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HOW TO PRIVATIZE FEDERAL SERVICES BY "CONTRACTING OUT"

INTRODUCTION

Privatization has come of age. The Reagan Administration's FY 1987 budget argues that considerable budget savings can be achieved thout cutting services but by transferring government functions to the private sector--in short, by privatization. A major privatization device is "contracting out," an inelegant term to describe what happens when the government hires private firms to provide government services under contract. A number of highly specialized goods and services for some time have been provided by private contractors. Notable examples include delivery of sophisticated communications satellites and military weapons procurement. But the greatest potential for budget savings would come from the federal government turning to private firms to supply such routine services as data processing, janitorial services, and maintenance work. These are generally known as "commercial services" because they are activities that are routinely provided in the private sector by commercial firms.

The Reagan Administration has been committed to contracting out commercial services since 1981, but its efforts have been undermined repeatedly. Federal agencies have been ignoring White House directives, while Congress has erected more than a dozen legislative impediments to contracting out federal services. The result: rather than reducing the size of the federal work force engaged in commercial activities, 120,000 additional workers have been added to the federal payrolls since January 1981. And despite the 1983 recommendation of the Grace Commission that 500,000 government positions be contracted to more efficient private firms, the Administration in 1985 reviewed ʼst 2,381 civilian agency positions as candidates for privatization.

At the current rate, it would take 100 years to conduct cost estimates for every federal commercial activity.[1]

If he truly intends to reduce federal spending, Ronald Reagan must make contracting out a top administrative priority. And he must seek institutional changes in the contracting out procedure. Studies have documented that 20 to 35 percent savings from contracting out are typical. Because contracting out does not reduce service levels, it provides a painless way to slash the deficit.

In recent months, the Administration has been sending mixed signals on contracting. For instance, the Administration's Management Report, accompanying the FY 1987 Budget, makes very useful recommendations for facilitating contracting out--most notably, allowing targeted commercial functions to be automatically contracted to private firms without requiring time-consuming cost comparisons with in-house provision.[2] Yet the Administration seems to be giving these initiatives secondary priority. Greater emphasis seems to be placed on the noble wish, invoked by heads of government from Washington to Moscow, that government productivity be improved. Rather than concerning itself with making government computer operators more efficient, for example, the White House should be asking why the government hires computer operators at all when private firms could provide them at low, competitive prices.

To accelerate contracting out, the Administration should change the procedure for awarding contracts so that the bias against private firms is removed. In addition, Congress should overhaul drastically the impediments that it has erected to contracting out. By working together to improve the process, significant reductions in spending could be achieved without reducing services to the American people.

HOW CONTRACTING REDUCES FEDERAL SPENDING

When the federal government contracts out an activity which is commercial in nature, it retains its funding responsibility, but relies on private sector competition to assure that the good or service is delivered at the lowest possible cost and at high quality. The federal government currently employs nearly one million workers who perform 11,000 separate commercial activities. This workforce

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1. W. Jackson Coleman, "Implementation of O.M.B. Circular A-76," Hearings, Subcommittee on Human Resources, House Committee on Post Office and Civil Service, October 30, 1985.

2. For more complete details, see: "Status Report on Federal Procurement," in Office of Management and Budget, Management of the United States Government, Fiscal Year 1987, pp. 92-103.

includes electricians, dentists, janitors, plumbers, caterers, laboratory technicians, and even veterinarians.[3]

Since 1981 at least a dozen studies have investigated the potential savings from contracting with private vendors for such services. Such contracting out now is routine in thousands of cities and is being carried out on a limited basis on the federal level. The findings of eight representative studies are shown in Table 1.

Private contractors tend to be more efficient than their public sector counterparts--not because federal employees are less able, but because they face different incentives. Since private firms operate under competitive conditions, they have a powerful incentive to seek innovative approaches to reduce the cost of providing their service. If they do not keep cost down and quality up, they soon will lose contracts to their rivals. No such incentive exists in the public sector. The lack of competition removes the pressure to be more productive. In fact, there are perverse incentives, for if a public sector agency becomes more efficient at providing a service, then that agency is likely to see its budget cut--to reflect the savings--for the next year.

Injecting competition into the procurement process even generates greater efficiency within the bureaucracy. Example: an analysis of cost comparisons in the Department of Defense reveals that the cost of services provided by federal employees fell by 17 percent when they were forced to compete with private firms. This alone has saved the Department over $100 million since 1982.[4]

If contracting out were expanded on the federal level, the Congressional Budget Office envisions a $1.2 billion reduction in government costs.[5] The Office of Management and Budget's latest projection puts the figure at $3 billion.[6]

<u>Improved Service Quality</u>

The most outspoken opponent of contracting out predictably has been the American Federation of State, County and Municipal Employees.

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3. Office of Management and Budget, "Circular No. A-76 (revised)," August 4, 1983.

4. Office of Management and Budget, "Enhancing Governmental Productivity Through Competition: A Program Report on OMB Circular No. A-76," 1984, p. 7.

5. Congressional Budget Office, "Contracting Out for Federal Support Services: The Potential Savings and Budgetary Impacts," 1982.

6. Office of Management and Budget, "Enhancing Governmental Productivity Through Competition," 1984, p. 10.

TABLE 1
COST SAVINGS ESTIMATES FROM CONTRACTING OUT
STUDIES CONDUCTED SINCE 1981

Source of Study	Type of Service	Percentage Savings From Contracting Out
Ecodata, under contract with HUD[7]		
" "	Municipal janitorial services	73
" "	Municipal refuse collection	42
" "	Municipal overlay construction	96
American Public Works Association[8]	Highway and street maintenance	16
Department of Defense[9]	Department services contracted between 1980 and 1982	22*
Department of Defense[10]	Revised 1985 estimate, all DOD contracted services	29*
U.S. Air Force[11]	Review of 132 contracted functions	33

7. Barbara J. Stevens, ed., Comparative Study of Municipal Service Delivery (New York: Ecodata, 1984).

8. John L. Whetman, "Contracting and Street Maintenance," Paper prepared for the American Public Works Association, 1983.

9. U.S. Department of Defense, Report to Congress on the Commercial Activities Program, March 12, 1984, p. 5.

10. Lawrence Korb, Assistant Secretary, Department of Defense, Testimony before the House Armed Services Committee, April 1985.

11. Air Force Times, June 17, 1985.

Institute of Transportation Studies, University of California, Irvine[12]	Municipal contracting of urban mass transit	25-50
U.S. General Accounting Office[13]	Federal cleaning costs	50
Office of Management and Budget[14]	Agencywide review of 60,000 positions contracted	24

* Includes savings from activities which remained in-house due to the agency reducing its initial cost estimate.

The union charges that while contractors may indeed provide services at lower cost, they "frequently cut corners by hiring inexperienced, transient personnel at low wages, by ignoring contract requirements, or by providing inadequate supervision."[15] This complaint is refuted by performance evaluations of contracted activities which reveal that, if anything, service quality is enhanced by hiring private firms.

A 1984 study of contracted municipal services by Ecodata, Inc., found no dimunition in service quality. In fact, it concluded that "for many of the services, the individual cities with the lowest costs of service delivery also achieved among the highest levels of quality."[16] Further corroboration of service quality is found in the California Tax Foundation 1981 survey of 81 local governments. By a margin of two to one, cities indicated that service had improved from contracting over those that complained of poorer service.[17]

12. Roger F. Teal, Institute of Transportation Studies, University of California, Irvine, "Transit Service Contracting: Experience and Issues," Paper presented at the Annual Meeting of the Transportation Research Board, Washington, D.C., January 1985.

13. General Accounting Office, "GSA's Cleaning Costs Are Needlessly Higher Than in the Private Sector," 1981.

14. Office of Management and Budget, Management of the United States Government, Fiscal Year 1987.

15. Gerald W. Maentee, "The Case Against Privatization," The Privatization Review, Fall 1985, p. 7.

16. Stevens, op. cit., p. iv.

17. California Tax Foundation, "Contracting Out Local Government Services in California," May 1981, p. 9.

These findings were to be expected. Private contractors typically are forced to meet rigid performance specifications, and the quality of services they provide is closely scrutinized. With public delivery, by contrast, such accountability is low or nonexistent.

<u>More Efficient Use of Resources</u>

A 1983 Joint Economic Committee of Congress (JEC) study of federal procurement finds that offering federal contracts to the private sector greatly stimulates business expansion.[18] Equipment and other capital purchased by a private firm to fulfill the terms of a federal contract are likely to be later adopted for other commercial ventures. By contrast, the government, because of its limited flexibility, often has capital sitting idle upon project completion. Technological spin-offs to other commercial markets from government funded research and development were particularly important, the study notes.

Contracting out also permits the federal government to marshall the specialized talents of private companies on a temporary basis, rather than keeping such expertise permanently within the government. Agencies acknowledge that this option offers the government greater flexibility in responding to changing priorities.

WHY FEDERAL CONTRACTING REMAINS THE EXCEPTION AND NOT THE RULE

The first presidential directive on federal contracting was issued by Dwight Eisenhower in 1955. It specified that "the federal government will not start or carry on any commercial activity to provide a service or product for its own use if such product or service can be procured from private enterprise." The intent of this directive has been thwarted repeatedly for three decades. The reasons:

<u>The Cost Comparison Process Prevents Contracting Out</u>

The original Eisenhower policy statement was stripped of much of its force in 1966, when it was replaced by Office of Management and Budget Circular A-76, which forms the basis of current policy. This new directive requires the federal agencies only to conduct detailed cost comparisons between "in-house government suppliers" and private vendors, and to choose the less expensive alternative. Despite the

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18. Robert Premus, David Karns, and Anthony Robinson, "Socioeconomic Regulations and the Federal Procurement Market," Joint Committee Committee, December 1984.

apparent reasonableness of this approach, the rules which govern the cost comparisons are heavily skewed against private contractors. Examples:[19]

o Unless the private contractor's bid beats the in-house estimate by at least ten percent, to cover government "transition costs," the function automatically remains in house despite the potential savings from contracting out.

o The private bidder must submit a "firm contract" proposal with a fixed price, whereas the agency is only required to submit a cost estimate. This places the private bidder at a significant disadvantage; if he underestimates his costs he will have to swallow the loss. The agency, on the hand, is not penalized by submitting low cost estimates. If its estimates prove to have been too low, it pays no penalty nor does it lose the contract. It simply draws additional agency funds.

o The commercial firm's bid must include an allowance for indirect costs, such as corporate salaries and other administrative expenses; the agency's need not. The U.S. Chamber of Commerce estimates that this alone constitutes a 20 to 30 percent handicap to the private bidder.

o Costs are added to the bid submitted by private providers to pay for government monitoring of contract performance; no cost for checking quality is added to the agency cost estimate.

o Very low bids may be rejected as being "outside the competitive range." This discourages breakthrough innovation and means that in many cases the selected proposal from private bidders is not always the lowest bid. It also leads to more decisions in favor of the agency provider.

This biased cost comparison process has placed private bidders at an estimated 35 percent cost handicap.[20] According to the Congressional Budget Office, eliminating the 10 percent rule alone would increase contracts awarded to commercial sources by 14 percent.[21]

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19. A comprehensive analysis of the cost comparison process and its flaws is examined in William D. Russell, Testimony before the Subcommittee on Human Resources, House Post Office and Civil Service Committee, October 20, 1985.

20. Ibid., p. 4.

21. Congressional Budget Office, p. 22.

The Campaign in Congress to Prevent Contracting Out

The unfair cost comparison process tilts decisions against private vendors. An even greater problem is that restrictions imposed by Congress ensure that only a small share of federal commercial activities are even subject to competitive bidding.

In recent years, Congress has passed over 20 separate prohibitions on contracting out. Congress usually justifies the impediments to contracting of Pentagon commercial activities, for example, by claiming that contracting out would jeopardize "national security" interests. But is is certainly in the interest of U.S. national security for the Pentagon to get maximum value from its defense dollars. Every dollar saved by contracting out routine Department of Defense commercial activities is an additional dollar to protect national security in other areas. And it is important to stress that if congressional restrictions from contracting such activities as firefighting and security guard functions on military bases were lifted, the Secretary of Defense would still have the authority to prevent contracting where legitimate security considerations arise.

In fact, mounting evidence suggests that Congress merely uses the "national security" motivation as a guise to conceal more parochial concerns. Congressmen Bill Nichols (D-AL), who has played a lead role in restricting contracting out by the Department of Defense, acknowledges that one of his goals has been "to protect [military civilian] jobs."[22]

Congressionally imposed restrictions on civilian agencies are equally insidious. The General Services Administration, for instance, is prohibited from contracting out guard, elevator operator, messenger, and custodian services.[23] These exemptions cost federal taxpayers $32 million each year.

The Veterans Administration (VA) is expressly prohibited from contracting its medical care activities, whatever the savings, unless in-house facilities can not fully handle the patient load. The Grace Commission found that when VA nursing home care was contracted out, the average cost per day was more than cut in half: $45 per day versus the $109 per day the VA charges. Quality of care concerns which motivate the VA restriction are dubious as well: the Air Force often contracts out for similar hospital care without degrading service

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22. As quoted in "Contracting Out: Win Some, Lose Some, Some Rained Out," Government Executive, 1985, p. 41.

23. OMB, Management of the United States Government, p. 72.

quality. The VA restriction costs the federal taxpayers at least $100 million annually according to the Grace Commission.[24]

The cost impact of these congressional obstacles to contracting is considerable. Thanks to the restrictions, only an estimated 30 percent of the government's $20 to $30 billion tab for commercial services is even eligible for the savings that contracting out offers.

Opposition to Contracting Out Within the Agencies

The Administration must share the blame for the unsatisfactory progress on fully implementing the A-76 directives. Congressional restrictions do not explain why less than 2,000 cost reviews were conducted in civilian agencies in 1984, and only 2,300 in 1985. The Executive Branch employs over 20,000 "program analysts" who should be undertaking comparisons, yet the number actually conducted is very small. The problem evidently begins with the heads of such Administration agencies as the National Oceanic and Atmospheric Administration, NASA, and the General Services Administration. Charges the General Accounting Office, "The commitment of agency heads to the reform effort has not been demonstrated and agency officials interviewed by GAO believe they do not have to follow the [Circular A-76] policy guidance."[25]

Even when the cost comparisons are reluctantly performed by an agency, the bureaucracy can skew the process so unfairly against the private bidder or delay the proceedings for so long, that few contracts ever get out the door.

Typical of such footdragging is at the General Services Administration. The GSA spends $250 million more to clean offices with its own custodians than it would cost to contract out this service. According to the GAO this waste of taxpayer money occurs "despite GSA's knowledge that it costs more to clean with its in-house custodial staff...Instead of actively pursuing the spirit of A- 76, GSA is only slowly converting to contract cleaning."[26] If the agency proceeds at its current pace, it could take fifteen years for janitorial services to be privatized. The message is clear: without a

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24. William R. Kennedy, Jr. and Robert W. Lee, A Taxpayer Survey of the Grace Commission Report (Ottawa, Illinois: Green Hill Publishers, 1984), p. 2.

25. General Accounting Office, "Progress of Federal Procurement Reform Under Executive Order 12352," 1983, p. ii.

26. General Accounting Office, "GSA's Cleaning Costs Are Needlessly Higher Than in the Private Sector," 1981, p. ii.

forcing mechanism attached to the A-76 program, agencies will not even try to obtain the saving achievable through contracting out.

FIVE STEPS BY WHICH THE WHITE HOUSE WOULD IMPROVE AND EXPAND CONTRACTING OUT

1) Issue an Executive Order to reconfirm the Reagan commitment to contracting out.

The Office of Management and Budget's contracting out initiatives are doomed to failure without Ronald Reagan's explicit and wholehearted support. Through an executive order, he should require federal agencies to classify all of their functions as either "inherently governmental" or "nongovernmental," with the second category eligible for contracting out. Once these designations have been made they should be reviewed for consistency by OMB, and made subject to appeal by private contractors. This general classification would eliminate time-consuming disputes and inconsistency. The President should also direct all agencies to conduct cost studies for a fixed number of civil service jobs each year that are subject to contracting.

2) Eliminate the cost comparison process when private sector delivery is clearly less expensive.

Certain inherently commercial activities, such as janitorial services, automatically should be contracted out to private firms. This would free up agency personnel to conduct reviews on more complicated cases. In early 1986, the Office of Management and Budget recommended this reform. The proposal would permit agencies to bypass the cost comparison process for certain activities.

3) Hold agency heads and lower level appointees accountable for any failure to execute A-76.

A chain of responsibility in each agency should be established to assure that cost comparisons are made and conducted in a fair and speedy manner. Progress reports from all program administrators should be required and carefully reviewed. Political appointees who fail to make progress in executing A-76 should be removed and replaced with those who will. Political appointees should also be required to publish information on the positive results of A-76, to counter public employee union lobbying.

4) Replace method specifications with performance specifications on most federal contracts.

Bids by private contractors have to cover the cost of rigid, and in many cases unnecessary, agency specifications. Contract solicitations routinely exceed 100 pages. A 1983 Joint Economic Committee investigation found that for 67 percent of businesses that had voluntarily reduced their participation in federal procurement, "complexity of contract requirements" was a major factor in this decision.[27] If requirements were simplified and related more to contract performance and progress rather than to the method the contractor employs to fulfill the terms of the contract, competition would be enhanced, costs would be reduced, and contracts would be awarded faster.

5) Contract out the contracting out process itself.

As long as the authority to determine whether or not an activity will be contracted out rests on the shoulders of the agency itself, contracting out will remain the exception rather than the rule.

The contracting out decision must be removed from the hands of the agency bureaucrats. A number of municipalities already use independent auditors. Example: Phoenix created a separate auditing department that not only evaluates outside bids, but verifies the accuracy of the in-house estimate. It computes the proper allocation of overhead and whatever indirect costs could be eliminated by contracting out. The auditor awards the contract and monitors its performance, whether it is being delivered by private firms or by public workers.[28]

The federal government should experiment with such an approach. An auditing office, for instance, could be added to OMB or GAO. Failure by a cabinet department to provide information quickly to the auditors could result in functions being contracted out by default. Reporting to such an independent auditing department would mean that performance standards would apply equally to contractors and the agencies, since in-house performance would be monitored.

There is no reason why this independent agency need be a government department. In fact, the federal government should consider contracting out the contracting out process. The President could nominate a panel of private auditing firms, subject to Senate confirmation, to undertake the cost comparisons. The private auditors would be responsible for making cost estimates, awarding contracts, and monitoring performance problems. Perhaps the auditors could receive payment based upon savings to the government and satisfactory performance of the contracts they awarded and managed.

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27. Joint Economic Committee, p. 39.

28. Innovating approaches to contracting out employed in Phoenix and other cities are described in Robert W. Poole, Jr., "Departments vs. Contractors," Fiscal Watchdog, February 1984.

FOUR STEPS FOR CONGRESS TO PROMOTE CONTRACTING OUT

1) Remove legislative restrictions on contracting out.

With few exceptions, congressional restrictions on contracting out have ill served the public. Where national security questions arise, the appropriateness of utilizing contracts should be determined by the Secretary of Defense. Where quality of care objections have prompted restrictions, as with veterans' health care, independent auditors, free of constituency pressure, should ensure that contractors live up to quality commitments.

2) Modify competitive bidding regulations to eliminate biases against contracting out.

The competitive bidding process imposes a 35 percent handicap on the contractor. The rules tend to keep contracts inside the government when taxpayer savings would be realized by contracting out. Legislation is needed to remove unreasonable restrictions. Representatives Robert Smith (R-OR) and Charles Stenholm (D-TX) have introduced the Contract Savings Act, which tackles the problem of congressional red tape.

3) Review the Service Contract Act and the Davis Bacon Act.

The objective of government procurement should be to assure that taxpayers' money is being spent wisely. In 1972 the Commission on Federal Procurement warned that "the cumulative effect of regulations already imposed on the procurement process and the addition of those contemplated could overburden it to the point of breakdown."[29] Nearly 15 years later, federal procurement is more burdened than ever, with only the most skillful and experienced contractors able to wiggle through stacks of paperwork requirements and red tape. On the federal level alone, 4,000 provisions of federal law, covering 64,000 pages, affect procurement and contracting.

Congress should reevaluate those existing contract regulations that are concerned with social policy, while placing a moratorium on new ones. This reassessment should look first at the labor requirements affecting A-76. The Davis Bacon Act requires that workers on federally contracted construction projects receive the prevailing wage in the area where the work is performed. The Service Contract Act is the counterpart of the Davis Bacon Act, applying to service contract workers. Surveys of contractors have found that Davis-Bacon

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29. United States Commission on Government Procurement, Vol. 1, 1972, p. 114.

is considered the single most burdensome regulation affecting federal contracts. The Service Contract Act is only slightly less inhibiting. These two regulations cost the taxpayer $1.3 billion.

4) Reform the small business and minority business set-aside rules.

These set-aside programs restrict eligibility on specified government contracts by mandating that they be awarded to small and minority-owned businesses. Aside from the questionable effectiveness of this method of promoting the growth of targeted businesses, there is strong evidence that the biggest winner from set-asides is the bureaucracy. The reason is that if no small or minority business is able to match the agency in-house bid, which is frequently the case, the bidding is not then opened up to large contractors. Rather, the activity remains in-house. If Congress genuinely wants to assist small businesses through federal contracts, it should do so by reducing regulations rather than eliminating competition.

CONCLUSION

The goal of government procurement, set down by the 1972 Commission on Federal Procurement, is to obtain "products and services of the needed quantity at the lowest reasonable price available." But thanks to congressionally imposed restrictions on contracting out, and the "civil disobedience" characterizing bureaucratic responses to contracting initiatives, the taxpayer has been denied the full benefits of contracting out under Ronald Reagan. In 1986 there are more federal workers performing commercial activities than ever before, and the competitive procurement process is more regulated and restricted than it has ever been.

Most of the privatization initiatives proposed by Reagan's FY 1987 budget must travel the treacherous route of winning congressional approval. By contrast, a more aggressive contracting out campaign can be undertaken immediately by the Administration, independent of Congress.

The Gramm-Rudman-Hollings timetable for federal deficit reduction means that Congress and the White House must seize every opportunity to cut unnecessary spending. Since contracting out cuts spending while preserving the level of services to beneficiaries--and in many cases improves the quality of service delivery--there is every reason why lawmakers should step up the pace of contracting out. Failure to do so will indicate that Washington is still not serious about cutting the deficit with the minimum of service disruption.

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