

Executive Policy Seminar Series
Capital Markets Research Center

**Restructuring the IRS:
Improving Performance and
Accountability**

The Honorable Charles O. Rossotti

**Senior Advisor, The Carlyle Group and
former Commissioner, U.S. Internal Revenue Service**

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GEORGETOWN



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David A. Walker

Director, Capital Markets Research Center

Welcome

Welcome to the 15th Anniversary Conference for the Capital Markets Research Center. The program consists of a premier executive policy seminar with Charles O. Rossotti (September 25, 2003), followed by a one-day conference on *Improving Corporate Governance*. Senator Richard Shelby (R-AL), Chairman of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, will present the keynote address at the luncheon between the morning finance symposium and the afternoon accounting symposium tomorrow (September 26, 2003). Charles Bowsher, former Comptroller General of the United States and a member of the Board of Advisors for the Center, is the program chair and has organized the symposia.

The finance symposium will feature a panel including: Abby Joseph Cohen, Chair, Investment Policy Committee and Managing Director, Goldman Sachs & Company; Robert R. Glauber, Chairman and CEO, NASD; and Edward S. Knight, Executive Vice President and General Counsel, The Nasdaq Stock Market, Inc. The accounting symposium panel will include: Charles A. Bowsher, former Comptroller General of the United States; Harvey J. Goldschmid, Commissioner, U.S. Securities & Exchange Commission; and Charles D. Niemeier, Board Member, Public Company Accounting Oversight Board.

Introduction of Charles O. Rossotti

Charles O. Rossotti completed his term as Commissioner of the U. S. Internal Revenue Service on November 6, 2002, and currently serves as Senior Advisor to The Carlyle Group. The subject of his executive policy seminar this evening will be the revitalization of the IRS under his administration.

Mr. Rossotti served four years in the Office of the Secretary of Defense, completing his service as Principal Deputy Assistant Secretary of Defense for Systems Analysis. He was one of a group of young leaders known as the “whiz kids,” who brought new technology to the Defense Department with Secretary Robert McNamara in the Kennedy Administration.

In 1970 Mr. Rossotti and several colleagues founded American Management Systems (AMS) with an initial venture capital investment of \$300,000. They founded the firm to assist managers of large companies and government agencies to make effective use of computers. Over his twenty-eight years at AMS he served as President, CEO, and chairman at various times. His jobs included virtually every executive task that is required for a start-up firm. AMS grew for 30 straight years, becoming a major internal business systems consulting and systems integration firm with revenue in excess of \$1 billion.

Mr. Rossotti has served on boards of private and public companies and non-profit institutions, including AMS, Sovran Bank (later NationsBank of Virginia), INTERSOLV, Index Technology Corporation, Artificial Intelligence Corporation, Caterair International, AES Corporation, the audit advisory board of the General Accounting Office, and Georgetown University.

Mr. Rossotti is a 1962 *magna cum laude* economics graduate of Georgetown University and earned his MBA with high distinction from the Harvard Business School in 1964. He has received a multitude of honors and awards. In 1970 the Department of Defense recognized him with their Distinguished Civilian Service Medal and in 2003 the Department of the Treasury awarded him the Alexander Hamilton Medal.

Restructuring the IRS: Improving Performance and Accountability

The Honorable Charles O. Rossotti

Senior Advisor, The Carlyle Group and
former Commissioner, U.S. Internal Revenue Service

Background

I completed a five-year term as IRS Commissioner in November 2002. If you had told me nine months before I took the oath of office that I was going to leave American Management Systems and become the IRS Commissioner, I would have laughed. Probably one of the main reasons that Secretary of the Treasury Robert Rubin sought me to be the IRS Commissioner, without my having a tax background, was because he thought that the biggest single problem at the IRS was the technology, and I had a technology background. With the twists and turns that life sometimes takes, in November 1997 I became the IRS Commissioner. The public's confidence level in the IRS had reached an all-time low.

For decades, the IRS was widely respected, both in America and around the world, as the most successful tax administration agency that had ever been created. Notwithstanding some difficulties from time to time, the IRS collected money honestly to fund the government's activities, and opinion polls showed that the IRS enjoyed a relatively favorable reputation. The IRS was as well regarded as most other public agencies.

The Environment of the 1990's

In the early 1980's the public's view of the IRS began to deteriorate. The General Accounting Office was criticizing the IRS at the end of the 1980's for its poor financial management practices. Naturally, people would ask, how can the IRS audit taxpayers when it cannot keep its own accounts correctly? The response was to initiate a major technology program to improve the IRS accounting

practices. The technology program was ultimately terminated in 1995 and declared to be a \$4 billion failure. By the mid-1990's there were large numbers of complaints being directed to Congress. Most Congressional offices began employing a full-time staff member just to handle these complaints.

In 1997 a Presidential Commission was established to assess the IRS. It produced a report recommending major changes to improve IRS services to the public. The Roper Opinion Survey had been measuring the public's rating of the IRS, along with many other public and private institutions, and reported that the IRS had the largest number of customers and the lowest rating of any institution in America.

In the fall of 1997 the Senate held some dramatic televised hearings. Taxpayers reported how the IRS ruined their lives. In response, IRS employees testified that they were being pressured by IRS management to harass taxpayers in order to fill revenue quotas. Senator William Roth (R-DE), the Chairman of the Confirmation Committee, recognized the tense environment I was entering and welcomed me by saying, "I want you to feel welcome here, Mr. Rossotti, and not like the officer sent to Little Bighorn as the replacement for General Custer." Shortly after I became the Commissioner, President Clinton announced that he was outraged by stories of American citizens being harassed and humiliated by a seemingly unaccountable, tone-deaf agency.

Approaches and Solutions

Nearly all the stakeholders of the IRS -- taxpayers, tax professionals, business groups, and many Members of Congress -- were dissatisfied with the performance of the IRS. So, the question was: what to do? Unlike a business, the IRS could not be merged or have its assets sold. There were some proposals in Congress and elsewhere to abolish the IRS, but the government could not operate without a tax collection agency. After a year of debate, people could agree on the problems, but not on their resolution, which is a common situation on Capitol Hill.

The Clinton administration and the Congress came to an agreement in 1998 and enacted a long and complex bill called the IRS Restructuring Act. This bill was the IRS version of the

Sarbanes-Oxley Act, and as with Sarbanes-Oxley, it included a little bit of everybody's favorite solution. The Restructuring Act outlined two major restructuring themes. For those who believed that the IRS could never be improved, regardless of its management or governance structure, the Act included about 70 specific rules pertaining to IRS operations. Stipulations included minute details, such as what postage stamps the IRS was required to use. These mandates, like those in Sarbanes-Oxley, were backed up by penalties.

One of the provisions in the bill became known inside the IRS as the "Ten Deadly Sins." Any IRS employee would automatically be fired if he or she violated any one of a long list of offenses. The IRS manual has 50,000 pages. One of the "Ten Deadly Sins" was that any violation of the tax procedures or tax laws should never result in the harassment of the taxpayer. The rules are written in a very punitive tone.

To incorporate the ideas of those who believed the IRS simply needed better governance, the legislation established an organization within the Treasury Department called the Treasury Inspector General for Tax Administration. With 1,000 employees, its only job was to audit and investigate IRS employees. The bill also established a Commission, headed by two outstanding individuals, former Senator Bob Kerry from Nebraska and Congressman Rob Portman from Ohio, to monitor IRS activities. Additionally, among the governance and management legislative provisions, the IRS Oversight Board was appointed to act like a corporate board of directors. The Board has seven private sector members who serve five-year terms.

The legislation reorganized the IRS and authorized the Commissioner to make a number of important changes in the way the agency operated. First, it established a five-year term for the Commissioner. I was the first Commissioner to serve a term appointment, rather than an appointment to coincide with a political administration. Under the new authorizations, we arranged a total reorganization of the agency. The first step was to bring in a number of senior executives from the private sector to help manage the agency. Another important provision directed the IRS to emphasize both the needs of the taxpayer and collection of tax revenues. Progress at the IRS was based upon the clear need for

change, and we had to develop and implement a plan.

Every change that we made in the IRS was proposed and had been tried by people inside the IRS before I became commissioner. However, there was no way, with the internal gridlock of a matrix organization and its rules, to make these agency-wide changes without having some external pressure such as the IRS Restructuring Act and what preceded it. To implement major changes, you had to find the people who wanted to be the change-makers and you had to arrange some buy-outs and reassignments for staff who resisted the changes.

Five Years after Restructuring

This is a good time to review some of the outcomes of the Restructuring Act. The Act did not solve all of the IRS's problems, and there is still a lot of work to improve the IRS to meet taxpayers' expectations. However, one observable difference is that most of those who study the IRS believe that it can change because they have seen major changes. Experts are expecting these positive changes to continue and for the IRS to become more effective. The public's opinion, as measured by surveys and other observations, has rebounded quite a bit. Visiting the IRS does not carry the same stigma it once did, and Members of Congress no longer have staff totally dedicated to handling IRS complaints. All the measurements indicate that service to the taxpayers is improving, and no one is demanding that employees be terminated according to the "Ten Deadly Sins." I think the main policy difference is a more balanced emphasis required in the Restructuring Act. The IRS is paying attention to the needs of people who pay taxes, and not just how much they pay.

Through some modernization efforts, the IRS has established a new compliance strategy that is consistent with today's economy and with the current taxpayer base. Part of the strategy involves being more effective in pursuing the more serious kinds of tax violators, such as those shifting money offshore or engaging in various tax schemes.

Last year 55 million people filed returns electronically, which is close to forty percent of all taxpayers. There are very few technology services that have reached forty percent electronic

penetration. People who are due to receive refunds receive them more quickly. There is a proposal before Congress to extend the deadlines for people who file electronically. We were able to arrange with the software industry to provide a free website for about sixty percent of the lowest income people, who generally have simple returns. The chance of having an audit is absolutely no different because you file an electronic return because the electronic filing enters a database. Once the information is in the database, it does not matter how it was entered. The auditing selection process is applied much later.

In the last couple of years, the IRS has begun to emphasize tasks that require several years to accomplish. One requirement is to update and modernize the IRS's computer systems, which are enormous and amazingly out-of-date. One of the first things I did after I was confirmed was to slow down the technology modernization program because I concluded that it would take many years to be successful. My perspective was that we had to deal with short-term problems. We needed to change the organization and how the work was done.

Technology in a business organization is nothing more than a tool; it does not solve managerial problems. For the IRS, technology is a processing tool. When I became commissioner, the IRS had 15 different information technology departments. Any plan for technology improvement will require years and will be tremendously expensive to support every department. There is now one contractor working on the modernization program.

The IRS systems are far out-of-date, still using tape files to maintain records. Therefore, it is necessary to have a strategy to make incremental changes. Any new system must be consistent with all the existing systems. My recommendation is never to get so far behind. If you do, you are not going to fix it easily. If the IRS were a business, it would probably be merged out of existence.

Senator Phil Graham of Texas summed up my confirmation hearing saying, "Anybody who wants this job under these circumstances probably ought to have it." The expectations were low for my administration, but now the IRS must live up to higher expectations. My successor, Mark Everson, may have a tougher job than I did because expectations are higher.

Conclusions

Some of the achievements of the Restructuring Act have been improving the direction, goals, and governance of the agency; staff qualifications; and the accountability of top management. The less useful, but well-intentioned, stipulations of the Act are what I call the micro-mandates -- the detailed rules about how the IRS operates. These were created to help the IRS do a better job for taxpayers, but instead they have consumed substantial management resources and budget without proportionate useful results.

The IRS previously lacked consistent governance to respond to the changing needs of the stakeholders and to the new challenges of the 21st century. Over the ten years prior to the passage of the Restructuring Act, there were five IRS commissioners and two acting commissioners, four Treasury Secretaries, and three Presidents from two political parties. The Congress had oversight responsibility for the IRS, and its oversight was divided among six different committees, each of which had broad responsibilities and frequent leadership changes. Because the top IRS management had no continuity, the IRS focused on short-term policy issues and emergencies and overlooked long-term performance. No one was responsible for assuring that the organization had long-term, state-of-the-art managerial, governance, and technology systems to meet the needs of its stakeholders.

The governance issues and their resolution at the IRS are parallel to those of almost any complex organization. There must be a mechanism to assure that the organization remains genuinely focused on the needs of its external stakeholders, and not just on internal matters. This means making financial commitments, cultural changes and organizational arrangements, and even changes in leadership, to ensure that the organization meets the needs of all of its stakeholders. This is the essence of the government's experience at the IRS.

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Jack Boorman, Director, Policy Development and Review Department, International Monetary Fund

Charles A. Bowsler, Comptroller General and Head of Government Accounting Office

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