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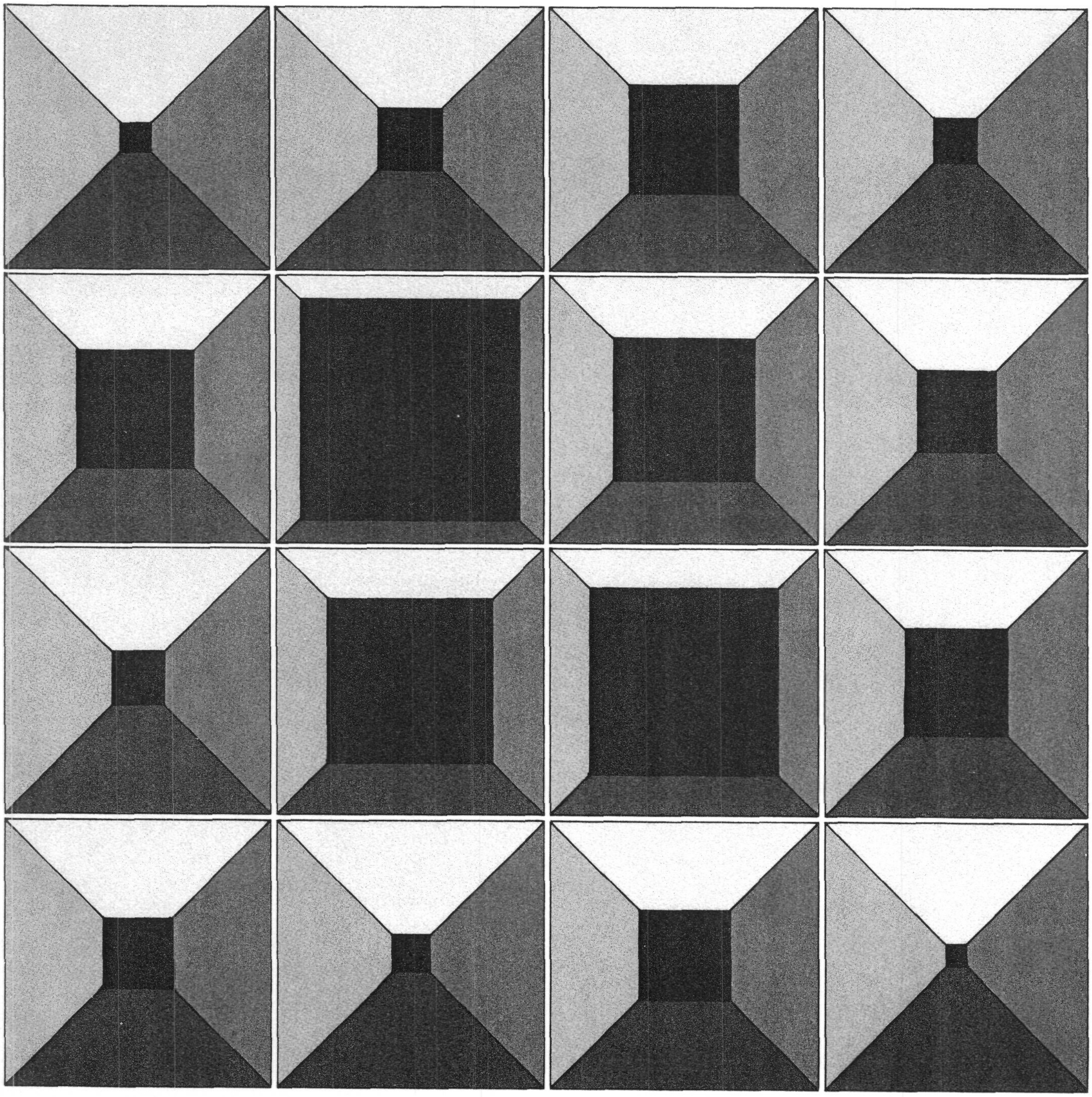
Contracting Out for Federal Support Services: Potential Savings and Budgetary Impacts

Congress of the United States
Congressional Budget Office



CONTRACTING OUT FOR FEDERAL SUPPORT SERVICES:

POTENTIAL SAVINGS AND BUDGETARY IMPACTS

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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.

Alice M. Rivlin
Director

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 First Year	Total Annual Savings Out Years	Near-Term 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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CONTRACTING OUT FOR FEDERAL SUPPORT SERVICES:

POTENTIAL SAVINGS AND BUDGETARY IMPACTS

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 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:

- o The accounting of federal costs for retirement benefits and government layoffs;
- o The significance of short-term impacts on budget outlays; and
- o 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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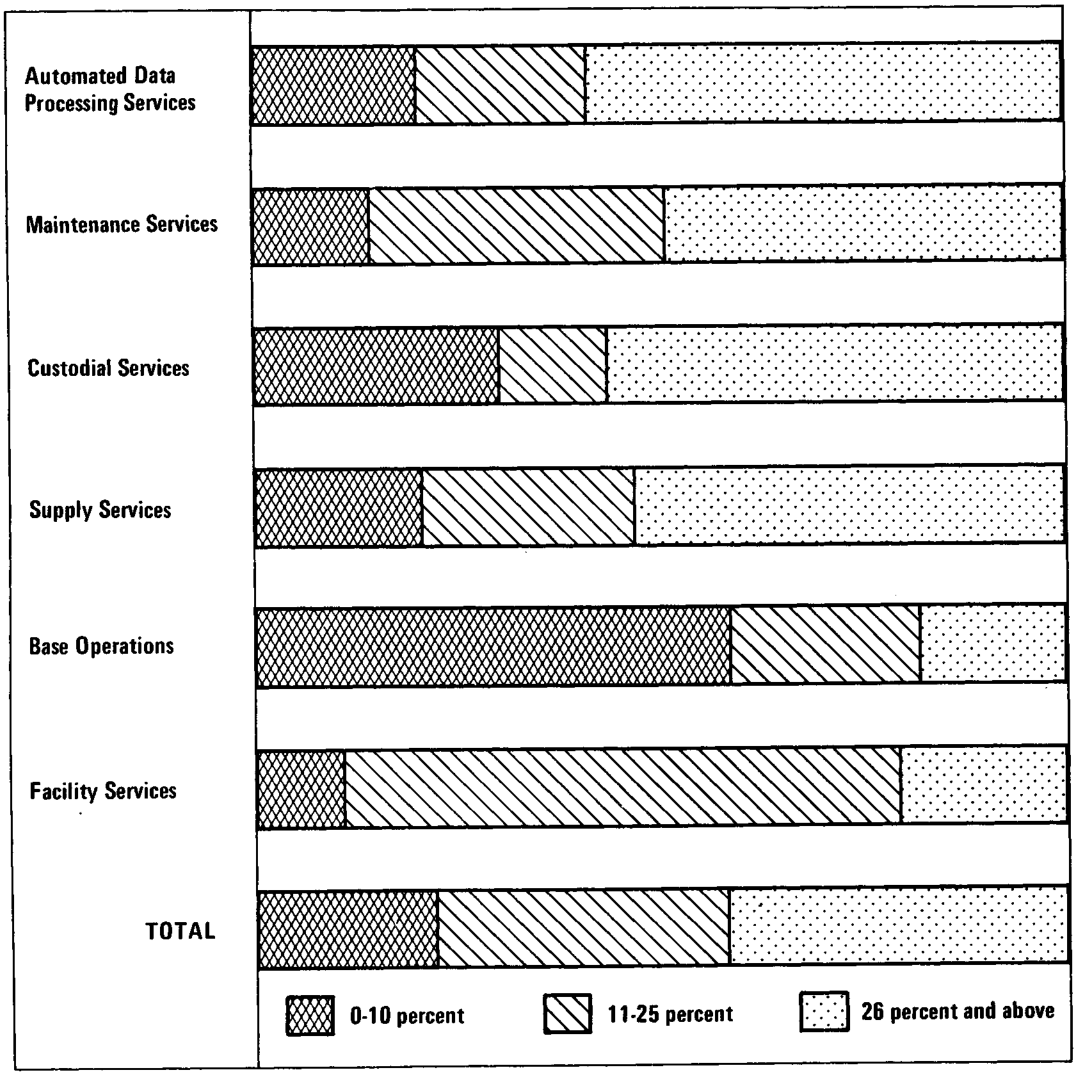
6. Within the past two years, several reports have incorporated the DoD data on an unadjusted basis that reflects 60 percent of the work shifting to contracts and average savings of 20 percent for such conversions. These factors would markedly change under current A-76 guidelines, which, by eliminating 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 Federal Workers c/	30	
Other Benefits b/	67	Transition Intangibles d/	150	
Nonpersonnel 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		
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.

CHAPTER III. POTENTIAL SAVINGS AND BUDGETARY IMPACTS UNDER THE CURRENT PROGRAM

The Administration's current program to accelerate federal contracting out offers significant potential for total government-wide savings. The savings represent net reductions in total federal costs that include both current disbursements and deferred disbursements for costs such as CSR. In some instances, in fact, more distant savings may be achieved at the expense of higher outlays in the near term. The level of estimated budgetary effects depends largely on two key assumptions--the number of federal jobs that are subject to contracting out and the outcome of cost comparisons.

The first part of this chapter gives CBO estimates of potential savings from further shifts to contracting under the current program. The second part considers the near-term effects on budgetary outlays.

ESTIMATES OF TOTAL POTENTIAL SAVINGS

Little detailed information exists on the costs that would be incurred by the multiplicity of firms bidding in different regions for various types of federal services. Without such information, estimates of the impact of increased use of contracts must be viewed as somewhat uncertain.

Assumptions in the CBO Analysis

The CBO savings estimates largely reflect differences between federal and private-sector labor costs for various occupations and geographic areas. Differences in other costs are assumed essentially to cancel one another out. (The CBO analysis assumes that reduced costs from a shrunken work force would offset higher contractor costs for nonpersonnel items.) Unit labor costs were compared for 15 selected occcupations and 18 geographic areas--covering some 60,000 workers in occupations that CBO categorized as essentially of a commercial nature. The results were extrapolated to determine government-wide impacts, using the OMB estimates of the federal civilian work force subject to contracting-out review under Circular A-76. The CBO approach, described in more detail in the Appendix, offers a way to approximate the potential shifts to contracting in the absence of detailed cost comparisons for the wide variety of activities that constitute the current inventory of inhouse work. (Government-wide estimates apply to no particular inhouse activities.)

The private-sector labor rates used in constructing the compensation comparisons assume that service contractors could maintain a work force without paying wages or benefits above rates mandated by DOL. Consistent with these requirements, the CBO estimates allow no cost for employer-sponsored pensions and for a minimal cost for time off and other fringe benefits. The private-sector costs reflect conditions that favor contracting out--a reasonable expectation under existing market conditions. Unemployment rates in many industries and wage areas suggest that prospective contractors might hire many workers without paying a premium in wages and benefits. Conversely, however, these assumptions imply that, in a more fully employed economy, the advantages of contracting out would be less than the following estimates suggest.

The CBO savings estimates (expressed in 1983 dollars) assume full implementation at the beginning of the first year; obviously, the Executive Branch would phase in new service contracts over several years. The CBO estimates further assume that contracting-out decisions would essentially follow current OMB cost-comparison guidelines, but that the resulting impacts would reflect the higher federal costs (identified in Chapter II) for retirement and government layoffs.1/ Without the CBO adjustments, the estimated first-year savings under current policy would be unduly inflated.

The CBO Estimates

According to CBO estimates, contracting out could shift some 165,000 jobs to the private sector, reducing total government costs in the first year by about 4 percent, or some $335 million. In out years, however, the annual savings would eventually grow to $870 million, because certain conversion costs for intangible transition factors and federal severance pay are transitory and do not occur year after year (see Table 5).

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1. The CBO estimates of savings incorporate a federal cost for CSR equivalent to 24.23 percent of payroll as calculated by Hay Associates (see Chapter II). This value is consistent with long-term economic assumptions used for the calculation of federal costs for Social Security. Adjustments for the extra costs of Social Security total 4.7 percent of pay, and adjustments for layoff costs total 4 percent of pay for defense agencies and 15 percent for nondefense agencies. By contrast, the decisions to convert assume that the cost comparisons incorporate the 2 percent layoff cost factor being considered by the Administration and 20.4 percent of pay for CSR. Estimated conversion rates and associated savings both incorporate the transition cost factor specified in A-76 at 10 percent of inhouse compensation.

TABLE 5. ESTIMATED IMPACTS OF CONTRACTING OUT

	Federal Inhouse Work Force (In thousands)	Total Economic Costs (In millions of dollars)
Base for Inhouse Activities Subject to Review	202	8,520 a/
First-Year Reductions from Contracting Out	165	335
(Percentage Decrease)	(81)	(4)
Annual Out-Year Reductions	165	870
Distribution of First-Year Impacts		
Defense	120	337
Nondefense	45	-2 b/

SOURCE: Congressional Budget Office.

a. The base estimates of total inhouse costs and near-term outlays include indirect costs for labor and nonpersonnel items.

b. Minus indicates an outlay increase.

The estimated effects reflect a shift of 81 percent of the inhouse work to private firms. This conversion rate is not inconsistent with that experienced by DoD in 1981. But the estimated first-year savings for activities converting, expressed as a percent of total inhouse costs, may represent only about one-fourth of the rate previously experienced by DoD. The lower-rate of projected savings results from the greater federal costs recognized by CBO and from the possibility that more lucrative conversions have already occurred. (The comparison of historical and projected savings rates should be viewed as a rough approximation because of changes in reporting methodology.)

Comparison of Estimates

The CBO first-year savings estimates of $335 million from contracting out under current policy falls well below an unpublished Executive Branch estimate of some $545 million.2/ The difference results largely from the greater costs recognized by CBO for compensation associated with federal employee layoffs. The CBO estimates reflect a current federal job market beset by continuing government layoffs.

Without the higher layoff costs, however, the first-year savings estimated by CBO would slightly exceed the Executive Branch estimate. This difference is largely attributable to certain divergent assumptions concerning the portion of work shifting to contract, the average savings for converted activities, and the cost per hour worked by the federal employees affected. For each of these factors, CBO estimates would have reflected values of 81 percent, 13 percent, $15.29 per hour; whereas OMB estimates reflect analogous values of 60 percent, 20 percent, and $13.16 per hour.

Unlike the CBO estimate, which is based on a framework that compares federal and private-sector unit labor costs for different occupations and geographic areas, the OMB estimate uses the savings and conversion rates experienced by DoD for the period 1979 through 1981 to determine future impacts for all agencies. Several drawbacks in OMB's methodology are evident. The particular cost base from which the DoD factors derived cannot be reasonably simulated for existing inhouse activities because of changes in agency reporting.3/ In addition, the DoD data inflate first-year savings estimates, because the intangible transition costs specified by the guidelines are not deducted from savings.

Impacts By Occupation, Geographic Area, and Agency

Government-wide savings from contracting out derive from the aggregation of numerous small effects, which vary significantly by region, occupation, and agency. According to CBO analysis, large shifts of federal jobs to private firms might occur in major wage areas in the far West, the

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2. Based on informal discussion with OMB staff.

3. The DoD savings factors applied to a cost base that included several large components that usually did not change much under contracting out--namely value of government-furnished property, cost of capital, and changes in utilization of government plant or equipment.

South, and the mid-East. Job shifts in these wage areas, accounting for about half of the possible conversions to service contracts, largely reflect the geographic dispersion of defense facilities.

Because of the large DoD work force engaged in performing support services, job shifts in defense agencies would outnumber those in nondefense agencies by nearly three to one (see Table 6). Within DoD, the potential for job shifts and related savings is greatest among the trade and craft occupations, which account for most of DoD's inhouse work force. In nondefense agencies, conversions and associated savings concentrate in lower-skilled occupations, such as laborer and janitor. Three agencies--the Veterans Administration, the General Services Administration, and the Department of Health and Human Services--account for more than one-third of the nondefense jobs that might convert to contract performance. (The estimates for the VA, however, do not cover the 23,000 commercial-type jobs that are precluded from contract conversion because of restrictions mandated by the Congress. See Chapter I.)

TABLE 6. DISTRIBUTION OF ESTIMATED FEDERAL EMPLOYMENT IMPACTS, BY OCCUPATION (In thousands of federal jobs eliminated)

	Defense	Nondefense	Total
Laborers and Janitors	28	13	41
Food Service Workers	2	2	4
Guards	6	7	13
Data Processors	1	1	2
Drivers and Operators	10	3	13
Trades and Crafts	55	8	63
Other Occupations	19	10	29
Total	121	44	165

SOURCE: Congressional Budget Office.

NEAR-TERM OUTLAY IMPACTS

The OMB contracting-out guidelines compare total economic costs--both those that occur as initial disbursements and those, such as federal retirement, that generate deferred disbursements. In not separating short-term effects on budgetary outlays, however, the cost comparisons may demonstrate total economic savings despite near-term outlay increases. The CBO estimates that the current Administration's program would reduce outlays in the first year by some $90 million, reflecting decreases of $105 million for defense agencies and increases of $15 million for nondefense agencies. As previously noted, the relatively small near-term outlay impacts would occur largely because of the cost treatment for two items--federal retirement and layoffs.

Civil Service Retirement. Under current practice, firms seeking federal service contracts bid against an estimate of inhouse costs that includes an accrual cost for CSR. Though federal outlays for CSR are deferred, the contractors' costs for compensation benefits are included in the bid price and are therefore passed on as current expenses to the government.4/ Thus, shifting federal services to private firms might increase outlays to cover the higher cash payments to contractors.

Federal Layoffs. The CBO analysis suggests, as described in Chapter II, that pending cost-comparison guidelines do not anticipate the full cost of federal layoffs that result from shifts to private contracts. If layoff costs should approach the levels estimated by CBO (4 percent of pay for defense agencies and 15 percent of personnel costs for nondefense agencies), and if the cost factor in pending guidelines (2 percent of personnel costs) is not changed, the federal government could incur substantial outlay increases in many conversion cases.5/ For nondefense agencies, the understatement of federal layoff costs could shift activities to service contracts at a cost in higher near-term outlays.

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4. As described in Chapter II, the federal government also incurs some long-term costs for Social Security from shifts to service contracts, but these do not affect current disbursements for contracting out.

5. A small portion of layoff costs for save-pay provisions (see Chapter II) include federal retirement benefits, which do not affect near-term outlays. This deferred impact, however, would probably be offset by outlay increases for CSR refund payments to many laid-off workers.

CHAPTER IV. OPTIONS FOR CONTRACTING OUT

In considering what action, if any, to take with regard to Executive Branch contracting out for support services, the Congress will want to weigh a number of factors. The goals that could be pursued by mandating changes in the present system include improving recognition and comparison of costs, reducing restrictions that limit conversions to contracting out, and maximizing near-term outlay reductions. The alternatives presented in this chapter address these objectives through various changes in the current program. The Congress could blend or modify some of the measures to fit particular objectives, or it could decide that the best course would be a continuation of the present system. Five possible choices are examined:

- **Option I--Continue current policy** with respect to contracting out;
- **Option II--Adjust the cost-comparison guidelines** to reflect more accurately the federal costs assigned for Civil Service Retirement, Social Security, and federal layoffs;
- **Option III--Expand contracting out** possibilities by reducing restrictions now applying to the DoD and VA;
- **Option IV--Limit contracting out** to cases in which near-term outlay savings could be achieved; and
- **Option V--Extend the limited moratorium** on contracting out now contained in the Defense Authorization Act of 1983.

The discussion of each option describes the number of federal positions that might shift to private firms, the total economic savings, and the changes that might affect near-term budget outlays (see Table 7). The analysis incorporates the unit labor cost comparisons and other factors described in Chapter III, and it assumes shifts to service contracts to occur at the beginning of 1983.1/ Although some negative consequences have accompanied federal contracting out in the past, this risk is not factored into the CBO estimates, which assume that decisions to keep activities inhouse would be based primarily on cost considerations.

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1. Savings reflect differences between federal and private-sector unit labor costs for selected occupations and geographic areas, the private-sector rates being adjusted to include the 10 percent factor for transition intangibles and layoff costs as estimated by CBO. The

TABLE 7. ESTIMATED POTENTIAL SAVINGS FROM CONTRACTING-OUT OPTIONS (In millions of dollars, based on 1983 prices)

	Option I	Option II	Option III	Option IV	Option V
	(All Agencies, Including DoD)				
Total Economic Savings					
First year	335	415	580	195	0
Out years	870	860	1,200	485	0
Near-Term Outlay Impacts	90	155	225	195	0
Thousands of Jobs Affected	165	135	185	95	0
(As Percent of Inhouse Work Force Before Conversions)	(81)	(68)	(69)	(46)	--
	(Nondefense Agencies Only)				
Total Economic Savings					
First year	-2 a/	75	140	35	0
Out years	135	165	270	80	0
Near-Term Outlay Savings	-15 a/	25	65	35	0
Thousands of Jobs Affected	45	30	45	20	0
(As Percent of Inhouse Work Force Before Conversions)	(79)	(53)	(57)	(33)	--

SOURCE: Congressional Budget Office.

a. Minus sign denotes outlay increases.

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results were projected government-wide, using the federal work-force levels subject to A-76 review (except for Option III) as reported by OMB. Other cost differences, including those attributable to a smaller contract work force and to increases in nonpersonnel items, are assumed to offset one another as stated in Chapter III.

With these qualifications, contracting-out options offer substantial savings but relatively small outlay reductions in the near term. The current program and the modifications to it offer a potential for annual out-year savings in total economic costs that range from an estimated $485 million (Option IV) to an estimated $1,200 million (Option III). Annual near-term impacts on government-wide budget outlays, on the other hand, would reach at most $225 million under any of the options. Among the first four options, contracting out could abolish from 95,000 to 185,000 federal jobs. Some general arguments for and against contracting out are described at the end of this chapter.

OPTION I: CONTINUE THE CURRENT SYSTEM

Option I would continue to encourage contracting-out as a way to reduce long-term costs for federal programs. The cost comparisons and resulting agency decisions would conform to the OMB specifications set forth in current A-76 regulations, and the Administration would retain wide discretion in determining the criteria for contracting out.

As described in Chapter III, the current program offers substantial opportunity for reducing total federal costs. The cost estimates prepared by CBO (adjusted to reflect certain federal costs for retirement and government layoffs) show that as many as 165,000 federal jobs might shift to private firms. The resulting savings could approach some $335 million in the first year and as much as $870 in out years.

The pros and cons of maintaining current policy generally follow the basic arguments for and against contracting out reviewed early in Chapter I and later in this chapter. Critics of the practice regard it as a deceptive way to make the federal government appear smaller than it is, point to the decline in service quality it can bring, and cite it as unfair to many federal workers. Further, they see it as undermining the controllability of federal program and work force costs. On the opposite side of the issue, advocates of contracting out--who in general regard performance of commercial services as beyond the proper purview of government--point to its potential for achieving federal cost savings. Moderate proponents of this stance would advocate maintaining current policy intact. Taking a stronger position, some would modify present practices along the lines of Options II and III to improve them or to allow expansion of contracting out possibilities.

OPTION II. MODIFY COST-COMPARISON GUIDELINES

Cost comparisons are required under the present contracting-out program to insure that federal services are obtained from the most economical source. Modifying cost-comparison factors would help improve the accuracy of these determinations by requiring better recognition of costs. Accordingly, this option would correct the failure of current cost-comparison guidelines to recognize fully the costs of retirement and federal layoff.

With respect to retirement costs, a value of 24.23 percent of pay would replace the current lower value of 20.4 percent now used to account for the cost of CSR; a value of 4.7 percent of pay would be incorporated for Social Security to cover unfunded costs of future benefits (see Chapter II) and income taxes forgone because of Social Security benefits' tax-free status. In addition, the option assumes, as estimated by CBO, that costs associated with federal layoffs would average 4 percent of inhouse personnel costs for DoD and 15 percent of the nondefense agencies.

Under Option II, the number of federal jobs eliminated would drop by 18 percent relative to the current program (Option I), because the more rigorous guidelines would allow fewer contract conversions. Those that did occur, however, would be more cost-effective, and estimated savings in the first year would thus rise to $415 million--an increase of 24 percent above savings estimated for the current program. In out years, savings would about equal those under the current program.

Though refinements of existing guidelines would likely meet with little opposition, disagreement could arise over which factors to modify and what particular values to assign. Some critics might even argue that the entire cost-comparison process is highly questionable because of the uncertain nature of assigning costs for retirement and federal layoffs. Despite these concerns, the modifications proposed in Option II would noticeably alter the estimates of savings and jobs converted because of the upward adjustment for layoff costs. These costs partly reflect the recent experience of retrenchment in nondefense employment levels. To the extent that agency employment levels stabilized, a lower layoff cost factor would be appropriate.

OPTION III: MODIFY COST-COMPARISON GUIDELINES AND REDUCE RESTRICTIONS ON CONTRACTING OUT

Of the four alternatives to the current program, this option offers the greatest potential for reducing federal costs. Incorporating the same cost-comparison modifications advanced in Option II, it would also modify current statutory and administrative provisions that exempt certain DoD and VA activities from being considered for contracting out. These changes would subject a greater number of activities to cost-comparison review. Thus, the number of federal jobs converting to contract under Option III could reach 185,000, compared with some 165,000 under a continuation of current policy (Option I). The net rise of 20,000 jobs affected includes a decrease of 30,000 resulting from modified cost factors and increases of

50,000 resulting from reduced restrictions. The total estimated first-year savings of $580 million includes near-term outlay savings of $225 million. In out years, total annual savings could grow to some $1.2 billion.

CBO estimates that, under present guidelines, approximately 150,000 civilian DoD positions could fall under contracting-out exemptions that apply specifically to supply, maintenance, and repair of military equipment. Officials at DoD and other proponents of the present exclusions justify them as necessary to insure a corps of technically competent inhouse equipment workers in the event of a national emergency. But the wide range of equipment support activities carried out by contract workers, during both peacetime and hostilities, suggests that a narrower exemption need not impair national defense capabilities. For example, contract employees were used extensively during the Vietnam conflict in various activities, from helicopter maintenance to quarry equipment repair. If the number of exempted activities were reduced administratively or through Congressional mandate, contracting out could markedly expand. (For estimating purposes, Option III assumes that about one-third of these positions would be subject to cost comparisons.)

Limitations imposed on the VA were motivated by concern that contracting out would decrease funds available for health-service delivery and diminish the quality of care provided at VA facilities. The instability of a contractor's work force--caused by high turnover rates, absenteeism, strikes, and other disruptions--has been often cited as jeopardizing the quality of VA health services. These prospects trouble VA officials, who point out that maintaining work-force continuity is especially critical for the large and increasing number of elderly veteran patients, many of whom suffer diminished mental faculties. Finally, it is also argued that the excluded VA activities should remain exempt, because they are an integral part of a basic governmental commitment to caring for U.S. veterans.

Advocates of rescinding the VA exemptions point out that other organizations, including the Air Force, have successfully used private resources to provide support services in health facilities without degrading service levels. Moreover, the VA cost of preparing comparisons, estimated at $10 million to $20 million by OMB, represent, at most, one-third of the savings available from contracting out. With exemptions lifted, CBO estimates first-year savings of about $70 million at the VA. (The estimate assumes 15,000 additional jobs would shift to private firms.) Finally, proponents maintain that VA activities, especially the support services, are no more inherently governmental than those of other agencies subject to A-76 and should not be singled out for special exemption.

OPTION IV: MODIFY COST-COMPARISON GUIDELINES AND MAXIMIZE NEAR-TERM OUTLAY SAVINGS

In addition to modifying selected cost factors in the comparison guidelines now pending, Option IV would limit future conversions to cases that would reduce outlays in the near term. Determinations of the most economical mode of performance would be based on initial outlay impacts, and thus conversions yielding total economic savings would not take place at the expense of short-term increases in budget outlays. Although the opportunity for long-term savings would diminish, the policy change required by this option would support current efforts to reduce the size of the federal budget. Option IV would be opposed by those who believe that achieving long-run economies should be the main objective of contracting out. Such critics would point out that outlay increases caused by job shifts to private firms are in part one-time or short-term effects that should not play a major role in contracting-out decisions.

Under Option IV, fewer activities would convert to service contracts than would shift under the current program. Relative to current policy, long-term savings and the number of jobs shifted to private firms would drop sharply but the potential for near-term outlay savings would markedly increase. Estimated total savings would decrease by about 40 percent relative to the current program (Option I), and the potential job shifts would likewise decrease from 165,000 to 95,000. Against the drop in total economic savings, immediate near-term outlays savings would increase, because conversions would be limited to those cases in which cash payments under contracting out were lower than current outlays for inhouse performance. Near-term outlay savings would total $195 million, an increase of some 116 percent over current policy. If this option were combined with a withdrawal of contracting-out restrictions (Option III), near-term outlay savings would rise even more, reaching an estimated $300 million.

OPTION V: IMPOSE A MORATORIUM ON CONTRACTING OUT

In light of the criticisms of the current system--and of contracting out in general--the Congress could adopt a one-year moratorium on all further shifts to contract services. This option would extend, on a government-wide basis, the limited moratorium now contained in the recently enacted Defense Authorization Act of 1983 (see Chapter I). Such a moratorium would give both the Executive and Legislative Branches more time to reassess the current program, including both the reasonableness of cost factors used in A-76 and the effects of contracting out on the quality of federal services. Obviously, no further cost savings or dislocations of federal personnel would result.

A moratorium would find support among persons who believe contracting out obscures the size and cost of the federal government. It would also be endorsed by federal employee organizations already angered by the loss of federal jobs and eroded compensation. Federal managers and policy officials concerned about maintaining effective program operations would also lend approval. It would also find support from those who believe that some types of services could be targeted for private-sector performance as a matter of basic policy. Advocates of this position might endorse a moratorium as a means to move current policy away from reliance on detailed cost comparisons.

From the opposite position, suspending shifts of federal services to contract firms would meet objection on the ground that such action would needlessly delay the opportunity to achieve long-term savings available under current policy. Advocates of the current system point out that pending regulations, which are the product of more than a year's study by Executive Branch agencies, will streamline the program and improve cost recognition.

OTHER CONSIDERATIONS

As already noted, many considerations other than cost surface in the course of debate on contracting out. Such concerns, summarized below, will undoubtedly exert some influence on any actions the Congress might take to change the current contracting-out program.

Spokesmen for contracting out argue that, without constraints imposed by labor negotiations or by Civil Service laws and regulations, it improves management's ability to adjust resources to changing workloads and to technological and budgetary conditions. This may be especially important for activities--such as data processing--that are subject to seasonal workloads and for activities requiring certain specialized skills not available within the inhouse work force.2/ Contracting out is also seen as especially advantageous for new or experimental activities. For example, a 1974 study of contracting by 84 California cities found a tendency to use service contracts in situations requiring high "tool up" expenditures or temporary

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2. See Rosaline Levinson, "Privatization of Public Services in California: How Much and How Fast," The Northern California Review of Business and Economics, (Winter 1980), p. 33; and Paul Jay Muzychenko, Jr., "Contracting with the Private Sector for Municipal Services: A Dialogue between Practitioners," Management Information Service Report, Vol. 12, No. 4 (1980), p. 2.

trial operations.3/ Others maintain that managers are freed from the demands of day-to-day operations and thus able to devote more attention to program planning and monitoring.4/ Finally, private-sector competition is held to encourage innovation in the delivery of services. In this view, government organizations are considered "less responsive than private producers in improving productivity or adopting advanced technologies because . . . incentives for such improvements are absent."5/

Critics of contracting out argue that federal management maintains better control if it hires its own workers--realizing advantages from the greater experience and loyalty thought to characterize inhouse personnel. A 1971 Rand Corporation study of commercial guarding activities, for example, found that inhouse security personnel "develop more loyalty and sense of responsibility to the firm they are protecting than do contract guards."6/ The study concluded that some of this difference resulted from contract guards having less experience and training and having to serve two employers. Some analysts also maintain that the rigidity of contract specifications can limit managerial flexibility.7/

Concerns about employees' reactions to the loss of jobs, Civil Service protections, and promotion opportunities emerge as major considerations in decisions to contract out work or not.8/ In addition, government organizations have reportedly turned to service contracts to circumvent various Civil Service regulations--such as preference for hiring veterans, salary limitations, prohibitions against moving expenses for new employees, or

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3. See Sonenblum, Ways to Provide Municipal Services, p. 4.

4. See Robert W. Poole, Cutting Back City Hall (Universe Books, 1980), p. 29.

5. See Sonenblum, Ways to Provide Municipal Services, p. 62.

6. See Kakalik and Wildhorn, The Private Police Industry, p. 100.

7. See Donald Fisk, Herbert Kiesling, and Thomas Muller, Private Provisions of Public Services: An Overview (The Urban Institute, May 1978), p. 8.

8. See Fisk, Private Provisions of Public Services, p. 97; and California Tax Foundation, Contracting Out Local Government Services in California (1981), p. 10.

affirmative action procedures.9/ But opinion is divided on this issue and on the extent to which contracting out is vulnerable to patronage considerations versus protections governing Civil Service employment. From the perspective of employee organizations and others wanting to keep activities inhouse, contracting out by the government also acts to condone and even encourage the substandard compensation practices of many private firms.

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9. See Ira Sharkansky, "Policy Making and Service Delivery on the Margins of Government: The Case of Contractors," Public Administration Review, Vol. 40, No. 2 (1980), pp. 117-118.

APPENDIX

APPENDIX. COST COMPARISON ANALYSIS METHODOLOGY

The CBO's estimated impacts of contracting out are based on a comparison of unit labor costs for commercial-type occupations and for wage areas with large concentrations of federal workers (see list on next page). Unit labor costs consist of wages and benefits, including the accrued cost of retirement, adjusted to reflect costs for paid time off. Projected nationwide changes in federal wages and in the Average Hourly Earnings Index were used to update costs from 1981 to 1983 prices.

Federal wages incorporated in the CBO comparisons were obtained from the Office of Personnel Management's Central Personnel Data File. Private-sector wage rates were obtained from survey data used by the Department of Defense (DoD) for setting wages under the federal wage system. When the private-sector wages for a particular occupation and wage area differed by more than 10 percent from rates determined by the Department of Labor (DOL) under the Service Contract Act, the DOL rates were used. (In some cases, the unavailability of either DOL or DoD data required substitution of imputed values using rates for similar occupations and geographic areas.) Private-sector costs for paid time off, retirement, and other benefits also reflect DOL determinations. DOL sets compensation rates for workers under service contracts on the basis of prevailing practice, and these rates were used to represent the costs incorporated in the price of the successful contractor's bid. The cost of benefit components used in the CBO compensation comparisons are as follows:

	Inhouse	Under contract
	(As a percent of pay)	
Retirement, Including Unrecognized Social Security Costs	24.23	10.67
Layoff Costs	--	4 to 15
Other Benefits	5.60	5.60
	(In hours per year)	
Scheduled Work Hours	2,080	2,068
Paid Time Off	371	215 to 361

The data sources CBO used (listed below) were selected to allow comparison of federal and private-sector unit labor costs for workers closely matched by occupation, geographic area, and skill level. The results of the cost comparisons were extrapolated to the population of commercial-type jobs subject to A-76 as estimated by the Office of Management and Budget. Adjustments were also made to reflect the distribution of the DoD commercial work force among different types of commercial activities.

Wage Areas:	Occupations:
Baltimore, MD	Carpenter
Charleston, SC	Painter
District of Columbia	Electrician
Hawaii	Metal Worker
Los Angeles, CA	Aircraft Mechanic
Macon, GA	Machinist
New York, NY	Mechanic
Norfolk, VA	Laborer
Oklahoma City, OK	Janitor
Pensacola, FL	Warehouse Worker
Philadelphia, PA	Operator
Portsmouth, NH	Food Service Worker
Sacramento, CA	Guard
San Antonio, TX	Key Entry Operator
San Diego, CA	Computer Operator
San Francisco, CA	
Seattle, WA	
Utah	