federal jobs. They argue that any changes in compensation or work-force size should be made directly through the federal wage system and work rules, and through program reforms. Contracting out is also opposed as an irresponsible policy, in that the government becomes a party to substandard practices that lower compensation and withhold federal job security from veterans and other workers.

Concerns About Quality and Legislative Responses

Notable among the critics of contracting out are many federal managers, who express concern that, despite potential fiscal savings, contracting out is not always cost effective. It can cause serious problems in obtaining satisfactory support services. The quality of services has been observed to slip when work shifts to private firms--in part reflecting a contractor work force that has less experience, higher rate of absenteeism, and greater employee turnover. In addition, managers caution that reduced control over support services and the prospect of strike action at private firms--an option not readily available to federal workers--threaten those firms' ability effectively to carry out basic program responsibilities.

In response to such concerns, several measures pending in the Congress would ease limitations on contracting out. Last year, the Congress enacted legislation that effectively bars the VA from undertaking cost-comparison studies. In enacting the Department of Defense Authorization Act for 1983, the Congress imposed a six-month moratorium on preparation of A-76 cost comparisons for most activities in the DoD. In addition, the pending Uniform Services Pay Act of 1982 would set in law current administrative criteria for exempting activities from contracting out because of national defense needs.

Budgetary Considerations

Three concerns with significant cost and budgetary implications have arisen out of current debate:

- The accounting of federal costs for retirement benefits and government layoffs;
- The significance of short-term impacts on budget outlays; and
- The exemption of certain activities from contracting-out review.

This paper provides background information on federal contracting out and identifies potential savings under current policy and various alternatives to it. Alternatives to continuing the current program would modify contracting-out decision rules concerning the A-76 cost measures, the scope of activities excluded, and the emphasis given near-term outlay impacts. (The paper does not address shifting services back to inhouse performance or the implications of procuring new services by contract.) The analysis of the current program and possible modifications of it focuses on the government-wide potential for reducing federal costs to obtain support services; it does not, though, overlook the prospect that considerations other than comparative costs may have equal or greater value in assessing contracting out. Some observers advise caution against further contracting out, for example, because of the risk that the quality of services delivered might decline; others believe that many commercial-type services should shift to private firms as a matter of basic policy regardless of marginal effects or costs.

Plan of the Paper

The remainder of this chapter provides an overview of current commercial-type activities that support federal programs. It also reviews the DoD's recent experience. Chapter II describes the current contracting-out program--its mechanics and the cost elements for support services, including personnel compensation. Chapter III offers estimates of potential savings from shifts to contracting out under current policy. Chapter IV identifies five policy choices and their associated effects on total costs, near-term budgetary outlays, and federal employment in general.

OVERVIEW OF CURRENT COMMERCIAL-TYPE ACTIVITIES

A service contract is a simple concept. Generally, it represents a contractual agreement that a private firm provide certain support services to a federal agency. Contracts awarded by federal agencies usually cover a three-year period. The value of such awards (expressed in 1981 dollars) increased 120 percent in the last three years--from $7.4 billion in 1979 to $16.3 billion in 1981 (see Table 1). The rate of increase in contracts awarded by nondefense agencies was somewhat higher during this period, averaging about 150 percent. This recent rapid growth has brought the government's contracting-out for commercial-type services to the current level of 40 percent of all service activities (see Table 2). When exemptions are disregarded, the portion contracted out increases to 60 percent. Despite the expanded use of service contracts, however, significant opportunity remains for further shifts of inhouse work to private firms.

TABLE 1. FEDERAL OUTLAYS FOR SERVICE CONTRACT AWARDS, 1979-1981 (In billions of 1981 dollars)

	1979	1980	1981	Percent Increase
Defense	6.0	5.8	12.8	(113)
Nondefense	1.4	1.7	3.5	(150)
Total	7.4	7.5	16.3	(120)

SOURCE: Estimated by the Congressional Budget Office from recent data available from the Federal Procurement Data Center.

NOTE: The amounts for contract awards are limited to contractor payments and thus exclude certain other costs associated with service contracts.

Present Inhouse Services

In 1981, support services provided inhouse totaled an estimated $19.4 billion, including $16.4 billion for DoD and $3.0 billion for nondefense agencies (see Table 2). According to calculations by the Congressional Budget Office (CBO), the federal government currently employs almost 495,000 civilian workers in occupations requiring skills associated with inhouse commercial activities. This work force covers a wide variety of services, with significant concentrations in equipment upkeep (accounting for some 34 percent of the inhouse work force) and facility support such as housekeeping, guarding, and food service (22 percent). Property maintenance and automated data processing also account for significant numbers of support service workers (8 percent and 7 percent, respectively).3/

3. The CBO estimates exclude workers employed by Legislative Branch agencies, the U.S. Postal Service, the Government of the District of Columbia, and agencies engaged in energy production, such as the Tennessee Valley Authority.

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TABLE 2. COMPARISON OF DEFENSE AND NONDEFENSE COMMERCIAL-TYPE ACTIVITIES IN 1981, BY MODE OF PERFORMANCE
(In billions of 1981 dollars)

	Inhouse	Contract	Total	As Percent of Total
Defense	16.4	10.3	26.7	(82)
Nondefense	3.0	2.8	5.8	(18)
Total	19.4	13.1	32.5	--
Percent of Total Activity	(60)	(40)	(100)	(100)

SOURCE: Estimated by the Congressional Budget Office from data supplied by the Office of Personnel Management and the Federal Procurement Data Center.

NOTE: Amounts represent estimated values for services provided in 1981 by federal employees and by firms under federal contract.

A-76 Exemptions. According to CBO estimates, about 59 percent of the inhouse commercial-type work done is exempt from consideration for contracting out (see Table 3). Activities now exempted by administrative rules include those for which contractor performance would constitute a violation of law, treaty, or international agreement; those that are "inherently governmental" in nature;4/ those for which no private source is available; and those necessary to maintain military readiness. Almost all the estimated exemptions fall under limitations that apply specifically to activities in the DoD and VA.

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4. Circular A-76 defines an inherently governmental function as covering monetary transactions and entitlement benefits; inhouse core capabilities such as research and development; and the discretionary application of governmental authority as in program management and control, investigation and prosecution, conduct of foreign relations, and regulatory activities.

TABLE 3. THE INHOUSE SUPPORT SERVICE WORK FORCE OF THE FEDERAL GOVERNMENT (In thousands of workers)

	Total Inhouse Work Force	Exempt from Contracting Out	Not Exempt from Contracting Out	Percent of Total
Department of Defense	407	260a/	147	64
Veterans Administration	25	23	2	92
Other	63	10	53	16
Total	495	293	202	59

SOURCE: Estimated by the Congressional Budget Office from the data supplied by the Department of Defense and the Office of Management and Budget.

a. Includes 225,000 jobs exempt for national defense reasons.

In DoD, OMB's Circular A-76 guidelines exempt certain activities from consideration for contracting out if inhouse performance is required to meet national defense needs. This exemption applies largely to activities that provide integral support to military functions carried out by armed services personnel and to activities involving supply, maintenance, and repair of combat equipment. The CBO's calculations place about 225,000 positions under this exemption, though only a fraction of this estimate has been authenticated by DoD review of individual activities. In the VA, statutory limitations exempt some 23,000 positions in the agency's Department of Medicine and Surgery.5/ The excluded VA positions support hospital and other health-care facilities, concentrating in functions such as custodial services, food preparation, and building maintenance. The Congress enacted the limitations on contracting out by VA because of concern about maintaining the quality of health-care services.

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5. Public Law 97-66, approved October 17, 1981, prohibits preparation of contracting-out studies in the VA Department of Medicine and Surgery unless funds are specifically appropriated for that purpose. Funds were not appropriated for 1982, and none are anticipated for 1983.

On the basis of reports filed by individual agencies, OMB estimates that, after exemptions, some 202,000 federal jobs are subject to review for conversion to private-sector performance. If the number of exemptions were reduced, this work force and the associated impacts from contracting out would rise (see Option III in Chapter IV).

PAST EXPERIENCE

The Defense Department has extensive experience with contracting out, having reviewed some 450 civilian commercial and industrial-type activities during the period 1979 through 1981. The activities DoD examined were located at defense facilities throughout the United States and covered a wide range of support services performed by some 12,400 federal civilian workers. The defense program offers some insight into past contracting out by the federal government.

The DoD data indicate estimated savings of $54 million from contracting out--an overall 12 percent cut in costs for all activities reviewed according to criteria in effect at the time. Data compiled by DoD show that 60 percent of the work reviewed was shifted to service contracts, and for this group, average costs dropped 19 percent.6/ In 1981, the year in which the most activities were reviewed, conversions averaged some 82 percent of total activities subjected to cost review--reaching as high as 98 percent percent for supply services. The civilian activities contracted out by DoD yielded a wide distribution of total savings. About one-fifth of the conversions showed total savings of 10 percent or less, about two-fifths showed savings between 11 and 25 percent, and another two-fifths showed savings above 30 percent. As illustrated in Figure 1, however, this distribution somewhat masks the variation of savings among different types of activities.

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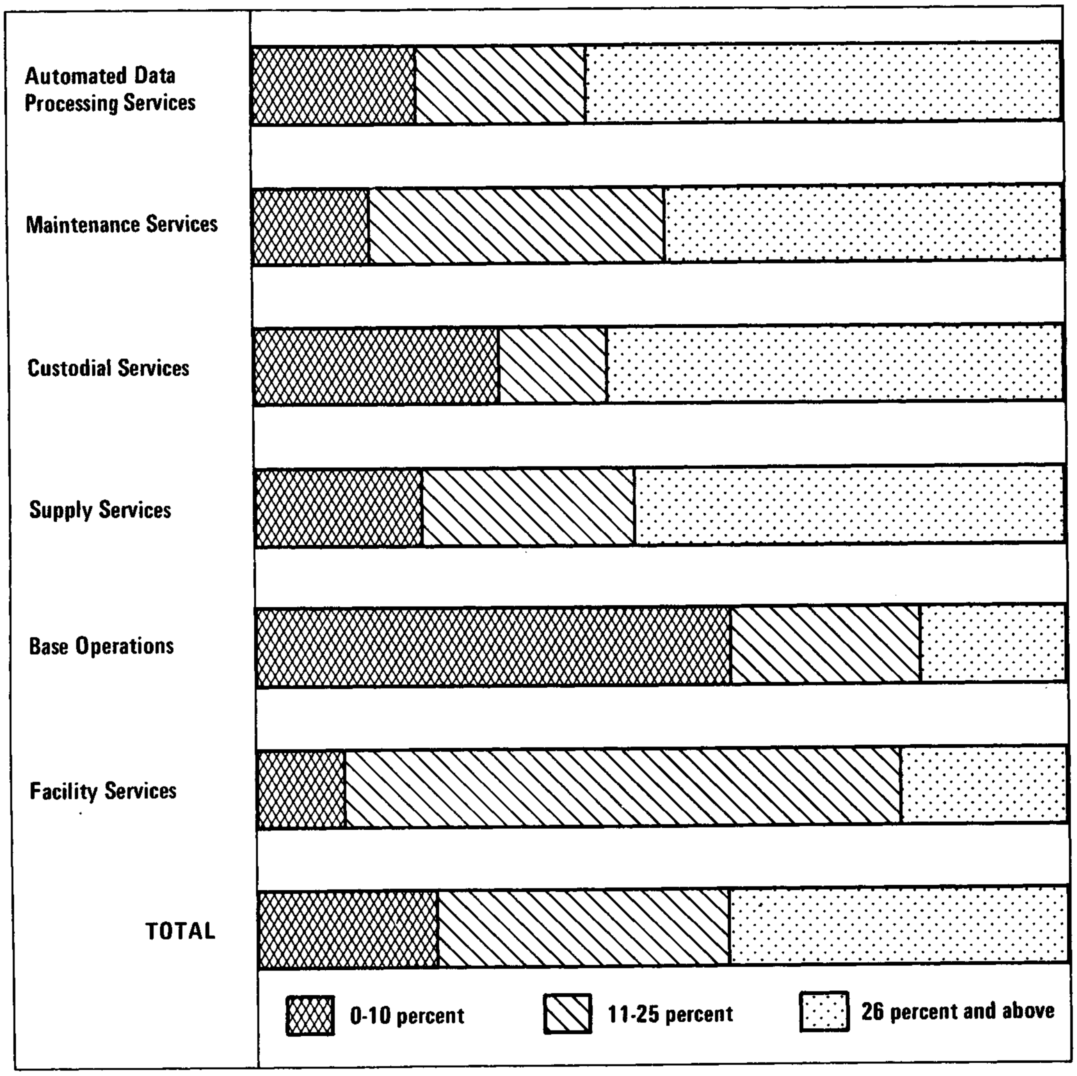
6. Within the past two years, several reports have incorporated the DoD data on an unadjusted basis that reflects 60 percent of the work shifting to contracts and average savings of 20 percent for such conversions. These factors would markedly change under current A-76 guidelines, which, by eliminating certain capital costs that do not usually change under contracting out, reduce the base against which savings are measured. The CBO estimates exclude activities performed mainly by military personnel and adjust costs for each of the three years to reflect 1983 prices. (In addition, contracting at the Hawthorne, California, munitions plant was excluded because of questions raised by the General Accounting Office.)

Figure 1.

Distribution of Estimated Defense Department Savings from Contracting Out, by Type of Service, as Percents of Inhouse Costs: 1979-1981



SOURCE: Derived by the Congressional Budget Office from DoD summary data compiled January 29, 1982.

NOTES: Costs are adjusted for each year to reflect 1983 prices. Estimates exclude activities performed by military personnel.

Reviews of contracting out at DoD indicate, however, that the department's experience with private firms has not always been trouble-free. In particular, conversion to contract has been found to degrade performance in a number of ways. A General Accounting Office (GAO) study, for example, found complaints of unsatisfactory contractor performance in five of 18 contracts reviewed.7/ The problems reported by DoD officials included safety violations, high error rates, and unacceptable backlogs. According to the GAO review, such performance shortfalls by the contractor were attributable to, among other things, high employee turnover, poor management, lack of training, and understaffing. The department's own review of contracting out in 1976 found that shifting services to private firms often delayed and disrupted service delivery.8/Finally, military base commanders have repeatedly expressed reservations about the loss of program control that occur when support services shift to private firms.

Other criticisms of contracting out seem not to be substantiated by experience reported at DoD. Although contracting out has helped to lower DoD civilian employment levels, the GAO review concludes that personnel ceilings have not influenced the outcome of A-76 decisions.9/ In addition, a separate GAO review of 12 contracts does not support claims that contractors bid low and then later raise their prices. According to GAO, when price increases did occur, most reflected either changes in the government's requirements or allowable wage increases. Moreover, such price hikes still did not cause costs to exceed estimated savings.

Problems experienced by DoD are an important element in the debate on contracting out, though information about such problems is too limited to permit any firm conclusions about their implications to be drawn. Nevertheless, the Congress will undoubtedly want to consider all such factors in deciding upon any change in the current system. (See the discussion of other considerations at the end of Chapter IV.)

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7. See General Accounting Office, Review of DoD Contracts Awarded Under OMB Circular A-76 (August 1981), pp. 2 and 3.

8. See Department of Defense, An Overview of Contract Services in the Department of Defense (October 1976), pp. 15 and 32.

9. See General Accounting Office, Factors Influencing DoD Decisions to Convert Activities from Inhouse to Contractor Performance (April 26, 1982), pp. 9-10.

CHAPTER II. THE CURRENT SYSTEM--COMPARING COSTS

Cost comparisons stipulated by OMB's Circular A-76 and related guidelines largely determine whether commercial-type activities are performed for the federal government inhouse or shifted to private firms under contract. In the past, private contractors have often been able to provide services to the government at lower cost because they hired fewer employees and offered them less compensation (pay and fringe benefits). Some of the contractors' cost advantage, however, is usually offset by higher costs for nonpersonnel items. In addition, the federal government incurs certain costs on top of contractors' prices--some of which are not fully recognized in current cost-comparison guidelines.

The first part of this chapter describes how cost-comparison guidelines work and the influence of personnel compensation costs. The second part considers differences between federal and private-sector retirement costs; the section following covers the recognition of costs for federal layoffs and other expenses that arise when work is transferred to private firms. Finally, the chapter illustrates the sensitivity of A-76 results to certain federal cost assumptions.

HOW DECISIONS ARE MADE

In private industry and in the public sector at the state and local levels of government, contracting out to curb costs is a common practice. Similarly, recent Administrations have issued regulations to federal agencies that encourage the use of contracting for federal activities of a commercial nature. The policy, first formally issued in 1955, reflects a belief that long-term economies can be achieved if certain services are performed by private-sector rather than by federal employees. Revisions in contracting-out regulations now pending would mainly simplify procedures and refine factors for preparing cost comparisons.1/ As

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1. See Office of Management and Budget, "Summary of Major Proposed Revisions to OMB Circular No. A-76 and the Cost Comparison Handbook" (includes revised draft circular of March 1982); and Stephanie Smith, "Side-By-Side Comparison of OMB Circular A-76 and Unpublished Draft Version," analysis prepared by the Congressional Research Service for the House Committee on Education and Labor, Subcommittee on Human Resources (June 23, 1982).

described at the end of this chapter, the outcome of cost comparisons can vary greatly, depending on the values assigned to the costs included.

To determine the more economical mode of performance, according to Administration regulations, bids from potential contractors must be compared against the estimated inhouse costs of the same service. The estimates of inhouse costs are prepared by operating units in individual agencies according to cost-comparison guidelines that accompany Circular A-76.2/ In comparing costs, the analysis considers the total cost of compensating the federal employees who would be involved in providing the service--including the costs of retirement (computed on an accrual basis) and paid time off, which together the regulations stipulate at 44 percent of payroll. Contractor costs, under A-76 guidelines, largely reflect the price of actual bids received from private firms. These bids are influenced by Department of Labor (DOL) regulations that set wages and fringe benefits for workers under service contracts with the federal government on the basis of prevailing local compensation practices.3/

To factor in certain costs that arise when the government transfers work to service contracts, the cost-comparison guidelines require several upward adjustments to the contractor price. These include expenses for contract administration, the cost of severance pay for laid-off federal workers (a new item now under consideration), and certain intangible costs associated with transition, such as temporary disruptions and losses of efficiency. The guidelines also require that contractor costs be reduced to reflect offsetting federal income tax revenues paid by private firms.4/

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2. Detailed guidelines, contained in the Cost Comparison Handbook, March 1979, will be revised by OMB in conjunction with forthcoming revisions of Circular A-76.

3. Minimum wages for most service contracts entered into by the federal government are set by the Secretary of Labor under authority of the Service Contract Act of 1965, enacted October, 1965.

4. The GAO questions the factor used in cost comparisons for contract administration; but this relatively small item averages less than 3 percent of total costs for contracting out. See GAO, Factors Influencing DoD Decisions to Convert Activities From Inhouse to Contractor Performance, (April 26, 1981), pp. 22-23. The Uniformed Services Pay Act of 1982 now pending in the Senate would add an additional cost to the contractors' bid price to cover the government's cost of preparing comparisons.

The cost components covered by A-76 comparisons are illustrated by the following hypothetical example (see Table 4). In this example, total first-year economic savings of $200,000 would grow to $380,000 in budgetary out years, because the costs for federal severance pay and transition intangibles--totaling $180,000--are temporary. Costs for several key components--such as retirement, severance pay, and transition items--are uncertain and difficult to assign for purposes of A-76 comparisions.

TABLE 4. INHOUSE VERSUS CONTRACTING-OUT COSTS--
EXAMPLE FOR CUSTODIAL SERVICE
(Costs in thousands of dollars)

Inhouse Costs		Contracting-Out Costs		Savings
Payroll	1,190	Contractor Bid	1,165	
Retirement a/	243	Severance Pay for		
Other Benefits b/	67	Federal Workers c/	30	
Nonpersonnel		Transition Intangibles d/	150	
Items	80	Contract Administration	47	
		Income Taxes	-12	
Total	1,580	Total	1,380	200
Cost Distribution				
First year	1,580		1,380	200
Out year	1,580		1,200	380

SOURCE: Congressional Budget Office.

a. The comparison assigns a federal cost for Civil Service Retirement of 20.4 percent of pay.

b. The cost of other federal benefits, including paid time off, is valued at 5.6 percent of pay as specified in Circular A-76.

c. Pending A-76 revisions specify average severance pay costs of 2.0 percent of personnel costs.

d. Transition costs, as specified in OMB Circular A-76, are considered equivalent to 10 percent of inhouse federal compensation costs.

PERSONNEL COMPENSATION--A KEY COST COMPONENT

When comparing inhouse and contractor costs, personnel compensation generally represents the single largest item and the one most influential in generating savings from contracting out. A review done by the GAO of selected cost comparisons prepared in 1980 shows that federal personnel compensation averaged 87 percent of total inhouse costs--ranging from a low of 70 percent to a high of 98 percent.5/ (These estimates have been adjusted by CBO to conform to current A-76 guidelines.) Supplemental data for five of the comparisons reveal that lower personnel costs invariably accounted for most of the reported savings under contracting out. In these cases, lower personnel costs more than offset higher nonpersonnel costs in the private sector.

In the cost comparisons reviewed by GAO, contractors were found to have hired fewer workers--averaging about 75 percent of prior inhouse employment--and to have paid lower wages and benefits. In most cases, nonpersonnel costs for contracted-out work exceed government nonpersonnel costs. Thus, contracting out offers cost advantages to the government only if personnel expenses are significantly lower in the private sector. Since contractors often use fewer workers to do a given job, the key remaining variable is cost per worker.6/

Lower Unit Labor Costs. The GAO data suggest that unit labor costs of firms contracting with the government were well below those the federal government incurs. The lower unit costs reflect cost differences in wages, and retirement and other fringe benefits. Although GAO does not

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5. See, Factors Influencing DoD Decisions, pp. 10-16.

6. For estimating purposes, changes in work force size may be viewed as offsets to increases in nonpersonnel costs that are generally incurred by contractors. Worksheets on comparisons of inhouse and contractor employment and compensation were collected by GAO for its report, Factors Influencing DoD Decisions, pp. 10-16. In three of four DoD cases reviewed, CBO found that the reductions from a smaller work force exceeded increases for nonpersonnel costs by a range of 8.1 percent of inhouse personnel costs to 18.4 percent. For the four cases as a group, net reductions (savings from a smaller work force offset by nonpersonnel increases) averaged 5.4 percent of inhouse personnel costs.

isolate the difference for each of these components, several examples of lower contract wages are provided--ranging from 10 to 50 percent below federal rates. Analysis by CBO supports the GAO findings and reveals that differences in costs for pay, time off, and retirement tend to be the major underlying factors in the lower unit labor costs found in the private-sector work force engaged in similar commercial-type services. (Other benefits, such as health and life insurance, appear to have relatively little impact.)

To determine the influence of the different components of compensation on decisions to contract out, CBO analyzed various federal and private-sector labor costs and estimated the portion of federal employees that might encounter significant competition from contract bids reflecting lower unit labor costs.7/ Consistent with current A-76 guidelines, the prospect of significant labor-rate competition is assumed to arise when average private-sector costs per hour worked are more than 10 percent below rates paid by the federal government for similar jobs in the same wage area. When considering all forms of compensation, the analysis shows that about four-fifths of the federal workers in commercial work are vulnerable to competition from private-sector workers. This vulnerability derived equally from differences in wages, time off with pay, and retirement benefits.

Work Force Characteristics. Many factors contribute to lower contractor unit-labor costs. For example, soft local job markets may give contractors the opportunity to recruit a work force as well trained and experienced as the federal government's, but at less cost. More likely, contractors may recruit a less expensive work force that differs from the government's--one that may be less stable and have lower levels of skill or senority.8/ Current Population Survey data for 1981 suggest that, overall,

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7. As described in Chapter III, CBO compared federal and private-sector costs for similar occupations in the same geographic area. The private-sector wage rates incorporated in the comparisons reflect rates determined by the Department of Labor for service contract employees as do unit costs for paid time-off and retirement benefits. The DOL determinations reflect prevailing wage and benefit practices for private-sector service workers.

8. Although the annual pay adjustments for federal blue-collar workers are intended to maintain comparability with the private sector, past pay calculations required by law have resulted in a premium that may reflect the above-average tenure and greater experience of federal

the private-sector labor force from which service contractors may recruit has--relative to the federal work force--a significantly greater proportion of younger and less educated blue-collar workers. Conversely, the federal blue-collar work force reflects a greater portion of seasoned employees (those aged 35 and over). In addition to lowering contractor costs, differences in work-force age and education may degrade service quality.

RECOGNITION OF RETIREMENT COSTS

The Civil Service Retirement (CSR) system is the major source of pension coverage for federal workers.9/ In the private sector, retirement coverage under Social Security is often not supplemented by an employer-sponsored plan. (Nationwide, about half of the private-sector work force is covered by employer-sponsored pension plans, but such coverage is particularly rare in certain geographic areas and in commercial-type occupations.) Costs associated with Social Security therefore serve as a measure of the post-retirement personnel costs for contractors' service workers. For contracting-out determinations, any assessment of the cost differences ought to recognize the differences between federal costs associated with CSR and those of Social Security.

Civil Service Retirement. The CSR plan is designed to substitute for the two-part private-sector system comprising Social Security and employer-provided pension benefits. Participation in CSR is mandatory for federal civilian workers, who are not covered under Social Security, and requires contributions from both employing agencies and employees. CSR benefits offer highly attractive income security for federal retirees.

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workers. See Congressional Budget Office, Alternative Approaches to Adjusting Compensation for Federal Blue-Collar Employees (1980), pp. 33-36. In addition, some research has found that contract services cost less, because firms hire employees with less seniority and experience greater turnover. See James S. Kakalik and Sorrel Wildhorn, The Private Police Industry: Its Nature and Extent, prepared by the Rand Corporation for the U.S. Department of Justice (December 1971), vol. II, pp. 96-100; Sidney Sonenblum, Ways to Provide Municipal Services: A Market Typology, Institute of Government and Public Affairs, University of California at Los Angeles, 1974), p. 54; and GAO, Review of DoD Contract Awards, pp. 2-3.

9. See Congressional Budget Office, Civil Service Retirement: Financing and Costs (May 1981).

In calendar year 1978, cost-comparison guidelines adopted a cost equivalent for CSR equivalent of 20.4 percent of payroll. This factor represents the estimated actuarial cost of CSR, minus the 7 percent of pay that employees contribute.10/ That is, it reflects the amount of current payroll that would have to be set aside to produce a sufficient accumulation at retirement to cover the federal cost of promised benefits. Elusive as the "true" cost of CSR may be, other more recent valuations of the system suggest a higher accrual cost. In 1979, the CSR Board of Actuaries estimated the federal cost at 29.5 percent of payroll after netting out 7 percent for employee contributions A more recent estimate prepared this year by Hay Associates, an independent actuarial firm specializing in personnel and compensation, places the federal cost of CSR at 24.23 percent of payroll (31.23 percent less the 7.0 percent employee contribution rate) This estimate reflects different long-term economic assumptions about annual rates of pay, interest, and changes in the cost of living.11/

Substituting either of the alternate rates--the CSR actuaries' 29.5 percent or Hay Associates' 24.23 percent--for the 20.4 percent cost currently specified would push up federal costs identified for inhouse services. Thus it would make contracting out appear somewhat more favorable from the standpoint of total comparative costs. Because an update of the CSR factor in the current guidelines seems in order, this paper incorporates the 24.23 percent Hay Associates estimate. This value, the more conservative alternative, is especially useful because it derives from economic assumptions consistent with those used for valuing Social

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10. Before calendar year 1978, the CSR cost factor changed many times because of changes in economic assumptions as well as cost methodology. The current 20.4 percent of payroll factor assumes a 5.5 percent annual increase in the wage schedule, a 6.5 percent annual rate of interest, and a 4 percent annual increase in inflation.

11. The factor of 29.5 percent of payroll was recently adjusted to 28.8 to reflect budget reconciliation action including the enactment of a once-a-year cost-of-living adjustment. The 24.23 factor was developed for the Congressional Research Service report, Restructuring the Civil Service Retirement System (January 1982). This factor is based on long-term economic assumptions that represent the midpoint between the most optimistic and pessimistic paths prepared for the Social Security Board of Trustees (5.5 percent annual salary schedule increases, 4 percent annual increase in the inflation and 6.1 percent annual rate of interest).

Security, an important cost under contracting out. Because statutory CSR provisions, retirement-plan experience, and economic conditions change from time to time, any cost factor adopted for A-76 comparisons will require periodic review and modification. The CSR cost factor, however, need not be changed because of modifications to federal employee benefits made by the recently enacted budget resolution for 1983.12/

Social Security--Private-Sector Retirement. According to DOL determinations, which reflect prevailing practices, workers in commercial-type services rarely, if ever, have employer-sponsored retirement benefits. Thus, Social Security usually provides the sole source of retirement coverage for service workers employed by firms under contract with the federal government. One aspect of workers' Social Security costs is taken into account in A-76 cost comparisons: contractors generally incorporate the costs of the employers' contributions to Social Security when they propose a bid price. Two other factors, however, result in federal costs that are not now taken into consideration: the tax-free status of Social Security Benefits (CSR benefits are taxed as income);13/ and the so-called "underfunding" of Social Security. The underfunding occurs because, as the system's financing mechanism is designed, current contributions do not fully cover the cost of future benefits.14/ Because the government incurs these two unrecognized costs when services are contracted out, cost-comparison guidelines should incorporate them. If so, costs identified with contracting out would increase, and thus the volume of work shifted to the private sector might decline.

Under current financing, the statutory employer and employee contributions to Social Security do not cover the full costs of future Social

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12. The 1983 budget resolution increases federal costs by requiring that agencies contribute for Social Security health-care benefits, but it also reduces federal costs by imposing a 50 percent cap on post-retirement cost-of-living adjustments for annuitants under age 62. The federal cost impacts for these two changes are relatively small, each representing about 1.3 of payroll, and they essentially offset one another.

13. Federal retirement benefits are subject to federal income taxes only after the amount paid out exceeds the accumulated employee contribution, usually about two years after retirement.

14. See for example, Congressional Budget Office, Paying for Social Security: Funding Options for the Near Term (February 1981), pp. 3-4.

Security benefits. To make retirement costs for private-sector employee compensation comparable to the actuarial value of CSR, one must estimate the full actuarial cost of Social Security, including the current statutory shortfall. The estimated Social Security shortfall, equivalent to some 2.7 percent of pay, represents the difference between the accrued cost of future benefits and employer/employee contributions.15/ With regard to the tax-free status of Social Security benefits--considered a tax expenditure--the federal cost of this provision may represent some 2 percent of pay as an accrued expense during active employment.16/

Taken together and expressed on an accrual basis, the two extra federal costs associated with Social Security represent an estimated 4.7 percent of total payroll during workers' active employment. If retirement comparisons were adjusted to reflect the full federal costs of Social Security, and the cost valuation of CSR were raised to Hay Associates' 24.23 percent of pay (mentioned above), then cost differences between federal and private-sector retirement would diminish slightly. The retirement-cost adjustments for CSR and Social Security would essentially offset each other: the inhouse costs for CSR rise by 3.8 percent of pay, from 20.4 to 24.23; and the contracting-out cost rises by 4.7 percent of pay for Social Security.

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15. The estimated Social Security shortfall of 2.66 percent of pay represents the difference between the full actuarial cost of 14.89 percent of pay and the present value of the stream of contributions from both employees and employers as a percent of the present value of the stream of payroll--12.23 percent. These cost factors were derived by the Office of the Actuary of the Social Security Administration, based on long-term economic assumptions of 5.5 percent annual increase in pay schedules, 4 percent annual increase in the Consumer Price Index, and 6.1 percent annual rate of interest.

16. See Office of Personnel Management (OPM), Total Compensation Comparability: Background, Methods, and Preliminary Results (July 1981), p. 15. Assigning a precise value to the Social Security tax expenditures is difficult. Some analysts would disregard the tax-free status of Social Security altogether, because they believe that revenues foregone (tax expenditures) are not relevant to decisions about the most efficient way to obtain support services.

RECOGNITION OF CONVERSION COSTS

When the government shifts services from inhouse to contractors, it incurs substantial transition costs for certain intangible factors as well as for payments associated with federal employee layoffs. Taken together, A-76 guidelines stipulate such costs at an amount equivalent to 12 percent of prior inhouse compensation. Both types of conversion costs have a significant impact on the outcome of cost comparisons.

Transition Intangibles

A shift of activities to the private sector can result in temporary decreases in efficiency and effectiveness, as well as such intangible costs as loss of production and personnel disruption. Circular A-76 recognizes these costs by requiring that an amount equivalent to 10 percent of inhouse personnel costs be added to an estimate for contracting out. Because quantification of the so-called transition intangibles is impossible, the 10 percent factor must be regarded as inexact. (The guidelines now pending retain the same allowance, and no basis exists for suggesting an alternate). The intangible factors force the contract option to surmount an arbitrary cost threshold. Because disruptions from transition to contracting out may vary significantly in different circumstances, the A-76 guidelines might allow some deviation from the 10 percent factor when justified by specific documentation.

By increasing the valuation cost of contracting out, the A-76 allowance for intangible costs effectively limits the number of conversions. According to CBO analysis of the potential number of federal workers affected by contracting out, shifts to service contracts would increase by some 14 percent were there no 10 percent upward adjustment. That cost-comparison guidelines allow for some recognition of the temporary disruption and other costs associated with transition seems appropriate, however. Accordingly, the CBO estimates incorporate the guideline allowance in estimating both the rate of conversion to contracting out and the amount of associated savings in the first year. (By contrast, Executive Branch agencies treat the 10 percent factor only as a threshold for decisionmaking.)

Federal Layoff Costs

Federal employees who are laid off may receive severance pay for up to one year, depending on length of service. In addition, federal workers whose jobs are abolished are offered protection from statutory "save-pay" provisions, which allow them to displace lower-paid workers with less seniority while receiving their previoius earnings.

A recent study by the Office of Personnel Management (OPM) reports that about half the potential salary savings from an abolished position are offset by the cost of current save-pay provisions. The estimate reflects a chain of downgradings that require payment of higher salaries in each job slot affected by the process of downgrading.17/

In the past, shifting services to private contracts did not generally result in large numbers of layoffs, and associated entitlement expenses were not factored into cost comparisons. In view of recent employment reductions, current cost-comparison guidelines now under review would require agencies to increase the cost of contracting out by a factor equivalent to 2 percent of inhouse personnel costs. The proposed factor, however, may greatly understate the layoff costs, especially for nondefense agencies.

The 2-percent-of-pay factor set forth in the guidelines now pending is based on the amount of severance pay disbursed by DoD for inhouse activities that were contracted out in 1980 and 1981. During this period, only a fraction of converted jobs actually resulted in federal layoffs. The CBO analysis of recent data on separations suggests little change in the DoD layoff rate (jobs abolished resulting in layoffs) but a much higher rate in nondefense agencies, currently averaging nearly 25 percent.18/ The large difference between defense and nondefense layoff rates reflects sharply contrasting employment situations: an expanding DoD civilian work force facilitates reassignment of workers whose jobs are abolished, while workforce contractions in most nondefense agencies makes employee reassignments much more difficult. Even more important, the 2 percent severance pay factor derived from the DoD experience does not reflect the costs of save-pay that accompany reductions in force (RIFs).

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17. See letter to Frank Siedl, Chief, Justice-General Management Branch, OMB, from William M. Hunt, Special Assistant to the Director, OPM, February 19, 1982.

18. The government-wide personnel information system does not report the percent of federal jobs abolished that result in layoffs. According to CBO calculations from data on separations of wage-board employees during the second half of calendar year 1981, about 2.3 percent of DoD jobs abolished (defined as separations for reasons other than resignations, retirements, and deaths) represented force layoffs. In nondefense agencies, however, layoff rates averaged 23.4.

Any standardized estimate of the cost of federal RIFs for use in cost comparisons is subject to considerable uncertainty. On the basis of available data, however, the CBO analysis suggests that consideration of save-pay could increase the proposed 2 percent factor to about 4 percent of pay for defense agencies and, together with consideration of higher layoff rates, to about 15 percent for nondefense agencies as a group.19/ About four-fifths of the nondefense estimate results from payroll costs arising from the save-pay provisions of current law. (Obviously, the layoff costs that arise for converting a particular activity could fall well above or below these estimated averages.)

The CBO estimates reflect current employment conditions in the federal government that have largely resulted from various budgetary actions. As economic conditions change, the layoff factors could require further modification. Because the magnitude of severance and save-pay costs is highly uncertain and difficult to project, flexible factors reflecting different agency experience, rather than an across-the-board approach, may be more appropriate (although more difficult) to administer. Variable layoff cost factors could be incorporated into a modified 10 percent intangible factor.

Regardless of how the layoff costs currently estimated by CBO might be incorporated in cost comparisons, the resulting increase in costs for the contract alternative would reduce both the number of conversions and the savings from work that shifts. Because severance payments may not exceed one year's salary, the resulting savings reductions would not be so great in budgetary out years.

SENSITIVITY TO COST FACTORS

As suggested above, a comparison of inhouse and contracting-out costs requires a number of judgments in assigning costs for several key components, namely, CSR, Social Security, federal severance and save-pay provisions, and the intangibles associated with transition. To illustrate how sensitive A-76 comparison results are to the cost treatment of these

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19. The layoff costs estimated for nondefense agencies incorporate OPM data on the reemployment of laid-off workers and thus reduce previous CBO estimates. Amounts for save-pay were derived from data contained in a February 1982 OPM letter (see footnote 17 above), which put the average cost of save-pay provisions at $12,500 per person.

factors, CBO has constructed two hypothetical comparisons that use different assumptions about certain federal costs (see below). Both examples assume a uniform $126,000 bid by a prospective contractor.

Example A uses the 1979 CSR Board of Actuaries' 29.5 percent value for federal retirement benefits, but it disregards any costs associated with transition and federal layoffs. This comparison shows that a shift to contracting out could reduce first-year federal costs by nearly 14 percent.

Example B assumes the Hay Associates' 24.23 percent of pay estimate for federal retirement. It also adds several factors to the cost of contracting out to recognize Social Security shortfalls and tax expenditures, layoff costs as estimated by CBO for nondefense agencies, and the

	Example A	Example B
Inhouse Performance	$150,000	$ 144,700a/
Contracting Out	$129,700	$166,800
Cost Difference	$-20,300	$+22,100
(Percent Change)	(-13.5%)	(+15.3%)

Distribution of Contracting-Out Costs

	Example A	Example B
Bid Price	$126,000	$126,000
Contract Administration and Corporate Income Tax Offsets	$ 3,700	$ 3,700
Federal Costs for Social Security, Transition, and Layoffs	--	$ 37,100
Total	$129,700	$166,800

a. The lower inhouse cost under Example B reflects the same federal work force and average salaries as in Example A but a lower actuarial value for the federal cost of CSR.

transition intangibles currently stipulated by OMB Circular A-76. In this example, these changes lower the inhouse cost by $5,300 and push up the the cost of contracting out by $37,100. The Example B results show that the contract option would increase federal costs by 15 percent and thus, that the activity would not be converted.

The sensitivity of A-76 results to the assignment of such costs is especially important in view of the large portion of cases that demonstrate relatively narrow cost differences between inhouse and contract performance. As indicated in Chapter I, approximately three-fifths of the DoD conversions in 1979 through 1981 showed savings of 25 percent or less on the basis of reporting methods used at the time.