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*Ultimate Objectives for the IRS:
Balancing Revenue and Service*

ALTHOUGH IT IS widely understood that the Internal Revenue Service has the mission to collect federal taxes, there is some debate as to whether that is its only mission. If there is a crisis in tax administration, it may be one of identity. There is consensus that the IRS must collect revenues, but there is little agreement on how and sometimes even whether it should pursue its many other functions. Even members of Congress have waxed and waned between demanding that almost all effort be put into pursuing noncompliance as opposed to emphasizing service and taxpayer rights.

A crucial unifying factor is limited resources. Decisions routinely have to be made weighing one IRS activity against another, and without some idea of a comprehensive objective for all of the IRS, those decisions cannot be consistent or optimal. Consider some of the expectations citizens have of the IRS. Most taxpayers want the IRS to issue refunds speedily each spring. Many of them look to the IRS to answer their questions about the increasingly complicated Internal Revenue Code. Some even believe the IRS to be the source of the complexity, failing to draw a distinction between lawgivers and law enforcers. Others want the IRS to do a good job as tax cop—helping to direct the “traffic” and assisting those who “break down,” while also catching and punishing those who violate the laws. The image that businesses have of the IRS is often colored by the significant record-keeping and information-reporting burden imposed on

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them. But the IRS does not just collect taxes; it pays out money under a vast array of subsidy programs. Both lawmakers and the public expect the IRS to implement social programs, just as would the Departments of Energy or Health and Human Services, and to ensure that federal funding reaches targeted purposes or people.

In the midst of these many public expectations, the IRS has had trouble balancing its many roles over the past thirty years. Certainly, even though the Internal Revenue Service has always pursued both revenue and service (just look at the agency's title), remarkable shifts have taken place. These shifts illustrate the tension that exists between the IRS's mission when defined narrowly as collecting revenue and more broadly as providing service. Our view is that meeting citizens' demands for justice under the laws is a service that entails collecting revenues that are owed, as well as providing subsidies that are due, and so the two goals are not as incompatible as they may seem. Still, the challenge remains: to identify and to implement the proper balance for all aspects of tax administration.¹

This chapter examines how this challenge has been met from a historical perspective and then offers a framework for identifying the proper balance. Once established, it can be used both to critique past performance and to provide some guidance for future resource allocations. Without a comprehensive understanding of its objective (or one that relates goals to one another), the IRS will not be able to make consistent choices in its allocation of resources. We believe that some of the changes in emphasis that took place over the past thirty years reflect this inconsistency.

Historical Perspective

Determining objectives and policies for the IRS requires that we first draw on lessons from the past. In this section we summarize trends in revenue, workload, taxpayer noncompliance, IRS size, resource allocation, enforcement results, and taxpayer service. These data reveal how the preferences of presidents, legislators, and administrators have played out against each other; at the same time they show the extraordinary difficulty the IRS has had in meeting multiple, conflicting, and shifting political demands with limited resources.

1. That challenge is highlighted by a lively debate among authors, editors, commentators, and reviewers of our chapter over whether (1) service is merely a means to the ultimate end of collecting revenue; (2) service is one of several goals in its own right; or (3) collecting revenues is perhaps the principal service. Regardless, it is our hope that this chapter will stimulate thoughtful debate about the proper role of the IRS and how that role should influence IRS decisionmaking in allocating resources.

Revenue

The IRS collects a growing amount of federal tax revenue. In the past thirty years, annual government receipts have grown ten fold, from under \$200 billion in 1971 to roughly \$2 trillion in 2001. Individual income tax and Social Security and related taxes have accounted for the largest share of government receipts, increasing from about 71 percent of all government receipts in 1971 to almost 85 percent in 2001. Almost all the growth in federal receipts has arisen from the growth in the economy. However, federal revenues as a percentage of GDP have usually fallen in the range from 16 percent in 1971 to 19 percent in 2001.

Workload

From a tax administration perspective, it is workload that must be allocated—from prefiling telephone assistance, to the processing of returns and refunds, to postfiling enforcement activities. Since 1974, for example, the number of individual income tax returns has increased by 60 percent by 2001, while the population has grown by less than 35 percent. This per capita growth in the number of returns is due largely to a shift from married-joint returns to other filing statuses (for example, single and head of household) as couples are getting married later (if at all) and are getting divorced more frequently.² Some growth is due to the increase in children being required to file, even though they are on their parents' returns already. The number of returns of corporations, fiduciaries, and partnerships has also been outpacing population growth (growing from 24 to 40 per thousand of population), although employment tax returns have held roughly constant with respect to the population. Fortunately for the returns processing function, the growth in electronic filing has exceeded the growth in returns; however, this shift toward electronic returns has not diminished the workload for prefiling and postfiling activities.

Taxpayer Noncompliance

The Internal Revenue Code imposes three basic obligations on taxpayers: to file timely returns, to report the correct amount of tax liability on those returns, and to pay that amount of tax timely. An obvious influence on the IRS workload, therefore, is the extent to which taxpayers do not fully comply with these obligations. Noncompliance not only drives most of the IRS's postfiling activities (audits, collection actions, criminal investigations, and so forth), but it also

2. The percentage of all individual "married, filing jointly" returns declined from 53.1 percent in 1974 to 39.1 percent in 2001.

Table 10-1. *Selected Federal Tax Compliance Estimates, Tax Year 1992*

Billions of dollars, except as indicated

	<i>Individual income tax</i>	<i>Corporation income tax</i>	<i>Employment taxes</i>	<i>Total income and employment taxes</i>
Total tax liability	558.7	113.5	431.6	1,103.8
Tax paid voluntarily and on time	457.0	92.6	381.5	931.1
Gross tax gap ^a	100.7	20.9	50.1	172.7
Nonfiling	13.8	0.0	0.0	13.8
Underreporting	73.1	19.4	42.8	135.3
Underpayment	14.8	1.5	7.3	23.6
Enforced and late payments	19.2	7.7	6.1	33.0
Net tax gap ^b	82.5	13.2	44.1	139.7
Noncompliance rate (percent) ^c	18.2	18.4	11.6	15.6

Source: Author's calculations based on IRS (1996) and unpublished IRS material.

a. Total tax liability minus tax paid voluntarily and on time.

b. Gross tax liability minus enforced and late payments.

c. Ratio of gross tax gap to total tax liability.

greatly influences filing and prefilling activities (for example, freezing or disallowing refunds and educating taxpayers to avoid noncompliance).

The amount of tax liability that is not paid voluntarily and timely is called the gross tax gap. The most recently published estimates of the entire tax gap are summarized in table 10-1. In 1992 nonfiling accounted for 8 percent of the gross tax gap and was concentrated among individuals. Underreporting on timely filed returns accounted for over 78 percent of the gap, while the remaining 14 percent arose when taxpayers did not timely pay the amount of tax that they reported on their returns as due. These estimates, which are somewhat old and inevitably subject to error, indicate that the noncompliance rate has been roughly the same for individual and corporation income tax and slightly lower for employment tax. Even though about 84 percent of all these taxes are estimated to be paid voluntarily and timely, the remaining gross tax gap was over \$172 billion in 1992. This presents an enormous challenge for the IRS. In fact, estimates indicate that over 80 percent of that \$172 billion will never be collected.³

Although more recent compliance data are not available, and comprehensive estimates are always subject to error (people do not report on how much they do

3. Although previous estimates of the gross tax gap suggest that compliance rates have been relatively stable over time, how the IRS administers the tax law presumably influences voluntary compliance and therefore the size of the tax gap.

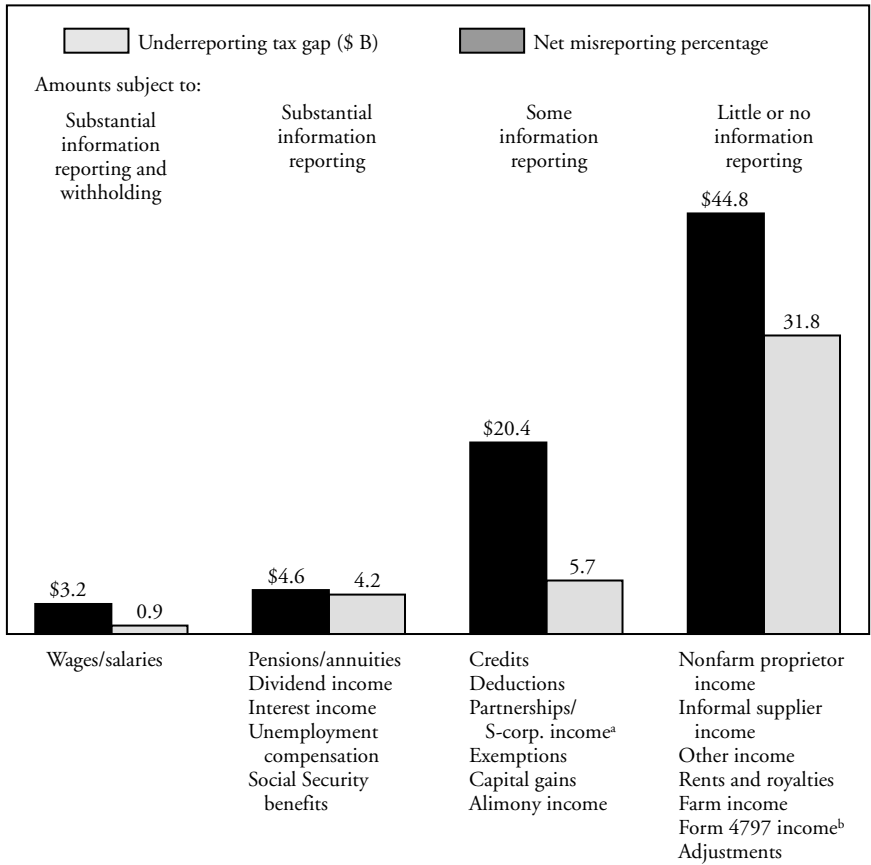
not report, and nonfilers are not anxious to identify themselves), it is clear that noncompliance is greatest where the opportunity is greatest. In figure 10-1 the IRS estimates are broken down according to the level of withholding and information reporting involved. Both the amount of individual income tax that is not reported timely (the underreporting gap) and the corresponding net misreporting percentage are inversely proportional to the extent to which a reported amount is subject to third-party information reporting, such as Form W-2 and Form 1099; the more completely an amount is covered by information reporting, the lower the noncompliance rate. When the amount is also subject to withholding by the payer, noncompliance drops even more. Clearly the greatest opportunities for significant gains in voluntary compliance are where taxpayers currently have the greatest opportunity to make errors—whether inadvertently or intentionally—and those errors cannot easily be checked on someone else's books (payer's or payee's).

One of the areas of noncompliance that has received much IRS attention in recent years is the earned income tax credit (EITC) for individuals. According to a targeted study of tax year 1999 returns (see table 10-2), just over half of all returns claiming EITC claimed an incorrect amount, with returns claiming too much accounting for 86.0 percent of the erroneous returns and 92.6 percent of the erroneous dollar amounts. Of the entire amount of EITC claimed, almost one-third should not have been. On the other side, there is also significant underclaiming of this credit by those eligible, but the IRS compliance studies (because they examined only EITC claimants) could not estimate the extent to which eligible people do not claim it at all.

IRS Size

How has the IRS coped with increasing workloads and the enormous challenge of taxpayer noncompliance? Comparing 1974 to 2001, the IRS has stayed roughly the same proportionate size—both in terms of its budget (roughly 0.1 percent of GDP) and in terms of its work force (approximately 0.04 percent of the population). However, there was a significant cycle of increase from 1982 to 1993 and decline thereafter. The challenge has been to accommodate the increase in the number of returns and number of programs administered, by becoming more productive. The growth in electronic filing has certainly increased the IRS's ability to process returns, but what about productivity in other aspects of tax administration? The next sections highlight recent trends in IRS resource allocation and productivity, with particular attention to enforcement programs and customer service activities. This dichotomy between enforcement and service, however, is somewhat misleading. In a sense, even enforcement activities can be thought of as service—particularly to honest taxpayers who benefit when tax evaders are forced to pay their fair share of the tax

Figure 10-1. *Underreporting of Individual Income by Visibility Categories, Tax Year 1992*



Source: IRS (1996).

- a. S-corp refers to corporations that are structured so their income “flows through” to the owners.
- b. Form 4797 relates to gains from sales of business property.

burden. However, when we use the terms *taxpayer* and *service* together, we follow the IRS convention of defining taxpayer service more narrowly as those (generally prefilling) activities in which the IRS provides assistance to taxpayers in understanding and meeting their tax obligations.

Resource Allocation

The three basic taxpayer obligations (filing, reporting, and payment) create three phases of tax administration: prefilling (predominantly helping taxpayers

Table 10-2. *EITC Compliance, Tax Year 1999^a*

	<i>Over-claim returns</i>	<i>Correct returns</i>	<i>Under-claim returns</i>	<i>Total</i>	<i>Alternative error definitions</i>	
					<i>Net (overclaims – underclaims)</i>	<i>Total (overclaims + underclaims)</i>
Returns claiming EITC (millions)	9.2	8.2	1.3	18.8		
Amount claimed (billions of dollars)	14,572	14,785	1,880	31,237		
Correct amount (billions of dollars)	4,920	14,785	2,646	22,351		
Amount of error (billions of dollars) ^b	9,653	0	-765		8,886	10,418
Overclaim and under-claim (percent) ^c	66.2	0.0	-40.7		28.5	33.4
Misreporting (percent) ^d	196.2	0.0	-28.9		39.8	46.6

Source: IRS, 1999 EITC Compliance Study.

a. Based on audits of a representative sample of EITC claimants. Estimates are lower bound, in that they assume that taxpayers who failed to appear for an audit have the same compliance (overclaims, correct, underclaims) as taxpayers who were audited.

b. Amount claimed minus correct amount.

c. Ratio of amount of error to amount claimed.

d. Ratio of amount of error to correct amount.

to understand and meet their obligations), filing (processing returns, payments, and refunds and maintaining taxpayer accounts), and postfiling (mostly enforcement). Although all three categories of IRS activity involve taxpayer assistance or service, and all three help to generate revenue, prefilling is dominated by taxpayer service, and postfiling is dominated by enforcement. The general rule in our system of voluntary⁴ compliance with the tax laws is that both taxpayers and tax administrators prefer to emphasize the prefilling phase. Contrary to what might be predicted by the TAG model presented in chapter 8 in this volume, comprehensive compliance studies have suggested that most individuals seek to meet their tax obligations fully. (Less than half the taxpayers could be found to have understated their tax, and many of the understatements that were made were small amounts, many of which were likely inadvertent. One way to use the TAG model to explain these findings is to

4. At first glance it may be hard to understand how a system that requires withholding and information reporting and that uses enforcement actions to deter noncompliance can be considered

characterize most individuals as risk averse.) Most taxpayers appreciate all the help they can get in understanding their obligations, while the IRS realizes that it is usually much more effective to help taxpayers before they file than it is to collect delinquent taxes after they are due.

A minority of taxpayers, nonetheless, are intentionally noncompliant, necessitating at least some enforcement action by the IRS. This raises one of the most important questions for tax administrators: What is the appropriate balance between their prefilings, filings, and postfiling activities? That is, how should they allocate their limited resources to these three needs (or even within them)? Is it possible to know if one of them is being emphasized (or deemphasized) to the detriment of overall agency performance? How can we judge the performance of the IRS, anyway?

As background to answering these questions, let us examine how the IRS has allocated its resources in the past. The chief IRS resource is its employees. About 69 percent of the IRS budget is devoted to personnel costs, although this is down from almost 77 percent in 1975.⁵ Figure 10-2 illustrates how the IRS has allocated its employees to three major categories of work: taxpayer service, the processing of tax returns and related data, and enforcement. Although these categories do not correspond exactly to prefilings, filings, and postfiling, they are close.⁶

Although enforcement may be a last resort, it nonetheless consumes the greatest share of IRS personnel, while taxpayer service activities have traditionally employed the least. Ignoring the period from 1995 onward for a moment, the mix of employees at the IRS has fluctuated somewhat since 1974 (due in part to enforcement hiring initiatives in the late 1980s), but the shares allocated to enforcement, returns and data processing, and general management and overhead remained roughly stable with respect to the number of returns filed, while the staff allocated to taxpayer service has been increasing over time—even as a percentage of returns filed. The traditional mix then changed dramatically in the period from 1996 to 2000: Enforcement and processing personnel were cut dramatically, while those allocated to taxpayer service more than doubled.⁷ Notice that this change began at least two years

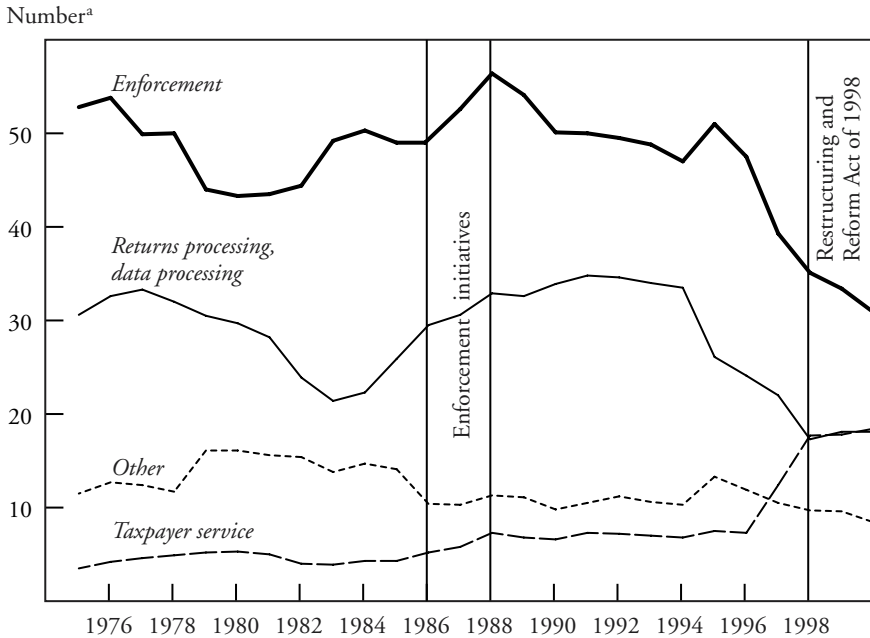
voluntary. In reality even these measures cannot force everyone—or even most people—to comply fully with the law. Unless they are compelled individually (and the data contained in this chapter confirm that only a few are), the extent to which taxpayers comply with their tax obligations is based on their own voluntary choice. This does not mean that everyone complies completely—only that the extent to which many comply is by choice.

5. As we understand it, this decline was due in part to increased investments in automation and to an increasing reliance on outside contractors.

6. Taxpayer service, for example, includes answering taxpayer inquiries about refunds that are pending during processing, and a significant portion of data processing supports enforcement activities.

7. According to conversations with IRS officials, this literally involved the reassignment of enforcement personnel to taxpayer service duties.

Figure 10-2. *IRS Staffing, Fiscal Years 1975–2000*



Source: IRS, *Commissioner’s Annual Report*, fiscal years 1975–92; IRS, *Data Book*, fiscal years 1993–2000.

a. Positions per 100,000 individual income tax returns filed.

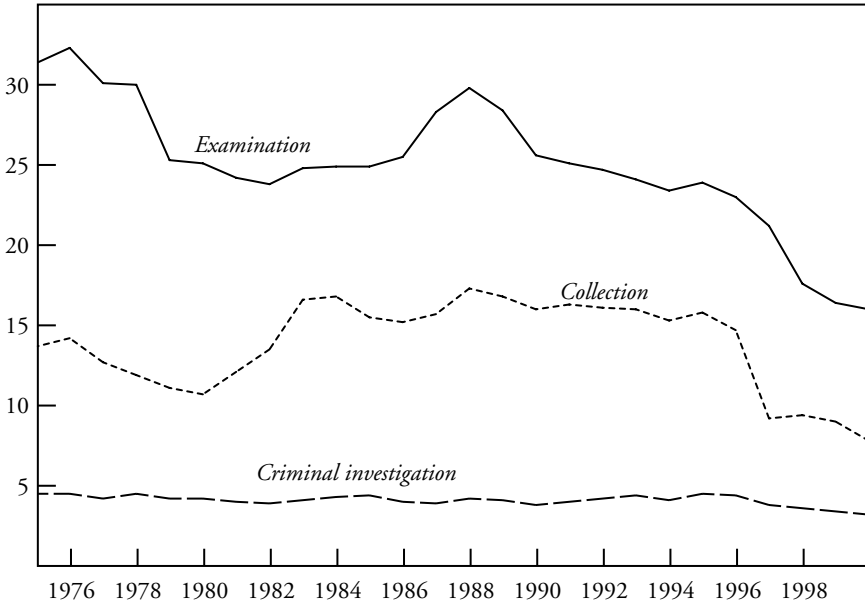
before the Restructuring and Reform Act of 1998 (RRA98), legislation that mandated this shift in emphasis.

Most enforcement personnel are allocated to three primary functions: the examination of tax returns, the collection of delinquent taxes (and securing delinquent returns), and criminal investigation (in that order of size). As illustrated in figure 10-3, examination personnel declined slightly, relative to the number of returns, even before the late 1990s.

The IRS has generally treated the processing of tax returns as mandatory, with enforcement and taxpayer service competing for the discretionary part of the budget. With processing put to the side for the moment, it is instructive to see how the measured outputs from enforcement and taxpayer service have changed over time.

Enforcement Results

The IRS uses the term *examinations* to refer to its scrutiny of tax returns to determine their accuracy. Although sometimes called audits, most examinations

Figure 10-3. *IRS Enforcement Staffing, Fiscal Years 1975–2000*Number^a

Source: IRS, *Commissioner's Annual Report*, fiscal years 1975–92; IRS, *Data Book*, fiscal years 1993–2000.

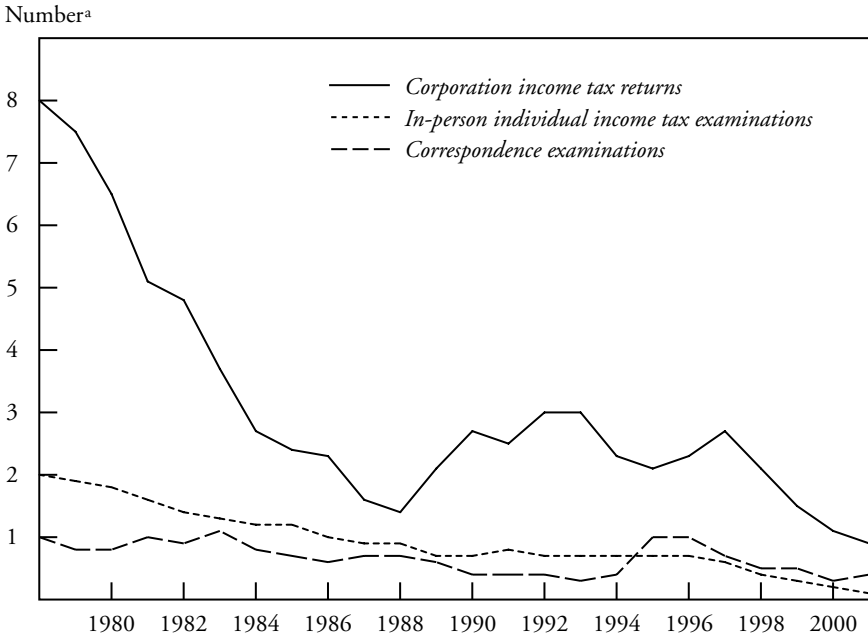
a. Positions per 100,000 individual income tax returns filed.

generally focus on just a few items that seem questionable and are not full audits, as accountants would use the term. While most examinations historically have involved direct meetings with the taxpayer, a growing share of examinations are conducted through semiautomated correspondence.⁸ Given the decline in enforcement resources in recent years, we should expect the corresponding decline that we see in examination coverage rates (see figure 10-4). What is more surprising is that coverage rates (particularly among corporations) have been declining significantly for a long time—with the exception of the early 1990s, when the impact of the enforcement initiatives was being felt, and more recently, with the rise in EITC-related correspondence exams.

At the same time, direct enforcement revenue (the tax, penalty, and interest paid by taxpayers as a direct result of their being contacted by an IRS enforce-

8. Neither of these types of examinations, however, includes the numerous enforcement contacts that arise from mismatches between third-party information documents and what taxpayers report on their tax returns.

Figure 10-4. *IRS Examination Coverage Rates, Fiscal Years 1978–2001*



Source: IRS, *Commissioner’s Annual Report*, fiscal years 1978–92; IRS, *Data Book*, fiscal years 1993–2001.

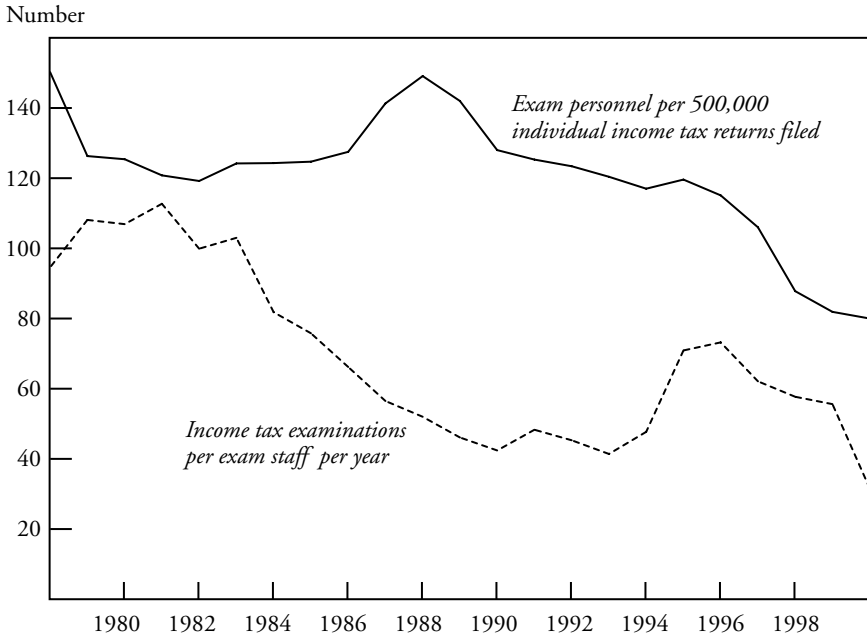
a. Examinations closed per 100 returns filed the previous calendar year.

ment program) fell from 2.5 percent of net dollars collected in 1995 to 1.8 percent in 2001. This decline may be associated with a decrease in examinations per examiner, as suggested by figure 10-5. With the exception of the late 1990s (which saw a significant shift in focus toward correspondence examinations of relatively simple issues, most notably the earned income tax credit), examiners’ productivity (as defined by returns examined per staff year⁹) has been declining steadily and significantly for over twenty years.

Undoubtedly many factors have contributed to this decline, including the increasing complexity (and variability) of the tax laws and the increase in time spent by examiners fulfilling the mandates of two major taxpayer bills of rights (which impose many rules and restrictions on how taxpayer contacts are conducted). And it is entirely possible that the expansion of computer-generated contacts based on the matching of information returns led to improved compliance

9. Note that this does not account for the possibility of greater productivity *within* any given examination, such as probing more intensively.

Figure 10-5. *IRS Examination Staff Resources and Output, Fiscal Years 1978–2000*



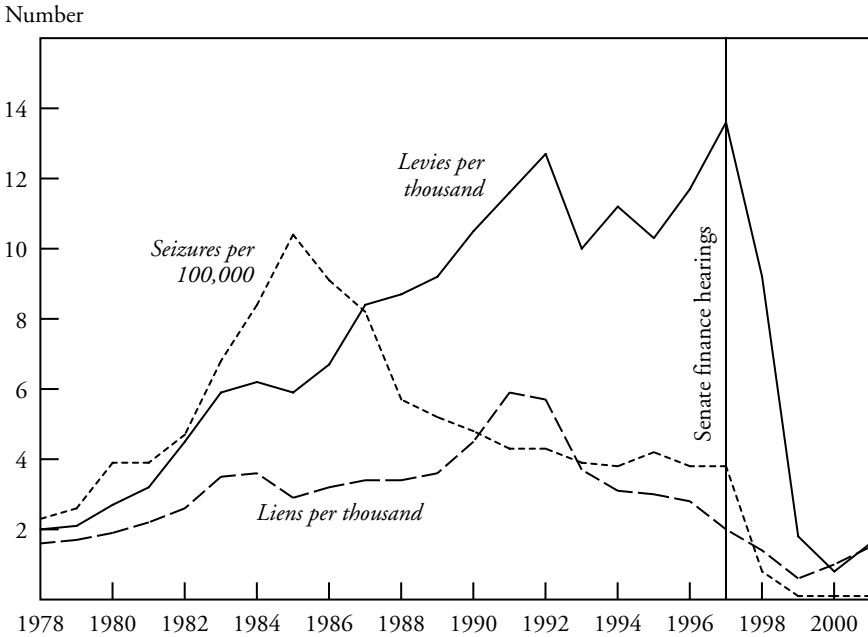
Source: IRS, *Commissioner's Annual Report*, fiscal years 1978–92; IRS, *Data Book*, fiscal years 1993–2000.

in areas easier to track, such as interest, dividends, and to some extent capital gains. This trend could lead to lower measured productivity (though not necessarily actual productivity, if indirect effects on compliance were measured). But whatever is going on, it is clear that a relatively stable allocation of resources to the examination of tax returns does not necessarily yield a correspondingly stable output of examinations or direct revenues from those exams.

Another challenge for IRS enforcement is that less than half of what is assessed by either in-person or correspondence examinations is eventually collected—even after seven years! Amounts assessed by the matching of information documents against what is reported on tax returns generally are twice as collectible, but even those amounts are not paid in full. Clearly, identifying non-compliance is only part of the challenge facing tax administration.

The collection function seeks to collect delinquent taxes, penalties, and interest, and to secure delinquent returns. The three primary enforcement tools it uses are liens (legal claims to property as security or payments for tax debts), levies (seizures of taxpayers' assets held by others to satisfy the taxpayers' tax debts), and

Figure 10-6. *IRS Collection Enforcement, Fiscal Years 1978–2001*



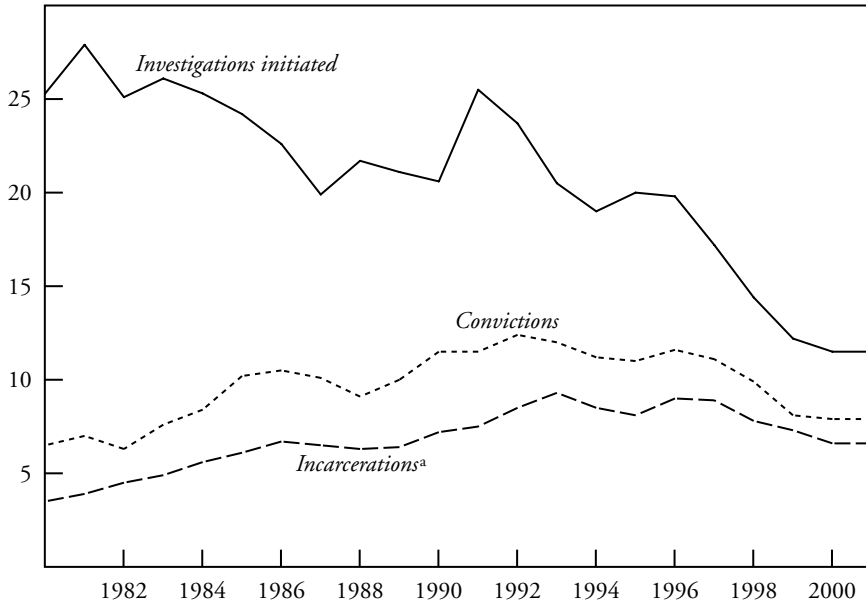
Source: IRS, *Commissioner’s Annual Report*, fiscal years 1978–92; IRS, *Data Book*, fiscal years 1993–2001.

seizures (taking control of taxpayers’ property that they hold, with the purpose of selling the property to satisfy their tax debts). Interestingly, although the use of all three grew from the early to the mid-1980s, each peaked at a different time (see figure 10-6): The use of liens has been declining since 1991, and seizures began declining in 1986. The use of levies continued to grow until 1998, when they (and seizures) dropped precipitously, after charges of IRS enforcement misconduct were made at hearings held by the Senate Finance Committee. It seems likely that the provisions of section 1203 of RRA98, which followed soon thereafter, also had an adverse effect on collection activities. This code section lists ten categories of misconduct (sometimes called the Ten Deadly Sins) for which an IRS employee can be fired, the first of which deals specifically with seizures of property in collection enforcement cases.

The criminal investigation (CI) function pursues tax crimes related to legal-sector income (for example, fraud), but it also investigates illegal-source and narcotics-related financial crimes. In fiscal year 2001, each of these three categories accounted for roughly one-third of all CI cases, though illegal-source financial crimes represented a larger share. Although the number of new investigations has

Figure 10-7. *IRS Criminal Investigations, Fiscal Years 1980–2001*

Number per million population



Source: IRS, *Commissioner's Annual Report*, fiscal years 1980–92; IRS, *Data Book*, fiscal years 1993–2001; and unpublished tabulations from the IRS Criminal Investigations Management Information System, 1980–89.

a. Incarcerations may include prison time, home confinement, electronic monitoring, or a combination thereof.

declined steadily over the past two decades (particularly relative to population growth), convictions and incarcerations have not fallen off until recently (see figure 10-7). The decline seems to be partly due to the gradual decline in CI staffing in recent years (see figure 10-3) and to a slight reduction in investigations started per staff year (falling from around 1.6 to about 1.0). However, the apparent increase in time per case seems to have contributed to a higher conviction rate. According to conversations with CI staff, their recent efforts have focused mainly on cooperating with financial and narcotics-related investigations, not with more traditional tax noncompliance, and this may also affect time allocation and conviction rates.

By virtually every measure (both inputs and outputs), IRS enforcement of the tax laws outside of computer-generated document matching programs has been in decline for many years, but particularly so from about the mid-1990s to the beginning of the new century.

Taxpayer Service

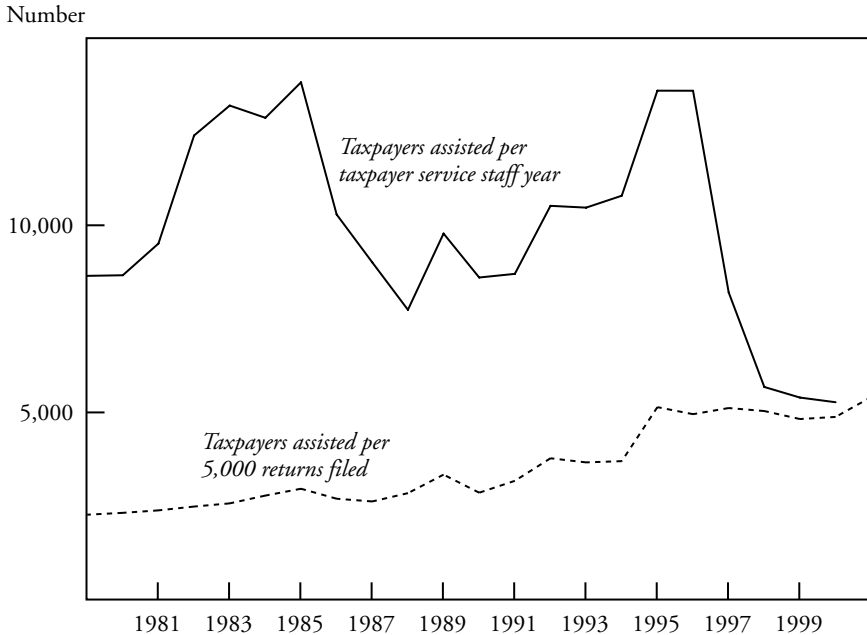
The growth in the resources allocated to taxpayer service activities¹⁰ (see figure 10-2) has resulted in more taxpayers being assisted in a variety of ways: getting an answer to an account or tax law question on the telephone; walking into an IRS field office to get a tax form, publication, or help preparing a return; attending an educational seminar for new businesses, and so on. In fact, since 1995, the IRS has on average responded each year to a number of requests approximately equal to the number of individual tax returns (of course, some taxpayers have multiple requests).

It is noteworthy, however, that the dramatic shift of resources to taxpayer service positions from 1996 to 2002 did not result in a corresponding growth in the number of taxpayers assisted. In fact, as figure 10-8 illustrates, the infusion of taxpayer service personnel in recent years has been accompanied by a dramatic drop in taxpayers assisted per staff year. This trend could have several explanations. For example, new employees can be expected to take a while to be as productive as seasoned workers. Moreover, the increased time per taxpayer contact may have resulted in an increase in the quality of those contacts, even if the ratio of contacts has not risen greatly. However, there is little evidence that this is the case for toll-free telephone assistance. The measured quality of the answers given to technical tax law questions has remained fairly stable. From the data, then, the net result from assigning more people to provide taxpayer service is not clear. Although there has probably been some gain, the data do not reveal whether any such gain has been cost-effective.

A Framework for Resource Allocation

The 1996–2002 shift of resources from enforcement to taxpayer service (assistance) activities was accompanied by a corresponding revision of the IRS mission statement. In 1984 the declared purpose of the IRS was “to collect the proper amount of tax revenue at the least cost to the public, and in a manner that warrants the highest degree of public confidence in our integrity, efficiency, and fairness. To achieve that purpose, we will: encourage and achieve the highest possible degree of voluntary compliance in accordance with the tax law and regulations; advise the public of their rights and responsibilities; determine the

10. Again, for clarity, we need to emphasize that the IRS and others often use the terms *taxpayer* (or *customer*) *service* synonymously with *taxpayer* (mostly prefiling) *assistance*. That is the sense in which we use the term here, even though we also want to emphasize that filing and postfiling activities are essential to serving taxpayers effectively.

Figure 10-8. *IRS Service Staff Productivity, Fiscal Years 1979–2001*

Source: IRS, *Commissioner's Annual Report*, fiscal years 1979–92; IRS, *Data Book*, fiscal years 1993–2001; and unpublished IRS data.

extent of compliance and the causes of noncompliance; . . . do all things needed for the proper administration and enforcement of the tax laws; and continually search for and implement new, more efficient, and effective ways of accomplishing our Mission.”¹¹

In the 1998 revision, the stated mission was to “provide America’s taxpayers top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.”¹²

Although they overlap significantly with respect to how the mission is to be implemented, the statements reflect much different emphases. The earlier statement characterizes the fundamental role of the IRS as collecting the revenue, while the current one emphasizes the role of providing service. Again, at one level these two goals are not contradictory. Better service can improve revenue collection by facilitating voluntary compliance, while enforcement activities serve compliant taxpayers by ensuring that all pay their required tax. Yet the new mission statement was, in part, a reaction to a perception in Congress that the

11. IRS (1984, cover).

12. IRS (1998, p. 2).

IRS had emphasized revenue collection to the detriment of taxpayer rights and with insufficient sensitivity to taxpayer needs, even though the earlier language also emphasized the need for integrity, fairness, and respect for taxpayer rights.

The 1984 statement is written from the perspective that enforcement and taxpayer service are both means to the ultimate end of collecting “the proper amount of tax revenue.” In contrast, the 1998 statement describes service not as a means to an end but rather the end itself, while suggesting that tax law enforcement is a means toward that end. Looking only at the words, the later statement leaves ambiguous whether service is defined narrowly in the traditional sense of taxpayer service or assistance, more broadly as public service, or something in between. However, the later statement only makes sense if the definition of service is broader and means much more than taxpayer service as defined on the organizational chart; it must include applying the tax law as a component of service.

Internal documents and public briefings elaborated on the new mission statement by emphasizing “balanced measures,” using the analogy of a three-legged stool. In this paradigm, the IRS mission is supported by three legs (business results, customer satisfaction, and employee satisfaction), which must be balanced if the mission is to be achieved. According to this model, business results (for example, collecting taxes) are not a means to the end of providing top-quality service, but it is one of three objectives, together with customer satisfaction (which is not really the same as service, either) and employee satisfaction. In order to balance these separate objectives, then, the IRS must trade off some of one to strengthen one or both of the others. Revenue collection, for example, might need to be de-emphasized in order to satisfy customers, employees, or both. Although this model appears to have origins in the private sector, the reality is that businesses pay attention to customer satisfaction and employee satisfaction because these are means to maximizing profits—the bottom line. They are not ends in and of themselves, nor are they even coequal with or “balanced” against profits. Nor is customer satisfaction meant to imply public service for a profit-making organization. This is borne out in the American Customer Satisfaction Index (ACSI), which the IRS uses to measure customer satisfaction. According to the ACSI Methodology Report, a “basic tenet underlying the ACSI is that satisfied customers represent a real, albeit intangible, economic asset to a firm. By definition, an economic asset generates future income streams to the owner of that asset. . . . [The] model links satisfaction to economic returns in the form of customer retention and price tolerance.”¹³

This statement acknowledges that firms do not seek to balance customer satisfaction with profits; rather, they improve customer satisfaction to the extent that it increases long-term profits. “The customer is always right” because that

13. National Quality Research Center (1998, pp. 4–5).

maximizes customer loyalty and market share and, hence, profits. Likewise businesses seek to improve employee satisfaction because that improves the productivity and retention of employees and therefore increases profits.

Therefore the analogy to a three-legged stool is best viewed as a recognition that a significant factor in taxpayer satisfaction is the perception that the IRS enforces the law fairly and effectively—ensuring that, to the extent possible (given IRS resources and constraints), all pay their fair share. This is much closer to a definition of public service than of simple customer satisfaction, or, in other words, a broad definition of customer service.

Traditional Direct Revenue Maximization

In general the traditional IRS approach to resource allocation placed the highest priority on filing (that is, the “required” tasks of processing returns and refunds and managing taxpayer accounts), with “discretionary” resources devoted mostly to enforcement (postfiling), and a smaller share allocated to taxpayer service (prefiling). Enforcement programs have traditionally pursued the objective of maximizing the revenue that they produce from the taxpayers whom they contact, subject to their budget constraint. However, various enforcement programs have had different interpretations of that objective. The examination function and the document-matching program, for example, defined *revenue* as the amount of additional tax and penalties assessed, with no regard for the amount of revenue actually collected. The collection function has defined *revenue* as the amount of tax, penalty, and interest actually collected, but it has not had a strong ability to distinguish among cases on the basis of how cost-effective it would be to pursue them. The appeals and tax litigation functions do not have much discretion as to which cases to work, and the decision to pursue litigation is dictated more by the precedent being sought than by the dollars at risk in the case in question. Therefore these last functions are not as revenue-driven as the others. Criminal investigation is also less focused on the revenue at risk in the particular cases they pursue. Instead they seek to enforce the law against criminals as a deterrent to noncompliance (and, as noted, have recently spent more time on nontax financial and narcotics functions than on more traditional tax functions).

Notwithstanding these differences, and the difficulty in allocating enforcement resources according to a unified objective, it is still true that the prevailing enforcement objective has been to maximize direct enforcement revenue. The appeal of direct revenue maximization is that, for the most part, it is measurable, and it provides a basis for making resource allocation decisions. For any given budget and absent other constraints, enforcement revenue can be maximized by working the cases with the highest expected revenue-to-cost ratios. Net revenue

is maximized only if the revenue-to-cost ratio at the margin is the same across all programs. In other words, if this optimality condition were not true, then revenue could be increased by reallocating resources from workload having lower revenue-to-cost potential to other workload having a higher revenue-to-cost ratio.¹⁴

There are several problems with maximizing direct enforcement revenue as an objective—particularly as it has been applied historically in the IRS. The most significant of these is obvious: It views enforcement in isolation from voluntary compliance. To the extent that IRS activities—whether enforcement or nonenforcement—indirectly affect the voluntary compliance of the general population, it is the combination of direct and indirect revenue that is important.¹⁵ Some types of enforcement cases, although yielding little enforcement revenue directly, probably have a large indirect effect on compliance and should therefore be expanded at the expense of cases with higher direct yields. Likewise some nonenforcement activities, although they produce no revenue directly, nonetheless contribute greatly to voluntary compliance—surpassing the combined direct and indirect effect of some traditional enforcement programs at the margin. Hence, if the IRS were to account for the impact of each of its activities on voluntary compliance, then both enforcement and nonenforcement resources could be allocated according to a common objective.

The second problem is that several enforcement functions (for example, examination and document matching) have attempted to maximize dollars assessed instead of dollars actually collected. In the case of the document matching program, the error is probably not large, but it has likely caused noticeable inefficiencies in the examination program, since the difference between the amount assessed and what is collected is significant and widely varied across the many examination categories.¹⁶ For years the IRS could not even trace by major taxpayer categories what dollars of assessments were actually collected.

A third problem has been that enforcement cases have been selected for many programs according to the amount of revenue at risk, rather than according to the expected revenue-to-cost ratio (here we are referring only to IRS costs). A

14. To the extent that there is discretion as to how intensively to pursue any given case (for example, how many lines on a tax return to examine), then this optimality condition applies to both the intensive margin (that is, how many line items to examine on any given return) and to the extensive margin (how many returns to examine).

15. The examination function has historically recognized this by requiring at least some minimum level of activity in each work category. Although these minimum constraints have been set somewhat arbitrarily, they recognize an impact on voluntary compliance.

16. To some extent this could be rationalized, along with the minimum coverage constraints, on the theory that voluntary compliance is improved by pursuing some cases among those likely to be uncollectable. However, if we were able to account for indirect effects on compliance explicitly, then what is important is not what is assessed but what is collected.

large amount of expected revenue is not attractive if it takes a disproportionate expenditure of resources to collect it. Although the most common guide for selecting returns for examination, the discriminant function (DIF) score, attempts to discriminate between returns that are profitable to audit and those that are not, it is not designed to reflect the degree of profitability. Therefore examining the returns with the highest DIF scores undoubtedly does not result in maximizing even the direct enforcement revenue at any given budget level.

The fourth major problem with maximizing direct enforcement revenue is that it does not reflect the value of getting to taxpayers the benefits to which they are entitled or refunding to them any amounts that they have overpaid. The overassessments uncovered in an examination, for example, have been subtracted from the additional tax and penalties assessed, thus reducing the apparent aggregate results. Ideally some value should be placed on those refunds and added to the enforcement collections, since both adjustments move taxpayers closer to their true tax liability.

The final difficulty is that various quantitative and qualitative costs must be taken into account, including the time of the taxpayer and the cost society would place on an unjustly administered tax system independently from its level of revenues.

Attempts to Operationalize the IRS Objective

After the recent reorganization of the IRS into four principal operating divisions, configured according to taxpayer characteristics, the remaining examination function was re-engineered. Although much of the effort centered on work flow and the division of responsibilities, it also sought to reconsider the traditional objective of maximizing direct enforcement revenue. What resulted was a list of seven objectives for the examination function, which could be “balanced” by decisionmakers:

1. Maximize dollars assessed (the traditional examination objective).
2. Maximize dollars collected (that is, the revenue arising directly from the examinations).
3. Maximize presence (that is, examination coverage within each category of taxpayer).
4. Reflect population distribution.
5. Reflect noncompliance distribution.
6. Minimize taxpayer burden.
7. Maximize relative change in dollars assessed (compared to the amount originally reported on the return).

These objectives are to be measured by the overriding values of efficiency, fairness, and coverage, which leaves them rather opaque. What does it mean to

“reflect” a distribution? And where is the objective to get to taxpayers the benefits to which they are entitled?

Although it is worthy to try to juggle more than one objective simultaneously, it must be done in a way that does not leave out legitimate objectives and has some mechanism to weight alternative objectives. Taken together, the seven objectives are incomplete. Maximizing dollars collected might be better than maximizing dollars assessed, particularly if the dollars collected include the indirect effect on voluntary compliance. Maximizing dollars assessed is clearly wrong in cases where taxpayers overpay their taxes. The “presence” objective presumably addresses the traditional approach to accounting for indirect effects on compliance (through minimum coverage constraints). If indirect effects were accounted for explicitly, however, this would not be necessary as a separate objective. “Fairness” means very different things in objectives 4 and 5 but, most important, there is a more basic aspect of fairness, which complements efficiency instead of competing with it. When taxpayers fail to pay their fair share of the overall tax burden, this shifts the burden unfairly to honest taxpayers. IRS enforcement efforts seek to rectify that imbalance as much as possible. However, to the extent that enforcement is conducted inefficiently (that is, less total revenue is collected than could be the case with the given budget), then the effective tax burden is distributed less fairly than it could be.

Taxpayer Burden

Six of the objectives proposed above seem to be closely related to the traditional enforcement objective of maximizing the total revenue collected. Minimizing taxpayer burden (objective 6), however, does go beyond the more narrow revenue objective. Here once again we see a reflection of the tension between revenue and service that faces the IRS as a whole. A key point is that minimizing taxpayers’ burden is one part of minimizing costs more generally, which in turn is part of the broadly defined mission of service.

If we define taxpayer burden as the time, expense, and inconvenience incurred to comply with the Internal Revenue Code and regulations, it becomes clear that a large source of burden is the tax code itself, and part of the IRS’s mission is to help taxpayers understand what is required of them by the law and to facilitate their calculations and payments. If we had the current tax code, for example, but there were no IRS (no tax forms, instructions, publications, toll-free numbers, and so on), taxpayers would still face the enormously burdensome task of determining and fulfilling their tax obligations. In the aggregate, they would also end up paying a much smaller fraction of the tax liability imposed on them by law—both out of confusion and from the opportunity to cheat. Clearly much of what the IRS does (forms, publications, and so forth) decreases

unnecessary burden, where little trade-off is involved with compliance. At other times it imposes a necessary burden to try to minimize some other cost, such as an inequitably enforced tax code. It is easy to be against waste, inefficiency, and unnecessary burdens; the more difficult task is to figure out what necessary burdens in the end best serve the public interest as a whole.

The lesson here is that it is too simplistic, and is often counterproductive, to act as if a particular form of taxpayer burden should be minimized on one front without considering the trade-offs on other fronts. The remainder of this chapter proposes a practical framework for examining those trade-offs more rigorously and offers several directions for the future.

An Objective Function to Guide Resource Allocation

We suggest that most of its goals can be accomplished if the IRS were to seek to allocate resources so as to collect the right amount of tax from each taxpayer at the least cost (including inconvenience) to the people. Unfortunately many taxpayers do not pay the amount of tax that is imposed on them by law. Some pay too much, and many pay too little—if any at all. Some of the error is unintentional but much is willful. All the error, however, causes the tax burden to be distributed in a way that is contrary to the intentions of Congress, which the IRS must assume represents the public will. With noncompliance, the tax burden is shifted from those who pay too little to those who pay too much. In both a relative and real sense, therefore, deficiencies are borne by the compliant, either in the form of higher taxes or lower benefits from programs financed by taxes. (Even this expression does not fully incorporate all services required of any agency to ensure that its programs are well run.) This characterization of the objective recognizes several critical factors:

—The ultimate intent is that each taxpayer (and this includes those who currently pay no tax or get “negative” tax payments from programs run through the IRS) pays the correct amount of tax, when it is required to be paid.

—The IRS must recognize its role in reducing overpayments and performing the other program objectives (getting out subsidies, enforcing charity tax laws, and so forth) that Congress builds into IRS programs.

—All IRS activities, whether service-oriented or enforcement-oriented, should pursue a consistent objective. Therefore resources should be allocated to all activities and programs on the basis of how effectively they contribute to this objective at the margin. Prefiling programs, for example (which help taxpayers avoid paying too little and too much), must compete at the margin with post-filing programs (which collect tax underpayments, refund overpayments, and promote voluntary compliance).

—In pursuit of this objective at any level, the IRS must minimize its own costs, as well as the time, expense, and inconvenience it (and the law) imposes on taxpayers. Even if all taxpayers were perfectly compliant, the IRS would still incur costs for enabling them to understand and meet their tax obligations, for processing their returns and payments, and for maintaining their accounts. Likewise these perfectly compliant taxpayers would bear a significant compliance burden (the time, expense, and inconvenience necessary to understand and meet their tax obligations) in addition to the tax burden itself. In other words, some taxpayer burden is inevitably imposed by the law, while other burden may be imposed by the IRS for the purpose of ensuring that the misallocation of the tax burden is minimized.

—Finally some consideration must be given to the economic cost of using up resources in the economy vis-à-vis transferring resources, as from noncompliant to compliant taxpayers. It is unlikely that a society would find it worthwhile to reduce output by a dollar to collect a dollar from a noncompliant taxpayer.¹⁷

In simple form (but not simple use), this approach can be expressed mathematically as an objective function for a constrained optimization problem as follows:

$$\text{Minimize: } \sum_i W_i [\theta_i(T_i^+), \Gamma_i(T_i^-), \Lambda_i(C_i)],$$

subject to IRS budget = B (constraint operates only after budget appropriation is set). The subscripts, i , refer to the range of taxpayers, W is a welfare weight, + and – refer to over- and underpayments of tax (T), C is the compliance costs for each filer, and the Greek letters are functions for the person i .

More simplified forms of this equation are possible. For instance one that gives equal weights to overpayments and underpayments and a separate but equal weight to all costs is:

$$\text{Minimize: } \sum_i |T_i^* - T_i| + w \sum_i C_i \text{ subject to: IRS budget} = B$$

where, for each taxpayer i :

T = the amount of tax actually paid;

T^* = the amount of tax that should be paid under current law;

C = the cost of complying with the tax code and regulations, including the time, expense, and inconvenience required to understand and meet those tax obligations; and

w = a weighting factor that expresses the value of reducing taxpayer compliance costs relative to the value of minimizing the misallocation of the tax burden.

The simplified form can then be expanded by adding in differences that take into account whether the IRS wants to treat overpayments differently from

17. Steuerle (1986).

underpayments, count errors differently according to the income or other circumstances of the taxpayer, or apply different weights to different costs.

Whether in simplified or more complex form, the advantage of this type of objective function is that it allows one to be more explicit about assumptions used to allocate resources. Overpayments are bad, just as underpayments are. (There is broad disagreement among experts as to whether the IRS should pay less attention to overpayments, but few would say they should be ignored.) Weighting factors recognize that a dollar reduction in taxpayers' compliance costs may be valued differently from a dollar reduction in the overall misallocation of tax. One reason is that the misallocations involve transfers (for example, to noncompliant taxpayers), whereas the costs reduce overall product and income in the economy. This has led some observers to imply that only the latter are important, but we believe that ignores the fundamental fact that taxpayers are willing to pay for a fair system of justice—that it is a real service with a positive value.

Considered in efficiency terms defined narrowly, Joel Slemrod questions how many resources should be devoted to enforcement of the tax laws and concludes that “the appropriate condition is that, at the margin, the resource cost of increasing enforcement should equal the saving of the excess burden attributable to the decline in exposure to risk.”¹⁸ In lay persons' terms, the efficiency gain at the margin should equal the efficiency loss, but simple pickup of revenue means nothing, since government taxes at that level simply involve a net transfer from some taxpayers to other persons. Unfortunately this rule gives no weight to such issues as equal justice under the law. In fact, people are willing to pay considerable sums of money to ensure a fair administration of justice. That is, equity has value and people are willing to pay for this service. People do care if government arbitrarily takes from one person's pocket without reason, and it is not simply because of risk.

A related issue over which there is much disagreement is how much weight to give to each type of taxpayer error. We believe that the public, through its representatives, wants people to pay the taxes they owe but not to pay taxes they do not owe. Others argue that overpayments should receive almost no weight at all. We believe that this view cannot be consistently held throughout the budget. That is, if the public cares so little about overpayments of tax, then it seems that they would care equally little about whether spending programs reach their targets (indeed many IRS overpayments are due to just that: People inadequately applying for their share of some subsidy program that just happens to be administered by the IRS rather than some other agency).

Note that giving more weight to a dollar of overpayment than to a dollar of underpayment does not by itself tell us a great deal about how the IRS should

18. Slemrod (2002, p. 11).

allocate its internal resources. Another part of the full equation takes into account the marginal cost of various types of actions to minimize deviations from true tax liability. It turns out that, for many issues, the least-cost way of preventing overpayment comes from the use of private advisors and tax preparers, rather than, say, IRS audits. The average (but not necessarily marginal) dollar spent on audit, then, is more likely to be cost-effective in preventing underpayment rather than overpayment.

The IRS can take the objective function listed here and make more explicit how much attention it wants to pay to overpayments versus underpayments. Sometimes the issue cannot be avoided. It will come up both in the development of broad discriminant functions for selecting workload and in assessing the success of auditors at their jobs (for example, will they be rewarded as much for helping taxpayers?).

On a practical level each year, the IRS often allocates its budget as if it is fixed. We recognize that B in fact is endogenous, and one should remove the constraint if the objective function were being considered by Congress or the president.

Among the many other issues to be addressed is the timeliness of taxpayer payments. Since late payments introduce costs to the IRS and often to the taxpayer, this objective can be handled by thinking of the equation in present-value terms. One can also give different weights to different taxes or tax subsidies, as well as to different costs.

Finally, some expansion of the equation is required to recognize programmatic responsibilities that are not fully related either to collecting revenues or to getting out payments to taxpayers. For instance the IRS plays a major role in monitoring receipts for macroeconomic planning purposes, and it essentially regulates the charitable sector's use of tax subsidies for charitable purposes, despite there being little revenue consequence. More broadly any agency has responsibility for seeing that all aspects of the programs under its supervision are efficiently run. As in many other areas, when these responsibilities do not show up easily in the narrow categories of revenue raising or taxpayer service, narrowly defined, they are in danger of receiving too little attention by the IRS. Indeed we suggest that neglect of these programmatic responsibilities has been among the most serious of IRS failures over the years.

Direction for Decisionmakers

At first this type of objective function may seem to be more tractable for enforcement programs than it is for taxpayer service efforts, because some enforcement results are observable and quantifiable, while that is generally not true of taxpayer service activities. However, since the impact of each on the voluntary compliance of the general population must be accounted for, it is not a simple

matter to apply it to either type of work. Moreover the weight applied to taxpayer compliance costs relative to taxpayer error is difficult to assess. Nonetheless this formulation of the IRS objective makes it possible to make several practical and sometimes operational suggestions for improvement—particularly in the context of the trends of the past thirty years.

—Incorporate indirect effects: Strive to quantify the extent to which each IRS activity is effective (at the margin) in prompting taxpayers (both those contacted and those not directly contacted) to pay the right amount of tax in a voluntary and timely manner, and then reflect that in resource allocation and workload selection models. Obviously, since these compliance impacts are not observed in isolation, quantifying them is extremely difficult—but it is not impossible. A couple of studies have already made preliminary estimates for individual income tax.¹⁹ Perhaps one of the most significant things the IRS can do to foster this type of research is to identify and compile the necessary data. Even if the data were not needed for any other purpose, their value in estimating these compliance effects would be enormous.

—Minimize conflicting objectives: Even an arbitrary assumption might still be informative when the IRS, for instance, decides to allocate some enforcement efforts to all classes of taxpayers. Once such an allocation is made, one can work backward through the equation to figure out the implicit gains being presumed if all marginal efforts yield the same benefit to cost. For instance if we assume that actual resource allocations take all factors into account, then an effort with a lower direct revenue-to-cost ratio at the margin generally implies a higher indirect revenue-to-cost ratio, which could be quantified to see if it passes some litmus test for feasibility. We can easily discard alternative objectives that clearly work well only on occasion or by accident—such as allocating examination resources in proportion to the population distribution, or selecting for audit the cases likely to result in the largest percentage of tax change. As stated, these fail any realistic benefit-to-cost criterion.

—Pursue overpayments: Prefiling activities help taxpayers determine their correct tax liability, alerting them not just to what is taxable but also to obtain benefits for which they might be eligible. The IRS has no less responsibility to get EITCs to taxpayers, for instance, than does the Agriculture Department to deliver food stamps.²⁰ By the same token, many types of taxpayer programs and subsidies in the Internal Revenue Code are handled on a cost-effective basis by the private sector, and the IRS's role is more to provide simplified instructions

19. See Dubin, Graetz, and Wilde (1990); Plumley (1996).

20. Actually the task of helping taxpayers take advantage of all the tax benefits to which they are entitled cannot be borne entirely by the IRS. The private sector has a significant role to play in pre-filing, just as they do in providing filing assistance and fostering greater compliance. The point is that the IRS cannot abdicate its role in this area either.

and regulations than to devote significant audit resources to tracking down remaining overpayments. Still, enforcement workers need to be as recognized for reducing overpayments of tax as they are for collecting underpayments. This should be reflected in how enforcement workload is selected and in how the results are portrayed.

—Manage taxpayer burden: The IRS needs to evaluate burden reduction proposals to determine how consistent they are with the ultimate objective. For example, changes that simultaneously decrease costs or (burdens) and tax errors are almost always good. However, changes that decrease burdens but also increase errors require explicit attention to the weight placed on different taxpayer compliance costs.

—Identify needed changes to the law: A necessary part of pursuing this mission is translating IRS experience in administering the law into studies that could inform legislative proposals and help to decrease the misallocation of the tax burden, the cost of tax administration, and the compliance burden borne by taxpayers. While Congress and the Treasury Department should consult with the IRS on the administrability of proposed changes to the Internal Revenue Code, IRS responsibility cannot be dodged when they fail to do so. It is one thing to be ignored; it is another to provide so little information that being ignored is easy.

—Research better methods: The IRS should continually attempt to be more cost-effective in all of its prefiling, filing, and postfiling activities. Sometimes doing more of the same thing will not be the most effective use of resources. When areas of low compliance are not addressed effectively by current enforcement approaches, the IRS needs to research new approaches—documenting their cost-effectiveness at the margin so they can compete for operational resources with existing approaches. The research approach may be the most cost-effective of all.

Conclusion

There is both good news and bad news. The good news is that taxpayers' compliance is much greater and their compliance costs are much smaller than if there were no IRS at all. In many ways the IRS has been doing a lot of things right. Compliance, after all, is much higher in areas where there is document matching and withholding. The bad news is that significant opportunities for greater effectiveness still remain. At the beginning of the twenty-first century, enforcement efforts in some areas (in particular, where there is little or no separate reporting by payers) were so low that many believe that noncompliance is or will be on the upswing.

IRS programs have not always sought the right outcomes, and resource allocation decisions have not always been based on the marginal effectiveness of those resources to collect the right amount of tax from each taxpayer at the least cost (including inconvenience) to the people. Mission statements incorporate many important objectives, but they are inherently vague and do not give much guidance on how to relate one objective to another. It is not surprising that the IRS (and Congress) has shifted emphasis from revenue to taxpayer service in recent years. In reality neither is an appropriate objective in and of itself, they are not mutually exclusive, and service incorporates far more than traditional taxpayer service functions. Although collecting tax revenue is an important purpose of a tax agency, more broadly it should be collecting the right amount of revenue from the right taxpayers, helping to get program benefits to the right taxpayers (often through use of the private sector), and minimizing productive losses to the economy as a whole from filing, enforcement, and compliance efforts. Fortunately there are several practical ways that the IRS can progress toward fulfilling that mission.

COMMENT BY

Donald C. Alexander

This thoughtful and excellent chapter provides much useful information, much sound evaluation of competing needs, and many recommendations for a sound system of tax administration. It is indeed refreshing to an old-timer concerned about the precipitous drop in the IRS's enforcement activity after the 1997 and 1998 hearings to see a recommendation that the IRS should allocate its resources so as "to collect the right amount of tax from each taxpayer at the least cost (including inconvenience) to the people."

I must quibble somewhat, however, with the heavy emphasis that the authors place on prefiling services to taxpayers and seeking out taxpayers who should get refunds and delivering such refunds to them. While I agree that the IRS has a special responsibility (which should not have been given to it) to try to deliver earned income tax credits to those who deserve them and have not claimed them, I do not believe, for example, that the IRS has any postfiling responsibility to try to find those individuals who would have saved money had they itemized deductions but chose not to do so.

The chapter's heavy emphasis on taxpayer service does not seem to recognize the vast array of taxpayer services rendered by the private sector. Many practitioners make their living through taxpayer services and through representing taxpayers. According to H&R Block's 2002 annual report, Block served nearly 21 million tax clients in its fiscal year ending April 30, 2002. Community Tax

Aid and other taxpayer clinics and organizations do a fine job in assisting low-income taxpayers, those for whom English is a second language, and EITC recipients. While the IRS should not abdicate the taxpayer service field to professional preparers and organizations like Community Tax Aid, it should do its best to encourage the latter through grants, and it should supplement the activities of the former for those taxpayers who need help. It should not misuse resources, however, by removing revenue agents from their compliance duties and putting them on telephones to answer taxpayer prefilling questions. The private sector does not supplement the IRS's enforcement efforts.

The chapter vividly demonstrates the precipitous decline in IRS enforcement actions but, in my view, it does not spell out the basic reason for this. Commencing with the 104th Congress, increasing in 1997, and culminating with the Senate Finance Committee's beautifully staged hearings in 1998, the IRS was blasted by Congress and the media, and it found little support in the Treasury. The IRS was ordered to reorganize, to change its attitude toward taxpayers and nontaxpayers, and to change its processes and procedures, particularly in collection actions. IRS employees who commit what Congress regards as impermissible actions became subject to summary dismissal.¹ The result of all this bashing and overkill was to reduce collection actions and to reduce examinations today by more than 40 percent of the level roughly maintained prior to the 104th Congress. It is ironic that some of the members of Congress who were shouting at the IRS for being overaggressive several years ago are now claiming that it is not tough enough. Many are concerned, and rightly so, that compliance with our nation's tax laws has dropped substantially and will drop further. Common sense tells us that this is the case; if the public is fully aware that those who run red lights will not be arrested, the public will run more red lights. To me it is foolish hypocrisy to pretend otherwise.

Despite substantial increases in IRS budgets since 1998, the outgoing commissioner recently complained about inadequate IRS resources, and indeed this complaint has some justification. The chapter points out that only about 69 percent of the IRS budget is now devoted to personnel costs, down from almost 77 percent in 1975. This indicates that the IRS is using its appropriated funds for purposes other than hiring revenue agents, revenue officers, tax auditors, and taxpayer service representatives. Instead the IRS has recently been spending substantial sums on consultants. As I understand it, Booz Allen Hamilton received a \$200 million contract from the IRS to help it reorganize. I hope that such diversions will cease in the future.

In allocating the IRS's resources, more emphasis should be placed on enforcement and somewhat less on taxpayer service. A strong and useful taxpayer

1. The ten impermissible actions or omissions listed in section 1203 of the IRS Restructuring and Reform Act are referred to as the Ten Deadly Sins.

service function should be maintained, directed particularly to those who are not adequately served by the large for-profit private sector. Standards for private practitioners should be set and maintained so that Gresham's law does not prevail, particularly for those that serve the EITC community and also for those who peddle outrageously bad tax products to the wealthy. Policing shabby practitioners is more effective than searching out taxpayers who have received shabby advice.

As to the allocation of revenue agent resources among the many taxpayer segments, I would begin at the top. The largest corporations in this country should be audited regularly (not necessarily annually), and individuals with the highest income should be audited at a much higher rate than those with low income. There should be some audit presence, however, in each category. The current National Research Program, today's successor to TCMP, should improve audit selection and, subject to maintaining some presence in each category, those with higher scores should be audited ahead of those with lower scores. The IRS must develop better and more effective ways of dealing with noncompliance through the use of pass-through entities such as partnerships and limited liability companies.

The IRS should have a stronger voice on Capitol Hill; the law is so complex now as to be almost unadministrable, and using the Internal Revenue Code as the means to deliver all sorts of specific grants intended for the economic or social good should somehow be brought to a halt and reversed. Also, tax laws should not be used to punish taxpayers for real or perceived bad deeds unrelated to tax compliance.

In the chapter's fifth suggestion for improvement, the following statement is made:

"While Congress and the Treasury Department should consult with the IRS on the administrability of proposed changes to the Internal Revenue Code, IRS responsibility cannot be dodged when they fail to do so. It is one thing to be ignored; it is another to provide so little information that being ignored is easy."

The thinly veiled criticism is that it is the IRS's fault for not speaking up about administrability issues. This brings to mind section 4021 of the 1998 IRS Restructuring and Reform Act: "It is the sense of Congress that the Internal Revenue Service should provide the Congress with an independent view of tax administration, and that during the legislative process, the tax writing committees of Congress should hear from frontline technical experts at the Internal Revenue Service with respect to the administrability of pending amendments to the Internal Revenue Code of 1986."

Unless I am missing something, I do not think that the IRS is reluctant to speak to Congress; I think that the Treasury (and probably the Office of Management and Budget) is reluctant to let the IRS speak. This was certainly true

in my day. Let us not blame the IRS for the Treasury squashing its efforts to talk to Congress, not that such talk would deter a Congress and an administration eager to spend through the Internal Revenue Code.

COMMENT BY

James W. Wetzler

Plumley and Steuerle correctly argue that we should not think of tax enforcement and taxpayer service as separate activities of a tax administration agency, each of which has its own objective. Rather, tax administration should be a unified program whose resources are allocated among its functions based on analysis of how each contributes to the program's overall objective. The authors examine what should be the objective of the Internal Revenue Service. They present data that reflect the priorities that have prevailed in the past twenty years—generally declining enforcement efforts relative to the large and possibly growing tax compliance gap, occasional injections of resources for short-lived revenue initiatives, declining productivity of the enforcement effort, and the recent substantial shift of resources away from enforcement toward taxpayer service. They make some helpful specific suggestions about how the IRS can improve the quantitative analysis of its activities. While they do not make this assertion, clearly the implication of the chapter is that the history of the enforcement effort over the past twenty years would have been different had priorities been chosen on the basis of rigorous quantitative analysis instead of through the political process.

The Plumley-Steuerle Objective Function for the IRS

Plumley and Steuerle believe that an objective of the IRS should be to promote fairness. Specifically it should use its available resources to strive to minimize an "objective function" equal to the weighted sum of (1) underpayments of tax, (2) overpayments of tax, and (3) the costs incurred by taxpayers in complying with the tax law. The relative weighting of these three elements should reflect the value society places on fair tax administration—on having taxpayers pay the amount of tax that the law says they owe. Resources should be allocated to each of the IRS's functions such that the marginal dollar spent on each function leads to an equal reduction in the weighted sum. Audit selection should reflect this principle as well. Were this concept to be implemented, political debate over the IRS's priorities could be narrowed to the rather dry topic of the appropriate

weights to be used in the weighted sum; everything else would be delegated to technical experts, who would analyze the extent to which the individual functions and strategies contribute to minimizing the weighted sum.

As Plumley and Steuerle point out, one problem with this approach is that it gives no guidance on how large the IRS's budget should be. Because the IRS appears to have little control over the size of its budget, and Congress has shown little disposition in recent years to set the IRS budget on the basis of cost-benefit analysis, this may not be too serious a problem in practice. However, the issue of how much government should spend on tax administration is an important one, and it would be helpful to have an analytical model that helps resolve it, such as that provided in Joel Slemrod's chapter in this volume. It would also be helpful to have better data on the key parameters of the model, such as the indirect or spillover effect of the IRS's audit and debt collection activities on voluntary compliance with the tax law.

One potentially controversial issue in specifying the IRS's objective function is the relative weight to be assigned to corrections of overpayments and underpayments.¹ Plumley and Steuerle believe that citizens place a high value on fairness and will support expenditures on activities intended to correct tax overpayments. This contrasts with the usual justification for the tax administration agency's budget that, because the agency generates revenue, it should not have to compete for funds with other programs.

Overpayments and underpayments are not symmetrical errors. Collection of tax revenue involves a deadweight efficiency loss, because taxpayers modify their behavior in response to the tax. Refunding an overpayment does not recoup whatever deadweight loss arose from the taxpayer's behavior under the mistaken belief that he or she owed the tax. Yet, when revenue must be raised in the future from another source to make up for the overpayers' refunds, the deadweight loss is incurred a second time. Conversely raising revenue by correcting erroneous tax underpayments enables taxes to be reduced in the future on compliant taxpayers, reducing the deadweight loss associated with their behavior while not incurring any deadweight loss with respect to the noncompliant taxpayer. Hence correcting a one-dollar tax underpayment should be more valuable than correcting a one-dollar tax overpayment by an amount equal to twice the deadweight loss from raising an additional one dollar of revenue. Moreover, as a practical matter, the amount of injustice arising from erroneous tax overpay-

1. To a certain extent, correction of overpayments can be justified as a means to the end of reducing underpayments. For example, if a tax administration agency fails promptly to refund overpayments requested by taxpayers, tax compliance can be expected to fall, because taxpayers will perceive the system to be unfair and because they are motivated to take care that they are never in an overpaid status. The issue here is the extent to which correction of overpayments should be valued in its own right.

ments is limited by the fact that the private sector can and does correct them when the private costs of doing so are less than the amount of the overpayment (although the overpayer must incur those costs).

While much of the tax administrator's prefiling activity, such as disseminating accurate information about the tax laws or developing user-friendly tax forms and filing methods, works neutrally to reduce both mistaken overpayments and underpayments, one wonders whether a tax administration agency would ever devote a substantial portion of its budget specifically to postfiling activities to identify and correct tax overpayments. Surely it would run the risk of the legislature's redirecting those funds to what are perceived to be more urgent government priorities.

Recent History and Its Lessons

Plumley and Steuerle present data on the quantity and productivity of various types of IRS enforcement activity, which characterize the past two decades as a period of generally declining commitment to tax enforcement. However, enforcement activity by the IRS is not the only way to increase tax compliance; it is also possible to do so by imposing greater compliance burdens on taxpayers, which lessen the amount of work the IRS must do to achieve a given level of tax compliance.

Thus there are two principal inputs to the tax administration program—the resources provided to the tax administration agency and the compliance burdens imposed on taxpayers.² A government's commitment of resources to tax administration should be measured with respect to both inputs, as should the productivity of the tax administration effort.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) initiated a period in which policymakers became willing to impose greater burdens on taxpayers in order to harvest the revenues from improved tax compliance. Faced with the need to restore fiscal stability after what they perceived as the excessive 1981 tax cuts, Senate Finance Committee Chairman Robert Dole and the other drafters of TEFRA reviewed numerous potential ways to raise revenue and concluded that improved tax compliance was a relatively attractive option.³ Hence TEFRA imposed various additional reporting, penalty, and withholding burdens on taxpayers.⁴ These tax compliance measures imposed significant burdens

2. There is some evidence that the compliance costs incurred by taxpayers are an order of magnitude larger than the IRS budget. See, for example, Slemrod and Blumenthal (1992).

3. The author served as chief economist of the Joint Committee on Taxation during the drafting of TEFRA.

4. The most controversial of these, withholding on interest and dividends, was repealed in 1983.

on taxpayers but were largely successful, at least temporarily, in dealing with such long-standing tax compliance problems as syndicated tax shelters, underreporting of interest, dividends, and capital gains, and even underreporting of tip income.

Because the political support for stronger tax enforcement was driven to a certain degree by the exigencies of budget accounting, it was somewhat vulnerable to budgetary gamesmanship. As a result, the provision of additional inputs for the tax administration program consisted largely of additional burdens placed on taxpayers, not additional outlays for the IRS, because budget scorekeeping enabled policymakers to score revenue gained from legislation that imposed additional burdens on taxpayers toward their deficit-reduction targets but generally not revenue gained from additional funds appropriated to the IRS.

Thus the period 1982–1994 should properly be characterized as an era of strong bipartisan support for stronger tax enforcement, which found expression in a greater willingness to impose burdens on taxpayers.

The 1994 elections produced a Republican majority in both houses of Congress, which began to ask the IRS to shift its priorities away from revenue-raising and toward reducing inputs to the tax administration program. The IRS's mismanagement of its systems modernization project had left it open to legitimate criticism; however, the virulence of the attacks on the IRS came as a surprise to many observers, especially in light of the fact that efforts to strengthen tax administration by imposing greater burdens on taxpayers over the previous dozen years had had substantial bipartisan support and, indeed, had been initiated in 1982 by the man who was to become the Republican presidential candidate in 1996, Senator Dole.

The demand that the IRS change priorities was implicit in a steady drumbeat of criticism of the department from members of Congress about the excessive burdens the IRS was placing on taxpayers, including highly publicized hearings about specific (generally poorly substantiated) cases of abuse. It found legislative expression in the provisions of the IRS Restructuring and Reform Act of 1998, which not only added new taxpayer rights provisions that, unlike previous such bills, could be expected to have significant revenue consequences but also imposed significant penalties on IRS employees who violated various rules and procedures. Plumley and Steuerle document the decline in both resources devoted to enforcement activity and their productivity after 1995.

However, the new priorities do not appear to have been sustainable for very long. The decline in enforcement has not gone unnoticed by taxpayers. The same elected officials who were criticizing the IRS for paying insufficient attention to the burdens that tax enforcement activity was imposing on taxpayers are now demanding that it crack down on use of foreign trusts, what is perceived as overly aggressive tax planning, tax protester activity, and other forms of tax evasion. Congress may give the IRS new tools with which to deal with these con-

cerns. If history is a guide, the congressional response will impose greater burdens on taxpayers rather than more funds for the IRS budget.

Lesson for the Future

The lesson of this brief recent history of tax enforcement is that the political leadership needs to establish a balanced, analytically based set of priorities for the IRS instead of constantly shifting those priorities in response to political, ideological, or budgetary needs. Fighting about priorities is not going to improve the Internal Revenue Service. What will improve it is more sustained focus on the politically unglamorous task of productivity improvement, which over a twenty-year period stands a much better chance of improving the agency's performance than does continuing to fight over priorities. Dedication to productivity improvement, which has the potential to produce both more revenue and lower burdens on taxpayers, would be a sea change in how the tax administration program is run, for there appears to have been little, if any, productivity improvement in recent years.

Commissioner Charles Rossotti's recent report to the IRS Oversight Board appears to embrace precisely this agenda.⁵ He lays out what he believes is needed to improve both the enforcement effort and service to taxpayers, which together would require an increase in the IRS's budget of approximately 22 percent. He then recommends that additional appropriations be spent on a 2 percent increase in staffing and modernization for a 3 percent annual increase in productivity over five years. This is an ambitious agenda, but history suggests that it does appear to be the best strategy for sustaining improvements in IRS performance.

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5. Rossotti (2002).

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