CONTRACTING OUT FOR FEDERAL SUPPORT SERVICES:

POTENTIAL SAVINGS AND BUDGETARY IMPACTS

Congress of the United States
Congressional Budget Office

NOTE

Unless otherwise noted all years in this text refer to fiscal years.

PREFACE

At the direction of the Office of Management and Budget, most federal agencies have long been procuring certain needed support services from private firms. The practice has adamant proponents and detractors. The present Administration, adhering to the position that the private sector is the most economical source of many support services, is pursuing a policy of accelerated contracting out. Besides issues of job security for federal workers and quality of services, the potential federal outlay savings that contracting out can achieve are the focus of much attention. Concern also centers on the mandatory cost measures that guide agencies in deciding what services to purchase under contract. This study, undertaken at the request of the Senate Committee on Appropriations, provides analytical background for the Congress' assessment of these questions.

R. Mark Musell of the General Government Management staff of CBO's Office of Intergovermental Relations prepared the paper under the supervision of Earl A. Armbrust and Stanley L. Greigg. The author gratefully acknowledges the contributions of Sherri Kaplan of CBO, who assisted with research and writing, and Linda Preshlock of the House Information Service, who provided computer support. Numerous staff members at the Department of Defense and the Office of Personnel Management also provided essential information. Johanna Zacharias edited the paper. In keeping with CBO's mandate to provide objective analysis, the study offers no recommendations.

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October 1982

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SUMMARY

Considerable debate surrounds the question of who should provide the federal government with services that are essentially commercial in nature--maintaining facilities and equipment, providing food, operating military bases, processing data, and guarding government property. Should such services be performed "inhouse" by federal workers, or should they be purchased--often at lower cost--from private-sector firms under contract to the federal government? Advocates of "contracting out" point to it as economically prudent, buttressing their position with the argument that the federal government ought not to engage in commercial-type activities that the private sector can provide. Opponents' criticisms focus largely on the lower quality of services that contractors often deliver and on the employment concerns of federal workers threatened by layoff. Skeptics also see it as giving an illusion of a smaller, less costly federal government.

In 1981, about $19.4 billion went toward some three-fifths of the commercial-type services performed for the government by a mostly blue-collar inhouse work force numbering roughly 495,000. The rest was contracted out to private firms. Since 1979, the number of service contracts with federal agencies has more than doubled, but there is still room for considerable expansion.

CURRENT POLICY AND THE ADMINISTRATION'S STANCE

The present Administration sees further contracting out as a way to achieve budgetary savings approaching $545 million in 1983 dollars, and it has already taken measures to accelerate contracting out. Executive Branch policy, articulated by the Office of Management and Budget (OMB) in its Circular A-76, stipulates that agencies rely on the private sector for commercial-type services unless the federal government can provide them more cheaply. Accordingly, guidelines that accompany Circular A-76 set down procedures according to which comparisons of potential inhouse and contract costs are made. At the same time, though, statutory provisions and Circular A-76 regulations prohibit contracting for certain services. Altogether, these restrictions may exempt activities performed by an estimated 300,000 federal workers--mostly in the Department of Defense (DoD) and the Veterans Administration (VA)--from being considered for

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contracting out. (The rationales underlying these exclusions stem mainly from concerns about military readiness and about the well-being of U.S. veterans.) A-76 guidelines are already undergoing adjustment, and after the revised regulations are issued later this year, agencies will have about 24 months to complete inventories of ongoing inhouse activities, examine cost comparisons, and award service contracts as justified.

Three issues with significant budgetary impacts concern

- **Certain cost measures used in A-76 comparisons,**

- **The scope of activities excluded from contracting out,** and

- **The emphasis given near-term outlay impacts in decisionmaking.**

Responding to these and other concerns, the Congress has effectively barred the VA from shifting further work to service contracts and has recently enacted a six-month freeze on preparation of cost comparisons by DoD. In view of the Administration's position and the legislative constraints, the Congress might want to consider mandating certain modifications to the rules used for contracting-out decisions.

COST-COMPARISON MEASURES

Analysis by the Congressional Budget Office (CBO) reveals that the **A-76 guidelines underestimate certain aspects of the costs assigned to personnel compensation and to government layoffs.** These factors, as well as the costs ascribed to intangible aspects of transition, deserve special attention because, though illusive, they heavily influence the outcome of A-76 cost comparisons.

Retirement

Circular A-76 guidelines seem to understate costs for both Civil Service Retirement (CSR), which applies to inhouse work, and for Social Security, which applies to work that is contracted out. Adjustments for these two items would improve A-76 cost recognition, though the net budgetary effect would be negligible because the results of changes would essentially offset one another. As statutes, plan experience, and economic conditions change, any retirement-cost factors adopted for A-76 comparisons will undoubtedly require periodic adjustment.

With regard to Social Security--in most instances the sole source of retirement coverage for service workers in the private sector--current guidelines fail to expose fully the costs associated with two factors: loss of future federal revenue caused by the tax-free status of benefits, and losses arising from the system's built-in "underfunding." The latter cost occurs because current statutory employer and employee contributions to Social Security do not cover the full cost of future benefits. Together, these two extra but unrecognized federal costs equate to some 4.7 percent of active-service payroll. Because such costs--albeit long-term ones--arise when work shifts to private firms, they ought to be considered in cost comparisons.

With regard to the federal cost of CSR, current guidelines assign a value of 20.4 percent of pay, although a more recent and probably more accurate actuarial valuation places federal costs for this item at 24.2 percent of pay. This latter estimate has the advantage of reflecting long-term economic assumptions used for valuing Social Security.

Federal Layoffs

In considering costs for payments to federal workers affected by layoffs that may occur when jobs are contracted out, A-76 guidelines would increase contracting-out prices by an amount equal to 2 percent of inhouse personnel costs. The 2-percent-of-pay factor, based solely on severance pay disbursed by DoD for inhouse activities that were shifted to contract in recent years, has two drawbacks. First, it does not recognize other costs associated with statutory "save-pay" provisions, which allow workers whose jobs are abolished to displace others with less seniority while receiving the same pay. Second, the proposed 2 percent factor does not consider the higher frequency of layoffs experienced in nondefense agencies. Currently, for example, job losses due to layoffs could average as high as 25 percent of all jobs abolished.

Review of recent data justifies increasing the proposed 2 percent cost factor to about 4 percent of pay for defense agencies and to 15 percent of pay for nondefense agencies. The CBO estimates of average layoff costs reflect current employment conditions in the federal government and will require modification as conditions change. Moreover, consideration might be given to using variable layoff-cost factors that fit circumstances for converting particular inhouse activities. Whatever approach is adopted, however, layoff costs increase the price associated with contracting out and thus reduce conversions and associated savings.

Transition Intangibles

Though no firm basis exists for evaluating disruptions and other intangible factors associated with transition, Circular A-76 takes account of these costs by allowing conversion only when a contractor's costs show savings greater than 10 percent of inhouse personnel costs. Though arbitrary, this factor influences contracting-out decisions, reducing the number of conversions affected by some 14 percent. Cost-comparison guidelines could allow different transition factors as indicated by individual agency justification. Because some recognition of costs for transition seems appropriate, CBO incorporates the 10 percent factor in its government-wide estimates of both contract conversion rates and associated savings.

POTENTIAL SAVINGS UNDER THE CURRENT PROGRAM--CBO ESTIMATES

The CBO analysis shows that the Administration's contracting-out initiative offers substantial savings, though for nondefense agencies some costs may rise in the near term (see Summary Table). The potential reduction in total federal costs consists of changes in both disbursements that occur initially and those, for items such as CSR, that occur years later. The estimated impacts are moderated by a federal employment market beset by continued reductions in force.

According to CBO estimates, the current program could shift to the private sector about 81 percent of inhouse commercial-type work reviewed. **These conversions**, excluding potential shifts of VA and certain military activities, **would eliminate some 165,000 federal jobs and generate annual savings of about $335 million in the first year.** (The Administration's estimates are some $210 million higher.) **In budgetary out years, annual savings would eventually grow to $870 million,** because costs for transition and severance pay are short term.

The CBO's estimates of **near-term outlay impacts are much smaller than total savings--reaching only $90 million government-wide.** For all nondefense agencies combined, outlays could increase slightly. Smaller outlay impacts occur under contracting out, because savings from avoided CSR benefits do not materialize as outlay reductions until many years later. At the same time, the contractor passes on to the government as a current expense the cost of employers' Social Security contributions. Furthermore, government layoffs arising under contracting out generate additional cash disbursements for payments to workers affected.

Different unit labor costs are the key variable used by CBO for estimating savings from contracting out. The estimated impacts derive from a comparison, by selected occupations and regions, of federal and private-sector unit labor costs per hour worked. The private-sector rates incorporated in the comparisons reflect prevailing compensation practices as determined by the Department of Labor under the Service Contract Act.

Uncertainties about the sums contractors will bid in the future for work now done inhouse and about the recognition of certain federal costs limit the accuracy of contracting-out estimates. The CBO approach offers a way to approximate the potential aggregate shift to contracting in the absence of detailed cost comparisons for the wide variety of activities that comprise the current inventory of inhouse work. Data collected by the General Accounting Office on cost components of activities recently converted to contract by DoD support the CBO analysis. In addition, the resulting conversion rates are consistent with those experienced by DoD in 1981, the most recent year for which data are available.

OPTIONS FOR CONTRACTING OUT

The Congress can either maintain the current contracting-out program or consider modifying it for three purposes:

- **To improve the recognition of comparative costs,**
- **To relax current exclusions,** and/or
- **To maximize outlay savings in the near term.**

It could also take steps in the opposite direction and bar further contracting out, at least temporarily. Except for the last choice, several alternatives offer substantial cost savings (see Summary Table).

These annual savings in total costs represent cost reductions regardless of when disbursements occur. In other words, the savings estimates include some reductions that offset current outlays and others that have deferred effects. Overall, the initial outlay impacts of the various options are relatively small, reaching $0.2 billion at most.

SUMMARY TABLE. ANNUAL SAVINGS, OUTLAY, AND EMPLOYMENT EFFECTS OF CONTRACTING-OUT OPTIONS

	Total Annual Savings		Near-Term	
	First Year	Out Years	Outlay Savings	Federal Jobs Eliminated
	(In billions of dollars)			
Option I--Continue Current Program	0.3	0.9	0.1	165,000
Option II--Modify Comparison Guidelines	0.4	0.9	0.2	135,000
Option III--Reduce Current Restrictions	0.6	1.2	0.2	185,000
Option IV--Maximize Outlay Savings	0.2	0.5	0.2	95,000
Option V--Impose a Moratorium	---	---	---	---

SOURCE: Congressional Budget Office.

NOTES: For estimating purposes, the options are assumed to take effect October 1, 1982. The estimates of total annual savings in the first year consist of changes in both disbursements that occur initially and those, such as a CSR, that occur years later.

Option I: Continue the Current System

As stated above, continuing current policy is a way to curb long-term costs for federal programs. **First-year savings from elimination of some 165,000 jobs would total roughly $335 million,** according to CBO. **In out years, these savings grow to $870 million** because of the near-term nature of severance pay and other transition costs. Both cost-comparison methods and resulting agency decisions would conform to current guidelines. The savings that CBO estimates, however, reflect higher federal costs for retirement and layoffs than the Administration estimates. Without the CBO adjustments, the estimated savings under current policy would be appear unjustifiably high.

This option has obvious appeal to analysts who favor contracting out for its potential economy to the government and who hold that current procedures and exemptions are correct. It would not, of course, respond to the criticisms of contracting out in general, nor to observers who feel that the present system needs refinement.

Option II: Modify Cost-Comparison Guidelines

This option would respond to the criticism that several key factors in the present guidelines misrepresent comparative costs of either keeping commercial-type services inhouse or contracting them out. It would recognize much higher costs for the layoff benefits federal workers are entitled to, estimating those costs to average 15 percent of payroll for all agencies except DoD. In addition, Option II would incorporate periodic adjustments in the estimated cost of retirement benefits. Initially, it would substitute a somewhat higher value for the federal cost of CSR--24.23 percent of payroll instead of the current 20.4 percent. At the same time, this upward adjustment of inhouse costs would be offset by a new contracting-out compensation cost factor (4.7 percent of pay) to recognize the underfunding of Social Security benefits as well as their tax-free status. The net effect of the changes for both retirement and layoff costs would allow fewer conversions to contracting out. But the more rigorous guidelines would mean greater savings for work that shifted.

The first-year savings attainable under this option would total about $415 million. In out years, savings would about equal those of current policy. The 135,000 federal jobs abolished would be fewer by 30,000.

While modifications of existing guidelines would likely meet with little opposition, disagreement over which factors to modify and what particular values to assign could be strong. Some critics might argue that the entire cost-comparison process is highly questionable because of the somewhat arbitrary task of assigning costs.

Option III: Modify Cost-Comparison Guidelines and Reduce Restrictions on Contracting Out

This option would lift current limitations on contracting out in DoD and VA and incorporate Option II's modifications to the current cost-comparison guidelines. Relative to current law, **this alternative would result in nearly 20,000 additional jobs' shifting to private firms, for a total savings of about $580 million** in 1983 dollars. **In out years, savings would grow to $1.2 billion.**

Current limitations have been supported on grounds that they help ensure military preparedness and high-quality health care for veterans, and they reduce the costs of conducting comparison studies. But proponents of the modification would argue that federal agencies have been quite successful using private firms to provide many types of support services under a variety of circumstances, including armed conflict. In any event, the substantial savings that could result if limitations were lifted would more than offset the administrative cost of conducting comparisons.

Option IV: Modify Cost-Comparison Guidelines and Maximize Near-Term Outlay Savings

In addition to modifying certain cost factors, Option IV would limit future conversions to cases with potential to reduce outlays in the near term. Thus, **conversions of some 95,000 federal jobs yielding total savings of $195 million in the first year and $485 million in out years would not take place at the expense of short-term outlay increases.** Under this approach, near-term outlay savings would markedly increase, because conversions would be limited to those cases in which cash payments under contracting out were lower than current outlays for inhouse performance. **Relative to current policy, outlays saved by contracting out would increase by 116 percent, and if coupled with Option III's reduction of exemptions, by about 233 percent.**

This policy change would support current efforts to reduce the federal deficit in the next few years. It would be opposed by persons who believe that achieving long-run economies should be the main objective of contracting out. Such detractors would point out that outlay increases occurring when jobs shift to private firms are generally one-time or short-term effects that should not play a major role in contracting-out decisions. In effect, long-run budgetary savings more than offset any near-term rise in federal outlays.

Option V: Impose a Moratorium on Contracting Out

In light of criticisms of the current system, the Congress could impose a freeze of, say, one year on shifts to service contracts. This option would extend, on a government-wide basis, the limited moratorium now mandated in the Defense Authorization Act of 1983. Such a moratorium would allow the Congress and the Executive Branch more time to re-evaluate the current program, including the potential effects on the quality of support services. Obviously, no further cost savings or federal job losses would result.

This approach would find support among those critics of contracting out who believe that the practice obscures the size and cost of the federal government. Federal employee organizations already angered by the loss of jobs would also endorse it, as would some program managers who have expressed concern about poor quality services from contractors. Observers who hold that certain types of services could be targeted for private-sector performance as a matter of basic policy might support a moratorium as a means to move current policy away from reliance on detailed and possibly imprecise cost comparisons.

Option V would be opposed on the grounds that it would needlessly delay the opportunity to achieve long-term budgetary savings. Advocates of the current system point out that implementation of the Administration's program is overdue, and that many delays have already occurred at the agency level. From this perspective, implementation of pending regulations--representing more than a full year's study--should proceed promptly.

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CHAPTER I. REVIEW OF FEDERAL CONTRACTING-OUT PRACTICES

In 1981, the federal government spent some $32.5 billion on services of a commercial nature, including maintenance of facilities and equipment, military base operations, security, food preparation, and data processing. Such services can be provided in one of two ways, either "inhouse" by government employees, or outside by private-sector contractors. At present, about 40 percent of the commercial-type activity performed for the government is "contracted out"; nearly one-half million federal workers (or roughly one-fourth of the entire civilian federal work force) provide the remainder. The inhouse work force performing commercial-type services consists mainly of blue-collar workers covered by the Federal Wage System. 1/ By far the largest employer of these workers is the Department of Defense (DoD), which accounts for roughly 80 percent of federal costs for commercial-type services. All other agencies together account for the rest in carrying out domestic programs.

CURRENT RULES AND ADMINISTRATION POLICY

With certain major exceptions, Executive Branch policy, set forth in Office of Management and Budget (OMB) Circular A-76, requires reliance on the private sector for provision of commercial-type services.2/ Significant exceptions, permitted by current statutes or regulations described below, cover certain support for military functions and veterans' health care. Taking all exceptions into account, current policy removes about three-fifths of inhouse commercial-type services from consideration for contracting out.

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1. Employees in trade, craft, labor, and other occupations covered by the federal wage system are often referred to as "wage board" employees. All jobs covered by the federal wage system are assigned grades (15 in all for most nonsupervisory workers) that represent particular levels of skill.

2. The A-76 guidelines referred to in this paper are those contained in the OMB revised draft circular of March 1982, except for the provision affecting activities performed by 25 employees or fewer, which is no longer under consideration. Statutory authority for Circular A-76 derives from the Budget and Accounting Act of 1921, U.S. Code, Title 31, Section 1 and following.

For governmental activities subject to contracting out, Circular A-76 requires agencies to compare inhouse costs against those proposed by contractors. The comparison measures total inhouse expenses, including federal pay and benefits, against a contractor's bid price, which is adjusted in certain ways. Unless the comparisons demonstrate that the government can perform the service inhouse at a lower cost, services are shifted to private firms. As described in more detail in Chapter II, the outcome of A-76 cost comparision is greatly influenced by the various accounting measures and cost factors prescribed in the circular and accompanying guidelines.

Under a program now in progress, the Administration is reviewing several revisions in the OMB guidelines and expects federal agencies to step up their contracting-out efforts. After revised regulations take effect sometime before the end of this calendar year, most agencies will have about 24 months to complete an inventory of commercial-type activities, examine cost comparisons, and award service contracts when circumstances warrant. The DoD, General Services Administration (GSA), and Veterans Administration (VA) will have an additional year for complying with OMB instructions. By the effective date, agencies must also submit to OMB justifications for activities remaining inhouse. The schedule for implementing current policy suggests that accelerated contracting out may become a significant personnel management issue affecting future budgets.

ISSUES IN THE DEBATE ABOUT CONTRACTING OUT

Contracting out is a subject of widespread controversy, with strong arguments on both sides. The current debate, however, centers more on how to obtain services than on whether they are needed at all. Advocates of the practice maintain that the government should not be in the business of providing goods and services that can be purchased from the private sector. While acknowledging the difficulties in implementing a contracting-out program and the need for periodic revision of regulations, supporters of the current system believe it reflects the best cost experience available.

Many opponents of the practice believe that past and present efforts to promote contracting out are advanced mainly to obscure the true size of the work force providing federal services and thus, to give the appearance of a smaller federal government; for example, DoD data show that, in 1981, private-sector contract firms employed the equivalent of some 133,000 federal workers. Not surprisingly, employee organizations and other critics view contracting out as a backdoor device for doing away with