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# Can the IRS Be Well Liked?: Rossotti's *Many Unhappy Returns*

Reviewed by Calvin H. Johnson

*Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America,* by Charles O. Rossotti. Published by Harvard Business School Press (2005). 340 pages. Price: $26.95.

*Many Unhappy Returns* is former Commissioner Rossotti's story, according to his subtitle, of *One Man's Quest to Turn Around the Most Unpopular Organization in America*. Rossotti was IRS commissioner for five years, 1997-2002, under both Presidents Clinton and Bush, and President Bush has since appointed him to the nine-person advisory panel on tax reform.

*Many Unhappy Returns* aspires to be a business-inspiration book, relevant for any leader. His story is set up to rise optimistically from crisis to achievement. It is published as part of a series called ''Leadership for the Common Good'' by Harvard Business School. Rossotti concludes with nine principles for successful change, most not especially focused on tax. His Principle #1, however, is that the IRS needs to treat taxpayers as valuable customers and not as adversaries. With a smile and a shoeshine, Rossotti sets out to improve the popularity of the IRS.

Beneath the good cheer is a far more interesting and realistic story of an agency in deep trouble. The IRS is a resource-starved organization doomed, perhaps even designed, to fail. The fundamental purpose of the IRS is to collect revenue. By all available statistical measures of its core purpose, however, IRS performance declined under Rossotti for reasons the boss seems responsible for.

What the IRS needs is a number system to guide and energize its agents. It needs to be able to recruit and retain more talent. It needs to be able to clear out some of the complicated nonsense that our elected representatives shamefully keep imposing on it. It needs clever systems to enforce the law without fuss against self-interested taxpayers. It is not clear that good cheer will help the IRS. Rossotti was hired because he was supposed to be a computer expert. What the IRS needs most is a new computer system.

## Business Inspiration

A business inspiration book has to have a plot that starts low and rises high, and Rossotti forces the story of his tenure into that plot, probably unfairly on both ends. He starts by depicting the IRS as ''out of control'' when he started, based on some sensational hearings Senate Finance Committee Chair William Roth held in 1997 and 1998 about IRS ''horror stories.'' The hearings seem to have been unfair to the IRS. Jeff Trinca, who served as chief of staff of the National Commission on Restructuring the IRS, has called the hearings ''a circus added at the end of a year of a lot of hard work.''[1] The sensational stories had ''a slippery foundation,'' former Commissioner Mortimer Caplin has said, but the corrective stories were told quietly and only after the damage was done.[2] Rossotti indeed seems to know this. In his section ''Public Allegations, Secret Vindication,'' he tells over and over again of exhaustive investigations of the accusations against the IRS that lead to its exoneration, kept secret, however, to protect taxpayer confidentiality (pp. 160-161).[3] The major indictment of the IRS seems to be that it measured how well agents were doing their jobs by revenue collected. Collecting revenue, however, properly measured, should be understood as the virtue of the IRS and not its crime.

The business inspiration format also requires Rossotti to find an upbeat ending. He finds that the approval rating for the IRS in opinion polls increased at the end of his five years to 49 percent from a low of 32 percent (p. 289). Rossotti also claims ''productivity'' increased by 2.4 percent during his five-year term, a figure that he compares favorably to the growth of productivity in the private financial sector.[4] His ''productivity'' measure seems counterfeit, however, because it is a measure not of more output, but of less input. He measures the reduction in full-time equivalents, or FTEs, over five years and that is not necessarily a story of greater accomplishment per unit. The declining FTEs seem to be just the continuing story of less IRS time, stretched ever more thinly over ever greater IRS responsibilities.

Rossotti concedes that ''traditional enforcement statistics were declining'' during his tenure (p. 125). Indeed they were. IRS seizures dropped from 10,090 in 1997 to 174 in 2000.[5] From 1996 to 2002 the number of tax returns filed rose by 9.4 percent but the number of examination audits fell by 61 percent; thus, the overall audit rate fell by 65 percent, from 1.37 percent to 0.48 percent.[6]

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[1]Quoted in Amy Hamilton, ''Former Commissioners, Top Officials Discuss Five Years of IRS Reform,'' *Tax Notes*, July 28, 2003, p. 472.

[2]Mortimer Caplin, ''The Tax Lawyer's Role in the Way the American Tax System Works,'' *Tax Notes*, Feb. 7, 2005, p. 697.

[3]All page number references without further note are to Rossotti, *Many Unhappy Returns* (2005).

[4]P. 291 (''about 3 percent, well above the historical average in the private financial sector''), p. 304 (2.4 percent); 2.4 percent is usually rounded down to 2 percent rather than up to 3 percent.

[5]Leandra Lederman, ''Tax Compliance and the Reformed IRS,'' 51 *Kansas L. Rev.* 972, 983-984 (2003), assembles these statistics, and I have selected the most dour ones.

[6]William Gale, ''Declining Audit Rates,'' *Tax Notes*, July 5, 2004, p. 87.

Rossotti knows the IRS is resource-starved. One of the strengths of the book is that Rossotti is willing to go off the reservation and criticize the White House as the main culprit for asking for too little funding for the IRS (pp. 280-281). The White House and Office of Management and Budget mistakenly treat the IRS as an expenditure program, whereas it is in fact a profit center (p. 279). The IRS helps pay for the Marines and close the deficit.

The IRS is computer-starved. The IRS cannot computer match the returns from passthrough entities to the taxpayers who are supposed to pay the tax (p. 246). The IRS can audit only 1 out of every 255 returns of passthrough entities (p. 247). The resources available to the IRS, as Rossotti tells us, are far too limited to do a minimally acceptable job (p. 290).

In his last report to the oversight board, Rossotti ended on an appropriately downbeat note:

> We are . . . losing the war. Over the last ten years, the size and complexity of the tax system increased enormously. Beyond the simple increase in number of taxpayers and revenue dollars, the majority of tax revenues now come from sources that are more subject to manipulation by those who wish to pay less than the law requires and much more difficult and time consuming for our agents to uncover. Meanwhile, the size of the IRS declined, not just relatively but in absolute terms, because of budget constraints.
>
> The cumulative effect of these conflicting trends over a 10-year period has been to create a huge gap between the number of taxpayers whom the IRS knows are not filing, not reporting or not paying what they owe, and our capacity to require them to comply.
>
> Recognizing the IRS' diminished capacity, promoters and some tax professionals are selling a wide range of tax schemes and devices designed to improperly reduce taxes to taxpayers based on the simple premise they can get away with it. When this perception becomes increasingly widespread, the essential pillar of our tax system is lost — namely, the belief of honest taxpayers that if someone does not pay what he or she owes, then the IRS will do something about it.[7]

Rossotti's final report said 60 percent of identified tax debts were not pursued, 70 percent of taxpayers who did not file a tax return are not pursued, 79 percent of identified taxpayers who used abusive devices to evade taxes are not pursued, and 78 percent of partnership and passthrough mismatches are not pursued.[8] For someone who claims that open and honest communications (p. 296) and right measurements (p. 294) are key principles of successful change (principles #3 and #6), forcing his story into an upbeat ending is most unfortunate. Rossotti is smarter, when his assessment is realistic, than his book plot aspires to be.

### Computer Superhero

Treasury Secretaries Robert Rubin and Larry Summers tapped Rossotti for commissioner because he was CEO of a large company that taught large organizations how to buy and use computers. Rossotti had also been a systems analyst for the Defense Department, back when government work was idealistic work for God and Country:

> For three years, I worked harder than I ever have before or since, analyzing one problem after another sent down from McNamara and Enthoven. The work, dealing daily with equally hard working people in the military services, was high pressure intellectually and personally, but also rewarding because of the obvious importance of what was at stake (p. 32).

The IRS really needed help with its computer systems. Its core master system was an antiquated magnetic tape drive that had been state of the art in 1961 at the dawn of the computer age. Every night, files still called "good tape" were transmitted to Martinsburg, W.Va., and accumulated for the weekly update. The update to the master tape started every Saturday and ended every Tuesday (p. 195). The organization as a whole was blind to any news that had happened since the last weekly posting. As information technology advanced, clever programmers found dozens of ways to jury-rig the system to get around its limitations. But only a tiny number of people in the IRS understood the accumulated tricks well enough to fix problems or make changes without causing more damage (p. 86). Rossotti calls it "third-world technology" (p. 117).

The IRS had also built dozens of supplementary systems to do specific jobs. For example, collections by telephone, collections by letter, and collections in person were supported by three separate computer systems, imperfectly integrated. The IRS needed 200,000 terminals for a peak of 120,000 employees because many agents needed more than one computer to access the numerous incompatible databases (p. 197). Some of the computer code was written in computer languages that had not been widely used for 20 years. The bulky computer languages of the 1960s meant, for instance, that a customer service representative had to digest four pages of detailed instructions to correct a simple transaction like a check applied to the wrong taxpayer account. The IRS was a living museum of archaic computer technology, with "an example of nearly every hardware and software product ever produced" (p. 207). The IRS also relied on paper when nobody else did. Updates to the IRS's manual were needed almost weekly. They were typed and sent out to front-line agents who had to insert the paper updates into the 83,000-page manual by hand (p. 200).

Rossotti later took key congressional staffers on a tour of MBNA Bank in Wilmington, Del., to show how it could be done right (pp. 198-199). At the bank, calls were answered, usually within 20 seconds, by representatives sitting at beautifully equipped work stations. The bank representatives had immediate access to every relevant

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[7] Commissioner Charles O. Rossotti, "Assessment of the IRS and the Tax System, Report to the IRS Oversight Board" (Sept. 20, 2002), *Doc 2002-21785, 2002 TNT 186-17*.

[8] *See, e.g.*, George Guttman, "IRS Oversight Board's Annual Report Too General to Be Useful," *Tax Notes*, Aug. 11, 2003, p. 755.

piece of information about customer accounts and could make adjustments with just a few key strokes. IRS agents had no similar access to taxpayer accounts.

Size alone does not not explain the state of IRS technology. UPS and Federal Express track packages with a database that is larger than the one the IRS needs and some banks and phone companies have more users on their networks (p. 203). No organization as big as the IRS, and as utterly dependent on computer systems, Rossotti tells us, had ever fallen so far behind (p. 204).

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Things were also not getting better. In the year before Rossotti was chosen, Summers concluded that the core computer system being developed within the IRS as a replacement was a fiasco and wrote off 11 years worth of work and $4 *billion* dollars (p. 197). The IRS clearly needed help.

If Rossotti was expected to be a computer superhero, he failed to live up to those expectations. In the five years that Rossotti was commissioner, there was only modest progress toward redesign of the core IRS computer system. *Many Unhappy Returns* has a fascinating account of the mess Rossotti came into, but tells little about his progress. An OMB report at the end of Rossotti's tenure graded the design of the new systems as mostly Ds, with some Fs.[9] Replacement of the tape-drive system was and continues to be slow, plagued by delays and cost overruns.[10] Almost eight years after Rossotti's appointment, the new core customer account system processes less than 1 percent of tax returns and only EZ returns at that.[11]

**Reorganization**

Rossotti made reorganization of the IRS a higher priority than computers. The logic was that a new technology needed to be designed to serve a modernized IRS. The IRS that Rossotti inherited was a highly decentralized organization, adapted to the technology of paper files. Before computers, taxpayer records were kept on paper on very long shelves in 66 local district offices (p. 171). Long-distance phone calls were expensive. Transfers of information from district to national office were time consuming. Decisions were therefore made locally. Each district needed expertise on everything and had to be able to perform every function.

Rosssotti had reorganized his former corporation in 1981, dividing it along the lines of his customers' industries, and he applied the same idea to the IRS. Under Rossotti's organization plan, the IRS has four major divisions: individuals with only wage and investment income, small businesses, larger businesses, and tax-exempt entities. Each division has its own tax counsel, taxpayer advocates, appeals, and criminal investigations.

Treasury Department officials worried at the time that the reorganization might be a distraction (p. 64) and, in fact, audit and collection statistics did drop. Sheldon Cohen, IRS commissioner under Lyndon Johnson, has said that "if you were in private industry you would never have done a reorganization if you couldn't recoup the costs in five years."[12] There were also harmful side effects in shifting decisions away from the local districts. District directors lost power and IRS district lawyers no longer reported to local bosses. The IRS also lost valuable local horse sense. When estate tax auditors were local they were familiar with local real estate prices and knew which of the local tax lawyers had to be watched most closely.

The reorganization is also said to have hurt computer modernization. The current IRS officer in charge of computers is quoted as saying we wrongly "assumed that our superstars in tax administration could also be superstars in implementing large [computer] projects and programs."[13] Rossotti seems to have moved modernization of the IRS computer system to a lower priority.

**You Get Only What You Measure**

Rossotti was hired in part to bring the techniques of the business world into government. One of the clearest mandates from the business world is that a large organization can be managed only with a good numbers system. When Alcoa began rating people based on how few workdays were lost to injuries, safety increased (p. 110). In the business world, CEOs control their divisions not with personal charm, but with quotas assigned to the divisions and with cost management numbers they get back from the divisions. Corporations also use number systems to motivate their employers. Corporations now pay their executives with performance incentives. The current wisdom is that when you pay executives just to show up, that is all they will do, and if you want employees to perform, you must pay them according to performance.[14] Managers also report to their shareholders with numbers, earnings per share, and managers jump over tall buildings to get their earnings up. In the business world, as Rossotti notes, what you measure is what you get (p. 109).

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[9]George Guttman, "OMB Pans Most Justifications of IRS Technology Projects," *Tax Notes*, Nov. 4, 2002, p. 591.

[10]*See, e.g.*, 2004 IRS Oversight Board Report 19, http://www.treas.gov/irsob/documents/2004_annual_report.pdf ("Particularly troubling were continuing and unresolved problems with the Customer Account Data Engine (CADE) — the so-called 'crown jewel' of Modernization"); George Guttman, "CADE Setbacks Put IRS Modernization at Risk," *Tax Notes*, Aug. 25, 2003, p. 999 (reporting delays in CADE that is to replace master tape drive).

[11]Elana Varon, "The IRS Makes Progress," *CIO Trendlines* (May 1, 2005) http://www.cio.com/archive/050105/tl_project.html (during the 2005 filing system, CADE processed 1.2 million EZ returns out of the 200 million returns that IRS must process each year).

[12]*Supra* note 1.

[13]Allen Kenney, "Budget Issues Hamstring Modernization, IRS Official Says," *Tax Notes*, Nov. 22, 2004, p. 1084.

[14]*See, e.g.*, Michael C. Jensen and Kevin J. Murphy, "CEO Incentives — It's Not How Much You Pay, but How," 68 *Harv. Bus. Rev.* 138, 138 (1990).

The IRS, however, is subject to congressional prohibitions on using number systems. In 1959 the IRS, under congressional pressure, provided that tax revenue collected would not be used as the measurement of any agent's individual performance (p. 109) and in 1988 Congress prohibited production goals or quotas as a matter of law (p. 110). Individual congressmen have gone beyond even that to treat numerical evaluation as if it were a vampiric rite. Sen. Roth called any use of quotas "a major problem that has become a part of the agency's culture" (p. 111). Sen. Richard Bryan of Nevada told Rossotti at his confirmation hearing that "what we need to do is to drive a silver stake through the heart of this quota process . . . and kill it, kill it, kill it for good" (p. 111).

Telling a large organization that it cannot use numbers to control its divisions and its officers paralyzes the organization. Numerical evaluation is not only a necessary part of the culture of the IRS, but of every large American enterprise. "What you measure is what you get" applies to the IRS as well. What the numbers need to measure is revenue collected because that is the IRS's core mission. If it does not collect revenue, there is no money to close the deficit or for anything else. Paralyzing the IRS rewards the vicious cheats who make suckers out of all those who actually pay tax. As long as we want the IRS to perform a function of supplying money to the United States, we have to be willing to evaluate the IRS, on both an agency and an individual-agent level, with *numbers* that measure the revenue collected.

Inexperienced IRS agents spend too much time on audit on issues with too little money at stake, and let big issues slip by. Agents are under pressure to finish an audit, but are not under very much pressure to do a good job in the audit. Evaluating audits by revenue collected would ameliorate both faults.

Building a number system to guide and motivate IRS agents requires that we accept approximate measures. We surely do not want IRS agents to collect tax that is not legally due. What we want to measure is a kind of personal tax gap — measuring how far below the tax law each taxpayer has fallen on his return and payments. Taxpayers will spend a great deal of time and effort to prevent the IRS from finding out just how big their personal tax gaps are. That makes the tax gap quite difficult to measure. In a world in which the individual tax gap is not knowable, we must make do with something less accurate — such as revenue-production quotas. The problem with the IRS is not excessive vigor, but insufficient vigor. Congress is not acting responsibly when it paralyzes the IRS by prohibiting numbers.

Rossotti, who was subject to the law prohibiting quotas, argues for "balanced measures of performance" (p. 189). He argues against "too narrow and unbalanced a focus on enforcement statistics" (p. 154), by which statistical measures Rossotti did terribly. A discussion of the structure and details of a balanced numerical system of goals that would make the IRS into an energetic and efficient agency would be fascinating. Rossotti's book, however, does not have it. As noted, the FTE yardstick he offers measures lower input rather than productivity. FTE requires that agents show up on the job, and a reduction in FTE means fewer show up. But FTE does not require them to do anything once they get there.

### Inevitable Systems

Rossotti had served in government as one of the whiz kids under Defense Secretary Robert McNamara analyzing defense contracting systems. The IRS needs more whiz kids working on improving the IRS system. The book does have some heroes on that score. Rossotti tells us that two IRS agents in New Jersey, Joe West and Dan Reeves, figured out that they could find taxpayers using secret offshore-bank credit cards by using the records of U.S.-based credit card processors (p. 259). Offshore credit cards are rich lodes of tax fraud because offshore credit card holders are often bringing offshore money home without ever paying any U.S. tax on their consumption. Our income tax as a whole probably depends on a smart system — withholding of employee tax by employers — that operates inevitably and without confrontation. We need more smart, inevitable systems like that to collect tax.

### Adversarial System?

What Rossotti cares about most is his position that the IRS needs to treat taxpayers as valued customers rather than as adversaries. Rossotti argues that the IRS must collect tax effectively while delivering good customer service. Rossotti also measures IRS performance by its approval rating (pp. 147, 289), as if to say that an agency that is auditing less and collecting less revenue is doing well if its approval rating is going up.

For lawyers trained on the adversary system, Rossotti's view is heresy. A lawyer's job is to represent his client with warm zeal. The client of the IRS is the tax base. Ultimately the IRS must produce the life blood that makes everything else work. For lawyers, even tax lawyers, the IRS's required role, warm zeal on behalf of the country, means that it has to avoid conflicts of interest that arise from getting too friendly with the other side. The IRS commissioners before Rossotti were mostly lawyers, and lawyers think of themselves as part of an adversary system, even when not in court. The IRS, moreover, has serious "agency capture" problems, exacerbated by specialization, under which the agents come to identify with the problems of the industries they deal with day after day and forget about their strong obligation, adverse to that industry, to the invisible public interest.[15]

Rossotti does not much like lawyers, especially IRS lawyers. At one point he derides the length of a 24-page Tax Court opinion involving a $50,000 petition by a "generally compliant" taxpayer (p. 142). Is the IRS supposed to concede all the petitions filed by taxpayers for amounts less than a *mere* $50,000 when the IRS is right on the merits? He chortles a bit when the Nevada casinos beat the IRS on a case of petty corruption, getting an exclusion for employee meals provided by the casinos,

[15]For agency capture, see, e.g., Thomas Merrill, "Capture Theory and the Courts, 1967-1983," 72 *Chi.-Kent. L. Rev.* 1039 (1997); Richard Stewart, "The Reformation of American Administrative Law," 88 *Harv. L. Rev.* 1667, 1684-1687 (1975).

supposedly by reason of business necessity (p. 121).[16] The boss of the IRS seems to have had a bad streak of anti-IRS attitude.

Customer service apparently does not contribute much to tax compliance. In controlled experiments coming out of Minnesota and Australia, taxpayers were sometimes offered help, with telephone help lines or copies of tax schedules, and sometimes not. The results suggest that offering more customer service generates no identifiable increase in money collected.[17]

Customer service is also not a very large part of the IRS budget (15½ percent) (p. 302). If customer service takes up the bulk of the attention of a commissioner, it is a distraction and should be spun off for some other group to run. An IRS commissioner needs to be spending the bulk of his time on other issues, such as designing smart systems to increase revenue collected.

Rossotti, finally, wants the IRS to answer its telephone inquiries: "Apart from the justifiable outrage it causes among honest taxpayers," Rossotti argues, "I have never understood why anyone would think it is good business to fail to answer a phone call from somebody who owed you money" (p. 285). That is a very good point. If the IRS could handle its phone calls, it is plausible that it could collect more tax, and it might even get more funding. The IRS has more than a passing resemblance to a credit card company in that it tries to get payments that people do not want to make. The credit card companies are generally polite and answer their phone calls with accurate information on hand.

It is a misdiagnosis, however, to say that IRS failures in handling its phone calls is an issue of good or bad manners. The credit card companies may be polite on the phone, but they rely on hard systems, rather than good cheer, to get payments. IRS failures to handle its phone calls are not intended as rudeness, however they are interpreted. Rather the IRS agents who answer the phones do not have the information on hand. Credit card representatives do, because the credit card companies have computers. The IRS dearly needs a better computer system.

A tax system, moreover, that rests *only* on the goodwill of strangers rests on too soft a foundation. In the design of a tax, you need to think in terms of systems that will work routinely and inevitably, even when applied to greedy, self-interested, money-hugging, disloyal taxpayers, that is, to real people and businesses. If the greedy, selfish, economic taxpayers pay their taxes on time without fuss, because it is rational under the system to do so, we need not worry too much about what taxpayers with God-given virtue will do.

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[16]*See* Calvin H. Johnson, "The Case for Taxing Fringe Benefits," *Tax Notes*, July 9, 1979, p. 43 (arguing that exclusion of employee meals causes deadweight loss).

[17]*Supra* note 5 (reviewing the experimental evidence).