year.

Customer Service and Tax Compliance

Providing top quality service to every taxpayer is integral to the IRS' modernization plans and strategic goals. There are many ways in which the IRS provides customer service, including toll-free telephone service, electronic customer service, written communications to taxpayers, and walk-in service. Each of these services affects a taxpayer's ability to voluntarily comply with the tax laws. The IRS has also developed a web site that provides taxpayers with convenient access to tax forms and information. The web site recorded over 1.5 billion accesses during the 2001 filing season. The IRS anticipates 2.5 billion accesses to its web site in Fiscal Year (FY) 2002.

A great deal of work is needed to achieve the IRS' primary goal of providing quality customer service as a key to improving tax compliance. The underlying theory of much of the IRS' modernization is that the overall rate of voluntary compliance with the tax laws will increase if the IRS provides the right mix of education, support, and up-front problem solving to taxpayers. Through its modernization efforts, the IRS has embarked on a course to reengineer its business processes and technology to focus on improving service to taxpayers, including processing returns and issuing refunds more quickly. In addition, telephone and Internet technology afford the IRS many opportunities to dramatically improve its customer service.

Although the IRS has made some strides in its use of technology, factors such as inadequate systems design and planning and human capital issues hinder some of the IRS' efforts to improve customer service. For example, the Electronic Tax Law Administration Program is intended to give taxpayers another way to communicate with the IRS. However, significant improvements are needed to raise the quality of answers. In a limited test during the 2000 filing season, the IRS responded correctly to 27 of the 50 SB/SE Division questions TIGTA submitted through the *Digital Daily*. Commercial web sites offering free tax advice provided correct answers only 47 percent of the time. Our analysis of response times showed that the commercial web sites provide responses faster than the IRS, although taxpayers were generally satisfied with the IRS' response times.

During our 2001 filing season audits, we identified the need for the IRS to improve the quality of answers to taxpayers. In a current review of the Tax Assistance Centers (i.e., walk-in sites) over a 2-week period, 90 contacts were made with IRS assistors. In seven of these instances, service was denied to our reviewers (e.g., reviewers were merely provided forms or instructions, or told no one was available to answer their questions). When service was provided, incorrect answers were provided 49 percent of the time, and insufficient answers were provided 24 percent of the time. Similarly, during a current review of the toll-free telephone system over a 4-day period, our reviewers were unable to talk with an IRS assistor 37 percent of the time and, when we did reach an assistor, we did not receive the service requested 47 percent of the time (e.g., reviewers were sometimes provided inaccurate or insufficient information, referred to publications or the IRS' Internet site without receiving an answer to the original question, or told an assistor was not available to answer a particular type of question).

Because the IRS has not conducted a Taxpayer Compliance Measurement Program audit since 1992, it currently has no reliable method to measure voluntary compliance or the effect that increased customer service and the diversion of compliance resources are having on voluntary compliance. However, one general indicator of voluntary compliance is revenue collected. IRS reports reflect that revenue receipts increased from $1.5 trillion in FY 1996 to $2.1 trillion in FY 2000. Despite this increase, revenue collected as a result of compliance activity decreased by $4.2 billion to $33.8 billion, and unpaid assessments have increased by 22 percent during this period. IRS management and many stakeholders have been concerned about the reduction in resources allocated to compliance activities and the related decrease in business results. To help address this issue, Treasury's FY 2001 budget submission included a request for 2,800 new positions over the next 2 fiscal years. These additional resources would be dedicated to enforcing tax laws and improving service to taxpayers.

Decreased enforcement has also been attributed to IRS employees' concerns over the mandatory termination provision in Section 1203 of the RRA 98. To help address these concerns, TIGTA has continued to brief the IRS staff on investigations related to Section 1203 violations. Also, TIGTA continues to be dedicated and involved with the IRS' efforts to comply with the legislative changes required by the RRA 98 through representation on an IRS task force with the focus on Section 1203 processes.

Revenue Protection

The IRS must continually seek opportunities to protect revenue and minimize tax-filing fraud in its programs and operations. To meet this challenge, it has launched promising new compliance initiatives. One initiative involves a partnership with the Department of Health and Human Services (HHS) that will allow the IRS to periodically receive information contained in the HHS Federal Case Registry regarding child support. Another initiative involves a partnership with the Social Security Administration (SSA) to provide the IRS with Social Security Numbers (SSN) for parents and individuals younger than 18 years old who have applied for a SSN. As a result of these partnerships, the IRS will be able to cross-check information regarding how the child is related to the taxpayer, the age of the child, and whether the taxpayer is the child's custodial parent.

In 2001, the IRS began checking all secondary SSNs, in addition to primary and qualifying child SSNs, on Earned Income Credit (EIC) returns. The IRS rejects returns if the names and numbers do not match SSA records. In a limited test of cases, the IRS had incorrectly disallowed the personal exemption and/or EIC in approximately 15 percent of the cases. The IRS immediately addressed this by revising its processing procedures for researching the taxpayer accounts before disallowing the exemptions or the EIC.

Despite its efforts to address EIC compliance, the EIC Program is a continuing concern for the IRS. An August 2000 IRS EIC compliance study reported that the amount of overclaims submitted was approximately $9.3 billion, or 31 percent of the amount claimed. The IRS' weaknesses related to the EIC are in three primary areas:

- Achieving full participation by eligible taxpayers.
- Ensuring compliance through verification of taxpayers' eligibility.
- Reducing inherent vulnerabilities (multiple use of dependent SSNs).

Despite extensive IRS programs and efforts to address certain refund schemes, relatively little effort has been made to systematically identify those schemes involving business returns and associated credits. A few business schemes have been identified, but it has generally been through labor intensive manual procedures. The IRS is concerned that fraudulent refund claims may be expanding to include business returns and that scheme perpetrators may be using the Internet or other means to promote and advertise their schemes.

Another area in which the IRS needs to significantly improve its compliance efforts is in the international taxpayer segment. The General Accounting Office and TIGTA have previously reported internal control and systemic weaknesses in the IRS' administration of its international programs. Improvements are needed in international compliance programs to focus on nonfiling, transfers of assets by United States citizens to foreign trusts, foreign tax credit claims, and foreign-sourced income. A recent TIGTA audit found that the IRS is in no better position to determine taxpayers' compliance levels in reporting foreign-sourced income than it was in 1997.

Taxpayer Protection and Rights

Although the IRS is not yet fully compliant with all of the RRA 98 taxpayer rights provisions that TIGTA has reviewed, it has made progress. Our audit work found that the IRS was fully or substantially compliant with the provisions involving seizures and notification requirements for levies. For other provisions, the IRS was continuing to take corrective actions to increase compliance with the RRA 98, including:

- Providing proper and timely notices for all federal tax liens.
- Timely consideration of innocent spouse relief claims.
- Fully eliminating the use of illegal tax protester designations.

The RRA 98 also placed restrictions on the IRS' use of enforcement statistics to evaluate employees or suggest production quotas or goals. TIGTA reported that most employee evaluations and management documents did not contain tax enforcement results and did not impose production quotas or goals; however, there were some instances in which these types of enforcement statistics were used.

The IRS determined that it would not be able to comply with some deadlines imposed by the RRA 98 relating to the requirements to provide certain types of notices to taxpayers and asked the Congress for an extension. These requirements included detailed notices of interest assessed, penalties imposed, and annual statements for taxpayers with installment agreements. The effective dates were extended by the Community Renewal Tax Relief Act of 2000 to June 30, 2001, for these notices and September 1, 2001, for the annual installment agreement statements. TIGTA is in the process of evaluating the actions taken by the IRS for these provisions.

Based upon TIGTA's statutory requirement to review determinations made by the IRS to deny Freedom of Information Act and Privacy Act requests, we determined that the IRS improperly withheld information from requesters in 10.7 percent of cases that were denied, partially denied, or categorized as no responsive record. The IRS did not respond timely in 20.1 percent of the cases reviewed. In addition, denied requests that were appealed were not always timely worked.

Regarding Collection due process, Appeals employees complied with legal requirements to protect taxpayers' rights when taxpayers appealed a lien or levy action taken by the IRS. However, we found that Appeals can improve customer service by timely contacting taxpayers and fully explaining the basis for the appeals determinations when responding to taxpayers on their requests for due process hearings.

TIGTA also assists in the protection of taxpayers and their rights by investigating allegations of misconduct by IRS employees. Since the passage of the RRA 98, TIGTA has received 1,152 complaints alleging Section 1203 violations. Shortly after Section 1203 became effective, there was an initial surge in what both the public and IRS employees thought were valid Section 1203 violations but which did not meet the requirements of Section 1203. The IRS has provided both public and employee education in Section 1203 requirements. As a result, TIGTA is currently noticing a decline in the number of complaints it receives.

Consistently, since the enactment of the statute, the vast majority of Section 1203 complaints received by TIGTA have alleged an IRS employee violated a provision of the Internal Revenue Manual or Internal Revenue Code in order to retaliate against, or harass someone. The second category, by volume, involves constitutional and civil rights/Equal Employment Opportunity violations.

In addition to those received and investigated by TIGTA, the IRS also receives and adjudicates numerous Section 1203 allegations where no investigation is needed.

Strategic Planning and Budgeting

Within the last 2 years, the IRS has developed a Strategic Plan and provided budget justifications that include the Annual Performance Plan(s). Collectively, these documents satisfy major requirements of the Government Performance and Results Act of 1993 (GPRA) by identifying the IRS' mission, strategic objectives, goals, and strategies. The documents also describe the IRS' priorities for the next 6 years and the key performance indicators (measures) used in assessing achievement of those goals.

The IRS Commissioner has indicated that it will take years to achieve a fully acceptable set of balanced measures that can be used at all levels of the organization. While the new operating units concentrate on implementing the new organizational structure, performance measures may not be a high priority. Based on our audits to date, TIGTA believes that the IRS can improve its measures, the data quality of its measures, and its reporting of annual accomplishments.

As part of its balanced measurement system, the IRS conducts surveys of taxpayers to gauge their satisfaction with various IRS customer services. The results of these surveys are also used for GPRA reporting purposes. The IRS conducted surveys in various functions, including the toll-free telephone, walk-in, collection, examination, and appeals operations. Our reviews of the controls and processes used in conducting these surveys indicated that survey data may not be statistically reliable. Specifically, the surveys did not always include all taxpayer interactions, the sampling methodologies did not ensure equal and unbiased opportunities for taxpayer participation, and the survey response rates were too low, thereby increasing the risk that the results may not be representative of the overall population.

In closing, it may be some time before we have conclusive evidence on the totality of the IRS' efforts to better protect taxpayer rights, modernize its systems and organization, and achieve a higher level of customer service. In this regard, my office will continue to review the progress made and problems encountered in implementing RRA 98 as part of our overall effort to promote economy, efficiency, and effectiveness in tax administration; detect and deter fraud and abuse in IRS programs and operations; and, protect the IRS against external attempts to corrupt or threaten its employees.

Chairman THOMAS. Thank you very much, Mr. Williams.
Mr. White.

OPENING STATEMENT OF JAMES R. WHITE, DIRECTOR, TAX ISSUES, GENERAL ACCOUNTING OFFICE; ACCOMPANIED BY RANDOLPH C. HITE, DIRECTOR, INFORMATION TECHNOLOGY SYSTEMS ISSUES

Mr. WHITE. Mr. Chairman and members of the committees, I am pleased to be here today as we approach the third anniversary of the IRS Restructuring and Reform Act of 1998. I will summarize some of our major points regarding IRS' current performance in its ongoing modernization effort. I will also note some issues related to IRS' fiscal year 2002 budget request.

First, current performance. We are calling IRS' current performance mixed. On the plus side, during this year's tax filing season, the IRS processed millions of tax returns and issued refunds without significant problems. Importantly, taxpayers calling IRS with questions had an easier time this year than last getting through. And for the first time, IRS earned an unqualified opinion on their financial audit.

On the down side, I want to highlight two issues. The trends in audit rates and enforcement programs continue to be troubling. As the board shows, which is also figure 2 on page 6 of my statement, audit rates in the upper left-hand corner, seizures in the upper right, and the use of liens and levies, the two lower graphs, are all down dramatically in recent years.

Also troubling is that IRS has not been able to work many cases of known delinquencies. IRS has been closing these cases after sending the taxpayers written notices, but without making follow-up contacts either by phone or field visit. IRS refers to this as shelving cases. The next board, figure 3, which is on page 7 of my statement, shows that, as of March 31, 2001, IRS has shelved about 2.5 million delinquency cases with outstanding debts totaling about $12 billion.

Related to these declines are declines in compliance staffing and productivity. For example, between 1996 and 2000, the number of IRS employees working collection cases fell by about a third, from 5,500 to 3,600. During the same time period, the amount of staff time per case increased by about a third. That is, productivity decline. We are concerned that these declines could increase the temptation for taxpayers to underreport their tax obligations.

Now I want to discuss IRS' ongoing modernization efforts where IRS made important progress this year. It implemented its new organizational structure, focused on types of taxpayers, and it also made progress in managing its business systems modernization program, its multi-year program to replace its antiquated computer-based information system.

Specifically, IRS made progress this year implementing a variety of management controls and capabilities. However, IRS' progress in this area, as in others, has been slower than expected. For example, we are concerned because business systems modernization projects are moving past critical milestones without certain essential management controls in place and functioning.

We have discussed these control weaknesses with the Commissioner and his modernization executives. They recognize the need to address these weaknesses. They have taken steps to implement many of these controls by the end of June this year, and decided recently to slow ongoing projects and new projects, giving priority to putting into place missing management capacity.

Because of the slowdown, it is unclear whether IRS needs the $53 million requested by the IRS Oversight Board for the investment account beyond the $397 million in the administration's request for fiscal year 2002.

Performance management is another key part of IRS' modernization. A performance management system that establishes goals and clear measures that is a structure of guiding and evaluating the transformation of IRS, and that creates incentives for front-line employees to work in new ways to support the goals, is essential to meeting congressional expectations for a new IRS.

Regarding performance management, IRS deserves credit for its strategic plan and its new management planning and budgeting process. However, IRS is still missing key measures of voluntary compliance without which the consequences of the decline in enforcement actions discussed earlier cannot be well understood.

Furthermore, managers throughout IRS do not routinely collect and analyze data to learn what caused past performance and, based on this understanding, make informed decisions to improve future performance. One example is financial data. While IRS received a clean audit opinion from GAO this year, the data underlying the opinion was compiled months after the fact. The data was not available to IRS managers on a real time basis and, thus, could not be used as an input into managerial decision making.

Another example is the productivity decline I mentioned earlier. IRS managers were unable to give us a data base explanation for what caused the declines, in turn leaving managers with less information about how to improve productivity.

Mr. Chairman, that completes my statement. I would be happy to answer any questions.

[The statement of Mr. White follows:]

United States General Accounting Office

GAO

Testimony

Before Congressional Committees

For Release on Delivery
Expected at 9:00 a.m.
Tuesday, May 8, 2001

IRS MODERNIZATION

Continued Improvement in Management Capability Needed to Support Long-Term Transformation

Statement of James R. White, Director
Tax Issues

Randolph C. Hite, Director
Information Technology Systems Issues

Steven J. Sebastian, Acting Director
Financial Management Issues

GAO
Accountability * Integrity * Reliability

GAO-01-700T

Mr. Chairman and Members of the Committees:

We are pleased to be here today as we approach the third anniversary of the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998,[1] which established Congress' expectation that IRS modernize to better meet taxpayer needs. We will discuss (1) how well IRS is providing service to taxpayers and ensuring compliance with the tax laws, and (2) IRS' progress in its long-term effort to modernize. We will also note some issues related to IRS' fiscal year 2002 budget request. Our emphasis will be on the developments over the past year since your last modernization oversight hearing and potential oversight issues for the future.

IRS modernization is a massive and multifaceted effort that will take at least a decade to complete. Historically, IRS has not been able to provide American taxpayers with the quality of service that Congress has demanded. Our past reports chronicle IRS' deficiencies, including inefficient, paper-driven processes; poor management; weak incentives for employees to provide quality service; and antiquated information systems. Because of the breadth and depth of these deficiencies, modernization encompasses changes to virtually every aspect of IRS, from its organizational structure and business processes to its technology and ways of measuring and managing the performance of the agency and its 100,000 employees. Implemented together, improvements in these areas are intended to provide improved service and compliance. At stake is IRS' ability to perform its mission. While the transformation is occurring, IRS is simultaneously challenged to deliver its stay-in-business activities without interruption—answering telephones, processing returns, issuing refund checks, and enforcing tax laws.

Our statement, based primarily on our recent audit work, makes the following points:

- IRS posted mixed results this year in collecting revenues, providing taxpayer service, and enforcing tax laws. On the plus side, during this year's filing season, IRS processed millions of tax returns and issued refunds without significant problems, taxpayers had an easier time getting through to telephone assistors, and IRS said it made progress in correcting weaknesses that threatened the security of electronically filed tax information. On the down side, the quality of service provided

[1]P.L. 105-206, July 22, 1998.

to taxpayers who visited taxpayer assistance centers, trends in audit rates and enforcement programs, and productivity declines continue to be troubling. We share concerns expressed in Congress and by tax practitioners that the declines in audits and enforcement actions may increase incentives for taxpayers either to not report or to underreport their tax obligations.

- With respect to modernization, IRS is making incremental progress in overhauling its organization, performance management system, business processes, and information technology. Successful completion of these efforts, each a management challenge unto itself, should give IRS a foundation to dramatically improve service and compliance in the future. IRS made important progress this year. It implemented its new organizational structure, continued to develop a blueprint for modernizing its business processes and information systems, and more fully defined its strategic direction. However, progress has not met expectations. For instance, IRS is not where it should be in implementing management controls over business systems modernization, which has contributed to project delays. IRS' efforts to develop a measure of voluntary compliance did not proceed at the pace IRS anticipated, and absence of this measure continues to compromise the effectiveness of the performance system as a whole. In an effort as complex and risky as IRS' modernization, however, it is important to remember that, while the timetable for change is important, cutting corners to achieve this timetable is not prudent.
- A performance management system that establishes goals, objectives, and measures—a structure for guiding and evaluating the transformation of IRS—is essential to meeting Congress' expectations for IRS. In addition, a performance management system gives employees a blueprint of how to do their jobs and incentives to support what IRS wants to accomplish as an agency. While IRS has made progress creating the structure of its performance management system, managers at the working levels of the organization are not yet routinely using data to monitor and manage performance. In some cases, relevant, accurate data, such as financial data, are not available or are not available on a timely basis. In other cases, analyses of past performance are not complete enough to give managers an understanding of how to improve performance.

IRS' Performance Was Mixed

IRS posted mixed results over the past year in processing returns, providing service to taxpayers, and enforcing tax laws. The return-processing and refund-issuing aspects of the 2001 filing season appear to be winding down smoothly, and officials said that they have corrected some internal control weaknesses that we identified in the last filing season that threatened the security of electronically filed tax data. IRS made some progress in improving taxpayers' access to telephone customer service, but concerns remain over the levels of access and the accuracy of information provided. Declines since 1996 in individual audit rates, the use of key enforcement authorities, and resolutions of tax delinquencies are troubling.

Returns Processed and Refunds Issued Without Significant Problems

Our preliminary review of the 2001 filing season did not identify any significant problems adversely affecting IRS' ability to process returns and refunds.[2] This accomplishment is a proud testament to the dedication and abilities of IRS employees who meet this critical responsibility despite shortcomings in information systems and the challenge of working in a rapidly changing organization. The successes in processing returns and issuing refunds were achieved in a period in which the number of returns filed continues to grow, as does the level of complexity in the returns.[3]

Our review of IRS' electronic filing systems during the 2000 filing season showed that IRS had ineffective controls to ensure the security of those systems and electronically transmitted taxpayer data. We demonstrated that individuals, both inside and outside of IRS, could gain unauthorized access to IRS' electronic filing systems and view, modify, copy, or delete taxpayer data. Although IRS said that it had not had evidence of any such intrusions, IRS did not have adequate procedures to detect intrusions if they had occurred. According to IRS officials, IRS moved promptly to correct the access control weaknesses we identified before this year's filing season. IRS developed plans to improve security over its electronic filing systems and internal networks and said that it had substantially implemented those plans. We plan to test the effectiveness of IRS' actions later this year. Sustaining effective computer controls in today's dynamic

[2] *Internal Revenue Service: 2001 Tax Filing Season, Systems Modernization, and Security of Electronic Filing* (GAO-01-595T, Apr. 3, 2001).

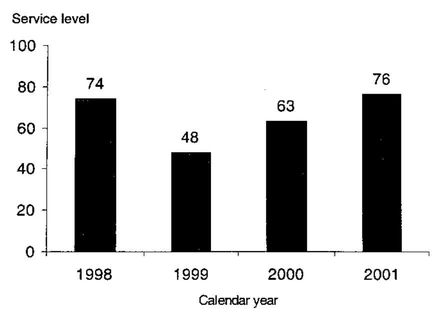
[3] Processing and issuing refunds is one issue; ensuring compliance is another. IRS controls to ensure that refunds are valid are often not applied until months after refunds are disbursed.

computing environment will require top management attention and support, disciplined processes, and continuing vigilance.

Despite Progress, Customer Service Lags Behind Goals

The news on telephone customer service activities is better this year than last, although IRS still has a long way to go to reach its goal of providing assistance comparable to that provided by leading public and private telephone customer service organizations. One indicator of IRS' performance in assisting the millions of taxpayers who call with questions is "level of service"—a measure of the number of calls answered divided by the number of calls attempted. As shown in figure 1, IRS answered a greater percentage of calls during the first 11 weeks of this filing season than it did at the same point in 1998, 1999 and 2000.

Figure 1: Toll-Free Telephone Level of Service for the First 11 Weeks of Filing Seasons 1998 through 2001



Note: IRS' level of service figures measure the percentage of call attempts that ultimately receive assistance—either from a customer service representative or an automated response menu. The figures do not address how long callers waited to receive assistance. The level of service computation for 2001 is not completely comparable to the computation for the other years because IRS is routing some refund inquiry calls this year to its Tele-Tax line for automated responses. In an effort to provide as accurate a comparison as possible to IRS' performance in past years, we adjusted the level-of-service computation to include refund inquiries answered by the automated Tele-Tax line, but Tele-Tax data does not account for taxpayers who may have abandoned their calls before getting an answer.

Source: GAO's analysis of IRS' data.

Despite these improvements in level of service, IRS officials recognize that to achieve the goal of providing telephone assistance comparable to that provided by leading public and private call center operations, IRS needs to do more to improve access to telephone assistance. Almost one-quarter of taxpayers' calls to IRS were not answered. Declines in the productivity of telephone assistors and delays in modernizing call routing technology—issues that we will discuss in detail in other sections of our statement—have prevented even greater improvement.

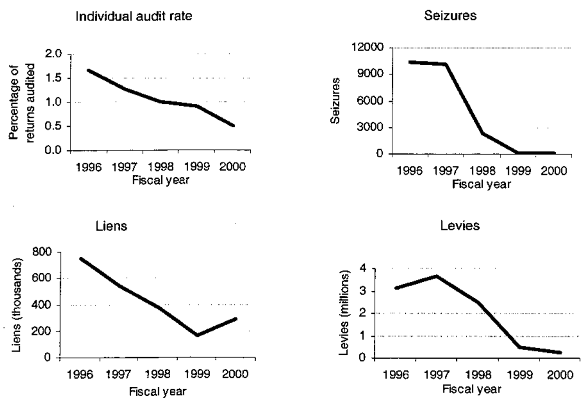
Answering the telephone is only half of the battle. Assistors then have to give taxpayers the right responses to their inquiries. For the 2000 filing season, IRS estimated that it provided accurate answers to tax law questions 73 percent of the time and to account questions 59 percent of the time. The Commissioner recently reported that this fiscal year, IRS provided accurate answers to tax law questions 78 percent of the time and to account questions 88 percent of the time. However, IRS changed its method for measuring accuracy this year, so accuracy rates cannot be compared to prior years.

In an attempt to improve service to taxpayers who visit walk-in sites, IRS changed the structure and increased the staffing of its field assistance program last year, but the quality of the service provided remains a concern. IRS reviewers posing as taxpayers conducted 272 visits to taxpayer assistance centers before the 2000 filing season and another 272 during the filing season. Of the questions asked, 81 percent were not answered correctly, and 21 percent of the reviewers were denied service. A similar but smaller study done in January and February 2001 by the Treasury Inspector General for Tax Administration found that reviewers received inaccurate answers about 48 percent of the time.

Trends in Enforcement Programs Are Troubling

Enforcement program trends continue to be troubling. IRS' audit rate for individuals has steadily declined since 1996, and examinations have declined across the full spectrum of taxpayers—from individual wage earners to businesses large and small. Figure 2 shows the declines in individual audit rates[4] and use of three key enforcement authorities: seizures, liens, and levies.[5] Although the Commissioner had predicted last year that these downward trends would reverse, by and large, they did not.

Figure 2: Declines in Individual Audit Rate and Use of Enforcement Tools, 1996 Through 2000



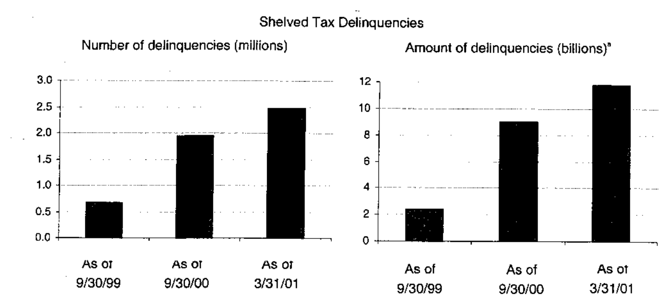
Source: GAO's analysis of IRS' data.

[4]The proportion of tax returns filed by individuals that IRS audits each year.

[5]Under the Internal Revenue Code, levy is defined as the seizure of a taxpayer's assets to satisfy a tax delinquency. IRS differentiates between the levy of assets in the possession of the taxpayer (referred to as a seizure) and the levy of assets such as bank accounts and wages that are the possession of third parties such as banks and employers (referred to as a levy). A lien is a legal claim that attaches to property to secure the payment of a debt. The filing of a lien would prevent the taxpayer from selling an asset, with clear title, without payment of the tax debt.

Also troubling is that IRS' telephone and field collection components have not kept pace with other IRS compliance programs such as audits that make tax assessments when taxpayers do not fully report their tax liabilities. Because of this, commencing in mid-1999, these collection components began closing delinquencies without working them—that is, without making collection contact with taxpayers through either telephone calls or field visits. This type of case closure is referred to as "shelving." As shown in figure 3, tax delinquencies shelved, together with related interest and penalties, totaled almost $12 billion at the end of March 2001. During our fiscal year 1999 and 2000 audits of IRS' financial statements,[6] we found instances of unpaid tax cases in which IRS was not actively pursuing collection despite evidence in IRS' files that the accounts had some collection potential. Once closed, the only provisions for reactivating shelved delinquencies for telephone and field collection action are (1) if the taxpayers had additional delinquencies or if information returns were filed identifying a previously unknown levy source and (2) if IRS found the resources to work the collection cases.

Figure 3: Tax Delinquencies Shelved by IRS



[a]Includes related penalties and interest.

Source: GAO's analysis of IRS' collection activity reports.

[6]*Financial Audit: IRS Fiscal Year 2000 Financial Statements* (GAO-01-394, Mar. 1, 2001) and *Financial Audit: IRS Fiscal Year 1999 Financial Statements* (GAO/AIMD-00-76, Feb. 29, 2000).

Declines in the number and productivity of enforcement staff contributed to the declines in enforcement programs and the shelving of cases. For example, from fiscal year 1996 to 2000, the number of IRS employees working collection cases in the field dropped from about 5,500 to about 3,600, or by about 35 percent. In part, this drop was due to attrition, and, in part, it was due to reassignments intended to provide improved service to taxpayers. IRS does not routinely measure the productivity of staff handling collection cases, but IRS officials agree that it is taking longer for staff to work cases. Our analysis of collection staff time spent on collection cases and the number of cases closed over the period 1996 to 2000 indicates that the amount of time spent to close a case, excluding the processing of offers in compromise, has increased by about a third.[7] While there may be valid reasons for the productivity decline, including additional statutory requirements and extra time spent to ensure quality, IRS officials have not been able to provide us with a data-based explanation of the factors that have affected productivity or the extent to which the productivity decline has contributed to the declines in enforcement programs.

We share concerns that have been expressed in Congress and by tax practitioners that these declines in audits, enforcement actions, and collections of delinquencies may increase incentives for taxpayers either to not report or to underreport their tax obligations. Because IRS lacks a measure of the extent to which taxpayers voluntarily comply with tax laws, it does not know the impact of the recent declines in enforcement activities and delinquency collections. Shelving of collection cases exacerbates our concern regarding voluntary compliance because IRS is not following through on cases in which taxpayers have been found to be noncompliant. (Further details on the implications of the lack of a voluntary compliance measure are discussed in the next section.)

IRS' inability to reduce growing backlogs in two other programs—innocent spouse and offer-in-compromise—negatively affect both taxpayer service and enforcement and will merit oversight in the year ahead. The innocent spouse program allows relief under certain conditions to an innocent spouse from tax liabilities solely attributable to the actions of the other spouse. The offer-in-compromise program allows for contracts between IRS and individual or business taxpayers to settle

[7]Including offers in compromise, the average time to close a case has increased by about 50 percent.

tax debts for less than the amount of the debts. Sizeable inventories of claims and offers and slow processing times under these programs are examples of poor service to taxpayers. IRS staff reassigned to reduce program backlogs, thus far unsuccessfully, have taken resources away from other collection activities.

Both the innocent spouse and offer-in-compromise programs were greatly expanded as a result of provisions of the Restructuring Act. At the end of fiscal year 2000, the inventory of innocent spouse cases being worked had grown to almost 40,000, but the influx of new cases appears to have stabilized in the past 2 years. The inventory of unresolved offer-in-compromise cases was about 87,500 at the end of fiscal year 2000, almost triple the number of unresolved offers IRS had pending at the end of fiscal year 1997. In addition, the timeliness of cases worked declined. The percentage of offers IRS completed within 6 months was down from 64 percent in 1997 to 38 percent in fiscal year 2000.

Modernization Is Progressing, but Transformation Will Be a Long-Term Effort

IRS' modernization, encompassing fundamental changes in organizational structure, business processes, information systems, and performance management, is a long-term effort to transform the agency into a more reliable, accountable, customer-focused organization. Over the past year, IRS has made important progress toward that end; however, work on certain key aspects of business systems modernization and performance management was slower than anticipated. In an effort as complex and risky as IRS' modernization, however, it is important to remember that, while the timetable for change is important, cutting corners to achieve this timetable is not prudent. To IRS' credit, senior officials are making the difficult decisions necessary to manage the modernization for the long term. Still, managers at the working levels of the organization are not yet routinely using a performance-based approach to their work. Such an approach, in which managers at all levels consistently apply performance management skills in their day-to-day work by routinely gathering and using data to define goals and assess progress, will help IRS design improvements and achieve the transformation Congress desires.

IRS Successfully Shifted to Its New Organizational Structure

In October 2000, IRS largely completed its transition to the new organizational structure. In a process that the Commissioner likened to putting together a giant jigsaw puzzle with literally thousands of pieces, IRS put the new organization in place without significant effect—positive or negative—on its processing of millions of returns this filing season. That the reorganization has not yet led to significant changes in filing season or other activities is not unexpected. The reorganization provides a focus on taxpayer segments that IRS expects will help it better understand taxpayers' needs and identify changes to its systems and procedures for meeting those needs. In the course of our work at IRS in the coming year, we will be monitoring how IRS' new operating divisions focus their efforts to address specific compliance and service problems associated with their particular taxpayer segments.

Despite Important Progress, IRS Has Yet to Fully Implement the Capabilities Needed to Effectively Manage the Business System Modernization Program

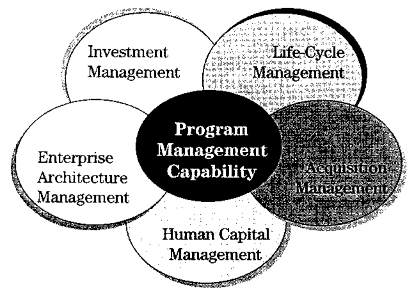
Business systems modernization (BSM)—a multi-year program to revamp business processes and put in place the supporting technology—is vital to achieving IRS' new, customer-focused vision and enabling IRS to meet performance and accountability goals. This multi-billion-dollar program began a little over 2 years ago and as of March 2001, had received congressional approval to obligate about $450 million.[8] BSM consists of a number of new systems acquisition projects that are at differing stages of acquisition and implementation, as well as various program-level initiatives intended to establish the controls and capabilities for IRS to effectively manage the projects.

We have long held—and communicated to IRS—the importance of establishing sound management controls to guide its BSM projects.[9] In general, the management controls and capabilities that IRS needs fall into five interrelated and interdependent categories as shown in figure 3—investment management, system life-cycle management, enterprise architecture management, software acquisition management, and human capital management.

[8]IRS requested and Congress established a multi-year systems modernization account and funded it with about $578 million via IRS' fiscal years 1998, 1999, and 2001 appropriation acts. In addition to the $450 million provided so far, Congress is currently considering a plan submitted by IRS to obligate the remaining $128 million to, among other things, fund program-level initiatives through mid-November 2001 and ongoing projects through their next life-cycle milestones.

[9]*Tax Systems Modernization: Management and Technical Weaknesses Must Be Corrected If Modernization Is to Succeed* (GAO/AIMD-95-156, July 26, 1995).

Figure 3: Information Technology Management Control Areas



Source: GAO.

In addition, we have reported on the risks associated with IRS' approach of concurrently building systems while developing and implementing these controls and capabilities.[10] We have also reported that the risks associated with building systems without the requisite management controls and capabilities are not as severe early in projects' life cycles when they are being planned (project definition and preliminary design), but escalate as projects are built (detailed design and development).[11] In this latter case, the risk of performance shortfalls and rework due to missing controls increases, both in terms of probability and impact.

To its credit, IRS has made important progress in implementing modernization management controls and capabilities. For example, IRS has (1) largely defined and has begun implementing its system life-cycle methodology that incorporates software acquisition and investment

[10]For example, see *Internal Revenue Service: Progress Continues But Serious Management Challenges Remain* (GAO-01-562T, Apr. 2, 2001).

[11]See *Tax Systems Modernization: Results of Review of IRS' Third Expenditure Plan* (GAO-01-227, Jan. 22, 2001).

management processes, (2) defined program roles and responsibilities of IRS and its modernization contractors, (3) begun formally managing modernization risks in an effort to proactively head off problems, and (4) made progress toward completing its enterprise architecture. IRS has also taken steps in response to our recommendations to strengthen the management of individual BSM projects as well. In addition, IRS recently hired experienced technical and managerial executives and augmented existing modernization staff with experienced IRS information systems and acquisition personnel.

We are concerned, however, because projects are proceeding past critical milestones without certain essential management controls in place and functioning. In particular, in our ongoing work for IRS' appropriations subcommittees, we found that IRS is proceeding with building systems—including detailed design and software development work—before it has implemented key controls. For example, IRS has yet to develop a sufficiently defined version of its enterprise architecture to effectively guide and constrain acquisition of modernization projects. In addition, it has not yet implemented rigorous, disciplined configuration management practices on key projects. IRS also has not ensured that the projects are following mature software acquisition processes. As we have concluded in our past reports, attempting to acquire modernized systems before having the requisite management controls increases the risk that systems will experience cost, schedule, and performance shortfalls, and these risks increase as projects move from planning into design and development.

Key IRS projects are now beginning to experience these shortfalls. For example, IRS data shows that a critical infrastructure project (called the Security and Technology Infrastructure Release) was 1.5 months late and $2 million over budget in completing its preliminary design phase in January 2001. However, these project shortfalls are understated because not all preliminary design phase commitments were completed then, and, as of mid-April 2001, IRS was still working to finalize 6 of 19 work products needed to complete this phase–meaning that the project is actually almost 5 months late.

We discussed these missing controls with the Commissioner and his BSM executives; they recognize the need to address these control weaknesses and have initiated steps to do so. IRS plans to fully implement many of these controls by the end of June 2001. In addition, the Commissioner decided recently to slow ongoing projects and new projects, giving priority to first putting in place missing management capacity and then building systems. For example, the Customer Account Data Engine (CADE) project is being delayed to a yet-to-be-determined time to, among other things, ensure that its design is sufficiently defined. In addition, the start dates for several new projects planned to begin in April 2001 are being delayed. IRS also plans to stagger these project starts, rather than initiate them all at once, with the first to begin this month.

With respect to BSM funding, IRS expects to totally exhaust congressionally-approved BSM funds by about November 2001 and is seeking approximately $397 million in its fiscal year 2002 budget to continue the program. Given that it has been slow to completely implement the full array of controls necessary for a modernization effort of this magnitude, this is a good time to ensure that the overdue modernization management controls are emphasized as a BSM priority.[12]

IRS' Oversight Board is recommending $450 million for BSM in fiscal year 2002, a $53 million increase over IRS' budget request. The Board stated that the additional $53 million is needed to fully carry out fiscal year 2002 BSM initiatives. Since the Board submitted its budget request, IRS, as mentioned above, has decided to slow ongoing and new projects in order to avoid exceeding its current capacity to effectively manage the program. Consequently, while we recognize that IRS needs funding to continue the BSM program, it is unclear whether IRS needs the additional $53 million in fiscal year 2002. Nonetheless, in the event that Congress does appropriate the $450 million, IRS' past appropriations acts and IRS' fiscal year 2002 budget request require such BSM spending to be submitted to Congress via an expenditure plan before BSM funds can be obligated. This provides a follow-on control mechanism to ensure that appropriated funds are managed and spent in an effective manner.

Effective Performance Management Is an Essential Element of IRS' Transformation

Through modernization, Congress expects IRS to provide top-quality service and, in doing so, to efficiently collect revenues for the Treasury. A performance management system that establishes goals, objectives, and measures—a structure for guiding and evaluating the transformation of IRS—is essential to meeting these expectations. In addition, when this structure successfully cascades down through the organization, a performance management system gives employees a blueprint of how to

[12]Congress limited IRS' ability to obligate funds until certain controls were in place by establishing a multi-year capital account—the Information Technology Investments Account—to fund IRS' systems modernization initiatives.

do their jobs and incentives to support what IRS wants to accomplish as an agency. IRS has continued to make progress in revamping its performance management system and has most fully developed it at the agencywide level. The system is less developed at the division level and is weakest at the front-line, where interactions with taxpayers occur. In the long run, if managers at all levels consistently apply performance management skills in their day-to-day work by routinely gathering and using data to define goals, assess progress, and design improvements, IRS will be better able to achieve the transformation it and Congress desire. IRS still has a long way to go in establishing this type of performance-based management culture.

Progress in Defining IRS' Strategic Direction

IRS made progress over the past year in defining its strategic direction. For example, IRS

- published a strategic plan for fiscal years 2000 to 2005 that lays out IRS' mission, strategic goals, and objectives; and
- implemented a strategic planning and budgeting process designed to reconcile competing priorities and initiatives with the realities of available resources.

However, IRS is still missing key measures of voluntary compliance. Because these measures are vital to understanding the ultimate impact of IRS' service and compliance programs, their absence from IRS' array of organizational performance measures continues to compromise the effectiveness of the performance system as a whole. In May 2000, the Commissioner appointed a project director to oversee the development of voluntary compliance measures, including filing, reporting, and payment compliance. This planning was not completed as quickly as anticipated and will probably not be finalized this fiscal year.

Mixed Success at the Division and Employee Levels

Clear strategic direction for IRS as a whole, while essential, is not sufficient. For its performance management system to act as a blueprint for employees throughout IRS, the elements of IRS' system must cascade down through the organization. In keeping with this principle, IRS' performance management plan calls for each operating division to have complementary goals, objectives, and measures and for front-line managers to develop plans identifying the actions they need to take to support operational objectives.

IRS has had mixed success in the challenging task of implementing its performance management system.[13] For example:

- While most division performance goals reflected IRS' agencywide goals and priorities, none of the 72 supporting objectives was stated in terms that were specific and measurable—that is, they did not include a time period, a numeric target, or a means to measure the objective. Also, with a few exceptions, the objectives did not include an expected result or program impact.
- In fiscal year 2000, IRS began requiring managers to develop plans that identify the actions they intend to take to meet their objectives. The action items in the plans developed by front-line managers were consistent with IRS' mission, but 91 percent of the items we reviewed were not specific, measurable, or outcome- or output-oriented.

Increasing the specificity of objectives and action plans could increase managerial accountability and create stronger incentives for front-line employees to achieve IRS' goals.

Our work on IRS' management of its telephone customer service operations illustrates how goals and objectives have not cascaded down through the organization. In a recent review of IRS telephone assistance,[14] we found that IRS does not have long-term goals for the level of service to be provided to taxpayers or annual goals aimed at achieving the long-term goal over time. Without them, IRS lacks meaningful targets for strategically planning and managing call center performance and measuring improvement.

Revamping IRS' evaluation systems for managers and front-line employees is another important means of establishing a clear link between individual employees' work and IRS' mission and goals. In February 2000, IRS implemented a realigned performance evaluation system for executives, managers, and supervisors. IRS had expected to implement a similarly aligned evaluation system for front-line employees last fall. However, negotiations with stakeholders are taking longer than expected, and IRS is uncertain about when the new evaluation system will be in place.

[13] See *IRS Modernization: IRS Should Enhance Its Performance Management System* (GAO-01-234, Feb. 23, 2001).

[14] *IRS Telephone Assistance: Opportunities to Improve Human Capital Management* (GAO-01-144, Jan. 30, 2001).

Managers Not Routinely Using Data to Monitor and Manage Performance

Performance evaluation—the collection of data on performance and the analysis of that data to determine the factors that explain performance—is a key part of performance management. IRS managers do not consistently evaluate the performance of their programs to make decisions about how to improve performance. In some cases, relevant, accurate data are not available or are not available on a timely basis to support program evaluations. In other cases, analyses of past performance are not complete enough to give managers an understanding of how to improve performance.

Financial information is an example of management information that is not available on a timely basis to IRS managers. IRS was able this year to use data from its financial systems to produce, for the first time, financial statements that received an unqualified opinion.[15] However, it did so through the use of substantial, costly, and time-consuming processes that provided data months after the fact for a single point in time. As a routine matter, IRS' financial management systems do not produce information that is current or accurate and that can be used to assist managers in day-to-day decisionmaking. For example, IRS does not track the cost accounting information needed to prepare cost-based performance information. Consequently, managers do not have the basic information needed to prepare reliable cost-benefit data for internal decisionmaking and for budget justifications, which could lead to inappropriate management or budgetary decisions.

IRS' analyses of the declines in productivity referred to earlier in this statement are examples of incomplete program performance evaluations. Taxpayer access to telephone assistors is less than it could be because telephone assistor productivity has declined for the third filing season in a row. IRS has done several studies of productivity, but only considered time spent handling a taxpayer call. IRS did not study other segments of assistors' time that would affect overall productivity, including time spent waiting to receive a call, time spent away from the telephone, and time assistors were not assigned to answer calls. Similarly, IRS officials could not give us an empirically-based explanation for declines in enforcement staff productivity. With more complete evaluations of the causes of productivity changes, IRS managers would have a more informed basis for making decisions about how to improve productivity and be more likely to meet performance goals.

[15] An unqualified, or clean, opinion means that financial statements are fairly presented.

Understanding the factors that drive productivity changes at IRS is important when evaluating IRS' budget. While the increase in IRS' workload and the complexity of its work might justify additional resources, declines in productivity raise questions about whether IRS is using existing resources efficiently. However, IRS' evaluations of productivity are not complete enough to use in making informed judgments about the extent to which existing resources could be used more efficiently. As a consequence, it was difficult to analyze IRS' budget request for additional staff (the STABLE initiative[16]). In a letter last week to the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, we said we were generally supportive of IRS' request on the grounds that the initiative targeted areas of need.[17] However, we also recognized that opportunities exist to improve productivity in those areas.

As IRS moves forward with modernization, the capacity to conduct sound performance evaluations will be one building block for success. Indeed, the Commissioner has written about the need for research and analysis that will help IRS decisonmakers find the best ways to improve performance against strategic and operational measures. We recently reported that it must address longstanding challenges to produce research results that meet the needs of managers and decisionmakers. These include, for example, ensuring that staff have the right mix of skills for the work and that research focuses on managers' needs. IRS recently established a Research Council to coordinate research activities, including standardized training, data needs, and quality standards.

Conclusion

Modernization of IRS' organizational structure, business processes, performance management system, and information technology is necessary if IRS is to achieve its goals of improving service to taxpayers and compliance with tax laws. While important progress has been made in laying the foundation for a new IRS, parts of the modernization effort have gone slower than expected. Clearly, this is disappointing. Unfortunately, it reflects the continuing need to build management capability. The goal of improving service to taxpayers quickly must be balanced with the need to prudently manage a massive, long-term effort like IRS modernization. As

[16]STABLE (Staffing Tax Administration for Balance and Equity) is designed to boost staff levels in tax compliance and customer service programs.

[17]*Fiscal Year 2002 Budget Request for the Internal Revenue Service* (GAO-01-698R, May 1, 2001).

of today, IRS does not have all the program management capabilities it needs to manage a very large systems acquisition program. Nor do IRS managers routinely use results-oriented management tools such as clear goal-setting and data-based evaluations of performance.

Mr. Chairman, that concludes our statement. We would be pleased to respond to any questions that you or other members may have at this time.

Chairman THOMAS. Thank you very much.

One of the difficulties that I think we're going to be in is trying to get a handle on the Oversight Board in terms of just exactly how we deal with reports, recommendations, especially the Inspector General from Treasury, since my assumption is the relationship to the Board is a dotted line and not a direct one—GAO gets to parachute in anywhere and examine at any time requests are made.

With that as a kind of backdrop, Chairman Levitan, my understanding is that the Board, because of the difficulty in going through appointments, was not up and running until September. How many meetings of the Board have we had so far?

Mr. LEVITAN. The Board came into play late in September. Our first meeting was September 29th. We meet as a full Board every two months for two days, and in addition to that, we have committees that meet periodically. In addition to that, we have individual Board members who do additional work. As Board chairman, I probably spend over half my time on these efforts.

Chairman THOMAS. And what about staffing?

Mr. LEVITAN. We have operated up until last week really without any full-time staffing. We have brought on board a staff director, Mr. Chuck Lacijan, who is seated behind me, who will help us in our efforts.

Chairman THOMAS. The reason I ask that question is to try to put into context the statements that you have made as chairman, in terms of your analysis in the time frame that you've been on board with the resources that you have available, the statement that the administration's funding proposal is inadequate, and that you not only have been able to assess that it's inadequate, but that you have been able to recommend specific amounts in specific areas.

I guess my question would be, how are you able to achieve that in the time frame that you've been up and running with the staff that you have?

Mr. LEVITAN. Well, the bottom line is through a lot of hard work. We realized in September, at our first meeting, that we needed to jump on the budget very, very quickly and spend a lot of time and effort working on it. So we have been working on it since September and, you know, the administration didn't come on board until January.

Quite honestly, from the discussions we've had, from the results, we feel that at the time the budget was prepared, both ours and the administration's, that we knew a lot more about the specific needs and situations at the IRS than the White House, the OMB, or the Treasury Department did.

Chairman THOMAS. Or the General Accounting Office?

Mr. LEVITAN. I am not aware of GAO's work on the budget, so I——

Chairman THOMAS. Not so much the budget, but the results of what the budget is intended to do, and that is to fund, in an orderly fashion, the various departments and agencies.

So I guess my question would go to you, Mr. Williams and Mr. White. Based upon the IRS' decision, in terms of dealing with the modernization question and the timing, versus the budget money available and the budget money proposed by the Board, clearly either there's going to be more money than they can spend reasonably or they are not following a timetable which indicates they need to spend more money in a more rapid fashion. So where do you, either Mr. Williams or Mr. White, come out in analyzing the IRS' decisions on its change of pace in modernization, versus the additional recommendation of additional resources to be supplied to that area?

Mr. WHITE. Mr. Chairman, I would like to break that question up into two pieces. One has to do with business systems modernization, and I have with me Mr. Hite from GAO, who is our Director of Information Technology, and he will address that part of the issue.

Chairman THOMAS. I believe my question allowed you to utilize the resources available to us.

Mr. HITE. Mr. Chairman, subsequent to the decision by the administration to fund the business systems modernization at $397 million, we have had discussions with the Commissioner and his executive staff about the need to ensure that plans for moving forward with the modernization are in line with their capacity to manage that. So, based on those discussions, the Commissioner has chosen to pull back on certain ongoing projects in terms of the pace and the plans for those, and also the timing for the initiation of new projects.

In light of those changes, it was our opinion that the necessity of the additional $53 million then becomes an item of question, and whether or not the money that would be needed, in fact, would have a material effect on the progress of the modernization over the next year.

I understand your position, that we don't want to throw more money at something unless we have the capacity to reasonably invest it in the software engineering community. This is referred to as the concept of the "mythical man month", where just throwing more resources at something doesn't necessarily mean that it's going to get done faster and better. You have to invest in something within the context of your capacity to manage that investment and, hence, our question about the necessity of that $53 million.

Chairman THOMAS. That gets to my initial question to the Commissioner. Any initial goals are stated with a degree of ambition and, to a degree, devoid of reality. As we move forward, my hope is that reality is what governs us. Because if, in fact, the IRS, as they have indicated on their business system projects, is beginning to experience performance shortfalls, not meeting deadlines, making adjustments, it clearly would have a budgetary impact in implementing.

My concern would be how we make sure that we coordinate so that we can get the best advice possible between the GAO, the Treasury Department, and the Oversight Board, with the Oversight Board urging "more gas, step on the pedal", and IRS and GAO overseeing, give me some indication that perhaps the original goals were a bit overambitious and that we need to re-adjust what our goals are, which would clearly affect the funding stream.

I don't want this oversight to be the usual "we didn't get enough money, therefore, we failed in what we were doing." I want to know if the original goals were achievable goals, which apparently there seems to be a reexamination of whether or not they're achievable. GAO would best function, for my purposes, in evaluating those goals and determining whether or not the reassessment or the readjustment of the reestablishment of those goals is an appropriate adjustment, and that an achievable time line has now been created so that we can measure against that time line.

My concern is that, at the very beginning of this process, I want to know how the Board views itself and its role in trying to accomplish those very laudable goals that were stated for the purpose of the legislation, and how you hope to achieve some integration between the monitoring of the ongoing historical structures and the role of the Board, both in terms of encouragement, oversight analysis, and hopefully resource for the Congress. That's my concern in how we continue this coordination.

So, with that, Mr. Levitan, on what basis do you feel comfortable evaluating the amount of money that you felt was a shortfall in the budget for the IRS, and whether or not the IRS, if they got the amount of money that you're proposing, could actually spend it in a meaningful way, given the adjustment of the various phase-ins of the modernization?

Mr. LEVITAN. Chairman Thomas, that's an excellent question, and I really believe, particularly on that $53 million, our positions are not that far off from GAO. But let me explain.

Another thing I would say is that I followed very closely the work that GAO has done in reviewing and auditing the work of modernization, and I think they are doing an outstanding job. By and large, I do agree with their conclusions.

In looking at funding for modernization in technology, the Board is really recommending three items. One is the money for laptop and desktop computers. It has nothing to do with the slowdown. It's needed today and should be spent today.

Secondly is multi-year funding for the ITIA account. That is again something to provide for additional management capability of the overall program. It will not increase expenditures actually in 2002, but will allow the IRS, with close oversight of GAO, Congress and others, to manage the program more efficiently.

On the $53 million difference between ourselves and the President's budget, we have looked at the detailed plan that the IRS has put together for modernization. We have also looked at the impact of the slowdown that was just implemented. We believe that the IRS can effectively utilize that money in 2002 and will allow us to go faster and get more done but still do it in an efficient manner.

Now, as far as the key question that you asked, are the goals realistic and can they be obtained, on modernization, the goals have to be obtained. The only question is, how long will it take and how much will it cost. Unfortunately, the answers to those are that it's going to take too long and it's going to cost too much. But, the primary way that the Board has looked at it is that we would like to see the job done as quickly as possible, consistent with the IRS' ability to both absorb change and to manage the program effectively. We believe that they could do that, that they could use that $53 million and, therefore, be further down the road.

Is it absolutely necessary expenditures for 2002? No. But the impact will be that they'll be further down the road and they will get the job done faster by being able to put more resources to work.

Mr. WILLIAMS. Mr. Chairman, our primary concern is that the ITIA fund would run out of money completely, or that the releases would be delayed for the wrong reasons, in the appropriation process. So we would support the idea of multi-year funding.

We have another concern, though. Modernization stumbled significantly as it came out of the starting blocks. To date, we have spent $400 million and nothing has happened to improve service to taxpayers. We're worried that the modernization hasn't caught its balance yet, and until it does, flooding more money could result in exactly the kind of problems that you suggested. We would like to see the first projects completed and we would like to think that IRS learned from some rather substantial mistakes that were made early on by the prime contractor and by the IRS itself before accelerated funding is considered.

Chairman THOMAS. Chairman Levitan, if you think you have difficulty meeting two days every other month, we do this once a year. So we are not going to get the kind of progress if we assume that these hearings are sufficient for an oversight function.

Frankly, I'm less concerned on where the three of you agree. We can put those in our pocket and walk away. My concern is where you don't agree. We are going to be conducting ongoing written dialogue in which, if you do disagree, we want you to present your argument as to why you disagree, so that we can create periodic monitoring sessions, notwithstanding not having the oversight.

I agree with you, Mr. Chairman, that it may cost too much and it may take too long, but it has got to be done. We don't have any friendly takeovers or hostile takeovers on the horizon. It's ours, and we have to deal with it, notwithstanding the frustrations associated with it. All I want from the resources available is the best possible achievable goal setting, prioritization, monitoring, and then follow up, so that we can actually show progress—not matter how slow—moving in the direction that we need to go.

I look forward to the Board getting a few more months under its belt, to continue this ongoing dialogue with the other monitoring agencies. Thank you very much for your testimony.

The gentleman from New York.

Mr. HOUGHTON. Thanks very much.

Mr. Williams, you talked about $400 million just a minute ago. Where did it go?

Mr. WILLIAMS. There has actually been a nice amount of progress in certain areas, and a troubling level of progress in others. The IRS has developed the platform and infrastructure for all of the improvements, the architecture plan is completed, and IRS has developed a project management discipline.

The projects themselves, the things that will actually change the level of service, in all too many instances, have been cut back, are late and are over budget.

Mr. HOUGHTON. Is that because there wasn't enough money or it wasn't applied, or the management was a little lax, what?

Mr. WILLIAMS. I have concerns with the delivery of the prime contractor, the consortium. They have been consistently late. I would also say, that the project management discipline that's been selected, the Enterprise Life Cycle, hasn't been followed very well. Many times the project is 90 percent done and the prime tends to move forward without completing the rest. You can't do that in projects of this magnitude and where issues of justice and taxpayer rights are involved. It has to be complete in a way that perhaps you would not find in private sector deliverables.

Also there was inappropriate sequencing. The IRS started the project work before the blueprint was done, and had to go back and retrofit some of the initiatives.

Also, there was a lapse in the area of management information systems development that was overlooked in the beginning, and it's vital to administering the program. Management information is still being organized for old bureaucracy, not for the new business units. That has to all be redeveloped.

Mr. HOUGHTON. Let me ask Mr. Levitan, do you feel the management has been a little lax in this area?

Mr. LEVITAN. The modernization, which started probably around two years ago, got off to a slow start. The IRS did not have the management capabilities. The prime contractor did get off to a slow start. I'm not sure that they had all of the right kinds of people with the right kind of experience on board.

Over the past year, I believe significant progress has been made in addressing those issues. Management processes have improved significantly——

Mr. HOUGHTON. You mean they've gotten better people?

Mr. LEVITAN. The IRS has gotten additional people and they've gotten stronger people with more experience. They have put into place better and improved management processes.

Are they enough? Are they a hundred percent? No, they're not. That effort does need to continue. GAO has pointed out specifically things that need to be done to improve it. We agree with those things.

Mr. HOUGHTON. If another $400 million was thrown at this issue, with the people you have now, do you think it would be better spent?

Mr. LEVITAN. First let me say I do not believe that $400 million has been wasted. I think that much has been accomplished and they are much further down the road. I think that the processes that are in place, and the people that are in place, with the continued improvement that must be made, I think will move them along and get the job done.

Mr. HOUGHTON. Finally, I would like to ask Mr. White a question.

Mr. White, in your testimony you talked about the number of IRS employees going down by about a third, in terms of following up on these collection cases, and that is substantiated by your chart on page 7, tax delinquencies.

I guess one of the things I have always talked to the Commissioner about—and, Mr. Levitan, you've heard me say this—is that one of the unique things of our system is the element of trust we have in it. If people feel that now they can take advantage of the system because there aren't the people to run it, it really does more than just destroy the numbers. It destroys the underlying support that we have.

How do you feel about that?

Mr. WHITE. Mr. Chairman, I think you raise an excellent point. Many people, inside and outside IRS, are concerned with those declines for exactly that reason. Our tax system does depend on people believing that their neighbors are paying their fair share and that their business competitors are paying their fair share, and without that trust that others are paying their fair share, there is a concern that people may be less compliant in filing their taxes.

One of the problems at IRS is that they currently do not have a measure of voluntary compliance, the extent to which people are voluntarily complying with the tax laws. They last measured it in 1988, and because of changes in the economy and the tax law, that is now outdated information.

IRS does have an effort underway to try to develop a new measure of voluntary compliance, but right now, they are managing blindfolded in this area. They don't know the consequences of the kind of declines that I talked about in my statement.

The STABLE initiative is designed to increase staffing in this area, as well as in the area of customer service, so that is part of their plan to address this issue.

Chairman THOMAS. I thank the gentleman.

Does the gentleman from Pennsylvania wish to inquire?

Mr. COYNE. Thank you, Mr. Chairman.

Mr. White, given GAO's concerns as expressed by you in some of the operations of the IRS, is it your recommendation that the Board's budget be adopted, or do you want to take a position on that?

Mr. WHITE. Again, we can answer that in two pieces. I will let Mr. Hite briefly respond on the business systems modernization piece, and then I would like to come back and talk about the operating portion of the budget.

Mr. HITE. With respect to the ITIA funding request, and whether it would be $397 or $450 million, we have not put forth an official GAO recommendation on the dollar amount.

Our position has been, the way the Appropriations Act of '99 was set up, the moneys that are appropriated for business systems modernization are not available to IRS for use until they put forth these incremental expenditure plans to the Appropriations Committees for approval of release of the money for a specific increment of work to be done, with specific objectives to be accomplished during that increment.

That's an additional control surrounding the use of appropriated funds that, in our view, mitigates the necessity to have a precise amount of money appropriated in the ITIA account, based on a specific, well-defined need for that year. It's the incremental release and the controls in place for assuring there's a justification for that incremental release that mitigates that need.

So, again, we have not taken a position and made a recommendation with regard to 397 versus 450 million.

Mr. WHITE. And with respect to the operating portion of the budget, where there are some differences between the Oversight Board and IRS, some of those differences, for example, are due to inflationary, nonpay costs that would be borne. IRS believes that they can cover those costs out of their budget, and until we see IRS lay out some facts about the negative consequences of failing to get that additional budget money, it is difficult for us to support the increase.

Mr. COYNE. Should we take from your testimony that it's not a desirable thing to be shelving these tax delinquencies?

Mr. WHITE. We are very concerned about what that does to the temptation to not fully comply with the tax laws, that the taxpayers see that and get concerned about whether their neighbors and competitors are paying their fair share.

Mr. COYNE. Is there any evidence in your finding that, if the budget were increased, if there were more resources available to the IRS, that there would be less shelving of the tax delinquencies?

Mr. WHITE. We do believe that the budget increase that IRS is asking for this year, compared to last year, does target areas where improvement is needed at IRS. The STABLE initiative is targeted on the compliance enforcement area. It is aimed to increase the number of full time equivalent staff there. It is also targeted on another area of need, telephone customer service.

Mr. COYNE. Mr. Levitan, what will happen to the IRS taxpayer service, the walk-in and telephone assistance, and taxpayer compliance generally, if there is not adequate funding as recommended in your proposal?

Mr. LEVITAN. We have reviewed the IRS' plans if they do not receive the funding for inflationary costs and other mandatory costs, which account for about $137 million. The net impact is that they will have 1,300 fewer people.

Now, 1,300 fewer people is not going to have a huge change on the service or the enforcement levels, but what STABLE was meant to do was to say let's provide a one-time increase, 3,800 people, to start to address these areas so that we can stop the level of performance degradation, stabilize it, and start to provide some level of improvement while we wait for modernization.

More people are not the right answer to fix the IRS' problems. More people is like sticking your finger in the dike to stop the leaking while we rebuild the dike. That was our recommendation, to finish STABLE as it was originally designed, bring the level of people to that point, and then hold it relatively on a stable, even basis as we move forward. So it will have some impact on service and on enforcement. Exactly how much, I can't tell you.

Mr. COYNE. Thank you.

Chairman THOMAS. I thank the gentleman very much.

If there are no additional questions, obviously, the purpose of the legislation was to make sure that the Internal Revenue Service functioned to its best capacity and in delivering the performance of its currently much needed services.

But my concern is that, in creating the Oversight Board, we have the traditional watchers and we have a new watcher. Our role is to watch the watchers. It is going to be much easier if, in fact, there is clear communication and, from a written point of view, I will request and hopefully you will provide assessments of each other's examination of the IRS.

It really doesn't serve, in my opinion, the purposes of the legislation to come and hear three separate voices and then "we thank you very much for the testimony". And we arrive next year and hear three separate voices.

If, in fact, there is agreement in terms of your analysis, we need to know where that agreement is. Where there is disagreement, we need you to discuss those areas of disagreement and attempt to come to an area of agreement. We will provide the umbrella for that dialogue to occur.

All of us, I think, have the same intention. Our goal is to make sure that, however much it costs, and for however long it takes, we have measurable, achievable goals and we move toward accomplishing what all of us want.

Perhaps the goal I will finally state is one that's unachievable; that is, a smoothly functioning, responsive, Internal Revenue Service, as long as we have a voluntary tax system in which the collection of that money is essential to provide the revenue to run the government.

You have an extremely difficult job, Mr. Levitan. Mr. Williams has a few other responsibilities under his umbrella, and the GAO, in terms of its money available in the job that it has, also has a difficult one.

Thank you very much for your performance and testimony today. I look forward to the continued written dialogue that I will share with members of this Joint Committee, so that we can talk about the goals that were set and achieved at the next hearing.

With that, the oversight hearing is adjourned.

[Whereupon, at 10:25 a.m., the hearing was concluded.]

[Submissions for the record follow:]

STATEMENT OF SENATOR CHARLES E. GRASSLEY

Tax Returns Vs. Financial Statements: Double Audit Standards at IRS

There is a double standard in auditing at IRS, and the taxpayers are getting the short end of the stick.

There are strict standards for the taxpayers and lax standards for the bureaucrats at IRS.

When the IRS audits a tax return, everything better be in order - or else. If not, penalties are imposed.

Most citizens live in fear of an IRS audit.

And it's only right that taxpayers be held to a very high standard of accountability. But the very same standards should also apply to the IRS.

The Chief Financial Officers (CFO) Act of 1990 opened the books of every government agency - including the IRS - to public scrutiny and audit.

The government has a sacred Constitutional responsibility to account for every penny in tax money it collects and spends.

If the government cannot do that, something is very wrong.

Under the CFO Act, every agency must prepare a financial statement every year. These are then subjected to independent audit by the General Accounting Office (GAO) or Inspector General.

The books are supposed to balance.

The problem is - the IRS' books don't balance

From day one, the IRS has flunked every CFO audit test - except this year. This year the IRS passed but used a very questionable "work around" maneuver to do it.

Here in my hand [hold up report] I have the IRS' latest report card - The GAO audit of March 2001.

From the front cover to the back cover, it tells a story of financial mismanagement. It tells us that IRS is not able to produce a financial statement that has integrity.

Yet with just two magic words on page three, the GAO gave the IRS an "unqualified opinion." That means the IRS passed the test.

As I pointed out a moment ago, the rest of the report paints a dismal picture. So where did the unqualified opinion come from? It does not compute.

Was the test rigged? Not quite.

This is what happened.

The IRS paid an accounting firm - KPMG - a lot of money to devise a "work around." KPMG had to manually reconstruct the records and fill in the gaps. Billions of dollars in unrecorded transactions had to be backed into the general ledger. The GAO characterized it as a "monumental labor intensive ad hoc" effort.

Unfortunately, the "work around" is not "sustainable." KPMG will have to re-invent the wheel again next year. The IRS simply cannot produce an acceptable financial statement.

The IRS "work around" is totally inconsistent with the law. And it is a waste of money and time.

The KPMG "work around" does not move the IRS one step closer to the goals envisioned in the CFO Act.

The goal is to produce accurate financial information as the basis for sound decisions.

The IRS - as the nation's tax collector and auditor - must set an example of excellence in bookkeeping. The IRS should be a leader in this field. No aspect of leadership is more powerful than setting a good example. The IRS must be willing to do what it asks the taxpayers to do. The IRS should be the accounting role model for the whole country.

The IRS needs to clean up the books and get its financial house in order.

I ask that my questions be placed in the record and answered in writing. Thank you

Senator Grassley's Questions for The Record

1) As the head tax collector, do you think it is important for the IRS to have its financial house in order? Is it in order?

2) The KPMG "work around" was a colossal waste of time and money. It does not advance the IRS toward the goal of having accurate financial information and effective internal controls. When will the IRS be able to produce an acceptable financial statement [GAO says10 years]

3) Many of the problems identified in the GAO report have existed since the beginning of time. What is the IRS doing to bring its financial management systems up to standards prescribed in law? [Spend $4 billion for new computers]

4) The GAO says that the IRS regularly fails to record transactions in the general ledger. Is that acceptable to you? How would a 4 billion dollar computer system overcome this problem?

STATEMENT OF SENATOR FRED THOMPSON
CHAIRMAN
SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS

SUBMITTED FOR

THE JOINT REVIEW OF THE INTERNAL REVENUE SERVICE

May 8, 2001

Thank you, Mr. Chairman, for convening this joint review of the IRS. And thank you Commissioner Rossotti for being here today.

When we passed the IRS Restructuring and Reform Act of 1998, we were trying to rein in an agency that, in the eyes of many Americans, had gotten out of control. Its enforcement actions were seen as too aggressive. We in Congress also saw the immense waste that occurred at the hands of IRS management – more than $3 billion in failed information technology investments – and wanted to put a stop to it. So it is appropriate to take stock now in how far we have come.

Unfortunately, when it comes to the details, statistics regarding IRS' performance are often confusing and sometimes contradictory. The audit rate doesn't necessarily encompass all audits performed by the IRS. The number of dollars reportedly recovered through its enforcement efforts may include monies recouped through discovering simple errors in tax returns rather than through ordinary audits. The level of customer service may not be as bad as the IRS says it is . . . it may be even worse.

Some things *are* clear. By any measure, IRS's tax enforcement activities, as well as revenues collected from enforcement activities, have trended down dramatically in recent years. And although it has devoted ever more resources to its customer service activities, the American people do not receive an acceptable level of timely and accurate service from the IRS. In addition, despite the benefits brought about by the IRS Restructuring and Reform Act, massive management problems continue to plague everything it does. The complexity of the tax code doesn't help.

The viability of our tax system depends on voluntary compliance. The steep decline in enforcement threatens to encourage those who are not inclined to comply voluntarily; it also poses fairness concerns from the perspective of those who do comply.

I am heartened to have at the helm of the IRS a man who has the vision and leadership capabilities to turn this agency around. Commissioner Rossotti has developed a plan, which, if effectively implemented, will bring about the level of productivity necessary to collect America's taxes in a fair and efficient manner. Unfortunately, all we have today is that plan.

I hope Commissioner Rossotti will give us his assurances that we will see improvements in the administration of the tax code in the near future. And I hope he can tell us that those improvements will be reported to us in a valid, verifiable, and understandable fashion. I have submitted some questions for the record which address many of the concerns share by members of the Governmental Affairs Committee. We look forward to receiving your answers.

QUESTIONS FOR THE RECORD FROM FRED THOMPSON, CHAIRMAN,
SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS

Questions for Commissioner Rossotti:

1. Providing top quality customer service and enforcing the tax laws fairly are, of course, key priorities for IRS. However, GAO's most recent high-risk report states:

   > "[I]nadequate financial and operational information has rendered IRS unable to develop cost-based performance information for its tax collection and enhancement programs and to judge whether it is appropriately allocating available resources among competing management priorities." (High-Risk Series: An Update, GAO-01-263 (January 2001), p. 158.)

   What are you doing to develop cost-based performance information? In the absence of such information, how can IRS and others make rational decisions about the agency's resource needs and how to deploy resources most effectively?

2. The staff report by the Joint Committee on Taxation states that IRS has not developed specific performance measures to achieve its first strategic goal of "Providing Top Quality Service to Each Taxpayer." Why haven't you developed such measures and when do you plan to do so? In the absence of such measures, how do you decide how to assign staff and assess their performance?

3. While differing in their detail, most reports on IRS customer service in such areas as accessability through the agency's toll-free number and accuracy of responses provided to tax questions indicate that the agency's performance is declining. For example, your Inspector General just reported that, in its recent tests, "The IRS did not provide correct or sufficient answers to us 73 percent of the time. Additionally, in some instances we were treated with discourtesy and had excessive wait times for service of 30 minutes or more." Department of the Treasury, Treasury Inspector General for Tax Administration, "The Internal Revenue Service Continues to Give Incorrect Tax Law Information in Taxpayer Assistance Centers," 2001-40-077 (May 2001).

   What do you think it will take to improve the agency's performance in this area?

   The IG findings concerning the accuracy of IRS employee responses to tax questions are much lower than the accuracy rates IRS self-reports. How do you account for this difference?

4. Your second strategic goal, "Providing Top Quality Service to All Taxpayers," equates to fair and uniform application of the law to all taxpayers. However, both the GAO and the Joint Committee staff report that IRS lacks a reliable measure of general compliance with tax laws. What is IRS doing to develop such a measure? Are there ways of measuring tax compliance that are less burdensome on innocent taxpayers than the methods IRS previously used?

5. IRS is converting its master file into a real-time, modern database format that will provide employees access to up-to-the minute taxpayer records and information. Having such a database obviously is essential to enhancing customer service to taxpayers. As your testimony states: "We cannot provide taxpayers with up-to-date information on their accounts, resulting in enormous frustration for both taxpayers and the IRS employees who want to help them." However, you report that the new system will not be fully deployed until 2006. Why so long? Can't you set a more ambitious goal for deploying this vital system?

Question for Mr. Levitan:

The Oversight Board recommends an FY 2002 budget for IRS that is about $838 million more than the Administration's request. Given IRS's lack of specific performance measures and reliable cost-based performance data, how do you know that the increased funding you advocate will translate into performance improvements by the agency?

Questions for Mr. Williams and Mr. White:

1. What do you believe IRS's budget should be for FY 2002, and what performance-based criteria would you apply in assessing its budget request?

2. You have criticized IRS's lack of specific performance measures and reliable cost-based performance data. What specific recommendations would you offer Commissioner Rossotti in terms of performance measures IRS should use and ways to enhance its performance data?

Question for Mr. Williams:

How do you account for the differences between what you report and what IRS self-reports with respect to the accuracy rate of IRS employees in responding to tax questions?

Senator Grassley's Questions for the Record

1) As the head tax collector, do you think it is important for the IRS to have its financial house in order? Is it in order?

We believe it is important for the IRS to have its financial management system work as well as possible. This past year, for the first time, the IRS received an unqualified opinion from the General Accounting Office (GAO) on all of its combined financial statements. However, we continue to overcome many of the remaining deficiencies the GAO noted, and those we must correct to meet the requirements of the CFO Act of 1990.

The IRS modernization plans include detailed specifications to replace and update current computer and financial management systems. The GAO distinguishes between two existing financial systems in its report for FY 2000. One system accounts for the tax revenues, and the other accounts for the annual Congressional Appropriation. With the IRS' and the GAO's hard work, the revenue accounting received its first unqualified opinion in 1997. However, the system, which is over 30 years old, does not meet the standards established by the CFO Act of 1990; it does not place the financial data into a Standard General Ledger (SGL) required by OMB.

On the Appropriations side, we received our first unqualified opinion from the GAO for FY 2000. This system, which was purchased in 1991, is 10 years old. It does not perform all of the accounting processes required by the laws passed during the past decade. The system is particularly deficient because it requires extensive manual intervention to complete work for financial statements. We are planning a new administrative accounting system to begin October 1, 2003, as part of the modernization of the IRS systems. Meanwhile, at the end of the year, it is important for the IRS to accurately state its financial condition. The GAO believes we can state our financial condition for FY 2000, by March of calendar year 2001, rather than the end of the year; however, to do so requires extraordinary efforts to compensate for the serious system deficiencies. Our goal is to maintain the unqualified audit opinion while working to improve all of our financial management systems and the timeliness of our reporting over the next few years.

2) The KPMG "work around" was a colossal waste of time and money. It does not advance the IRS toward the goal of having accurate financial information and effective internal controls. When will the IRS be able to produce an acceptable financial statement (GAO says 10 years)?

The GAO said our financial statements met the Generally Accepted Accounting Principles, and that the statements fairly represented the financial condition of the agency at the end of the year. Each of the steps that we have taken to improve our financial reporting has been intended to produce financial statements that meet the requirements of the CFO Act and provide meaningful information to our managers, the Congress and other stakeholders. We used contractor staff, when appropriate, to help us in accomplishing our goals. Our financial information has become timelier and more accurate each year. Since 1992, recommendations from the GAO at the end of each of their audits, and our own analysis, helped us meet this goal. We reconciled our cash balances at the end of FY 1999 and maintained that process during FY 2000. We improved management of property and equipment, so that this cost was fairly presented in the financial statements. We significantly improved stewardship of the assets in our facilities. This year, our goal is to overcome the control weakness the GAO reported for property and equipment. However, joining the data that tracks tax revenue collection into a Standard General Ledger with data from the administrative accounting system is some years away. We are planning a new administrative core accounting system for the beginning for FY 2004. The complete modernization of the tax accounting system will take up to ten years.

3) Many of the problems identified in the GAO report have existed since the beginning of time. What is the IRS doing to bring its financial management systems up to standards prescribed in law? [Spend $4 billion for new computers]

We carefully researched and planned the modernization of our computer systems using an Enterprise Life Cycle process of analysis and implementation. All concerned parties are represented at the Executive Steering Committee meetings, including the Assistant Secretary for Management and CFO from the Treasury Department, the Office of Management and Budget, and the General Accounting Office. The Commissioner submits requests to the Congress to support the plans and approve and release the necessary funding from the Information Technology Investment Account (ITIA). Since the computer systems for tax revenue accounting are operated using technology from the 1960's, modernizing the systems will require a large investment. The tax accounting system does not produce information that can be used in a Standard General Ledger as required by OMB. This is the primary reason the current accounting for tax revenue does not meet the requirements of the CFO Act and other OMB standards. Two of the modernization projects, Customer Account Data Engine (CADE) and the Custodial Accounting Project (CAP) will correct long-standing financial management weaknesses. CADE will replace the master file for tax revenue accounting. CAP will provide the first installation of an enterprise-wide data warehouse used for analysis, research, and case selection. CAP will also provide a clear audit trail for financial reporting. The first phase of the CAP project will start March 2003. However, the extremely complex replacement of the computer systems will take up to ten years.

4) The GAO says that the IRS regularly fails to record transactions in the general ledger. Is that acceptable to you? How would a 4 billion dollar computer system overcome this problem?

The GAO report for FY 2000 said: "IRS often does not record material transactions in its general ledger system until months after they occur." (GAO Financial Audit: IRS Fiscal Year 2000 Financial Statements. GAO-01-394, p.85). The report does not say we do not record transactions. The primary problem of our computer systems is their age and outmoded technology. Consequently, while the financial statements are complete and accurate at the end of the year, it takes months after the year's end to complete the work. A new computer system will help speed this process, making it more timely and more useful.

Questions for the Record from Fred Thompson, Chairman
Senate Committee on Governmental Affairs

Questions for Commissioner Rossotti

1. **Providing top quality customer service and enforcing the tax laws fairly are, of course, key priorities for IRS. However, GAO's most recent high-risk report states:**

   > **"[I]nadequate financial and operational information has rendered IRS unable to develop cost-based performance information for its tax collection and enhancement programs and to judge whether it is appropriately allocating available resources among competing management priorities." (High-Risk Series: An Update, GAO-01-263 (January 2001), p. 158.)**

   What are you doing to develop cost-based performance information? In the absence of such information, how can IRS and others make rational decisions about the agency's resource needs and how to deploy resources most effectively?

We do not have a cost accounting system that integrates with the core financial system and the time and volume production systems. However, we can perform ad hoc cost studies that highlight opportunities for savings and improvement. In particular, we conducted a study of filing paper and electronic returns. This study was significant because it highlighted improvement opportunities and affected management decisions about electronic filing. From this, we built a model to predict the cost changes as returns moved from the paper to the electronic environment.

As part of IRS systems modernization, we are implementing a Joint Financial Management Improvement Program (JFMIP), an approved commercial off-the-shelf (COTS) financial management system. As we begin the new, integrated core financial system in FY 2004, cost accounting will be regularly available to managers without conducting time intensive studies. Then we will have moved to an environment where our managers can be accountable for measurable, cost effective results.

We will use the information from the new cost accounting system in the various phases of the new Strategic Planning and Budgeting/Performance Measurement (SP&B/PM) cycle. We will use information related to cost effectiveness in every step of the cycle. However, this information will be especially important for:

- Developing the Commissioner's planning guidance
- Preparing and updating the performance plan
- Justifying OMB budget and Congressional

- Developing the business and resource allocation plans
- Executing and reviewing the strategy and program plans and the budget.

It will also be an important component in developing the agency's performance goals and monitoring our performance against the plan.

Not having cost based performance data does not necessarily mean we cannot effectively deploy resources. While the GAO has identified problems with the general ledger, we can produce sound budget authority and obligation data. We use the information to manage operations. We specifically need this information to report fund allocation and control items of Congressional interest.

Cost/expense data specifically assists us in efficiency issues and relating costs to outcomes, and the new core financial management system is key to developing cost based performance information. We are improving this capability as part of our systems modernization. Meanwhile, we can allocate and control funds to meet Congressional mandates, to justify budget requests, and to ensure priority activities and programs are funded.

2. **The staff report by the Joint Committee on Taxation states that IRS has not developed specific performance measures to achieve its first strategic goal of "Providing Top Quality Service to Each Taxpayer." Why haven't you developed such measures and when do you plan to do so? In the absence of such measures, how do you decide how to assign staff and assess their performance?**

We plan to assess our progress in serving each taxpayer through measures of customer satisfaction and burden. We obtain our customer satisfaction information through many sources, including the American Customer Satisfaction Index (ACSI), Roper Starch, and product/service specific transactional surveys. We are implementing our customer survey program incrementally. Eventually, we plan to expand existing surveys and add new surveys to cover other products and services and to provide aggregate data for each of our taxpayer segments.

The ACSI results are currently available at an aggregate level for individual filers and for a subset of electronic filers. These filers report on taxpayer levels of satisfaction. We also use the ACSI data as a benchmark against private sector industries and companies, and other public sector organizations.

The Roper Starch Worldwide surveys show Americans' opinions of the IRS. The resulting score, which is a percentage of the total public that has a favorable opinion of the IRS, with detailed analysis, helps us better understand those factors that most influence public perceptions and attitudes toward us.

While these surveys provide us useful information, the way they are compiled and reported make it difficult to identify specific and actionable areas for improvement. Therefore, we also use transactional surveys tied to major products and services. These transactional survey results capture a snapshot of taxpayers' experiences and expectations, and tell us the changes our customers want to see. Customer comments help identify and address systemic issues and problems that may be negatively affecting our service.

In addition to customer satisfaction survey data, we plan to use other survey data to measure the burden imposed on taxpayers in complying with their tax responsibilities. We plan to obtain information from taxpayers and practitioners about the time and expenses they incur. We have begun to design and implement strategies, programs, and activities that make it easier for taxpayers to obtain assistance and file their returns. Burden data will help us improve and assess the impact of changes on taxpayers. Our initial efforts in this area have focused on the individual filer; we plan to focus on developing burden estimates for other taxpayer segments.

3. **While differing in their detail, most reports on IRS customer service in such areas as accessibility through the agency's toll-free number and accuracy of responses provided to tax questions indicate that the agency's performance is declining. For example, your Inspector General just reported that, in its recent tests, "The IRS did not provide correct or sufficient answers to us 73 percent of the time. Additionally, in some instances we were treated with discourtesy and had excessive wait times for service of 30 minutes or more." Department of Treasury, Treasury Inspector General for Tax Administration, "The Internal Revenue Service Continues to Give Incorrect Tax Law Information in Taxpayer Assistance Centers, " 2001-40-077 (May 2001).**

   What do you think it will take to improve the agency's performance in this area?

In preparing for the 2001 filing season, the first filing season under the modernized IRS organizational structure, we began to implement our Taxpayer Assistance Center (TAC) quality service plan. The plan is based on our 2000 review of IRS walk-in customer service, which reflects the same results found by the TIGTA. We are working aggressively to improve the face-to-face customer services we provide at almost 500 TACs by:

- Creating a new position, Tax Resolution Representative, which significantly raises the level of skill and accountability in providing quality service for customers who visit our TACs. In addition to providing more comprehensive and informed assistance, this position will minimize our reliance on seasonal staff support from employees from other divisions
- Providing employees fast, on-line access to resources they need

- Integrating standard probe and response methods used in the telephone customer service environment
- Converting from periodic Problem Solving Days to scheduling daily problem solving appointments at the taxpayers' convenience
- Reconfiguring TACs for more efficient staff access to the resources to assist taxpayers
- Providing additional training since FY 2001 for employees, including a new customer communications module
- Establishing a special referral process for difficult questions, including TAC employee calling the Customer Accounts Services and Compliance Services phone sites for assistance

The IG findings concerning the accuracy of IRS employee responses to tax questions are much lower than the accuracy rates the IRS self-reports. How do you account for this difference?

The IRS and TIGTA generally agree on the accuracy and quality of the face-to-face services provided in IRS TACs. However, during hearings before the Senate Appropriations Committee last April, TIGTA referred to telephone customer service quality that was significantly less than we reported. The TIGTA findings were based on a small sample of unrepresentative test calls and gave the misleading impression they were reporting on the accuracy of answers to actual questions taxpayers asked during the 2001 filing season. The TIGTA used hypothetical questions they developed with information from our website and conducted a statistically unreliable survey. We have a reliable quality measurement system that samples taxpayer calls. Our system is statistically sound and meticulously scores quality and accuracy. The TIGTA rated 182 calls over a four-day period, although taxpayers made 8.3 million calls during the ninety days of the filing season. To date, the actual accuracy for the filing season is 78% for tax law calls and 88% for account calls, while TIGTA reported that only 53% were accurate.

Clearly we need to improve the quality of our telephone service, but the TIGTA report drastically overstated the actual error rate. We are working with TIGTA so our future reports on this subject will not differ so significantly

4. **Your second strategic goal, "Providing Top Quality Service to All Taxpayers, " equates to fair and uniform application of the law to all taxpayers. However, both GAO and the Joint Committee staff report that IRS lacks a reliable measure of general compliance with tax laws. What is IRS doing to develop such a measure? Are there ways of measuring tax compliance that are less burdensome on innocent taxpayers than the methods IRS previously used?**

We established the National Research Program (NRP) office in April 2000 to explore and develop approaches to measure taxpayer reporting, filing, and payment compliance. The NRP researched several approaches that focus on more reliance on internal, operational data to shift the burden of measuring compliance from the taxpayer to the IRS. In May, the NRP office presented a proposal to the IRS Oversight Board and Senior Management Team. The Secretary of the Treasury approved the proposal in December and Congressional staff briefings began in January.

5. **IRS is converting its master file into a real-time, modern database format that will provide employees access to up-to-the minute taxpayer records and information. Having such a database obviously is essential to enhancing customer service to taxpayers. As your testimony states: "we cannot provide taxpayers with up-to-date information on their accounts, resulting in enormous frustration for both taxpayers and the IRS employees who want to help them." However, you report that the new system will not be fully deployed until 2006. Why do long? Can't you set a more ambitious goal for deploying this vital system?**

The current approach for converting our master files into modern databases resulted from a thorough analysis of possible alternatives to accelerate the modernization process without introducing unmanageable risks to the IRS's tax processing systems. Our goal was to modernize quickly to realize taxpayer benefits without causing adverse taxpayer consequences.

The key to the selected approach was its "segmented" nature. For example, we brought individual taxpayers to the modernized environment in five releases, starting with the least difficult filing situations to the most difficult. This phased-in approach will lesson the risk of replacing all of the individual master files in one release, while delivering taxpayer benefits relatively early in the technical modernization effort. Currently, the Customer Account Data Engine Project (CADE) release schedule for converting the individual master files is as follows:

- 2002 Release 1: 2-3 million 1040 EZ Telefilers with refunds
- 2003 Release 2: 32 million additional electronic filers with refunds
- 2004 Release 3: 41 million additional taxpayers, paper returns, full paid, refund or balance due
- 2005 Release 4: 34 million additional Small business/Self Employed taxpayers
- 2006 Release 5: 12 million additional taxpayers with complex situations

By 2003, as a result of this approach, millions of taxpayers who file electronically will receive refunds within several days instead of waiting two weeks. In 2004, CADE and other modernization projects, like the Customer Account Maintenance (CAM) Project, will enable on-line access to taxpayer accounts, faster problem resolution, and other improved post filing processing. After we begin Release 3, and based on our experience, we will evaluate whether we can accelerate the remaining releases while limiting the risk to ongoing tax processing and improving the probability of overall modernization success. Therefore, we will realize significant master file modernization and benefits to the taxpayer well before 2006.

IRS Oversight Board Reply
to
Questions for the Record from Senator Fred Thompson, Chairman,
Senate Committee on Governmental Affairs

Question for Mr. Levitan:

The Oversight Board recommends an FY2002 budget for IRS that is about $838 million more than the Administration's request. Given IRS's lack of specific performance measures and reliable cost-based performance data, how do you know that the increased funding you advocate will translate into performance improvements by the agency?

Reply:

The RRA 98 established the IRS Oversight Board to "oversee the IRS in its administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws or related statues and tax conventions to which the United States is a party". The IRS Oversight Board has been given specific responsibilities to review and approve strategic plans of the IRS, review IRS operational functions, review the selection, evaluation, and compensation of IRS senior executives, and review and approve the budget request of the IRS prepared by the Commissioner.

The IRS Oversight Board wants to assure the Joint Committee on Taxation that recommendation of an FY2002 budget that is higher than the Administration's request should not be interpreted as a sign that the IRS Oversight Board favors giving the IRS additional money without accountability for the funding it receives. The history of the IRS' earlier attempt to modernize shows that throwing money at a problem does not produce success.

The vision of the Board is to provide the continuity, expertise, and accountability to the IRS that comes from having a organization in place to review the operations of the IRS on a permanent basis, with the ability to provide strategic direction to the IRS, review resource allocations to meet strategic objectives, assess the results, and hold the IRS accountable for the outcome. The Board intends to accomplish this objective by ensuring that the IRS has in place an approved strategic plan, resource allocations designed to meet strategic objectives, and meaningful data-driven performance measures. The Board will hold the IRS accountable for results achieved.

Thus, the Board's responsibility for recommending an IRS budget is an important part of its overall mission to oversee the IRS and improve its performance, but it is not its only responsibility. The Board intends to hold the IRS accountable for funds spent and the results achieved.

Accountability using data-driven performance metrics will be an essential part of the Board's plan. The Board has formed a Performance Measure subcommittee that has already spent considerable time in reviewing the IRS' Balance Measures program. One central theme the Board will insist upon is that the IRS use meaningful data-driven performance measures to evaluate its own performance and use the results to drive performance improvements.

The Board also has the responsibility to review the selection, evaluation, and compensation of IRS senior executives. Once a performance baseline is established, and accountability assigned to individual IRS executives, the Board intends to link individual performance assessment and compensation to organizational performance. The Board has already established a Personnel subcommittee that will coordinate with the Performance Management subcommittee to perform this function.

As stated in the testimony of the Board's chairman, Larry Levitan, the Board believes that the IRS is not effectively and efficiently serving the needs of the American taxpayers. Although the Board is not yet aware of all the problems facing the IRS, the Board identified the following pressing problems:

- Despite management focus and certain improvements, customer service is still inadequate
- The level of enforcement activities has fallen consistently for many years, raising questions about tax compliance and fairness to the vast majority of citizens who pay all their taxes
- The IRS computer systems are outdated, resulting in a work environment that is completely inconsistent with efficient and modern practices
- IRS employee morale and job satisfaction are not adequate

Accordingly, the Board has recommended a budget higher than the Administration to help resolve both the short and long term concerns. The Board budget recommendation is based on three IRS needs:

- Rebuilding the IRS personnel base in the short run to improve critical performance areas,
- Seeking immediate improvements via short term productivity improvements, and
- Modernizing IRS technology effectively and efficiently to drive long-term productivity improvements

In reviewing the FY2002 budget request, the Board applied its collective expertise and judgement accumulated from years of senior positions in both the private sector and government, as well as service on other boards of directors. It analyzed the most pressing needs of IRS, reviewed major resource gaps impacting achievement of strategic goals and resource gaps in current tactical programs, explored areas of productivity improvement, and reviewed key budget drivers for both FY2002 and FY2003. In making its recommendations for the FY2002 budget, it arrived at the following conclusions:

- Although the IRS has plans to add 1822 additional positions because of the STABLE program, approximately 1300 of these positions will be offset by personnel due to the requirement to absorb $137 million of costs it cannot control.
- Failure to provide $54 million to purchase laptop and desktop replacements will put the IRS on a seven-year replacement schedule for this equipment, and delay use of software the IRS has already developed or purchased.
- The Information Technology Investment Account (ITIA) was originally intended to be analogous to a capital account to fund needed Business Systems Modernization (BSM)

projects. Because of the multi-year nature of this account, additional controls were placed on this account that are not normally applied to appropriated funds. Before these funds can be released for spending, the IRS is required to develop a detailed Expenditure Plan, which is reviewed by the General Accounting Office (GAO), and approved by the appropriate subcommittees of both the House and Senate Appropriations Committees. That process has been followed for all funds placed in the ITIA. By the end of FY2001, the balance in these accounts will fall to zero, which the Board believes is highly worrisome and counterproductive to managing a large program such as BSM in an effective manner. Low reserves in this account provide incentives to make decisions based on short term conservation of expenditures; discourage decision-making based on long term needs; inhibit performance-based contracting in favor of time and material contracting approaches; and encourage gaps in funding that result in constant project start-ups and shut-downs that make it extremely difficult to retain the talented information technology personnel required for such an ambitious project. The Board believes that this fund must be restored to a level where it contains at least one year of funding above that which can realistically spent in the next fiscal year.

For the appropriated FY2002 IRS budget, the Board will ensure the IRS establishes meaningful performance measures for FY2002 that quantify the expected level of performance the IRS plans to achieve. These measures will likely be developed from the Balanced Measures program the IRS is developing. Again, the Board wants to assure the Joint Committee on Taxation that the IRS Oversight Board will hold the IRS accountable for spending appropriated funds efficiently and effectively.

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION RESPONSE TO QUESTIONS FOR THE RECORD FROM FRED THOMPSON, CHAIRMAN, SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS

Question: You have criticized IRS's lack of specific performance measures and reliable cost-based performance data. What specific recommendations would you offer Commissioner Rossotti in terms of performance measures IRS should use and ways to enhance its performance data?

Answer: We have conducted several reviews in the past two years assessing the Internal Revenue Service's (IRS) implementation of the Government Performance and Results Act (GPRA). The IRS Commissioner has indicated that it will take several years to achieve a fully acceptable set of balanced measures that can be used at all levels of the organization.

As the IRS continues to refine its measures, we recommend that the Commissioner ensure that all performance measures are properly defined, any limitations on the measures are fully disclosed, and that all major tax administration activities are included. We further recommend that the IRS establish a sound verification and validation process to ensure that the data being reported are accurate and reliable.

For example, we have reported that the customer satisfaction surveys did not always include all taxpayer interactions, the sampling methodologies did not ensure equal and unbiased opportunities for taxpayer participation, and the survey response rates were too low. These conditions increased the risk that the results may not be representative of the overall population. We recommended several actions to improve the survey process, and advised the IRS to properly disclose any survey limitations when reporting survey results.

The IRS presently doesn't have a reliable method to measure voluntary compliance. The IRS recognizes this long-standing problem, and has developed a conceptual framework for a series of strategic measures focused on three core components that make up overall compliance: filing, reporting, and payment compliance. We encourage the IRS to pursue this endeavor, as measuring compliance is a critical part of tax administration.

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION RESPONSE TO QUESTIONS FOR THE RECORD FROM FRED THOMPSON, CHAIRMAN, SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS

Question: How do you account for the differences between what you report and what the IRS self-reports with respect to the accuracy rate of IRS employees in responding to tax questions?

Answer: A number of factors contribute to the difference between our reported accuracy rate and the IRS' reported accuracy rate for toll-free tax law service. The IRS statistics:

- Are cumulative for the entire filing season, whereas our sample was taken over a 4-day period.
- Encompass many tax law topics that address both individual and business taxpayers. We tested 10 questions that we believed were relevant to Wage and Investment taxpayers rather than business taxpayers.
- Do not include the quality of calls received on Sunday. We did include calls made on a Sunday and found the quality rate for this day was slightly lower.
- Do not include the quality of calls made before 7:00 AM and after 11:00 PM EST. Our test calls were made beginning at 6:00 AM and ending at 12:00 AM and covered three time zones – Eastern, Central, and Pacific.
- Do not include the quality of calls that are deferred for later response. (Two of our questions met this criterion.)
- Include both procedural and technical accuracy.
- IRS considers offers to return the taxpayer's telephone call as correct responses. In these instances, the Customer Service Representative answering the initial telephone call is unable to answer the taxpayer's question and offers to have someone call the taxpayer back. The IRS does not review the quality of the return telephone call. We had five calls where the IRS offered to return our call, but did not.

When we modified our computation method to mimic IRS' computation method our overall accuracy rate of 53% increased to 65%. IRS statistics for the same 4-day test period show a 66% technically correct response rate.

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION RESPONSE TO QUESTIONS FOR THE RECORD FROM FRED THOMPSON, CHAIRMAN, SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS

Question: What do you believe IRS's budget should be for FY 2002 and what performance-based criteria would you apply in assessing its budget request?

Answer: I don't have a basis for giving you a strong recommendation in support of either the Administration's budget proposal or the IRS Oversight Board's budget proposal. However, I do believe that the Congress should fully fund the Information Technology Investment Account (ITIA) in line with the IRS' request for the FY 2002 budget. Although most projects are taking longer and costing more than originally anticipated, IRS' systems must be modernized to achieve the goals of RRA 98.

With respect to assessing the IRS' total budget request, I would use a combination of the performance measures found in the budget request, and the IRS' Annual Performance Plan (APP). The budget request lists, per program activity, the performance measures and results that the IRS uses to determine the level of its success and, to an extent, links the measures and results to the proposed budgeted amounts. The APP provides the linkage between the IRS' strategic direction and the program activities in the budget request. In addition, the Clinger-Cohen Act suggests that projects collectively stay within 10% of cost and schedule goals. I believe that until the IRS begins to achieve this standard while delivering quality systems, the controls currently in place for review and release of funds from the ITIA should be continued.

Answers to Questions for the Record from Senator Fred Thompson

1.) What do you believe IRS' budget should be for FY 2002, and what performance-based criteria would you apply in assessing its budget request?

Ultimately, assessments of the adequacy of agency budgets involve value judgments about federal priorities that must be decided by the Congress. Recognizing this we focused in past reports and testimonies on the extent to which IRS' budget is linked to performance measures and selected expenditures address identified needs.

Fundamental to assessing IRS' budget request is a clear linkage between expected performance or results and the resources requested. Conclusions about what IRS will accomplish with the taxpayers' money cannot be drawn without an adequate explanation of how performance is expected to be affected. While we recognize that it is not easy to clearly link budget levels and performance results, we believe IRS could do a better job of making that linkage. Key to improving the linkage is the development of better performance measures. IRS is working on such measures. Specifically, IRS is working on developing data to measure progress against three strategic goals: service to each taxpayer, service to all taxpayers, and productivity. Importantly, IRS is also working to develop measures at the division and employee level that are aligned with the strategic measures. If IRS is successful, Congress and other stakeholders will be able to make more informed decisions about adjusting IRS' resource levels.

We reviewed selected IRS' proposed fiscal year 2002 expenditures, including the $86.4 million requested for the Staffing Tax Administration for Balance and Equity (STABLE) initiative and the $397 million requested for Business Systems Modernization (BSM) program. The STABLE initiative is intended to improve customer service and enhance IRS' tax compliance efforts by improving the level of service provided to taxpayers over the telephone, increasing the number of overdue accounts closed by telephone collectors, and freeing up compliance staff detailed to provide assistance during tax filing seasons to return to their duties of examining returns and collecting overdue accounts. We were generally supportive of IRS' request on the grounds that the initiative targeted areas of need, such as the processing of Schedule K-1s and increasing customer service staff.[1]

The BSM program is IRS' multiyear effort to put into place the technology that will support revamped business processes. The program consists of a number of new system acquisition projects that are at differing stages of acquisition and implementation and various program-level initiatives intended to establish the capacity for IRS to effectively manage these projects. BSM is vital to achieving IRS' new, customer-focused vision and enabling IRS to meet performance and accountability goals. In our May 8, 2001 statement we described IRS' progress in implementing modernization management controls and capabilities.[2] We also expressed concern because projects are proceeding past critical milestones without certain essential management controls in place and functioning. We recognized that IRS needs the requested funding to continue the BSM program, but at the same time we suggested that overdue modernization management controls

[1] Schedule K-1s are filed in conjunction with returns filed by trusts, partnerships, and S-corporations. Those returns are referred to as flow-through returns because they pass their income through to beneficiaries, partners, and shareholders. Schedule K-1s show the amount passed through to a particular beneficiary, etc.

[2] *IRS Modernization: Continued Improvement in Management Capability Needed to Support Long-Term Transformation* (GAO-01-700T, May 8, 2001).

be emphasized as a BSM priority and that this was an opportune time to ensure that the agency address these missing controls and capabilities as a condition of future funding.

IRS' Oversight Board recommended $450 million for BSM in fiscal year 2002, a $53 million increase over IRS' budget request. The Board stated that the additional $53 million was needed to fully carry out fiscal year 2002 BSM initiatives. Since the Board submitted its budget request, IRS decided to slow ongoing and new projects in order to avoid exceeding its current capacity to effectively manage the program. Consequently, while we recognized in our statement that IRS needed funding to continue the BSM program, we also said that it was unclear whether IRS needs the additional $53 million in fiscal year 2002.

With respect to IRS' operating costs to cover inflationary increases in nonpay expenditures and certain other costs, IRS recognized unfunded costs of $57 million, but indicated they could be covered through improved resource management. The IRS Oversight Board recommended a budget increase of $137 million to cover these unfunded costs. The consequences of not increasing IRS' budget to fund these costs are unclear. We said at the May 8 hearing that it would be difficult for us to support a budget increase for these costs without some facts from IRS showing the consequences of not getting the increase.

2.) What specific recommendations would you offer Commissioner Rossotti in terms of performance measures IRS should use and ways to enhance its performance data?

As we said in our May statement, a performance management system that establishes goals, objectives, and measures—a structure for guiding and evaluating the transformation of IRS—is essential to meeting Congress' expectations for IRS. In addition, a performance management system gives employees a blueprint of how to do their jobs and incentives to support what IRS wants to accomplish as an agency. Although IRS has made progress creating the structure of its performance management system, managers at the working levels of the organization are not routinely using data to monitor and manage performance. In some cases, relevant, accurate data, such as financial data, are not available or are not available on a timely basis. In other cases, analyses of past performance are not complete enough to give managers an understanding of how to improve performance.

In February 2001, we made recommendations that as IRS continues to refine its performance management system it add at the agencywide level a measure of quality for the strategic objective of providing quality service to taxpayers who need help or who may owe additional taxes. We also recommended that IRS provide a performance measure for the objective to increase fairness of compliance. At the division level, we recommended that IRS revise or develop operational performance measures to ensure that the measures are directly linked to operational objectives. In addition, we recommended that IRS provide better guidance to unit managers on how to develop action items that are few enough to focus employees' attention and are specific, measurable, and outcome or output oriented.[3]

Other steps that would enhance IRS' performance data include developing a measure of voluntary compliance with the tax laws; developing division-level and smaller unit performance goals that are specific, measurable, and results-oriented; and revamping the evaluation system for frontline employees—areas that we have reported on and will continue to report on.

[3] *IRS Modernization: IRS Should Enhance Its Performance Management System* (GAO-01-234, Feb. 23, 2001).

Furthermore, IRS does not track the cost accounting information needed to prepare cost-based performance information impeding the preparation of reliable cost-benefit data for decisionmaking and for budget justifications. In August 1999, we recommended that IRS develop the data to support meaningful cost information categories and cost-based performance measures.[4]

IRS could also make better use of existing performance data. In some cases, analyses of past performance lacked the depth to give managers insight into how to improve performance. An example is the decline in the productivity of telephone assistors, IRS has studied the amount of time assistors spend handling a call, but not other segments of assistors' time, including the time waiting to receive a call. We have recommended that IRS develop and follow written plans to collect and analyze data to test conclusions about factors that affect performance and evaluate improvement actions.[5]

[4] *Internal Revenue Service: Serious Weaknesses Impact Ability to Report on and Manage Operations* (AIMD-99-196, Aug. 9, 1999).
[5] *IRS Telephone Assistance: Limited Progress and Missed Opportunities to Analyze Performance in the 2001 Filing Season* (GAO-02-212, Dec. 7, 2001).

○