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Testimony for Commercial Activities Panel

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Introduction

Please accept my thanks for the invitation to present my views to the Panel. I am not an A76 expert, so I am obliged to address the topics before this Panel in somewhat general terms.

An economist – I think it was Alan Enthoven – once said students learn all the economics they need as undergraduates, and the purpose of graduate study is to convince them what they have learned is really true. So I will regale you with what I think is simple but useful theory. I am convinced this is worth doing when I look at the manner in which contracting is discussed, specified in law and regulation, and implemented in practice. In few areas of endeavor are basic principles of economics so often invoked and so little adhered to. I would like to stipulate at the outset that my testimony focuses on the economic context for contracting. I do not engage questions outside the economic realm that go to what is properly governmental and what is not. In this regard I would commend the testimony before this panel of my colleagues Paul Light and Daniel Guttman.

Good Reasons to Contract

Leaving aside the problem of what is “inherently governmental,” services are candidates for contracting if their nature admits of easy stipulation in contract language, and easy oversight of contract performance. “Nature” in this context refers to the tangibility and quantifiability of output and of the extent to which program objectives are served.

If we want to exploit market forces for the sake of public sector efficiency, we need to attend to the factors that make markets work well or badly. Some of the elements of market failure have not been neglected in the contracting debate; indeed, they rank as sore subjects. In particular, the stipulation that many sellers are required for competition is commonly appreciated. So too has the quality of easy entrance and exit of buyer and seller been raised, albeit in the somewhat disguised form of maintaining some residual government capacity in services that are partially contracted out.

In contrast, one looks in vain for attention to the problem of decreasing cost. One important rationale for contracting – though not the only one – disappears under monopoly conditions. In consequence the contracting decision is also more complicated. An example may be seen in the area of data processing. Suppose a job entails the conversion of a periodic conversion and analysis of data. If a firm or organizations have been doing this job for ten years, chances are they can do it in the 11th year at a lower cost than any potential rival, public or private. An expertise and capital base of software can be built up over an extended period of time. Suppose anyone could develop the same assets, given the same time frame. What would determine a bid for a limited-term contract? The contractor's profit depends on the duration over which its services are retained, since this affects the extent to which the organization can build up and amortize its investment. The public interest is to locate work where the cost over the long run is least, but bids need not reveal this. Soliciting bids for a permanent contract opens up the government to excessive costs over time. The only remedy would be to fix the price of the contract for all time, but the impracticalities of this are obvious.

Now we certainly see the use of private firms as regulated monopolies, but the distinction between such a firm, an independent public entity, or a public agency is thinner than the difference between performing work in-house or outsourcing it. We are no longer in the halcyon world of cutthroat competition and cost minimization. Even so, contracting remains conceivable if anti-competitive factors such as decreasing cost are recognized.

I would argue that the problem of information is neglected the most, if not affronted altogether. Markets work better if transactions are transparent to

all concerned parties. In particular, recognition of marginal costs and benefits permit the attainment of an optimal result from the standpoint of resource use.

The complexity of a service militates against easy contracting in two ways. One is multi-dimensionality. When a service has more than one attribute of interest to the customer, comparison of providers and their performance is more difficult; one must weigh the trade-offs to the public interest in alternative mixtures of results. The second is intangibility. When attributes are difficult to measure or gauge, use of contracting is less advised. In both cases, productivity is difficult to specify for the purpose of implementing material incentives for the contractor, or for choosing the contractor in the first place. A basic difficulty in transparency is the proprietary rights of vendors, about which more below.

From a strictly economic standpoint, the health of a market governs the feasibility of contracting. The A-76 process attempts to exploit competitive forces, but as everyone knows, A-76 is ignored more often than not. The General Accounting Office reports that in 1999, only two percent of Department of Defense procurement followed the A-76 model, and *one-tenth of one percent* of non-defense procurement. This could reflect the disinclination of Federal managers to contract competitively, or it could signal the inapplicability of the A-76 process. One seems clear is that the 'make-or-buy' decision is difficult to control from the outside.

The official concept of "inherently governmental," as defined in OMB circulars, is seriously flawed.

The FAIR Act was supposed to open the way to more efficient decisions by requiring Federal agencies to report an inventory of "commercial activities" presently being performed by public employees, in contrast to activities that they deem to be "inherently governmental." These activities were defined as those that could be performed by the employees of private sector organizations. At bottom this is a meaningless distinction because nearly any task can be performed by a business firm or non-profit organization. Whether it is appropriately performed or performed more efficiently, is an entirely different matter. In practice, the contracting net has been cast quite widely to touch on direct exercise of sovereign power. Contractors run prisons and participate in military action (Spiegel, 2001; Markusen, 2001); they perform testing and evaluation of government programs; they perform

oversight over contractors. Most telling of all is the example of the Environmental Protection Agency, which employed a contractor to define for EPA its own inherently governmental functions (DiIulio, Garvey and Kettl, 1993).

More important than the definition are the exceptions allowed agencies to segregate certain positions or functions from contracting. The latter exception seems to boil down to the stipulation that jobs of high importance should be retained in the public sector, while others need not. This formulation is not rich in economic content. To take the classic economist's example, a fireworks show is a trivial sort of amusement, but there is a good economic reason for it being a public service. Delivering fresh milk to infants, on the other hand, is important enough but clearly does not require public participation, much less public employees. Putting aside non-economic reasons for excluding certain activities from outsourcing, the question could be boiled down to how Federal agencies can be moved to higher levels of efficiency from the outside? What sort of regulations, information, and political context are most conducive to efficient decisions on whether or not to contract?

An alternative formulation is proposed by Paul Light (2000), who takes as inevitable the shrinkage of the Federal workforce proper. He suggests that "core functions" that are central to an agency's mission be retained in-house. This could be well taken as a tactical resort. All I want to do is remind the Panel that it is not necessarily best from an economic standpoint.

Motives for Contracting

Governments' 'make-or-buy' decisions often hinge on factors other than cost or efficiency. The lack of competition inherent in public production afflicts contracting as well.

Contracting is often defended by reasoning from motives, rather than empirical results. Specifically, the vendor is supposed to have an incentive to perform well for the sake of continuing business and financial reward. In fact there is research to the effect that contracting is often not undertaken for the sake of efficient delivery of the service in question. In the state-local sector, contracting may be mandated by law but not well founded in cost comparisons. Indeed, such comparisons may often not be conducted, as is true in the Federal sector. Alternatively, contracting may be a habit that is

reinforced by inertia or by government incapacity – in other words, by perceived transition costs. And finally, contracting could be a blatantly unethical and possibly illegal political exercise of power. If we infer results from motives, we could imagine some very bad outcomes of contracting.

It may surprise some that unwholesome motives infect outsourcing, *wholly within the private sector*. There might be a presumption that the profit motive disciplines managerial behavior in this realm. In fact there is a long-standing literature on the distinction between the motivations of managers and owners. Owners are likely to be focused on profits, though not necessarily in the short term. Potentially, however, managers are an entirely different breed. The extent of outsourcing in the private sector is not a reliable guide to its effectiveness.

In the specific area of information technology outsourcing, research has turned up a similar array of motives outside of cost considerations. One is the desire to appear to be showing initiative. Another is the need to emulate decisions made by other firms, or by other departments within the firm (Lacity and Hirschheim, 1993, 1995). In contrast to the testimony of Corbett, Beeks, and the Information Technology Association of America, private sector outsourcing has its own history of blunders. We might fail to perceive this because the outsourcing we observe is that which is successful, which has yet to be discredited and abolished, or which is related to us by its beneficiaries.

Contractors and Other Advocates

All human participants in out-sourcing or 'in-sourcing' have financial interests and are prey to self-seeking motives, but their capacity to act upon these motives, and the ensuing harm to the public interest, is not necessarily uniform.

The basic problem here is political: commercial interests advocating privatization are disadvantaged by information that shines a light on their performance, cost, and profits. These interests support or oppose legislation and regulation in order to focus attention on the performance and cost of their competitors – public agencies – and away from their own operations. They seek to restrict the *freedom to contract, or not contract* of Federal agencies charged with acting impartially in the public interest.

One example may be found in a statement by the Coalition for Outsourcing and Privatization that criticizes H.R. 3766 (“TRAC”) because that legislation calls for information on contractors’ compensation policies: “The wage survey requirements . . . require an unnecessary and intrusive survey into contractors’ proprietary salary and benefits information.”

Federal personnel policies are an open book. Compensation of Federal employees has always been an object of public policy. There is no reason the same interest should not apply to those who seek to do business with the public sector. One reason for such interest may be found in research by my colleague Chauna Brocht: the abysmal levels of pay by contractors. Aside from ordinary concerns of fairness, there should be a real financial interest of the Federal government, since tax-financed public benefits are available to persons based on income. The public sector subsidizes low-wage employment. The Federal government has a right, if not a responsibility, to consider the extent of such subsidies to organizations with which it does business.

The A-76 process has raised some legitimate concerns on the part of contractors, insofar as they are obliged to provide a detailed schema of their production techniques to the public agency with which they are competing. Such concerns should not arise if the information they are required to provide is more limited. At the very least, they should be required to report compensation arrangements that fall below whatever standards the Federal government deems appropriate. Such standards could reasonably include minimum levels of compensation and basic fringe benefits like health insurance. They might also attend to the use of non-standard work arrangements – part-time or temporary help – that attracts a public interest.

More comprehensive employment data is also a matter of public interest in the aggregate sense. If such data is submitted to an independent agency and reported in aggregate, there should be no privacy or proprietary issue whatsoever.

Simulating Competitive Conditions

Benefits are held to result from competitive market arrangements, but the requirements for such markets are rigorous and difficult for third parties to construct within bureaucratic settings. Mere employment of a contractor does not imply the capture of market efficiencies.

The record of Federal agencies in exploiting competitive forces is severely lacking. Mandates that bias decisions in favor of contracting can incur excessive costs.

I would not venture to propose any sort of new, improved procedures for A-76 type competition. The political failure of this model seems obvious enough, but there is little doubt that it will continue to be pursued. A basic principle is consistency in comparisons of alternative means of providing services or getting public work done. This means symmetry in terms of information reporting by public and private organizations, parallel accounting systems, rules governing managers and workers, and the like.

A neglected dimension of this problem is the setting for A-76 and FAIR procedures. What sort of external pressures and constraints can improve the privatization decision? In a nutshell, I would say politics and money.

Relocating the Emphasis of Oversight

There is insufficient oversight of program objectives by the Congress. One indicator is the lack of available data. A second is the failure to arrive at a baseline methodology for discretionary programs. A third is the neglect of capital budgeting. One can also observe ideological attempts to restrict the freedom of public agencies to contract or not contract.

A stronger commitment by the U.S. Congress to evaluate program objectives in light of cost could prompt managers to make better decisions. If so, managers ought to have more discretion and be less bound by rules that push them to either keep work in-house or to contract it out. Where the extent to which program objectives are met is less easily quantified or otherwise measured, program operations require greater supervision and contracting is less advisable. Another environmental pressure is outside evaluation. As with political scrutiny, the pluralistic nature of such attention is essential to its effectiveness. Contention and conflict consume time and resources, but they also bring information to light.

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