Business Systems Modernization laid the foundation for success of this massive program. Both the long-term vision and enterprise architecture were established and embedded as a living blueprint for all business and technology improvement programs.

BSM began delivering projects with tangible and meaningful benefits to taxpayers, such as moving the first set of taxpayers to a modern, reliable database early next year. Over the next five years, all individual taxpayers will be moved to it, cutting times for refunds on e-filed returns to less than a week and allowing us to provide taxpayer and employees with up-to-the-minute accuracy on their accounts. Of paramount importance, we implemented the first project on our new security system, which provides one standard for ensuring the security of all future IRS data and systems.

All major management processes, which are needed to manage this program on a continuing basis, were improved. Our goal is to obtain certification in the near future as only the second agency in the federal government to reach Level Two in the Software Engineering Institutions Capability Maturity Model.

Steady Progress Can Continue Year after Year

The aforementioned progress and achievements do not mean that the IRS solved all of its problems, or that there are no more opportunities to improve. Rather, it means that the IRS addressed the major impediments and obstacles that previously stood in the way of progress and has a clear committed plan to continually reach even higher levels of performance. There should be no doubt that the IRS can be raised to a level of quality and efficiency comparable to the best managed financial services organizations.

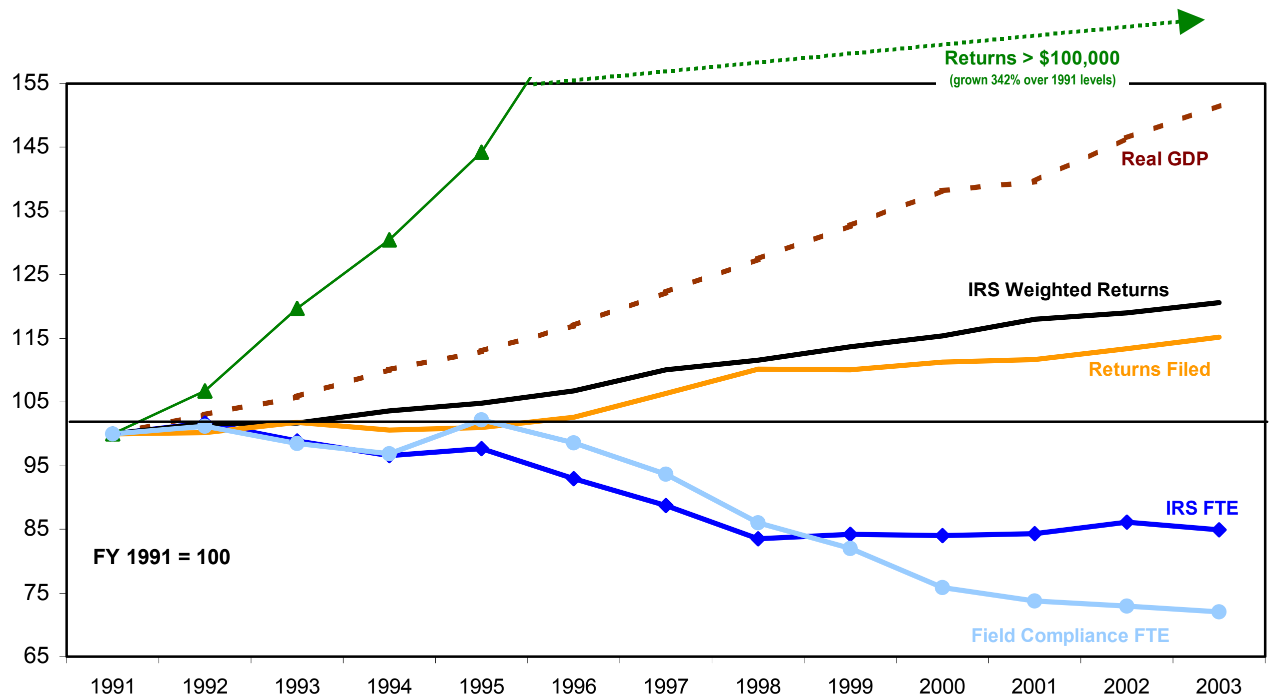
Winning the Battle but Losing the War

Despite significant improvements in the management of the IRS, the health of the federal tax administration system is on a serious long-term downtrend. This is systematically undermining one of the most important foundations of the American economy.

The source of this problem is two conflicting long-term trends: one, ever increasing demands on the tax administration system due to rapid growth in the size and complexity of the economy; and two, a steady decline in IRS resources due to budget constraints. The cumulative effect of these conflicting trends over a 10-year period has been to create a huge gap between the number of taxpayers who are not filing, not reporting or not paying what they owe, and the IRS' capacity to require them to comply.

As seen in the next chart, "Trends in Indicators of IRS Workload and Resources," from 1992 to 2001, *weighted average returns filed*, a measure of overall IRS workload, increased by 16 percent because of the economy's growth. However, during this same period, FTEs dropped 16 percent from 115,205 in FY 1992 to 95,511 in FY 2001. Since more and more of the IRS' declining resources are required to perform essential operational functions – such as processing returns, issuing refunds and answering taxpayer mail – a disproportionate reduction occurred in Field Compliance personnel, falling 28 percent from 29,730 in FY 1992 to 21,421 in FY 2002.

Trends in Indicators of IRS Workload and Resources



1991 to 2001 GDP data from the Bureau of Economic Analysis. 2002 & 2003 projections from OMB.
1991 to 2001 IRS FTE from the Budget of the United States Government, OMB. FY 2002 from AFS Month 04 Current Financial Plan. FY 2003 reflects IRS current financial plan. IRS FTE excludes FTE associated with the EITC program. Field Compliance FTE from IRS Databook, Pub 55B.

In assessing these trends, it is extremely important to recognize a critical fact: tax administration workload increases every year because of increased filings by taxpayers related to the long-term growth of the economy. These workload increases affect every facet of tax administration, from processing returns to answering correspondence to collecting delinquent returns to accounting for payments and refunds. In addition to this growth related to the economy, tax legislation often adds additional workload.

Looking more closely at the most recent five years (see chart), we see that the number of income tax returns increased by 12 million, while 19 tax bills were passed that changed 292 tax code sections and required 515 changes to forms and instructions. On the average, IRS workload grows at a compounded rate of 1.8 percent per year. Therefore, just to handle this increased workload, the IRS would either have to add staff – which is what occurred fairly consistently for the 45-year period from 1950 through 1995 – or would have to increase productivity by 1.8 percent per year just to stay even.[1]

[1] By comparison, during the decade of the 1990s, the overall economy increased productivity at a rate of about 2 percent per year. The private financial services industry, in its best decade ever, increased productivity at about 2.3 percent per year.

Federal Tax System Has Been Growing and Changing Rapidly From 1997 Through 2002

Volume of Activity Has Been Growing Rapidly

• Income Tax Returns	12 Million Increase	9.4%
• IRS Gross Collections	$527 Billion Increase	32.5%
• IRS Refunds Issued	$121 Billion Increase	61.3%

Tax Code Has Been Changing Rapidly

- 19 Public Laws passed
- 293 Tax Code provisions changed
- 171 (58%) of provisions with concurrent or retroactive effective dates
- 515 completed changes to forms and/or instructions

Restructuring and Reform Act Added Many Taxpayer Rights

- 71 taxpayer rights
- 1,900 implementing actions
- Hundreds of thousands of new transactions per year
    - Innocent spouse
    - Collection due process
    - Offers in compromise
    - Third party notification
    - Section 1203 allegations

Special Events Created Additional Activity and Change

- Century date change required massive three year project
- Advance rate reduction credit – 126 million notices, 91 million taxpayers, $39 billion
- Returns of political organizations (section 527) – new reporting to IRS
- September 11th terrorist attack – victims relief, IRS security response, money laundering task forces
- Anthrax threat – rapid response required prior to 2002 Filing Season

Globalization Is Increasing International Tax Activity

- US controlled foreign corporations up 25%
- Foreign controlled corporations up 31%

Resources Have Been Shrinking

- IRS full-time equivalent personnel -2,952

This is no different from a car company producing 1.8 percent more cars or a hospital servicing 1.8 percent more patients. But, rather than increasing staff, IRS staff decreased during this period, creating a major gap in IRS capacity to administer the tax system.

In addition to growth in raw numbers, the tax revenue stream is now dominated by sources that provide greater opportunities for manipulation by those who wish to take advantage of the decline in IRS compliance resources. For example, returns for taxpayers with incomes exceeding $100,000 grew by 342 percent over 1991 levels. The enormous amounts of money that flow through "passthrough" entities – such as partnerships, trusts and S-corporations – also adds to the complexity of tax administration and increases the opportunities for underreporting of income. In Tax Year 2000, these "passthrough" entities filed 4.78 million returns with gross revenue of $6 trillion and income to partners/shareholders of more than $660 billion.

The IRS Restructuring and Reform Act of 1998 added major new or expanded taxpayer rights programs, such as innocent spouse relief, third party notification and collection due process. The rights are very important to taxpayers but created very substantial additional resource demands on the IRS to process hundreds of thousands of new transactions and additional steps in existing audits and collection actions.

Business globalization creates another administration complexity and more opportunities for reducing U.S.-reported income. From 1997-2002, U.S.-controlled foreign corporations and foreign-controlled corporations grew respectively by 25 and 31 percent.

Looking at this imbalance, one fact emerges. The IRS is simply out-numbered when it comes to dealing with the compliance risks. As noted, IRS employment (FTEs), and in particular, Field Compliance FTE steadily declined. With the decline in personnel came a decline in the coverage of all types of returns (see chart). Even after we refocus on the most egregious non-compliance cases, we can only handle a small fraction of them.

Coverage of All Types Plummeted 60 – 70%

Number of Cases Per Thousand Returns				
Fiscal Year	**Document Matching**	**Correspondence Exam (Non-EITC)**	**In Person Exam Of Individuals**	**Exam of Passthrough Entities***
1992	33.1	4.0	5.8	5.1
1993	23.7	2.6	6.3	5.5
1994	23.3	2.0	6.8	5.0
1995	23.6	3.5	6.0	4.6
1996	16.6	2.6	5.6	4.7
1997	7.9	3.5	5.8	5.5
1998	14.3	2.8	4.7	5.7
1999	14.4	1.1	3.1	4.5
2000	10.8	0.9	2.0	3.6
2001	9.1	1.2	1.5	2.9

*Primarily Partnerships, S-Corporations and Fiduciaries

The effect of these trends was to create a gap in what work the IRS should be doing and what it had the capacity to do. In the last two years, the IRS made progress in quantifying this gap, which is summarized below. As noted, the majority of the workload gap is in compliance.

Selected Tax Administration Programs
Work Done and Not Done
($ in millions)

	Known Workload in Contacts or Cases/Yr				Direct Revenue Loss Per Year	Direct Cost to Fill Gap	
	Required	Done	Gap	%Gap		FTEs	Dollars
Service To Compliant Taxpayers							
► Phone Service Level of Service	87.5%	71.5%	16.0%	18%	NA	2,274	$114.8
► In-Person Service	NA	NA	NA	NA	NA	3,084	196.7
Total	NA	NA	NA	NA	NA	5,358	$311.5
Collection of Known Tax Debts							
► Field and Phone Accounts Receivable (TDA)	4,506,060	1,816,713	2,689,347	60%	$9,470	5,450	$296.4
Identification and Collection of Taxes from Non-Filers							
► Non-Filer Cases (TDI)	2,490,749	625,025	1,865,724	75%	$1,693	2,016	$101.5
Collection of Underreported Tax							
► Document Matching	13,300,000	2,926,980	10,373,020	78%	$6,960	4,740	$229.2
Identification and Collection of Underreported Tax							
► Cases of Abusive Devices to Hide Income	82,100	17,000	65,100	79%	$447	3,418	$272.1
► Individuals Over $100,000 Income	123,006	54,468	68,538	56%	$266	2,603	$207.2
► Individuals Under $100,000 Income	843,380	296,986	546,394	65%	$4,492	7,435	$430.1
► Small Corporations	39,659	29,721	9,938	25%	$54	640	$50.9
► Mid and Large Corporations	24,523	17,684	6,839	28%	$6,526	1,812	$180.0
Total	1,112,668	415,859	696,809	63%	$11,786	15,908	$1,140.3
Tax Exempt							
► Reporting Compliance	20,690	6,780	13,910	67%	NA	1,192	$101.6
Grand Total	NA	NA	NA	NA	$29,909	34,664	$2,180

For each category of compliance, the IRS computed the number of known cases of taxpayers who did not file or pay, or who substantially underreported their taxes. These numbers, therefore, represent not general estimates or assumptions, but specific taxpayer cases. Based on the information available to the IRS, they should and could be treated as cases of non-compliance through collection, audit or other actions.

However, as can be seen from the chart, only a fraction of each category of case, even the most serious, can be worked with available resources. The "gap" represents the number of cases that should be, but cannot be worked because of resource limitations. These cases represent tens of billions of dollars per year that could be, but are not collected. More importantly, they represent a failure of fairness to the millions of honest taxpayers whose commitment to paying their taxes is based on the assumption that the IRS will act if they or their neighbors do not pay their fair share.

Tax professionals, promoters, sophisticated taxpayers and even some ordinary taxpayers are becoming more aware of our deteriorating ability to deal with compliance. Increasingly, this issue is being reported by publications ranging from *The Wall Street Journal*, the *New York Times, Fortune* and *Forbes*, and even on national television.

Recognizing the IRS' diminished capacity, promoters and some tax professionals are selling a wide range of schemes and devices to taxpayers based on the simple premise they can probably get away with it. When this perception becomes increasingly widespread, the essential pillar of the fairness of our tax system is lost.

Our John Doe summonses of records for credit cards issued by offshore banks in tax haven countries revealed one facet of the problem. Just one of these summons, issued in 2000 to MasterCard, yielded a large database of transactions by those using cards issued by banks in Antigua, Barbuda, the Bahamas and the Cayman Islands. Many of these taxpayers were solicited through various channels by a variety of promoters.

Indeed, some sophisticated tax professionals, including those in accounting and law firms and investment banks, are aggressively marketing tax shelters to their clients. Some of these turn out to be abusive tax avoidance transactions prohibited by the Treasury Department.

Demand is also driving up supply. There is widespread anecdotal evidence from honest practitioners about clients demanding that their return preparer find a way to reduce reported income, to the point of refusing advice from honest professionals to comply with required reporting and disclosure. In effect, they are saying, "Get me one of these deals or I will take my business elsewhere." This has reached the point where recently a former IRS Commissioner was faxed a solicitation from a "Senior Investment Manager" that began, "As we approach December 31st, you may have a large income tax liability for the year 2002. The amount you pay could be up to you."

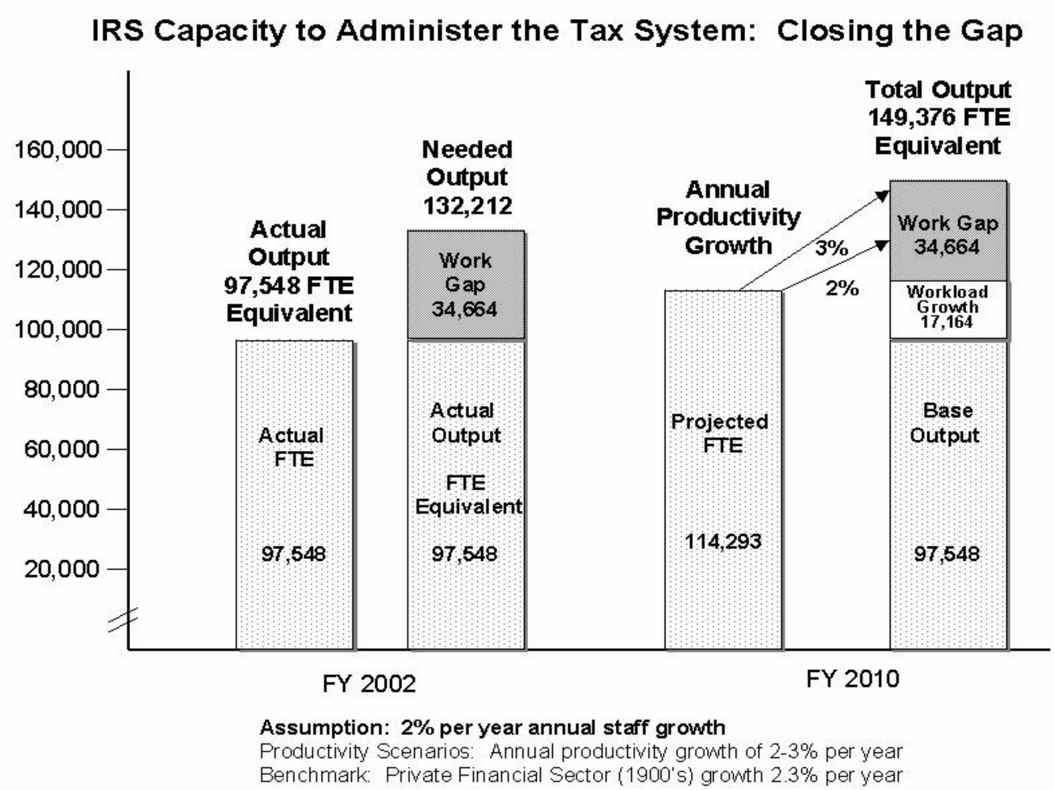
Although it is impossible to prove conclusively that attitudes towards tax compliance shifted, we must make informed judgments about behavior and trends. The only responsible conclusion I can draw is that the trend in attitudes of taxpayers and tax professionals poses a real threat to the health of the tax system and ultimately to the American economy.

If these problems and conditions are left unaddressed, we could face an enormous crisis in confidence in the tax administration system. It would not be surprising if this problem emerged into the forefront of public concern, causing an eruption about the IRS similar to those that occurred periodically over the last 50 years. The long-term impact on the economy and our nation of not reversing this trend will be extremely high.

What Is Needed

What is the answer? Fortunately, the problem is not open-ended and can be solved with a reasonable amount of resources. We need what the National Commission on Restructuring the IRS argued for five years ago: a steady and consistent budget. It must consist of two items over the next five years. The first is a steady growth in staff in the range of 2 percent per year. The second is steadily increased funding for modernization until this program levels off several years from now.

Together with aggressive increases in productivity, as called for by the IRS Strategic Plan, this combination can solve the problem by the end of this decade. In fact, as shown in the "Closing the Gap" chart below, a combination of 2 percent per year staff growth with 3 percent per year productivity growth will keep up with increasing demand and close the gap by 2010. But without both elements – modest but steady staff growth and aggressive productivity increases – the trend will not be reversed.



Computer systems alone, even with the most aggressive reasonable assumptions about the productivity gains from modernization, cannot solve the problem. Trained and effective staff is also required. However, modernization will allow the IRS to perform the tax administration function with proportionately fewer staff than in the past. If the IRS staff grew by 2 percent per year through 2010, the total staff would still be smaller than it was 20 years earlier (1990), while the economy is projected to be 86 percent larger in real GDP and the tax system far more complex.

There is another critical point. Sufficient funding must be provided to fund the actual projected staffing. There is no "extra" funding lying around to "absorb" items that are mandated, but not paid for. As shown below, the IRS dollar budget consistently under-funded advertised staffing levels. The actual number of FTEs is lower every year than proposed in the budget. This is the effect of making unrealistically optimistic assumptions about such items as pay raises, inflation and other mandates, including specific mailing and notification requirements.

IRS Dollar Budget Has Consistently Under-funded Advertised Staffing Level
(Full Time Equivalent [FTE] Personnel without EITC)

	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004
FY 2000 President's Budget	96,767				
FY 2001 President's Budget	95,523	98,051	99,873*		
FY 2002 President's Budget	95,155	97,273	99,116		
FY 2003 President's Budget		95,511	97,548	98,727	
FY 2004 Treasury Submission			97,423	96,182	98,182

* Includes 1,822 FTE for STABLE Annualization

Our plan already requires very rapid and sustained productivity growth of over 3 percent per year – in excess of the 2 to 2.4 percent achieved in the private sector. It supposes complete success of BSM, aggressive reallocation of internal resources, such as eliminating some submissions processing centers, rapid growth of e-filing, and use of productivity enhancing techniques, such as competitive sourcing for some activities. These items make it possible to cope with growth in filings and filling the gap in required workload with very limited staff growth, but do not make it possible in addition to "absorb" unfunded but required line items.

Simplifying the Tax Code

Most informed observers are justifiably horrified at the complexity of the Tax Code. The cost of taxpayer compliance with this code is over $80 billion per year, more than eight times the cost of the IRS budget. The sheer size and complexity in itself can be a source of disrespect for the law. Therefore, it is a worthy, though difficult and uncertain, challenge to pursue simplification to the maximum extent possible.

However, there is no proposal that has been seriously advanced for simplification that would have any significant effect in the foreseeable future on the problem of IRS resources.

Apart from the fact that even simplifying changes take time and effort to develop, pass in Congress and to implement, the reality is that the gap in IRS resources is so large that nearly all of our resources are required to perform the basic operations of the tax system and to pursue the clearest and most important cases of non-compliance.

With the exception of some resources in the large corporate sector, the IRS redirected nearly all compliance resources away from less significant technical tax issues to cope with current operational requirements and the most serious cases of non-filing, non-payment or underreporting of income. Even then, resources are far below what is required.

The only reasonable course is to pursue parallel paths: to address the practical problem the tax administration system faces by gradually closing the gap in the capacity of the IRS to perform its essential tasks, while pursuing a parallel path attempting tax simplification.

Conclusion

Five years ago, the IRS embarked on a new direction. Following it, we achieved much progress for America's taxpayers, although we have much more left to do to improve the entire way the IRS works. Today, we are faced with a growing crisis – in our ability to do our job and the fairness of our tax system. We cannot turn our back on this crisis or believe that it will go away, because it will not. But like five years ago, I believe the problem is solvable. We know the right course of action and we should have the courage and resolve to take it.