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## GOVERNMENT CONTRACTORS: Criteria Needed For Allowable Employee Health Care Costs

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Subcommittee on Legislation and National Security
Committee on Government Operations
House of Representatives





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## SUMMARY

The employee health care costs incurred by government contactors under negotiated contracts are reimbursable as long as they are "reasonable." The government, however, has not established a quantitative definition of reasonableness.

In 1985, the government reimbursed its 10 largest contractors about $1.2 billion for their employee health care expenses, an average of $2,344 per employee. These costs exceeded the average per-employee costs incurred by

-- the contractors, considering both government and private sales, by $199;

-- the typical medium to large manufacturing firm by $448; and

-- the government in providing health insurance to its employees by $824 to $1,177.

The government lacks effective internal controls to ensure that only reasonable health care costs are reimbursed. Federal procurement regulations should be revised to specify (1) the criteria to be used in assessing the reasonableness of health care costs, (2) the criteria for assessing other elements of compensation, and (3) the factors contractors can introduce to justify challenged costs and the criteria that will be used to evaluate them.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss efforts to ensure that the employee health care costs paid by the government under negotiated contracts are reasonable. Specifically, I will (1) compare the health care costs of the government's 10 largest contractors to those of other manufacturing industries and the government work force, (2) discuss the primary reason for those cost differences, and (3) evaluate the adequacy of the internal controls over allowable compensation costs established in federal procurement regulations.

In fiscal year 1986, the Department of Defense (DOD) awarded about $82 billion in contracts without price competition. Overall, about 98 percent of the dollar value of DOD contracts is negotiated, meaning that health care and other compensation costs can be passed on to the government as long as they are "reasonable." Firms that compete extensively for private sector business must contain compensation costs in order to preserve their competitive position. But 6 of the 10 largest government contractors do not compete extensively for private sector sales. Because market forces are not enough to contain such contractors' compensation costs, additional steps should be taken to ensure that only reasonable costs are reimbursed under government contracts.

## CONTRACTOR HEALTH CARE COSTS ARE HIGH

In 1985, the government reimbursed its 10 largest contractors about $1.2 billion for their employee health care expenses, or about $2,344 per employee. Figure 1 shows that the 10 contractors' costs ranged from $1,613 to $2,830 per employee. The two contractors with the lowest per-employee costs competed most extensively for private sector sales. By comparison, in 1985 the average per-employee costs for manufacturing industries was $1,896, and the government's maximum cost was $1,167 for nonpostal employees and $1,520 for postal workers.

**Figure 1: Comparison Health Care Costs per Employee for 10 Government Contractors to Various Cost Criteria (1985)**

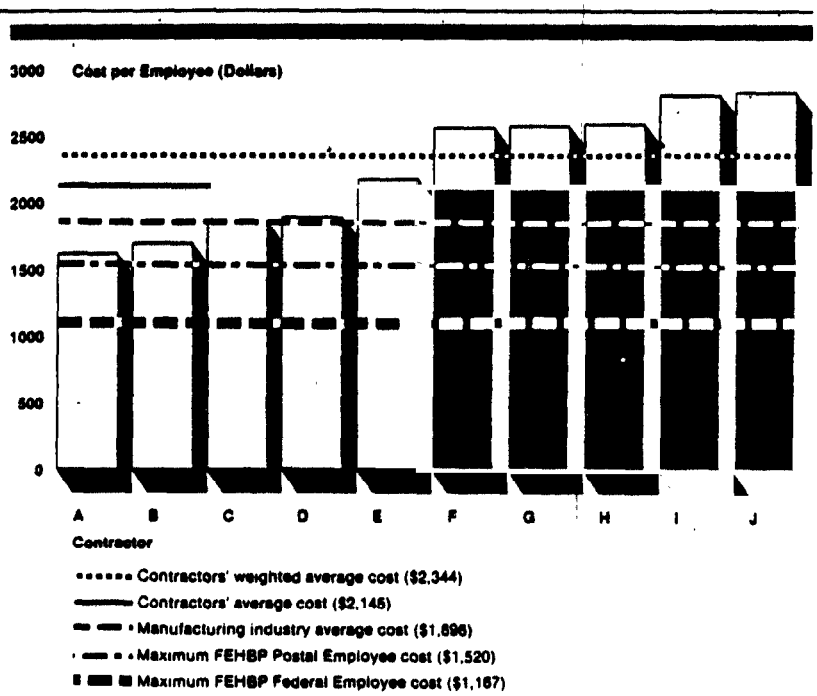
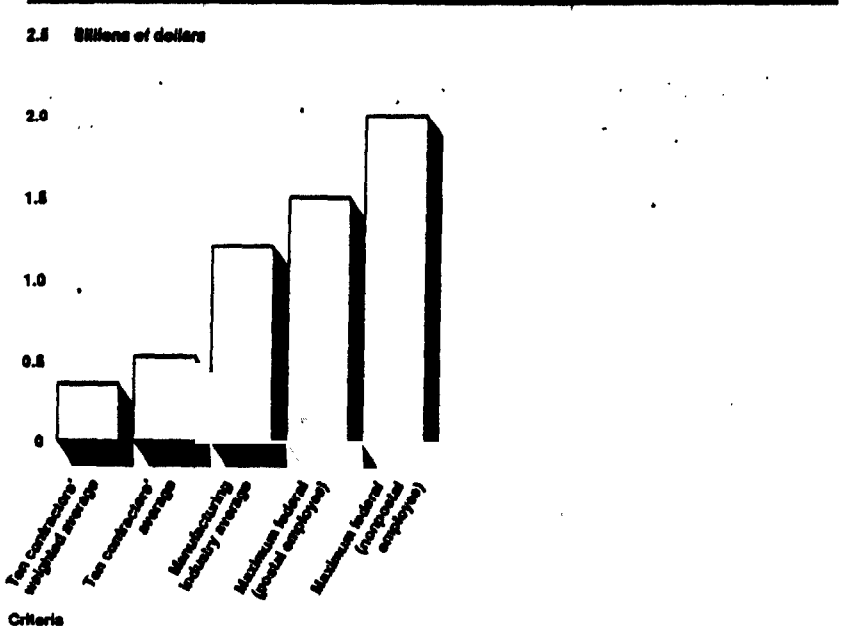


Figure 2 shows that over the 5-year period 1981-85, the government's share of costs for health benefits provided to the 10 contractors' employees would have been $1.2 billion less if the contractors' costs were that of a typical manufacturing firm and up to $2 billion less if they were that of the Federal Employees Health Benefits Program. Because of the concentration of government business among contractors with higher health care expenditures, the government's actual costs exceeded the average costs incurred by the 10 contractors by about $524 million.

**Figure 2: Estimated Costs That Would be Challenged if Health Insurance Reimbursement to 10 Contractors Had Been Limited to Selected Criteria (1981-85)**



LIMITED EMPLOYEE COST SHARING

Although many factors can affect a company's health care costs, such as geographic location or age of the work force, the cost differences I just discussed can largely be explained by the lower cost sharing required of contractor employees compared to other private sector employers and the government.

All federal workers have shared in the cost of their health insurance since the inception of the Federal Employees Health Benefits Program in 1959. Premium cost sharing has increasingly become the practice in the private sector, with 39 percent of private sector employees contributing to their own premiums and 58 percent contributing to the cost of their dependent coverage in 1985. By contrast, only 7 percent of contractor employees contributed to the cost of their coverage and 36 percent to the cost of their dependent coverage. And those employees who did contribute paid less than federal employees and the average private sector employee.

At least 62 percent of the differences between the cost of government employees' health insurance and the cost of the contractors' coverage was due to differences in employee premium cost sharing. For three of the contractors, the higher costs could be explained entirely by the lack of employee premium cost sharing. In other words, if the contractors required their employees to share the costs of their premium to the same extent as federal employees, the contractors' costs would actually be lower than the federal government's costs for its own employees.

The 10 contractors also required less cost sharing by their employees in terms of deductibles and coinsurance than the government required of its workers and most private sector firms required of their employees. Although it is difficult to quantify the effect of limited cost sharing on insurance costs, cost sharing through deductibles and coinsurance has been shown to be an effective way to reduce the utilization of medical services and thus health care costs.

I would like to spend a few minutes now discussing the difficulties facing government contracting officers and auditors in trying to determine the reasonableness of contractors' health and other compensation costs.

Before April 1986, federal procurement regulations required that a contractor's compensation be considered reasonable if total compensation conformed generally to compensation paid by other firms of the same size, in the same industry, or in the same geographic area. The government, however, had little success in challenging the reasonableness of compensation costs under this approach despite concerns expressed by the Air Force about the level of defense contractor compensation.

In April 1986, the regulations were revised to allow the government to challenge the reasonableness of any single element of compensation, such as health benefits, and to assess total compensation from a building block approach. The regulation puts the burden on the contractor to prove the reasonableness of the challenged costs either by justifying the challenged costs or by

introducing "lower" costs for other elements of compensation to offset the unreasonableness of the challenged element.

The objective of the revised regulation is clear--to make it easier for the government to prevent payments for excessive compensation. However, the tools needed to achieve this objective are not contained in the regulation. We believe that the government's contracting officers and auditors need specific quantitative criteria for assessing the reasonableness of each element of compensation developed from a uniform data base of employers. In addition, the government should specify the factors contractors can introduce to justify challenged costs and the criteria that will be used to evaluate such factors.

Right now, contractors are not told in advance what criteria will be used to evaluate the reasonableness of their compensation costs. Contracting officers and auditors can assert criteria from a variety of available data sources, including the U.S. Chamber of Commerce's annual Employee Benefits Survey and contractor-developed surveys. As a result, similar contractors could be subjected to different criteria. Because the government cannot demonstrate that contractors have been treated fairly and consistently, it will, in our opinion, be difficult to sustain a challenge to the reasonableness of a contractor's compensation costs.

More importantly, the current procurement regulations do not require that criteria developed from a uniform data base be used to evaluate all elements of a contractor's compensation package.

Without such a requirement, the government cannot determine the reasonableness of total compensation or determine the "value" of the offsetting elements introduced by the contractors. Because it has not specified the criteria to be used in evaluating offsets, it will be difficult for the government to challenge offsets claimed by the contractor.

Finally, the regulation does not place any limit on the factors a contractor can introduce to justify the reasonableness of a challenged element, allowing the contractor to introduce any number of factors other than the compensation practices of other firms of the same size, in the same industry, and in the same geographic area. Nor does the regulation specify the basis for evaluating those factors. Again, this will make it difficult for the government to dispute the factors introduced by the contractor.

Although the intent of the April 1986 revision to the procurement regulations was to enable the government to negotiate from a position of strength, the regulation, without quantitative criteria on an element-by-element basis, leaves the government in a weak negotiating position.

In summary, we are recommending that the contracting agencies and the Office of Management and Budget develop and publish in the Federal Acquistion Regulations quantitative criteria for determining the reasonableness of the government's reimbursement of contractor health insurance and other compensation costs. In developing the criteria, they should work

with the industry to make sure that the criteria are fair and equitable to both sides.

Mr. Chairman, this completes my prepared statement. We will be happy to respond to any questions that you or other members of the Subcommittee may have.