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I am honored by the invitation to appear before the Commission.

At the outset, perhaps I should clarify what I can and cannot do to assist the commission. I have not spent enough time, within the last three years, inside the IRS to comment with any authority on recent developments in the Service's compliance strategy. I don't know how far their compliance strategy has come, nor what it has achieved recently.

But I have been asked to comment on its significance, and to try to provide a analytic framework which will allow the Commission to make an accurate assessment for itself. The relevant experience which I have been asked to draw upon involves recent reforms in a wide variety of regulatory agencies, both at the federal and state levels, and abroad. At the federal level, I have worked closely with the U.S. Customs Service, and with OSHA, and (to a lesser extent) the EPA. These other regulatory agencies, surrounded by imperatives for "reinvention," and searching for more "results-oriented" approaches, face remarkably similar issues to the IRS.

In 1994 I published a book, "Imposing Duties: Government's Changing Approach to Compliance," which showed how the professions of policing, environmental protection, and tax administration were each struggling to escape their traditional approaches, which relied heavily on enforcement and the assumption of deterrence. Each of these professions sought to develop more sophisticated and more effective methods of procuring compliance, and adopted a broader range of tools. The IRS featured heavily in that book. In particular, the emerging compliance philosophy, termed "Compliance 2000" at the time, was described in some detail. The "Compliance 2000" vision encapsulated IRS aspirations to develop the capacity to identify specific non-compliance problems, and to deal with them--using whatever combination of tools turned out to be most effective. In Congressional testimony in July 1991, then Commissioner Fred Goldberg, now a member of the commission, described the transition thus:

> “At present the focus of our compliance effort is principally after-the-fact, case-by-case enforcement. Examinations, collection actions, and criminal investigations are, and always will be, an essential part of what we do; indeed they should be expanded in the years ahead. But they cannot be pursued in a vacuum. We are changing the way we approach our compliance activities. We are devising, implementing and assessing comprehensive [new] strategies to improve voluntary compliance--strategies that combine traditional enforcement actions with education, outreach, and simplification of regulations and legislation. The

> ultimate objective is not to maximize yield through costly, intrusive, and burdensome enforcement efforts. The objective is to enhance voluntary compliance."

What I hope to do this morning is help the commission understand what it would take, in organizational terms, to turn this vision into practice. If we can make clear what apparatus and capabilities would be required, then the commission will be better positioned to find out what exists and what doesn't, and to decide where future investments might be made.

The public, of course, would surely expect that the IRS made it their business to identify patterns and trends of non-compliance, and found methods to deal with each one; just as they might expect OSHA to engage in systematic analysis of the causes of injuries and illnesses in the workplace; just as they might expect environmental agencies to focus on the most pressing environmental problems of the day, and to use their imaginations and creativity in addressing them. Perhaps citizens would be alarmed to discover that, as a general rule, that's not how governmental bureaucracies behave. Perhaps they would be more alarmed to discover that existing budgetary systems and organizational structures often *prevent* such important work from taking place.

To make this challenge more concrete, it is useful to distinguish between three different models of professionalism, each relevant to all regulatory agencies; all three certainly relevant to the IRS.

The first model of professionalism focuses on *functions*, the second on *processes*, and the third on significant *non-compliance problems*. It is worth asking which of these is more or less well developed than the others, and understanding the order in which they generally appear.

<u>1st Model of Professionalism: Functional Expertise</u>

Being functionally organized, one obvious form of professionalism for the IRS is to improve each of its functional capabilities. Relevant investments would include increasing the quality of recruits, improving training, increasing the productivity and efficiency of each functional unit, and improving the quality of the work done by each one.

<u>2nd Model of Professionalism: Process Management</u>

The 2nd model recognizes that citizens have to deal with multiple functional units of the IRS: a tax return passes first through tax-returns processing, but may then move to examinations, audit, collections, or even criminal investigation. Meanwhile, taxpayer services may be handling related phone calls and queries. In the absence of effective coordination *across* functions, taxpayers may still have an unnecessarily miserable experience dealing with the bureaucracy, and may encounter the IRS as inept, however well each of the separate functions performs in isolation.

The second model of professionalism recognizes this basic truth, and seeks to identify and improve the agency's core operational *processes*. Recognizing the cross functional nature of these processes, this model emphasizes taking a "systems" view, and brings together cross functional teams in order to smooth the handoffs, eliminate glitches or bottlenecks, and to provide seamless handling of taxpayers' business.

Relevant managerial tools for making investments in this second form of professionalism include "Quality Circles," "Process Ownership," "Business Process Redesign," or the more radical "Process Re-engineering." Such tools, energetically imported into American government from the private sector, generally hold at their core a "customer-service" orientation.

3rd Model of Professionalism: A Compliance Strategy

The third model adds a distinctively different organizational capacity: the capacity to identify significant non-compliance problems, and to design solutions or remedies that effectively eliminate or substantially mitigate those problems.

The traditional assumption, made by a broad spectrum of regulatory agencies, was that functional expertise, coupled with process management, would automatically take care of compliance. But the first half of the 1990's has shown that the tools of process improvement, useful as they have been in helping to improve high-volume core operational processes, turn out to offer little help to regulatory agencies trying to understand the challenge of procuring compliance.

Some particular examples of non-compliance problems have recently helped persuade regulatory agencies that compliance does not automatically follow from the first two forms of professionalism. Worse still, that a regulatory agency can be first class in its functional expertise, and expert in process management, yet still miss the point entirely when it comes to recognizing and addressing important compliance issues.

IRS executives, in 1991, aware that the most serious non-compliance problem in the U.S. tax system at the time was "non-filers" (individuals or businesses which have never filed a tax return and which remain essentially invisible to the system), were looking for more effective ways to tackle that problem. They asked themselves which of their processes they would need to improve or "re-engineer" in order to do a better job of dealing with the non-filer problem. The answer, the service realized, was that none of their major operational processes had much relevance to the problem at all. All their processes dealt with what came in—letters, phone calls, tax returns. And the problem with non-filers was that nothing came in.

In 1993 the U.S. Customs Service also began to realize the limitations of process management. They had used it to great effect in facilitating the movement of passengers through international airports and cargo through shipping ports, cutting wait times substantially. But the customer service basis for these tools provided little guidance on what it meant to do a quality inspection. And when Customs tried to apply the process improvement toolkit to narcotics interdiction (a major area of their responsibility), the effort produced only confusion. It was quite impossible to "map the process" because narcotics interdiction was not a process at all. Rather, drug smuggling was a pattern of human behavior, external to the organization, which Customs needed to pick apart analytically and address intelligently, piece by piece, as they sought to constantly disrupt smuggling patterns. Smooth, predictable, uniform, well-oiled and customer friendly importation processes did not and could never constitute a solution. Customer service ideals and process management tools did not even provide a useful way of thinking about interdiction responsibilities.

The historical order of acquisition

In U.S. Government agencies, the first model of professionalism--functional expertise--is the best established of the three. Organizational charts usually emphasize functional units. Budgets are divided and subdivided along functional lines. And productivity of functional units is relatively easy to measure.

Since 1985 or so, substantial advances have also been made with respect to the second form of professionalism--process management. Instructed by private sector manufacturing industry, U.S. government agencies have adopted a broad range of process improvement strategies, and (to varying degrees) can demonstrate significant accomplishments in reducing waste, increasing timeliness, smoothing cross-functional handoffs, and increasing efficiency.

The National Performance Review, placing significant emphasis on customer-service and process re-engineering, has added substantial momentum to this learning. And the IRS, like most other government agencies, has now learned the lessons of process management reasonably well. (The Service adopted quality management principles as far back as the mid 1980's, and has since won awards for customer service and process improvement.)

Much less well established in most regulatory agencies (and I suspect, too, within the IRS) is the third form of professionalism. "Compliance Strategies" constitute a relatively new feature for federal regulatory agencies. Even where present, these strategies are young, immature, and often beset with unresolved tensions and dilemmas (which I won't try to elaborate in this summary).

The essential elements of a modern compliance strategy, nevertheless, have become sufficiently clear that we can now lay them out, and look to see which pieces do or do not exist within any one agency. In 1991, Commissioner Goldberg referred to the IRS "devising, implementing and assessing comprehensive [new] strategies to improve voluntary compliance." Based on experience within the police profession and a range of other regulatory agencies, we can now add a degree of detail. A "compliance strategy," for any regulatory agency, would typically involve each of the following elements:

- systematic identification of important hazards, risks, or patterns of non-compliance;
- emphasis on risk assessment and prioritization as a rational and publicly defensible basis for resource allocation decisions;
- development of the organizational capacity for designing and implementing effective, creative, tailor-made solutions for each identified problem;
- utilization of a broader range of tools for procuring compliance and eliminating risks;
- recognition of the need to retain and enhance the agency's enforcement "sting,"
- integration of the enforcement function into coherent compliance strategies, organized around specific, identified, non-compliance problems.

In a nutshell, what a regulatory agency wants from a "compliance strategy" is the capacity to identify, prioritize, and fix significant patterns of non-compliance.

A number of regulatory professions have now committed to developing this third form of professionalism, not as a replacement for the other two, but as an important supplement vital to their ability to demonstrate *effectiveness* in tackling important public problems.

The police profession calls this approach the "problem-solving" or "problem-oriented" approach to policing. The U.S. Customs service now has a "Strategic Problem Solving" Program, initiated in the fall of 1995, which focuses on specific drug-smuggling problems in a systematic attempt to eliminate identified smuggling practices, methods, or patterns. The Occupational Safety and Health Administration has incorporated a problem-solving approach (a "problem-solving approach to the mitigation of hazards in the workplace") into their "Redesign Model" for Area Offices, now being rolled out across the country.

Different types of "problem-solving"

The terminology "problem-solving" has been used in a variety of contexts, and it is important to understand which particular kind of problem-solving these innovative agencies are adopting. Three distinct contexts for use of the problem-solving language are:

(1) In the context of *teams* or cooperative partnerships: the language of "problem-solving" has been used to describe conflict resolution within such teams, where the purpose is to make the partnership or team productive again.

(2) Under "Quality Management," or TQM: where Quality Circles or other teams examine internal agency processes with a view to improvement, redesign or re-engineering. The teams are usually cross-functional in composition, as important agency processes span multiple functions. However, the focus here is *internal* and the "problems" being "solved" are glitches or inefficiencies within existing processes.

(3) As an *operational methodology*. This is the version under discussion here. It differs from (1) and (2) in that the problems to be addressed are external to the agency, rather than part of the agency's internal workings. The other forms of problem solving may be useful too, but they are much more natural and traditional. Unless these different forms of problem-solving are carefully distinguished, agencies tend to invest in the first two (internal) forms, rather than in problem solving as an operational methodology. The danger, if that happens, is that the agency remains introspective and focused upon its own existing process machinery, rather than looking outside for particular risks or patterns of non-compliance worthy of focused, creative attention.

Assessing implementation of a Compliance Strategy

Any agency operating this kind of compliance approach should be able to answer a logical series of questions relating to its compliance activities. These questions may help the Commission determine the maturity of the IRS' compliance operations.

(1) Inventory: The agency should be able to provide an inventory of non-compliance problems identified as worthy of attention.

(2) Problem Selection: The agency should be able to show on what basis it chooses amongst these, and which specific problems it has so far chosen to work on.

(3) Project Records: With respect to each non-compliance problem being tackled, there should be a record of the work undertaken to date, including:
   a) Problem Definitiona reasonably precise definition of the problem
   b) Evidence: data, and analysis, which constituted the initial evidence of the problem's existence
   c) Assignment of Responsibility: names of personnel assigned to solve the problem (e.g. team leader, team members) and to coordinate IRS' response to the issue
   d) Risk Assessment: an estimate of the magnitude, extent, and seriousness of the problem
   e) Measurement: an indication of the measures, indicators, or metrics which will be used to determine whether any designed solution actually has any impact on the problem; and initial "benchmarking" for the measures selected
   f) Search for an effective solution: a record of "solutions," "prescriptions," or "action plans" proposed, discussed, and adopted
   g) Implementation: a record of actions taken to date
   h) Review: evidence of impact, if any, of actions taken.

The third form of professionalism, being data-driven and results oriented, increases the premium placed on analysis and analytic skills. I believe that the creation of DORA and NORA sites within the IRS was specifically designed to provide the analytic support necessary for this type of work. In assessing the maturity of this strategy, however, the Commission might want to ask the following questions:

(1) What impact have the analyses of the DORA and NORA sites had on resource allocation within the agency?

(2) When a specific non-compliance pattern or problem is identified through analysis, what mechanisms exist for assigning personnel to design, test, and implement remedies?

(3) Who decides whether a non-compliance problem is serious enough for a project to be initiated? On what basis do they decide? Is it clear whose job this is? Is their decision recorded?

(4) Once a project is initiated, how is the planning coordinated across the multiple functions that might be involved as parts of the solution?

(5) Without line authority over any of the necessary resources, how effective are the analytic units in obtaining assistance and support from the core functional groups within the IRS?

(6) Is the compliance strategy able to handle and address non-compliance problems of different shapes and sizes. (i.e. can it deal with broad national issues as well as regional or local ones; and can it address problems specific to industry segments, or to particular business behaviors, or to particular forms, etc.)

Institutionalizing the Compliance Approach

The IRS can claim some remarkable successes within the third area of professionalism. For example, the IRS identified a specific non-compliance problem where taxpayers were claiming fictitious dependents on form 1040, line 6(c). In 1986 they solved the problem quite elegantly by redesigning the form to require a Social Security Number for each defendant claimed. The following year the number of deductions claimed dropped by seven million, even though the IRS had no SSN verification procedures in place at the time.

Another example was provided by James E. Donelson in his testimony to the commission on February 26th 1997. He described a specific non-compliance problem: the underreporting of tip income. He described a tailor-made solution: the development of Tip Rate Determination Agreements, which resulted in reported tip income increases of over $2 billion.

So the identification of non-compliance patterns is not new for the IRS. Nor is the implementation of artfully designed solutions, some of which turn out to be remarkably effective.

Like so many other regulatory agencies, the IRS has had some compliance successes. But, like so many other regulatory agencies, the IRS has probably not yet finished the task of institutionalizing this approach, or making it a normal method of conceiving and organizing its business. Also, given the ever present demands of their process workload, the IRS may need substantial help and encouragement in building the organizational infrastructure necessary to turn the concept of a coherent compliance strategy into an operational reality.

Conclusion

An important challenge for the Commission, I believe, is to assess the development of the IRS' organizational capacity for systematically identifying significant non-compliance issues and devising, implementing, and assessing appropriate solutions for each one, drawing from the full range of available tools and methods.

Another aspect of this challenge is to balance this third kind of professionalism against the other two forms. All three are important. Functional expertise and process management remain critically important. But the third type--the focus on compliance problems--tends to be the least well understood, and the least well developed of the three.

If there is any way I can assist the Commission or the IRS in bringing this important work to maturity, I will be pleased to do so.

Attachments:

[As other witnesses to the Commission (e.g. Susan Long) have raised the issue of the Taxpayer Compliance Monitoring Program (TCMP), I have taken the liberty of attaching testimony on this subject I gave when the 1995 cancellation of a proposed TCMP was under consideration.]

Copy of testimony provided the House Committee on Ways and Means, Subcommittee on Oversight, on the subject of the importance of the TCMP to IRS' compliance program. Tuesday July 18th 1995.
