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IRS MODERNIZATION

Continued Progress Necessary for Improving Service to Taxpayers and Ensuring Compliance

Statement of James R. White
Director, Strategic Issues

Robert F. Dacey
Director, Information Technology Systems Issues

Steven J. Sebastian
Director, Financial Management and Assurance

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Highlights

Highlights of GAO-03-796T, a report to Congressional Committees

IRS MODERNIZATION

Continued Progress Necessary for Improving Service to Taxpayers and Ensuring Compliance

Why GAO Did This Study

Congress passed the IRS Restructuring and Reform Act of 1998 in response to frustration with the Internal Revenue Service's (IRS) inability to effectively carry out its mission. IRS's inability to deliver new computer systems that worked, allegations of abuse of taxpayers by IRS employees, and taxpayers greeted by busy signals when calling IRS for assistance all fed the frustration. The act set two goals for IRS—improve service to taxpayers while continuing to enforce compliance with the tax laws. The act also mandated annual joint congressional oversight hearings, of which this is the fifth and final.

What GAO Recommends

GAO is not making any new recommendations. However, numerous recommendations made in previous GAO reports about how to deal with the challenges facing IRS are cited.

www.gao.gov/cgi-bin/getrpt?GAO-03-796T.

To view the full report, including the scope and methodology, click on the link above. For more information, contact James R. White at (202) 512-9110 or whitej@gao.gov.

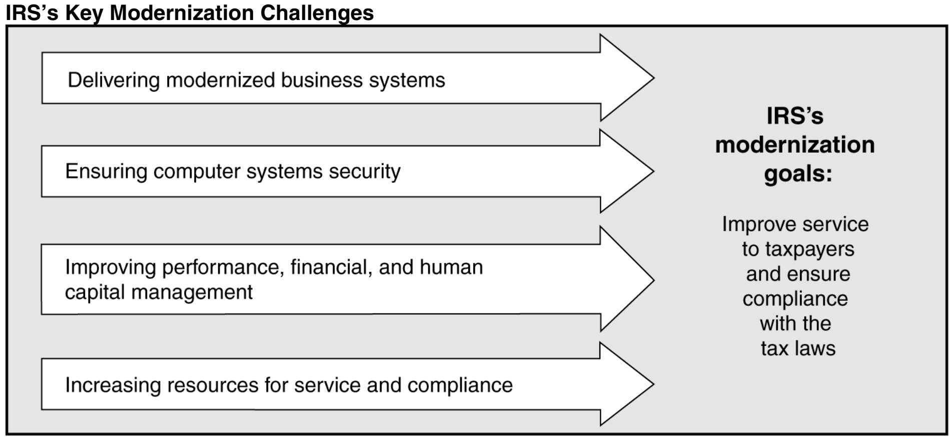
What GAO Found

IRS's accomplishments in the 5 years since the act was passed are significant. IRS has increased its capacity to manage with, for example, more effective controls over information system acquisition and better performance measures. In addition, the improvements have had a noticeable impact on service to taxpayers. Taxpayers have an easier time reaching IRS by telephone and are increasingly using IRS's Web site to download tax forms and publications and check the status of their refunds. Nevertheless, IRS is only part of the way to where taxpayers and Congress expect it to be.

Compliance is perhaps IRS's greatest challenge looking forward. Although IRS lacks current data about the level of voluntary compliance, what is known is that there have been significant and pervasive declines in many of IRS's key compliance and collections programs. As a result of these declines, taxpayers have less incentive to voluntarily comply, thereby potentially undermining the integrity of the tax system and risking revenue collections. Reversing this decline will be a challenge. Another challenge will be closing the gap between the level and quality of taxpayer services that IRS provides and what Congress and taxpayers want and expect. Despite improvements, almost one-third of callers receive busy signals or hang up without receiving service, and almost 20 percent get incorrect answers to tax law questions.

The means for realizing IRS's goals is continued progress modernizing, but this will be a challenge. The scope and complexity of the business systems modernization is growing, but management capacity is still maturing. Long-standing computer security weaknesses continue to threaten the confidentiality, integrity, and availability of sensitive systems and taxpayer data. Performance, financial, and human capital management all need further improvement. IRS is also challenged to realize the increased staffing levels for service and compliance called for in recent IRS budget requests.

IRS's Key Modernization Challenges



Source: GAO.

Mr. Chairman and Members of the Committees:

We are pleased to be here today to contribute to this joint oversight hearing on the Internal Revenue Service (IRS). Five years ago, Congress passed the IRS Reform and Restructuring Act of 1998[1] (Restructuring Act), as part of an effort to modernize IRS and provide taxpayers with additional rights and protections. In this hearing, the fifth and final one mandated by the Restructuring Act, we will report on IRS's accomplishments over recent years and the challenges ahead.

Throughout the 1990s, Congress grew increasingly frustrated with IRS's inability to effectively carry out its mission. IRS's inability to deliver new computer systems that worked, allegations of abuse of taxpayers by IRS employees, and taxpayers greeted by busy signals when calling IRS for assistance all fed the frustration. In response, Congress established the National Commission on Restructuring IRS in 1995 and passed the Restructuring Act in 1998, which increased Congress's oversight of the agency. In passing the act, Congress set two basic goals for IRS: improve service to taxpayers while continuing to enforce compliance with the tax laws.

Since passing the Restructuring Act, Congress has maintained its increased oversight of IRS. For example, Congress has reviewed IRS's expenditure plans for its Business Systems Modernization (BSM) program before allowing authorized funds to be spent. Congressional committees have also held numerous hearings on IRS's modernization progress, including the five joint oversight hearings.

In addition to oversight, Congress has invested in IRS. In the last 5 years, Congress has appropriated $1.35 billion for BSM. Congress also has virtually fully funded IRS's annual budget requests for each year.

Now, halfway through the 10 years that the then Commissioner projected modernization would take, is a good time to take stock—to look back on what has been accomplished to date. We are pleased to report that, while still far from realizing the goals set by the Restructuring Act, what has been accomplished is significant.

[1]Pub. L. 105-206.

- IRS has increased its capacity to manage. While still only partway to where it needs to be, IRS has put in place an organizational structure and improved processes to set strategic priorities, allocate resources, and achieve results aligned with priorities. IRS has established a strategic planning and budgeting process, put in place many of the management controls needed to effectively acquire and implement modernized business information systems, reorganized around taxpayer groups, established a balanced performance measurement system, implemented a new employee evaluation system, and issued reliable annual financial statements.

- The modernization accomplishments to date have had a noticeable impact on service to taxpayers. For example, taxpayers are more frequently reaching, and waiting less time to speak to, telephone assistors and are increasingly using IRS's Internet Web site to download forms and publications and get other types of information, such as the status of their refund.

  The service improvements mean that the congressional oversight, efforts made by IRS managers and employees, and dollars invested in modernization are beginning to show payoffs that American taxpayers can see. Less apparent on the list of accomplishments is compliance. While several significant compliance efforts have been started, few have been completed.

  With a new commissioner just confirmed, now is also a good time to list the challenges facing IRS in the coming 5 years. Last year in this same hearing, we said that IRS was at a critical juncture, in part, because of the impending change of commissioners and the challenges a new commissioner would face. With the change just completed, IRS remains at essentially the same critical juncture. Both of IRS's goals—improving taxpayer service and ensuring compliance—are challenges. Similarly, the means for achieving these goals—modernization of management and systems—is a challenge. Without continued focus by managers and employees on modernizing, IRS would put the progress made to date at risk and jeopardize the possibility of realizing Congress's twin goals for modernization.

- The area where progress is least apparent—compliance—is perhaps IRS's most significant risk and greatest challenge looking forward. Compliance is a risk, in part, because neither IRS nor we know the level of voluntary compliance, which compliance problems are the most significant, and what the impact changes and IRS's compliance programs and efforts have on the level of voluntary compliance. What is known is that there have been significant and pervasive declines in many of IRS's key compliance and collections programs. The declines can be seen in measures such as cases closed, staffing levels, cases not worked, and the inventory of uncollected tax debt. As a result of these declines, taxpayers have less incentive to voluntarily comply, thereby potentially undermining the integrity of the tax system and risking revenue collections. Reversing this decline will be a challenge.

- While service to taxpayers has improved, gaps remain between the quality of taxpayer services that IRS provides and what Congress and taxpayers want and expect. For example, while the percentage of callers who receive busy signals or hang up without receiving service has fallen since 1997, it still remains at 32 percent.

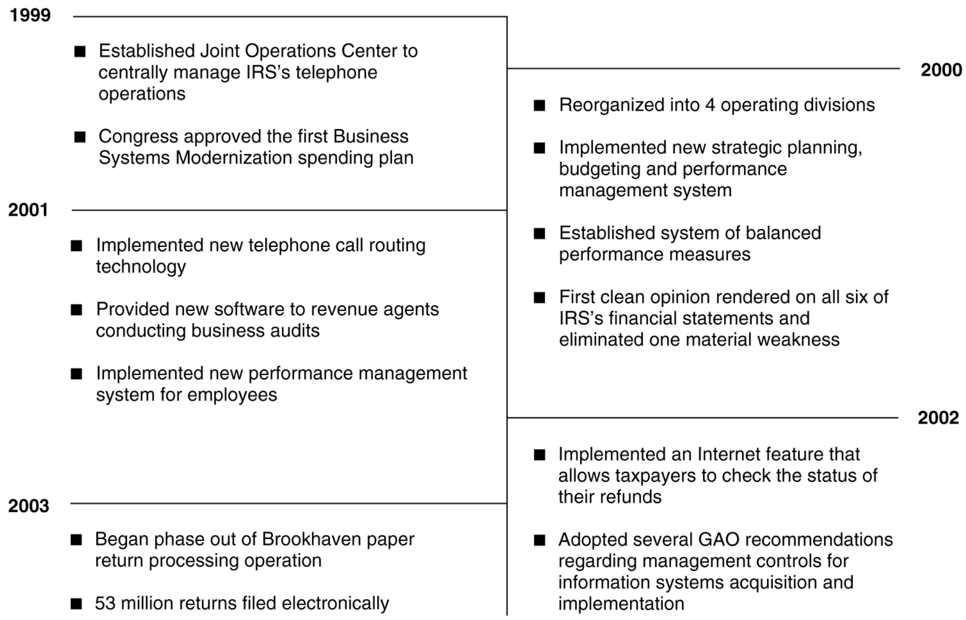
- Continuing the progress that has been made in modernizing management remains another challenge. The scope and complexity of the BSM is growing, but management capacity is still maturing. Long-standing computer security weaknesses continue to threaten the confidentially, integrity, and availability of sensitive systems and taxpayer data. Performance, financial, and human capital management all need further improvement. Finally, realizing the increased staffing levels for service and compliance called for in recent IRS budget requests has not always been possible.

Our assessment of both major accomplishments and key challenges is based primarily on recently issued GAO products and ongoing reviews.

IRS Has Improved Management and Taxpayer Service

Over the 5 years since the Restructuring Act was passed, IRS has made significant progress in modernizing. Figure 1 shows some of the major accomplishments of the last 5 years. The figure includes actions that have been implemented or completed and that represent significant steps in the overall modernization effort. The figure is meant to illustrate important progress—it does not show every accomplishment.

Figure 1: Selected Major IRS Accomplishments in Modernizing, 1999-2003



Source: GAO.

Most of the accomplishments shown in figure 1 are internal management improvements that will not be noticed by taxpayers, such as management controls for information systems acquisition and implementation. While such improvements do not directly affect taxpayers, they should lay a foundation for improving service and ensuring compliance.

Figure 1 does include some accomplishments that are noticeable to taxpayers such as the ability to check the status of their refund using the Internet and the increase in electronically filed returns. One accomplishment—the new software for revenue agents to help conduct business audits—involves IRS's enforcement programs.

IRS Has Made Management Improvements

IRS has completed a number of major modernization steps to help improve management of its operations. While IRS still faces challenges in each of the areas discussed below, the steps completed to date are major accomplishments.

Modernizing Business Systems

IRS's multibillion dollar BSM program is critical to the success of the agency's efforts to transform its manual, paper-intensive business operations and fulfill its obligations under the Restructuring Act. To date, about $1.35 billion has been appropriated and released for BSM.

IRS's challenges in modernizing its business systems date back to the mid-1990s, when we reported on a number of technical and management weaknesses and made a series of recommendations for correcting them and limiting modernization activities and spending until they were corrected.[2] It was then that we designated the modernization program as a high-risk area.[3] These challenges remained virtually unchanged until 1999, as IRS made limited progress in correcting its weaknesses and our ongoing reviews of the program continued to identify additional weaknesses and produce additional recommendations.

Beginning in 1999, IRS started making progress in strengthening its modernization management controls and capabilities. For example, IRS submitted and Congress approved the first of a series of expenditure, or spending, plans for BSM. These plans facilitate congressional oversight and provide a description of the expenditures, functionality, and delivery schedule planned for each project. Other notable accomplishments since 1999 include (1) developing and using a modernization blueprint, commonly called an enterprise architecture, to guide and constrain its modernization projects and (2) investing incrementally in its projects, both of which are leading practices of successful public and private sector organizations.

Since 2001, IRS has progressed in establishing the infrastructure on which future business applications will run. Establishing this infrastructure is a necessary prerequisite for business applications that are intended to provide benefits to taxpayers and IRS. In addition, it has delivered three applications that are today producing benefits. For example, the Customer Communications 2001 project improved the telecommunications

[2] U.S. General Accounting Office, *Tax Systems Modernization: Management and Technical Weaknesses Must Be Corrected If Modernization Is to Succeed*, GAO/AIMD-95-156 (Washington, D.C.: July 26, 1995), and *Tax Systems Modernization: Blueprint Is a Good Start But Not Yet Sufficiently Complete to Build or Acquire Systems*, GAO/AIMD/GGD-98-54 (Washington, D.C.: Feb. 24, 1998).

[3] U.S. General Accounting Office, *High-Risk Series: An Overview*, GAO/HR-95-1 (Washington, D.C.: February 1995).

infrastructure, including telephone call management, call routing, and customer self-service applications.[4]

In response to congressional direction and our previous concerns about projects getting ahead of the agency's ability to manage them effectively,[5] IRS scaled back its projects, giving priority to implementing needed management capacity. In our February 2002 report,[6] we again recommended that the Commissioner of Internal Revenue reconsider the scope and pace of the program to better balance it with the agency's capacity to handle the workload. In response, IRS took steps to better align the pace of the program with the maturity of IRS's controls and management capacity, including reassessing the portfolio of projects that it had planned to proceed with during the remainder of fiscal year 2002 and reducing the planned scope and pace of the program for fiscal year 2003.

Securing Taxpayer Information

Information security is a critical consideration for any organization that depends on information systems and computer networks to carry out its mission or business. It is especially important for government agencies, like IRS, where the public's trust is essential. The dramatic expansion in computer interconnectivity and the rapid increase in the use of the Internet are changing the way IRS communicates and conducts business. Without proper safeguards they also pose enormous risks that make it easier for individuals and groups with malicious intent to access sensitive information, commit fraud, or disrupt operations.

Due to the nature of its mission, IRS collects and maintains a significant amount of personal and financial data on each American taxpayer. These data typically include the taxpayer's name, address, Social Security number, dependents, and income. The confidentiality of this sensitive information is important because if this information is disclosed to

[4]The other two are Customer Relationship Management Examination, which provides off-the-shelf software to IRS revenue agents to allow them to accurately compute complex corporate transactions, and Internet Refund/Fact of Filing, which improves customer self-service by providing taxpayers with instant refund status information and instructions for resolving refund problems via the Internet.

[5]U.S. General Accounting Office, *Business Systems Modernization: Results of Review of IRS' March 2001 Expenditure Plan*, GAO-01-716 (Washington, D.C.: June 29, 2001).

[6]U.S. General Accounting Office, *Business Systems Modernization: IRS Needs to Better Balance Management Capacity with Systems Acquisition Workload*, GAO-02-356 (Washington, D.C.: Feb. 28, 2002).

unauthorized individuals, taxpayers could be exposed to a loss of privacy and to financial loss and damages resulting from identity theft and financial crimes.

IRS has made important progress toward improving information security over taxpayer data and implementing a comprehensive agencywide information security program. It has established and updated a substantial set of information security policies, standards, and guidelines that generally provide appropriate guidance to personnel responsible for securing IRS information systems and data. If effectively implemented, these would protect IRS information systems and taxpayer data from many threats. IRS has also increased the resources devoted to securing its systems and data—increasing, for example, the number of specialists assigned to the office responsible for ensuring that IRS has effective security programs in place. To help improve the security of IRS's systems and taxpayer data, IRS has also (1) implemented and improved control measures that limit physical access to facilities and computing resources and (2) established a virus protection and eradication program that helps to protect against new malicious software threats as they emerge.

Reorganizing IRS and Managing Performance

A major principle of IRS's modernization strategy is that understanding the taxpayer's point of view and improving service is fundamental to helping the majority of taxpayers who are willing to comply with the tax laws and pay what they owe. To help realize this customer-focused approach to providing service, in October 2000 IRS reorganized into four divisions, each responsible for a group of taxpayers with similar needs, such as IRS's Small Business/Self-Employed Division.

A sound organizational performance and human capital management system is essential for assessing how well IRS meets its goals and for identifying and making programmatic improvements. IRS has made progress by establishing a system of balanced measures to hold managers and frontline staff more accountable for improving performance. For example, IRS determined that the three elements of balanced measures were customer satisfaction, employee satisfaction, and business results (quality and quantity measures) to ensure balance among priorities. Similarly, in October 2001, IRS implemented its new employee evaluation system for frontline employees. This main human capital management system, like the one implemented earlier for executives and managers, was designed to structurally align performance expectations for employees with IRS's three strategic goals to encourage behaviors and actions that support and advance those goals.

In 2000, IRS implemented a new strategic planning and budgeting process that provides the framework for developing goals, objectives, and measures at the operating division level. Although we have not evaluated the effect of the process on IRS performance, the operating divisions are identifying strategic goals intended to be tailored to the specific characteristics and needs of their taxpayers. IRS senior management is also using the process to reconcile competing priorities and resource needs of the operating divisions.

Improving Financial Management

Current and accurate financial information is critical to informed decision making by senior management. IRS has made considerable progress towards improving financial management, including achieving unqualified (clean) audit opinions on financial statements.

When former Commissioner Rossotti was confirmed in November 1997, IRS was exhibiting virtually the same pervasive financial management weaknesses we had been reporting since we began auditing IRS's financial statements in 1992. These weaknesses, which led GAO to add IRS financial management to its high-risk list in 1995,[7] stemmed not only from IRS's reliance on obsolete and inadequate financial management systems, but also from the serious weaknesses in IRS's policies and procedures. In the five years that have passed since 1997, however, IRS has made considerable progress in addressing weaknesses in its financial management systems and internal controls by, for example, committing extensive additional resources. This and other efforts have resulted in reducing the number of material internal control weaknesses and attaining unqualified opinions on its financial statements. This achievement was due in no small part to the strong commitment made by senior IRS management.

During our audit of IRS's custodial financial statements[8] in fiscal year 1997, we found material weaknesses in IRS's internal controls that had shown little improvement since our first audit in fiscal year 1992. These weaknesses included an inadequate financial reporting process,

[7] GAO/HR-95-1.

[8] The Custodial Financial Statements report the assets, liabilities and results of activities related to IRS responsibilities for implementing federal tax legislation, including collecting federal tax revenue, refunding overpayments of taxes, and pursuing collections of amounts owed. IRS also has administrative activities, which include managing costs funded by appropriations and reimbursements from other federal agencies, state and local governments, and the public.

deficiencies in controls to properly manage unpaid assessments, and deficiencies controls over tax refunds and computer security. To overcome these weaknesses, IRS implemented extensive compensating procedures that enabled it to derive reliable balances related to its custodial activity such as taxes receivable, enabling IRS to receive, for the first time in fiscal year 1997, an unqualified opinion on its custodial financial statements.

During fiscal years 1998 and 1999, we were unable to issue a clean opinion on five of IRS's six financial statements due to the continued affects of the material weaknesses in IRS's internal controls. We were able to continue to issue unqualified opinions on IRS's statements of custodial activity, primarily due to IRS's extensive use of compensating procedures.

Beginning in fiscal year 2000, IRS received an unqualified opinion on all six of its financial statements by successfully producing a single set of financial statements that were fairly stated in all material respects. This significant achievement was made possible by years of strong commitment and hard work by both IRS senior management and staff to develop and implement compensating procedures to overcome the fundamental systems and internal control deficiencies that continued to exist and enable IRS to report reliable financial balances at fiscal year-end. IRS also instituted monthly reconciliations of its Fund Balance with Treasury, a process similar to companies or individuals reconciling their checkbooks to monthly bank statements, thereby eliminating this issue as a material weakness.

In fiscal year 2002 IRS reported its financial results and received an unqualified audit opinion 6 weeks after the close of the fiscal year—about 75 days ahead of the reporting deadline required by the Office of Management and Budget. As before, this achievement, and continued progress in addressing its material internal control weakness, was the culmination of years of IRS efforts to refine the compensating procedures it has relied on to overcome material weaknesses, in its internal controls, as well as making substantive improvements in the way it records transactions, maintains records, and reports financial results.

Taxpayers Have Seen Some Improvements in Service

IRS has improved and expanded service to taxpayers, including the accessibility of telephone assistance and increased electronic filing and Internet services. These improvements are a significant accomplishment, but IRS taxpayer service is not yet at the level that taxpayers and Congress want. Also, IRS has begun to reap some rewards from electronic filing—

for example, the closing of its paper processing operations at its Brookhaven location.

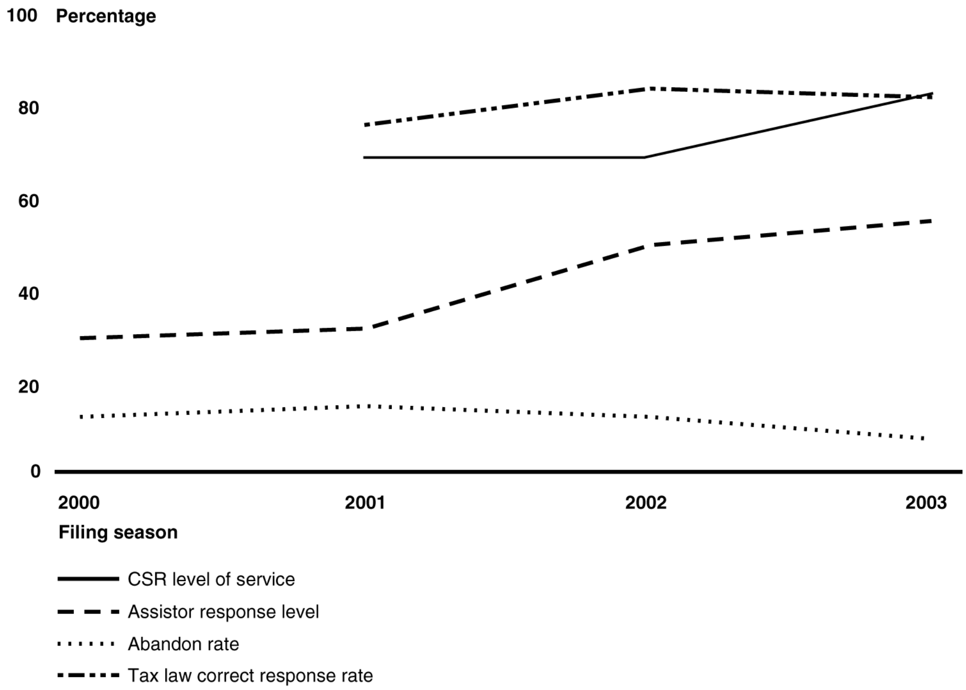
Improved Telephone Service

Since the mid-1990s, access to telephone assistance, an important function that affects millions of taxpayers, has improved. In 1997, about 49 percent of calls to IRS primary assistance lines either received a busy signal or were abandoned before being answered. This compares to about 32 percent of calls to date in 2003. As figure 2 illustrates, other measures of access show improvement as well. The percentage of calls where taxpayers attempted to reach an assistor and received service increased from about 70 to 83 percent between the 2001 and 2003 filing seasons. The figure also shows that callers are waiting less time to speak with an assistor and are hanging up less frequently before getting through. Telephone service is important because it affects so many taxpayers. In 2002, IRS received over 100 million phone calls.

IRS's telephone service improvements are, in part, the results of numerous improvement efforts sustained over time. In 1999, IRS centralized its toll-free telephone operations and established the Joint Operations Center to enable it to route calls to assistors across the country based on actual availability data. Similarly, from 2000 through 2003, IRS made several business process changes and implemented new technology. For example, in 2001, IRS shifted millions of calls to its automated service so it could use its assistors to answer more challenging taxpayer calls. Also, as part of its Customer Communications Project, IRS enhanced its call routing system.

Figure 2 shows that the accuracy of tax law information provided to taxpayers by assistors has remained relatively stable. According to IRS officials, accuracy stayed stable despite simpler calls being routed away from assistors to automated systems.

Figure 2: Improvements in IRS's Service and Assistor Response, 2000-2003



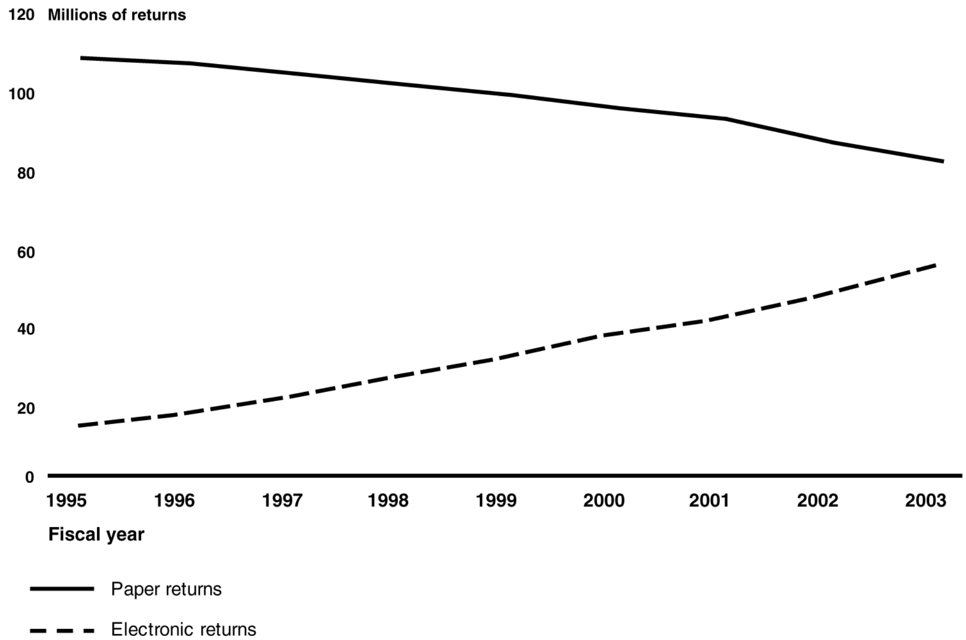
Source: GAO analysis of IRS data.

Note: CSR level of service–of the calls that IRS estimates were from taxpayers attempting to reach an assistor, the calls that received service; Assistor response level–of the calls that reached an assistor, the percentage in which the caller waited 30 seconds or less; Abandon rate–of the calls routed to an assistor, the percentage that hung up before speaking to an assistor; and Tax law correct response rate–of the calls in which IRS provided tax law information, the percentage in which the assistor provided correct answers. IRS has comparable data only for the years shown. Accessibility data covers the period of January through mid-April. The correct response rate covers the period January through April and is an estimate (90-percent confidence level +/- 1 percentage point).

Increased Electronic Filing and Internet Services

Although it still represents less than half of all individual income tax returns, electronic filing grew from almost 12 million returns in 1995 to an estimated 53 million in 2003, as shown in figure 3. The figure also shows that the number of paper returns is declining. The growth of electronic filing is one key to IRS's modernization strategy, because electronic filing allows IRS to control costs and improve customer service by reducing labor-intensive processing of paper tax returns. As a result, IRS is phasing out its paper processing operations in the Brookhaven location.

Figure 3: Increase in Individual Electronic Returns and Decrease in Paper Returns, 1995-2003



Source: GAO analysis of IRS data.

Note: GAO estimated that, based on the number of returns received electronically to date, IRS will receive a total of 53 million returns filed electronically in 2003.

Another indication that taxpayers are receiving payoffs from modernization is the breadth and quality of the services provided on IRS's Internet Web site. The services being offered to taxpayers and tax practitioners via the Web site have grown considerably over the last few years, and it is used more each year by taxpayers and tax practitioners. As of March 31, 2003, about 283 million forms and publications had been downloaded since the beginning of the filing season.

IRS's Web site is a critical part of modernization because, according to IRS, it is more cost-effective than other methods of providing taxpayer assistance, such as answering telephone calls. The IRS Web site currently provides a way for taxpayers and tax practitioners to receive assistance without having to call or visit an IRS office. Among other things, the site provides the potential to download hundreds of tax forms and publications, contains current information on tax issues and electronic filing, and, in a more recent feature, gives taxpayers the opportunity to check the status of their refunds. The capability to check the status of refunds is particularly important because IRS data shows it has decreased the refund call inquiries handled by IRS's telephone operations and has the potential to further decrease those calls, enabling assistors to handle more complicated calls about tax laws or customer accounts that cannot be answered through automation.

Key Challenges, Especially in Compliance, Remain

Despite the progress modernizing and the improvements in taxpayer service, IRS faces significant challenges looking ahead. Perhaps IRS's most significant risks and biggest challenges are in the area of compliance—an area wherein accomplishments have not been very apparent. Compliance is a risk, in part, because IRS does not have current data on how well taxpayers are complying with the tax laws and therefore cannot appropriately target areas for improvement nor can assess the impact changes to its compliance program have on the level of voluntary compliance. However, the available data show declines in many of IRS's enforcement activities, such as collections. The declines have prompted concerns that taxpayers' willingness to voluntarily comply could be put at risk. Meeting IRS's goal of ensuring compliance is a challenge because of the effort and resources that will be required to reverse these program declines.

Meeting IRS's goal of improving taxpayer service also presents a challenge. Despite IRS's accomplishments, there remains a gap between the quality of service that taxpayers currently receive and the service that taxpayers and Congress want and expect.

A key to ensuring compliance and improving taxpayer service is continuing to modernize IRS's management and systems. This includes delivering modernized systems; ensuring computer systems security; improving performance, financial, and human capital management; and increasing resources for taxpayer service and compliance.

Declines in Enforcement Programs Make Ensuring Compliance a Challenge

A visible enforcement program is considered by many as critical for our tax system to encourage voluntary compliance with the tax laws. While improving taxpayer service may enhance voluntary compliance, taxpayers' willingness to voluntarily comply with the tax laws depends in part on their having confidence that their friends, neighbors, and business competitors are paying their fair share of taxes. To provide that confidence, IRS operates a number of compliance and collection programs, including computerized checks for nonfiling and underreported income, audits, and telephone and field collections. Collecting taxes due the government[9] has always been a challenge for IRS, but in recent years the challenge has grown.

Limited Information on Voluntary Compliance

Understanding taxpayers' compliance with the nation's tax laws is essential to IRS improving the effectiveness of its programs to enforce and promote voluntary compliance. While IRS strives to ensure that enforcement audits are targeted at noncompliant taxpayers, this has become increasingly difficult to do because the information used to identify potentially noncompliant tax returns is out of date. We remain concerned about IRS's ability to appropriately allocate its enforcement resources, including staff, to its various compliance and collections activities. Without current data on voluntary compliance, IRS does not know which is the highest priority area of noncompliance.

IRS's new effort to review compliance, the National Research Program (NRP), should, if implemented as planned, provide IRS with the first up-to-date information on compliance rates and sources of noncompliance since it last measured the compliance rate using 1988 tax returns. IRS has agreed with recommendations we made regarding implementation of NRP and more effective use of such data in the strategic, planning, budgeting, and performance management process.

Enforcement Program Declines

Absent measures of voluntary compliance, the only compliance-related data available are on IRS's enforcement programs. In recent years, steep declines have occurred in some of IRS's compliance programs for individual taxpayers and in programs to collect delinquent taxes. These trends have triggered concerns that taxpayers' motivation to voluntarily comply with their tax obligations could be adversely affected. Since the

[9]Total unpaid taxes due the government include (1) delinquent taxes that IRS is attempting to collect, (2) taxes that IRS knows are due but has decided not to pursue collecting, and (3) an unknown amount of unpaid taxes that IRS has not identified.

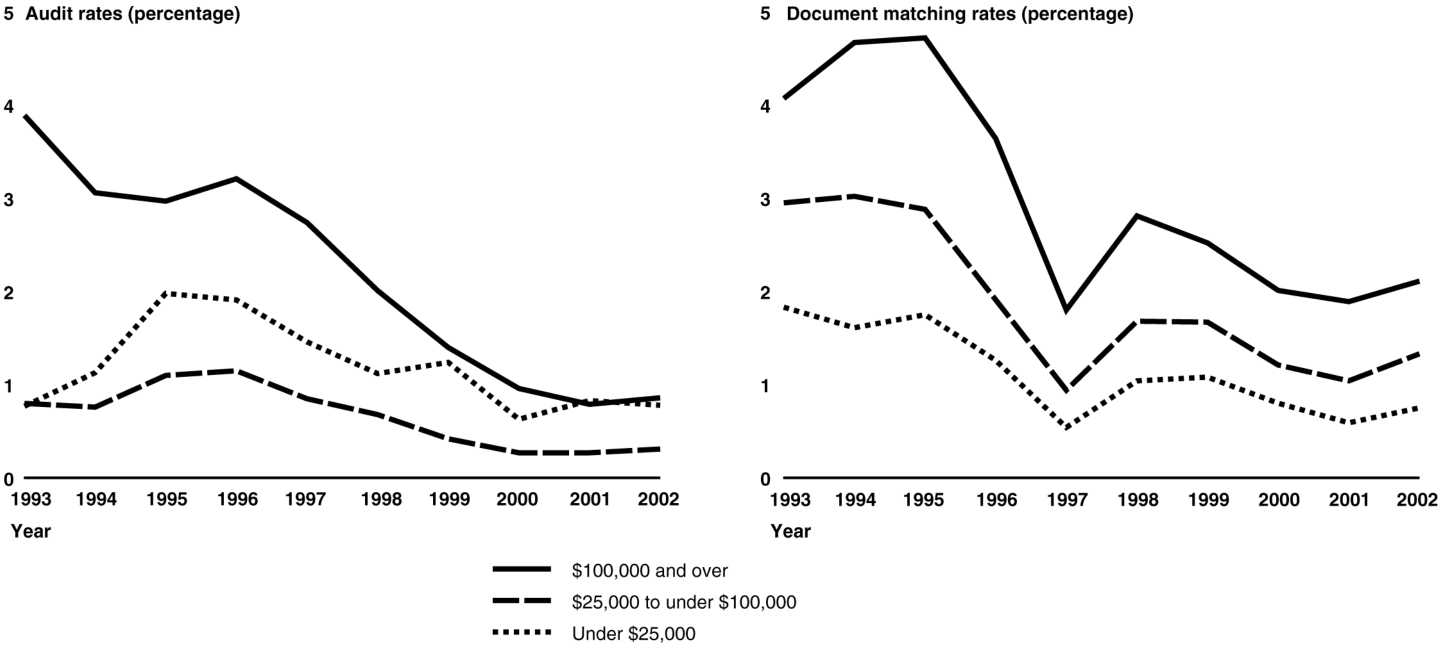
mid-1990s, we have issued six reports on IRS compliance and collection trends in response to congressional concerns.[10]

Figure 4 shows compliance program trends for various income ranges. The audit contact rates for the highest and lowest income individuals essentially converged at around .8 percent in fiscal years 2001 and 2002. Most of the audits of the lowest income individuals dealt with earned income credit claims. Document matching contact rates[11] for all three income ranges rose somewhat from 2001 through 2002. However, rates for all three income ranges ended significantly lower in 2002 than 1993.

[10] U.S. General Accounting Office, *Tax Administration: Audit Trends and Results for Individual Taxpayers*, GAO/GGD-96-91 (Washington, D.C.: Apr. 26, 1996); *Tax Administration: IRS' Audit and Criminal Enforcement Rates for Individual Taxpayers Across the Country*, GAO/GGD-99-19 (Washington, D.C.: Dec. 23, 1998); *Tax Administration: Use of Nonaudit Contacts*, GAO/GGD-00-7 (Washington, D.C.: Mar. 16, 2001); *IRS Audit Rates: Rate of Individual Taxpayers Has Declined With the Effect on Compliance Unknown*, GAO-01-484 (Washington, D.C.: Apr. 25, 2001); *Tax Administration: Impact of Compliance and Collection Program Declines on Taxpayers*, GAO-02-674 (Washington, D.C.: May 22, 2002); and *Tax Administration: IRS Should Continue to Expand Reporting on Its Enforcement Efforts*, GAO-03-378 (Washington, D.C.: Jan. 31, 2003).

[11] Document matching is where IRS compares information provided by a third party, for example a bank, against taxpayer return information to identify discrepancies.

Figure 4: IRS Individual Audit and Document Matching Contact Rates by Income Level, Fiscal Years 1993-2002

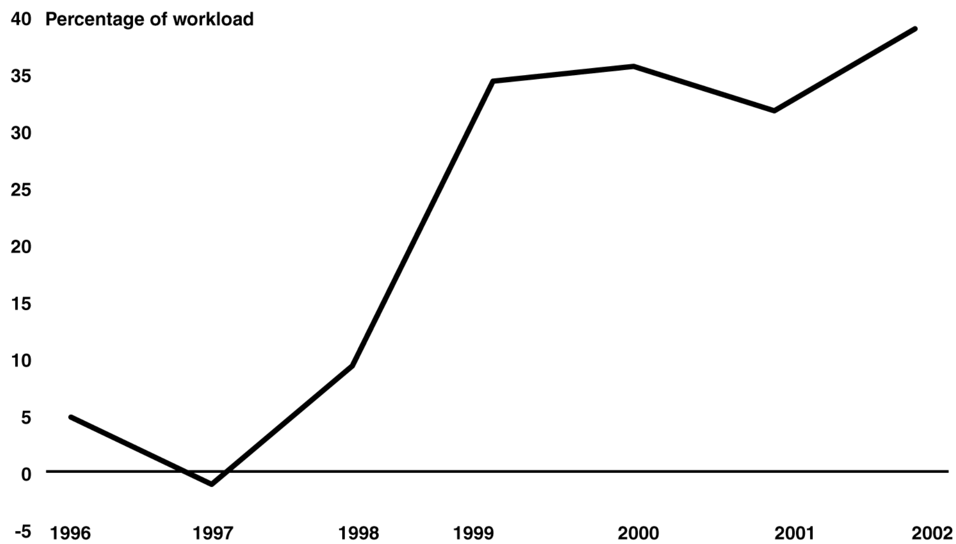


Source: GAO analysis of IRS data.

Collection programs have also declined as shown in figure 5. As we reported in May 2002, from fiscal years 1996 through 2001 trends in the collection of delinquent taxes showed almost universal declines in collection program performance, whether measured in terms of percentage of workload completed,[12] cases closed, direct staff time, productivity, or unpaid taxes collected.[13] From 1996 through 2002, IRS was unable to keep up with the growth in collections workload.

[12]Workload is the number of delinquent accounts assigned to field and telephone collection. Work completed is the number of delinquent accounts worked to closure, excluding accounts for which collection work has been deferred.
[13] GAO-02-674.

Figure 5: Percentage of Collections Workload Not Completed, Fiscal Years 1996 to 2002



Source: GAO analysis of IRS data.

The increasing gap between collection workload and work completed led IRS in March 1999 to start deferring collection action on billions of dollars in delinquencies. By the end of fiscal year 2002, after the deferral policy had been in place for about 3 and one-half years, IRS had deferred taking collection action on about $15 billion in unpaid taxes, interest, and penalties. As of 2002, IRS was deferring collection action on about one out of three collection cases. As of September 30, 2002, IRS had a total inventory of $112 billion of known unpaid taxes with some collection potential.[14]

Earned Income Credit Noncompliance

There are significant compliance problems associated with the EIC that have led us to list IRS's tax administration of the credit as a high-risk area

[14]The $112 billion includes two categories of known unpaid taxes: (1) taxes due from taxpayers for which IRS can support the existence of a receivable with a taxpayer agreement or a favorable court ruling (federal taxes receivable), and (2) compliance assessments in which neither the taxpayer nor the court has affirmed that the amounts are owed.

for the federal government.[15] Under the code, taxpayers who meet earned income, family size, and other requirements are authorized to claim the EIC. The credit offsets the impact of the Social Security taxes paid by low-income workers and is intended to encourage low-income persons to seek work rather than welfare. For most recipients, the credit amount exceeds the amount of their income tax liability; in such cases, because the credit is refundable, the taxpayers receive a refund.

IRS estimates that of the $31.3 billion in EICs claimed by taxpayers in tax year 1999, about $8.5 billion to $9.9 billion should not have been paid.[16] This level of noncompliance has remained relatively unchanged even after a 5-year effort to reduce it. IRS has to balance its efforts to combat noncompliance with its efforts to ensure that qualified persons claim the credit. With the data available, we were able to estimate that for every three households that claimed the credit, there was an additional eligible household that did not.[17] Because IRS has struggled to reduce the overclaim rate and because of the magnitude of the financial risk, EIC noncompliance has been and remains both a management challenge and a high-risk area.

Early in 2002, the Assistant Secretary of the Treasury and the IRS Commissioner established a joint task force to seek new approaches to reduce EIC noncompliance. The task force sought to develop an approach to validate EIC claimants' eligibility before refunds are made, while minimizing claimants' burden and any impact on EIC's relatively high participation rate. Through this initiative, administration of the EIC program would become more like that of a social service program such as Food Stamps or Social Security Disability, for which proof of eligibility is required prior to receipt of any benefit. IRS's 2004 budget proposes new spending to implement this strategy and it intends to ramp up rapidly. Planning and implementation for this initiative will proceed simultaneously. The success of the initiative will depend on careful planning and close management attention as IRS's implementation progresses.

[15]U.S. General Accounting Office, *Major Management Challenges and Program Risks: Department of the Treasury*, GAO-03-109 (Washington, D.C.: January 2003).

[16]IRS estimated that $1.2 billion would be recovered as a result of enforcement efforts.

[17]U.S. General Accounting Office, *Earned Income Tax Credit Eligibility and Participation*, GAO-02-290R (Washington, D.C.: Dec. 14, 2001).

Closing the Gap between Actual and Desired Taxpayer Service Remains a Challenge

Despite progress, improving service to taxpayers remains a challenge for IRS. The progress that IRS has made to date in modernizing has, as noted, improved service but not to the level that taxpayers, Congress, and IRS management agree is needed.

Providing good service to taxpayers by making it as easy as possible for them to understand and meet their tax obligations could improve voluntary compliance—payments and tax returns filed without IRS audit and collection action—and reduce the need for these intrusive and costly enforcement activities. According to IRS, preventing compliance problems by educating and informing taxpayers, or helping taxpayers resolve problems early on, is less expensive and time-consuming for both IRS and the taxpayer than enforcement action taken later. Facilitating voluntary compliance is especially important because the U.S. tax system relies on it. About 98 percent of all tax revenue collected is paid through withholding, remittances sent with tax returns, or other forms of payment without any IRS enforcement action.

While IRS has improved service in some areas, millions of taxpayers still have difficulty reaching IRS by telephone, and when they do, they may not be able to rely on the accuracy of information IRS provides. For example, IRS data shows that 32 percent of calls to IRS either received a busy signal or were abandoned without receiving service. In addition, about 20 percent of callers received inaccurate information when calling IRS with tax law questions.

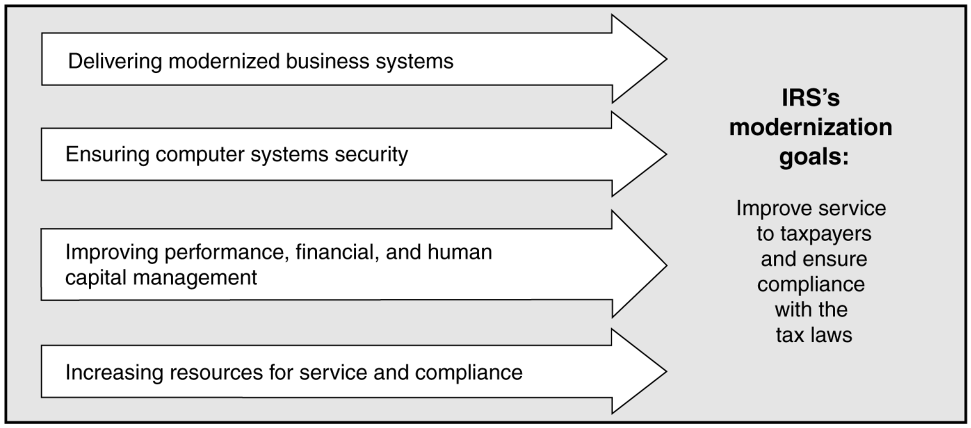
Similarly, the accuracy of the assistance provided at IRS's walk-in sites is below expectations. While it has improved in recent years, 25 percent of answers provided were incorrect so far in 2003.

Revamping taxpayer service will require that IRS simultaneously meet the other significant management challenges discussed in this testimony. For example, to ensure that changes result in efficient, improved service, IRS will need to establish consistent, comparable measures and conduct more and better program evaluations to identify ways to improve service.

Modernization Is Key to Improving Service and Ensuring Compliance

Modernization is the means for achieving IRS's two goals of improving service and ensuring compliance. Figure 6 shows four key components of modernization. Each alone is a significant challenge—in combination they are an even greater challenge.

Figure 6: IRS's Key Modernization Challenges



Source: GAO.

Delivering Modernized Business Systems

IRS's modernization strategy includes reengineering efforts intended to automate or eliminate work, improve productivity, and free up staff time that can then be redirected to service and compliance programs. Reengineering efforts rely heavily on IRS's BSM program.

Despite important progress in IRS's BSM program, it remains a high-risk challenge for two reasons.[18] First, the scope and complexity of the program are growing. Specifically, the number of projects under way continues to increase, and the tasks associated with those projects that are moving beyond design and into development are by their nature more complex and risky. Second, IRS's modernization management capacity is still maturing. For example, IRS has yet to fully implement a strategic approach to ensuring that it has sufficient human capital resources. It has also yet to fully implement management controls in such areas as estimating costs and employing performance-based contracting methods.

The continuing challenge for IRS is to ensure that the pace of acquiring systems does not exceed the agency's ability to manage them effectively, a problem we have reported[19] in the past. The imbalance between program pace and management capacity adds significant cost, schedule, and performance risks that escalate as a program advances. For example, as

[18]U.S. General Accounting Office, *High-Risk Series: An Update*, GAO-03-119 (Washington, D.C.: January 2003).

[19]GAO-01-716 and GAO-02-356.

indicated in IRS's March 2003 expenditure plan, most of the BSM initiatives or project milestones experienced cost increases and/or schedule delays exceeding 10 percent of the estimated cost and duration stated in the November 2001 plan. Moreover, these risks increase as IRS moves forward because interdependencies among current ongoing projects and the complexity of associated workload activities to be performed increase dramatically as more system projects are built and deployed.

IRS has acknowledged these risks and has initiatives planned or under way to address them. The timely implementation of these initiatives is critical. While the lack of controls can be risky in a project's early stages, it is essential that such controls be in place when multiple interdependent projects are being designed, developed, and implemented. To mitigate this added risk, IRS needs to fully implement the remaining management controls that we have recommended. Until that time, the BSM program remains high risk, and we will continue to monitor IRS's progress in this area.

As the BSM program moves forward, there are several other challenges and risks to the successful and timely implementation of future planned modernized systems. A major issue is the ability to successfully integrate modernized systems with the reengineered business processes being implemented in the operating divisions. Failure to coordinate the acceptance and operation of new systems may result in increased costs and delayed delivery of benefits to taxpayers. Finally, a major concern for all aspects of the program is the extent to which the program will be consistently funded in an environment of budgetary deficits and competing priorities. Without a consistent level of funding, IRS will have difficulty establishing the infrastructure needed to build and sustain additional modernized systems and expediting the replacement of the outdated systems currently in use.

Ensuring Computer Systems Security

Although IRS has made important progress securing its systems, information security remains a challenge. Long-standing computer control weaknesses continue to threaten the confidentiality, integrity, and availability of sensitive systems and taxpayer data. IRS's inconsistent implementation of electronic access controls at its facilities did not effectively prevent, limit, or detect access to computing resources. In addition, weaknesses in other information system controls (including physical security, segregation of duties, software change controls, and service continuity) reduced IRS's effectiveness in protecting and controlling physical access to assets, minimizing the risk of errors or fraud, mitigating the risk of unauthorized or inappropriate software programs, and ensuring the continuity of data processing operations when unexpected interruptions occur. Further, access to key computer applications was not always limited to authorized persons for authorized purposes. These weaknesses increased the vulnerability of data processed by IRS's information systems and continued to expose IRS's tax processing operations to disruption. As a result, we continued to report information security as a material weakness in our report on IRS's fiscal year 2002 financial statements.[20]

An underlying cause of these weaknesses is that, although it has made important progress, IRS had not yet fully implemented certain elements of its agencywide information security program. The challenges facing IRS are to adequately (1) identify and assess information security risks to determine needed security measures, (2) implement and comply with its security policies and controls to meet those needs, (3) promote awareness and provide security-related training so that employees understand the risks and the policies and controls that mitigate them, (4) monitor the effectiveness of established policies and controls, and (5) mitigate known security vulnerabilities. IRS has acknowledged the seriousness of its information security weaknesses and has revised its approach to implementing the agencywide information security program. Until IRS can fully implement an effective program and adequately mitigate its information security weaknesses, it will remain at heightened risk of access to critical hardware and software by unauthorized individuals, who could intentionally or inadvertently read, add, alter, or delete sensitive data or computer programs. Such individuals could possibly obtain personal taxpayer information and use it to commit financial crimes in the taxpayer's name (identity fraud), such as establishing credit and incurring debt.

Improving Performance, Financial, and Human Capital Management

Challenges remain in three important areas of management—performance, financial, and human capital. As noted in our discussion of accomplishments, IRS has made significant progress in these three areas. By continuing to show progress in these areas, IRS will be better able to improve taxpayer service and better ensure compliance.

[20]U.S. General Accounting Office, *Financial Audit: IRS's Fiscal Years 2002 and 2001 Financial Statements*, GAO-03-243 (Washington, D.C.: Nov. 15, 2002).

Performance Management

Our work over recent years shows that IRS faces challenges in managing and judging its performance.

- First, IRS needs to ensure that its organizational performance measures are objective and reliable, consistent through time, and limited to key performance indicators. Such performance measures would enable IRS managers to monitor progress over time without being overwhelmed by too much information.
- Second, IRS needs to associate explicit goals with its performance measures. Without goals, it is difficult to determine if appropriate progress is being made.
- Third, IRS needs to conduct more and better programs evaluations. Such evaluations could help managers and staff better understand what they are trying to accomplish, how their actual performance compares to their objectives, and the reasons for any gaps. This would provide a more informed basis for determining how to improve performance.
- Finally, in keeping with the Government Performance and Results Act of 1993,[21] IRS should continue its efforts to better link budget requests with program results. Such a link could allow Congress to make more informed budget decisions and better oversee IRS's use of resources.

Financial Management

Financial systems and internal control weaknesses continue to preclude IRS from providing managers current, accurate financial information with which to make day-to-day decisions affecting IRS's operations. These weaknesses include

- an inadequate financial reporting process, resulting in IRS not being able to prepare reliable financial statements without extensive compensating procedures or not having current and reliable ongoing information to support management decision making and to prepare cost-based performance measures;

[21] Pub. L. 103-62 was enacted to hold federal agencies accountable for achieving program results.

- weaknesses in controls over billions in unpaid tax assessments, resulting in IRS's inability to properly manage unpaid assessments and leading to increased taxpayer burden;

- weaknesses in controls over the identification and collection of tax revenues due the federal government and the issuance of tax refunds, resulting in potentially billions of dollars in improper payments and lost revenue to the federal government; and

- weaknesses in controls over property and equipment, resulting in IRS's inability to have reliable and timely information on its balance of property and equipment throughout the year and to reasonably ensure that its property and equipment are safeguarded and used only in accordance with management policy.

These weaknesses and the computer security control weaknesses previously discussed render IRS incapable of reporting current, reliable information regarding its operations to management, Congress, and the public and adversely affect its ability to effectively fulfill its responsibilities as the nation's primary collector of federal revenue. IRS's financial management has been on our list of high-risk government operations since 1995.[22]

The future challenge for IRS will be to continue the improvements made in recent years and develop and implement the fundamental long-term solutions that are needed to address the internal control weaknesses we have identified. Resolving many of IRS's most serious financial management challenges will depend on the successful implementation of its new financial management system, which will not occur for several years. For example, IRS's Integrated Financial System (IFS) is intended to provide IRS with a single general ledger that is compliant with existing standards and integrated with its subsidiary records. However, IFS is not scheduled to be fully functional and able to provide reliable cost information that can be used by IRS in routine management decision making until at least fiscal year 2005. IRS is also implementing the Customer Account Data Engine and the Custodial Accounting Project to replace the current primary taxpayer database and address IRS weaknesses in management of unpaid assessments. However, these systems are not scheduled for full implementation until at least fiscal year

[22]U.S. General Accounting Office, *Major Management Challenges and Program Risks: A Governmentwide Perspective*, GAO-03-95 (Washington, D.C.: January 2003).

2007, at which time IRS's custodial transactions will be fully integrated with IFS. In the interim, several serious financial management issues will continue to exist.

In the near term, however, some problems can be addressed through the continued efforts and commitment of IRS senior management and staff. IRS will need to continue to refine the accounting procedures it relies on to compensate for the deficiencies in its automated systems. More important, IRS will need to continue its efforts to enhance the way it processes transactions, maintains records, and reports financial results. Other problems, which involve IRS modernizing its financial management systems, will take years to fully achieve and require the continued commitment of the new Commissioner if they are to be brought to a successful conclusion.

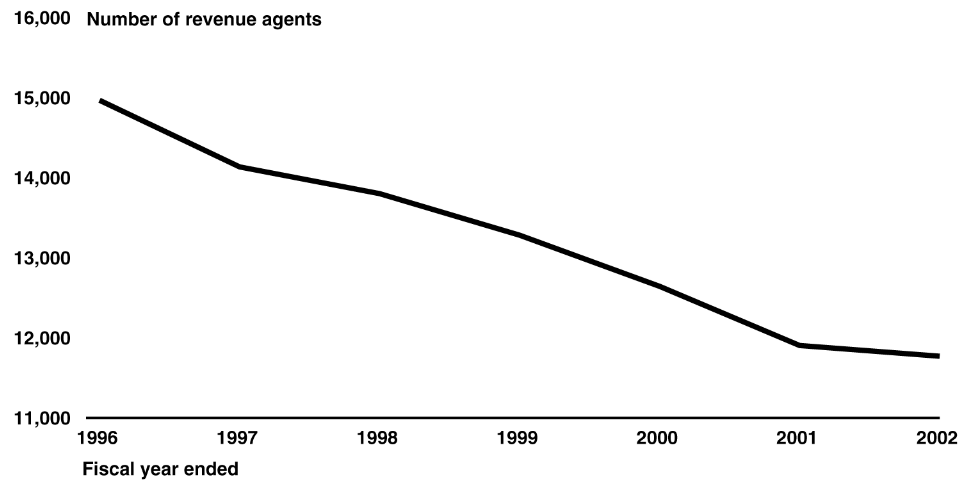
Human Capital Management

IRS's new human capital performance management system could be a powerful tool in helping the agency achieve its mission. The system could reinforce behaviors that support strategic goals by clearly aligning employee and organizational objectives, ensuring that managers' expectations are specific and output- or outcome-oriented, and monitoring whether employee feedback is useful and aligned with IRS's goals. To help ensure IRS achieves such benefits, we have made several recommendations. For example, for telephone performance, we have called for systems and evaluations to identify gaps in assistors' skills, meet training needs to fill those gaps, monitor and address the causes of attrition, and ensure that human capital management practices help IRS achieve taxpayer service goals. Similarly, with respect to BSM, we have recommended full implementation of its strategic approach for ensuring sufficient human capital resources.

Increasing Resources for Service and Compliance

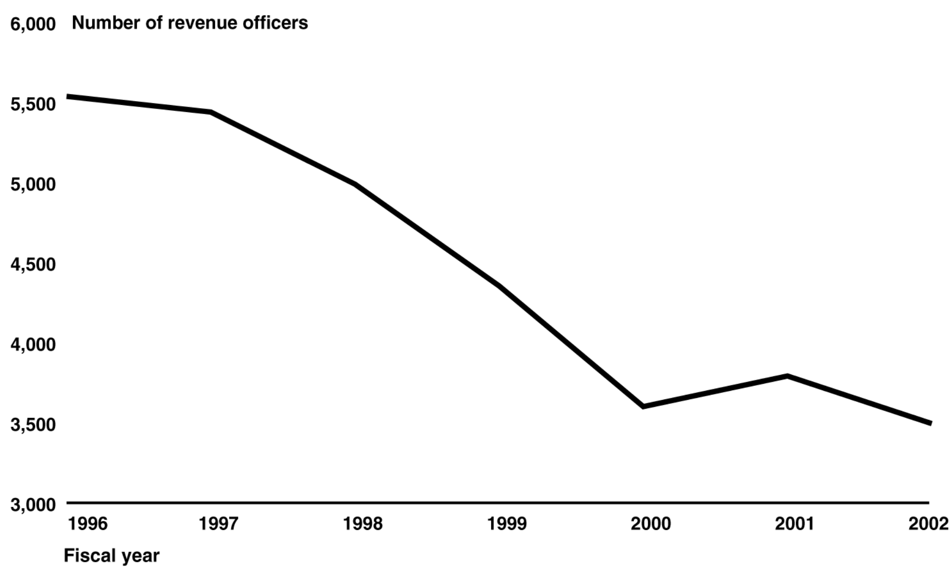
Realizing increased staffing levels for taxpayer service and compliance programs, called for in IRS's recent budget requests, has proven to be challenging. Since 2001, IRS's budget requests have made increasing its compliance and collection staff one of several key priorities. In its 2001 budget request, IRS asked for funding for the Staffing Tax Administration for Balance and Equity initiative, which was designed to provide additional staff for examination, collection, and other enforcement activities. However, as shown in figures 7 and 8, staffing in two key compliance and collections occupations were lower in 2002 than in 2000. This continues a general trend of declining staffing in these occupations for a number of years.

Figure 7: Number of Revenue Agents, Fiscal Years 1996-2002



Source: Treasury Inspector General for Tax Administration.

Figure 8: Number of Revenue Officers, 1996-2002



Source: Treasury Inspector General for Tax Administration.

The declines in compliance and collection staffing occurred for several reasons, including increased workload and unfunded costs. In September 2002, the Commissioner attributed the decline in compliance staffing to increases in workload in other essential operations, such as processing returns, issuing refunds, and answering taxpayer mail. In the most recently completed fiscal year, 2002, IRS faced unbudgeted cost increases, such as rent and pay increases, of about $106 million. As a result, IRS had to delay hiring revenue agents and officers. IRS noted in its 2002 budget request that any major negative changes in the agency's financial posture, such as unfunded salary increases, will have a negative effect on staffing levels.

IRS has also been unable to realize internal savings that would allow it to shift staff to higher priority areas. Our review of IRS's 2004 budget request, as well as its experience thus far in fiscal year 2003, raises questions about whether IRS will be able to achieve the proposed internal savings. According to IRS officials, four of the seven most significant efforts outlined in its 2004 budget request—in terms of staff years and dollars to be saved—will not achieve all of their projected savings because the projections were based on assumptions that will not be realized.

Recent trends in the electronic filing program also have implications for IRS's ability to shift resources to higher priority areas. The increase to an estimated 53 million returns represented the smallest percentage increase in the last 9 years. The current growth rate will not allow IRS to achieve its goal to have 80 percent of all tax returns filed electronically by 2007. Instead, based on current growth rates, IRS will achieve about 61 percent of all individual returns by 2007.

This year, like every other year since the initiation of electronic filing, IRS has taken actions to alleviate impediments to electronic filing and encourage taxpayers to file electronically. IRS entered into an agreement with the Free File Alliance, a consortium of 17 tax preparation companies, to offer free on-line tax preparation and filing services for at least 60 percent of all taxpayers. However, as of April 16, 2003, only about 2.7 million taxpayers file via the Free File Alliance consortium, and IRS estimated that only about 1 million were new electronic filers. Slower growth in electronic filing will reduce IRS's ability to shift resources out of paper return processing.

Concluding Observations

IRS has come a long way from where it was in the mid-1990s. It is easy to lose sight of progress when it is gradual, but over the last 5 years, IRS has significantly enhanced its management capabilities and has succeeded in improving service to taxpayers. This progress in modernizing was achieved with a consistent, sustained focus on certain fundamentals of good management, such as controls over systems acquisition, financial data, and performance measures.

Looking forward, IRS will be challenged to meet the expectations of taxpayers and Congress. The same focus on management fundamentals that proved successful over the last 5 years should help the new Commissioner deal with these challenges.

Mr. Chairman, this concludes my prepared statement. I would be happy to answer any questions.

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