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# **Moving Toward Market-Based Government:** The Changing Role of Government as the Provider

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New Ways to Manage Series

IBM Endowment for
**The Business of Government**

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# FOREWORD

June 2003

On behalf of the IBM Endowment for The Business of Government, we are pleased to present this report by Jacques S. Gansler, "Moving Toward Market-Based Government: The Changing Role of Government as the Provider."

In this important report, Professor Gansler attempts to clarify the somewhat muddled debate currently under way across the nation about the various ways in which government can undertake a specific activity: outsourcing, competitive sourcing, privatization, public-private partnerships, or government entrepreneurship. This debate represents a significant evolution in the changing role of government. Professor Gansler argues that government is now undergoing a major shift away from providing services itself to becoming a "manager of the providers."

But this new role as "manager of the providers" is fraught with complexity. As Professor Gansler describes in the report, government now has to make a decision as to which of the following mechanisms can best accomplish the given program objective: competitive sourcing, privatization, or creation of a public-private partnership or a government franchise.

A major contribution of this report is that Professor Gansler directly addresses the six concerns most frequently raised about the shift from "government as the doer" to "government as the manager of the doers." Based on his analysis presented in this report, Professor Gansler finds that empirical data refute all six of the common concerns. He found that market-based government actually improved government performance, decreased costs, realized savings over time, benefited small businesses, separated few government employees, and gave government even greater control than it has today over government activities.

We trust that this report will assist government executives in clarifying the current debate about how government can effectively move from "doer" to "manager of doers."

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# Overview

One of the major changes taking place today in government management (federal, state, and local) is the shift *from* the government as the historic "provider" of public services *to* the government as the "manager of the providers" of services to the public. The basic rationale for this change is that—when properly implemented—it results in significant benefits, in terms of improved performance *and* lower costs, to both the government and to the public being served. Essentially, it is a shift from a monopoly supplier (the historic government "provider") to a competitive environment. These benefits are realized regardless of whether the winner of the competition is the public or private sector supplier.

While the empirical data (as presented in this report) demonstrate the benefits of this shift, it is still not widely understood or accepted. Part of the resistance is the natural fear of change, especially if jobs are at stake. Another part of the resistance is due to understandable confusion over the details. The wide variety of approaches (public-private competitions, outsourcing, privatization, public-private partnerships, government entrepreneurships, etc.) adds to this confusion. Moreover, there has been little effort made at defining terms, collecting data and lessons learned, documenting best practices and case studies, and developing educational programs in this area. It is the purpose of this report to help in this regard.

The report is divided into sections. The first section, "Understanding the Issue," provides the background and the highlights of the various sourcing options. Each of the second through sixth sections examines one approach and, for each approach, provides a clear definition; summaries of example case studies (e.g., for competitive sourcing, for privatization, etc.); a discussion of strengths and weaknesses; lessons learned/best practices; actual performance and cost results achieved; and other relevant considerations—such as personnel impacts, small business considerations, and government management-control perceptions. And, in each area, detailed references are provided for the reader who wants to pursue further the specifics of the implementation for a particular issue.

The seventh section of the report, "Contractors in Security Operations: A Special Case," examines an area that, although not a unique sourcing option, has become a high-interest item for the Department of Defense and numerous other agencies—namely, using contractors in security operations (including combat)—and describes the special considerations for this area along with some example cases.

Finally, "Findings and Conclusions" discusses the six common arguments against changing the role of government, summarizes the actual results achieved for each of these areas, and presents specific recommendations for moving forward.

It is hoped that the material in this report will help in providing a better understanding of this important—and, the author believes, essential—shift in the way government will provide its public services in the 21st century.

## Acknowledgments

The author is indebted to Pelin Turunc and Erin Johansson, who, while graduate students at the University of Maryland, performed much of the basic research for this report. Additionally, I want to thank my coworkers Kim Ross (the executive director of the Center for Public Policy and Private Enterprise at the School of Public Affairs at the University of Maryland) and William Lucyshyn (a research scholar at the Center for Public Policy and Private Enterprise) for their assistance with the research and for their review of the manuscript.

The author would like to acknowledge the outstanding work of E. S. Savas, whose three books on this report's topic from 1980–1999, along with his personal work in New York, helped to establish a good deal of the theoretical and empirical work in this field—particularly at the state and local levels.

Finally, the author deeply appreciates the support of Mark Abramson and the IBM Endowment for The Business of Government in supporting not only this work, but also a number of other essential activities in this and related areas devoted to improving the way in which government can provide better and more cost-effective services to the public.

# Understanding the Issue

## Background

It has always been the stated U.S. federal economic policy that the government will not produce products or provide services that are available in the private sector.[1] Free enterprise and capitalism are the basic models of the American system. However, over the nation's history the American public has asked government at all levels to provide more and more services, to the point where today federal, state, and local government expenditures make up one-third of the gross domestic product of the nation (with a growing shift from federal to state and local). And, as government expenditures grew, so did the number of government employees. In many cases it was assumed that these governmental functions should be performed by government employees, resulting in the build-up of large government bureaucracies.

In recent years the assumption that government services must be carried out by government workers has been questioned. This began first at the state and local level, where people asked, "Why is garbage collection or bus transportation an inherently governmental job? Wouldn't it be better to let the private sector perform such functions under a competitively awarded government contract?" In an effort to meet tight budgets, city council members and local mayors thus attempted to implement—in a variety of forms—competitions for this work.[2] In some cases, the approach was to allow private sector competition for the work among firms that specialized in that business. In other cases, the work was competed between the current government employees and the private sector; while in still other cases, the work was simply privatized by letting private companies bid for the government capital equipment and employees.[3]

There was, of course, resistance to these trends from government workers, their unions, and their political representatives. Nonetheless, the results of these steps were positive. As the advocates had claimed (and as the large amount of data in this report will demonstrate), performance improved and costs were reduced. While this concept was catching on widely at the state and local levels in the 1980s and early 1990s, it was not until the mid-1990s—led by the Department of Defense—that there was widespread consideration of this approach taking hold at the federal level.[4]

With the election of President George W. Bush, it became official policy for the executive branch. In his President's Management Agenda (released in August 2001), the President stated, "Government should be market-based—we should not be afraid of competition, innovation, and choice. Our government must be open to the discipline of competition." To implement this policy, the Office of Management and Budget (OMB) explicitly set targets and dates. In response to a congressional mandate (in 1998, through the Federal Acquisition Inventory Reform Act [FAIR])[5] that all federal agencies must identify those positions that were "not inherently governmental," agencies identified 849,389 positions in February 2001. OMB declared that by 2005, at least half of these positions should be up for competition in one form or another. This would affect approximately 50 percent

of the 1.7 million federal positions considered "eligible" for competition (military personnel, for example, were excluded). Clearly, when fully implemented, this could potentially have a dramatic impact on the way the government provides its services. It is the intent of this report to explicitly address the following questions: *How* could this be done? *Why* is it desirable? *What* results are likely to be achieved?

## Selecting the Business Model

Before agencies examine detailed sourcing options they should first examine their missions and identify the services they are truly required to provide in order to perform those missions most effectively. This effort must consider the fact that governments have many tools they can use to provide a required service indirectly. These include grants, loans/guarantees, the tax code, insurance, and regulation, as well as several different sourcing options that can be used to transfer the responsibility to another organization or level of government. This review can result in changes to the form of services and how they are provided.

The U.S. Postal Service (USPS), for example, was being overwhelmed by bulk mailings. One distinct option was to buy more sorting equipment, hire more employees, and handle the increase in volume. They came up with a different approach, and instead offered their customers a discount if they pre-sorted their mail prior to pickup by the postal service. This shifted a portion of the USPS workload to the private sector by simply changing the way they conducted business.

Another example is the Veterans Health Administration (VHA). The VHA had failed to keep up with the trend in the health care industry. It was using the same model of delivering health care developed in the1950s—in-patient care in large hospitals—centrally controlled from Washington. In the mid-1990s the system was reengineered, creating 22 regional networks that integrated the hospitals with nursing homes and emphasized home health care and outpatient options. The decentralization and shift in emphasis allowed regions to significantly improve the care provided to veterans without increasing their budgets.[6]

Once an agency decides on a business and governance model of how to provide its services, it can begin to examine sourcing options for its core missions.

## Four Principles of Program Delivery

Based on the large number of cases that have now been completed at the local, state, and federal levels, four key principles of the market-based approach for shifting from a monopoly to a competition-based environment stand out in the implementation area.

1. **The key to success is shifting from a monopoly to a competitive environment.** Simply shifting from a government workforce to a private sector one while still in a monopoly environment does not create the incentives required to achieve the potential performance gains and cost reductions that a competitive environment offers. Similarly, after an initial competitive award is made—either to the public sector workers or to the private sector—it is essential that the potential for future competition (in a few years) still be maintained.

   This potential need not be exercised if the winning performer not only realizes its claimed performance improvements and cost reductions, but also continues to demonstrate enhanced performance at lower costs. But the potential for competition must be maintained. Unfortunately, it has been found in a number of cases—particularly when the government workforce won the initial competition—that this potential disappeared and the performance and costs reverted back to monopoly conditions. *It is the presence of competition (or even the clear potential for it) that forces the performer to innovate for higher performance at lower cost.*

   In the absence of such competition you must deal with a monopolist; and monopolies, as is well documented, tend to become inefficient, ineffective, and unresponsive. Nonetheless, people somehow believe that because the monopoly is a public one (i.e., being run by government employees), it therefore will (somehow) operate totally in the public interest—and be efficient, effective, and responsive. As all of the data in this report indicate, that has not been the case. Shifting to a competitive

environment results in an improvement in efficiency, effectiveness, and responsiveness.

2. **The competition must be run for "best value" rather than simply for "low cost."** The idea, which comes out of looking at the lessons learned from prior efforts, is not simply to get cheaper services; rather, it is to get better services at lower costs. This is a dramatically different approach than simply going to the "low bidder" who promises to meet "minimal acceptable performance."

   This is admittedly a more difficult action for the buying organization of the government, because it requires a serious value judgment in comparing potential performance and costs for each of the bidders (public or private). *It also means that the contract itself must be a "performance-based contract,"* i.e., one that specifies what the buyer broadly is striving to achieve, but doesn't tell the supplier how to do it. This type of contract is also more difficult to write—especially when buying services rather than products—but it is absolutely essential in order to get the best overall value from the performer. This procurement area is one that will require considerable workforce education and training in order to skillfully perform best-value awards on performance-based service contracts.

3. **Even when the government contracts out work to be performed, it does not give up any of its control or management responsibilities.** In the case of service contracts, for example, a recurring problem is the government's failure to maintain responsibility for assuring that the contracted-out function is performed effectively and efficiently. This means that the government still has a strong oversight function: to manage the contract and to monitor its performance and cost. If the work is not done properly, the responsibility still rests with the government.

   Clearly, the government can terminate the contractor as an ultimate control mechanism. Prior to that action, however, the government should be continuously monitoring the contractor's performance and cost to ensure the required function is being properly performed. This point cannot be overemphasized; and yet, as noted, it has been a major problem in a number of prior efforts (i.e., the government did not properly oversee the supplier—public or private—once the award was made).

4. **There is a critical need for detailed metrics.** The government manager and the performer (public or private) must agree at the beginning of the contract on the key measurements of performance and cost that will be continuously monitored and reported. Obviously, these must relate to the performance and cost measures associated with the government function being achieved; and while many of these functions

**Table 1: Sourcing Options**

| Sourcing Approach | Definition |
|---|---|
| *Outsourcing* | Organizational activities are contracted out to vendors or suppliers who specialize in these activities (usually in a competitive fashion). |
| *Competitive Sourcing* | Current public providers and private providers compete. |
| *Privatization* | Current government capital equipment, facilities, and workers are moved into the private sector—either competitively or on a sole-source basis. |
| *Public-Private Partnerships* | Attempts are made to combine the best of both the public and private sectors—either in a competitive or sole-source environment. One type of public-private partnership is *private financing:* In private financing, instead of having the government provide the resources for public functions, this work is actually financed by the private sector in a variety of approaches. |
| *Government Entrepreneurship ("Franchising")* | One government agency specializes in a given function and provides it to other government agencies or even to the private sector—again, either competitively or on a sole-source basis. |

may be long term, shorter-term measurements must be implemented to determine progress.

Additionally, these metrics should be compared with historical data and "best practice" benchmarks to show improving trends in both performance and cost. In prior efforts, particularly when the government workforce prevailed in the competition, good visibility into these metrics was not maintained. This has proven to be a particularly difficult thing for the government providers when they are not clear about their total-cost basis in the first place, as they do not have any initial benchmarks to utilize.

To achieve such metrics for the government workforce will often mean a transition to some form of activities-based costing, so that one can determine the actual government total cost associated with the function being performed. (This would include all government "indirect" costs that support the particular function being performed, and costs which are not currently identified to that function—such as finance, legal, personnel, etc.)

## Understanding Sourcing Options

As can be seen in Table 1, these choices cover a wide spectrum—from more work being done internally, to more work being shared, to full external services (but still under government management). Further, there are appropriate times and places for each of these techniques as well as best practices that should be applied (practices based on lessons learned from previous attempts at either the state, local, or federal levels). There are pros and cons for each approach, and the following sections discuss—with examples—appropriate applications for each as well as the likely results (again, based upon the results of prior demonstrations in each category).

Needless to say, there are no hard and fast rules that can be applied in this area; which technique is used and what results are actually achieved will vary considerably from case to case depending on the unique circumstances in each. Nonetheless, when properly implemented, the overall results are consistent—both qualitatively and quantitatively. The key, of course, is how to do them "right."

One of the things that scares people away from this area is the sheer number of different ways in which to approach the shift from the government as the "provider" to the government as the "manager of the providers." The reality is that there is no right answer to this dilemma other than the following points highlighted earlier in The Four Principles of Program Delivery: create the right incentives via *competition;* utilize *best-value* rather than low cost in the competitions; *continue to manage* the provider (public or private) after the award; and utilize performance-based and cost-based *metrics* that are monitored throughout the contract. Beyond these basic guidelines, each case can be treated as an individual event, and the government managers need to make their own assessment as to which of the various forms discussed herein would best fit the situation. In fact, it may well be that a number of the forms fit the situation, and that it becomes a question of "management judgment" as to which would be appropriate for that individual case. The important thing to realize is that if the basic principles—particularly that of competition—are utilized, there should be significant performance improvements and cost reductions from any of the various forms to be considered.

Nonetheless, it is appropriate to define the six approaches, to provide a few examples of each along with comments on observed "best practices," and to review the actual results of these efforts. With these data, a government manager should be in a good position to both argue the case for the change and anticipate what are likely to be the benefits. With this in mind, the following sections address the five categories introduced in Table 1, presenting the most common ones first, then moving to those less frequently used.

# Outsourcing

## Definition

Outsourcing is a management strategy that contracts out organizational activities to vendors or suppliers who specialize in these activities in order to perform them more efficiently and effectively. Outsourcing is defined as the practice of turning over entire business functions to an outside vendor that ostensibly can perform the specialized tasks in question better and less expensively than the organization choosing to outsource.[7] Outsourcing differs from privatization in that in outsourcing, the workload is shifted from in-house government providers to the private sector, but no transfer or sale of assets has occurred. Outsourcing or "contracting out" still requires the government to remain fully responsible for the provision of all services and management decisions. Other common outsourcing transactions include "direct vendor delivery," hiring of long-term trained (but private) staff, and vouchers.

Outsourcing can be done either sole-source or through competitive bidding. However, one of the major advantages of outsourcing is the potential for introducing competition among firms and to encourage innovation for performance improvements and productivity gains, so competitive bidding should be used whenever possible. And, to gain the benefits of greater performance at lower costs, the competitions should be based on the "best value" combination of performance and cost (rather than simply "low bid" to a minimum performance requirement). Also, so that the government does not get stuck with a monopoly supplier who subsequently reduces performance and/or raises prices, the government should assume that it maintains the option of subsequent competition (but only needs to exercise this option if performance or costs do not meet expectations).

Cost savings are generally considered to increase as the complexity of the outsourced application increases.[8] According to one report, companies that outsource to a web hosting company can save up to 40 percent in costs, while increasing the quality of their infrastructure.[9] Outsource vendors provide superior performance at lower cost because the function they provide is their core function, they have good specialists, and they invest in improving their techniques and technology to stay competitive in their market. Outsourcing allows firms to concentrate on their core functions and grow their business while the government benefits from the higher performance at lower costs, and the ability to use employees only when they are needed (rather than having permanent employees).

The reason outsourcing sometimes fails is that outsourcing candidates were not examined carefully before making the selection decision. To prevent these failures, management should examine qualifications of potential outsourcing candidates and should choose the one that best fits with the firm's strategic goals. Issues such as prior experience, culture clash, training needs, metrics and control, and the level of relationship between the parties must be carefully considered. Organizations should build relationship management capabilities to develop trust between themselves and the outsourced firm.

Although outsourcing involves signing a contract, there are important differences between the terms "outsourcing" and "contracting" as they are used.

Firms use contractors when they need specialized staff services for relatively shorter periods of time. In addition, contractor personnel are usually integrated into an organization's normal operations. In contrast, outsourcing agreements are usually long term, with an average of seven to 10 years. However, the government needs to frequently monitor contractor performance and cost—and maintain the option of termination or competition at any time—if results are undesirable. Finally, the outsourcing firm is generally off-site, and performance measurement of the outsource firm is not through assessment of individual tasks, but through compliance with some type of service level agreement.

## Case Studies

### 1. National Mail Order Pharmacy Program of the Defense Supply Center Philadelphia (DSCP)[10]

In the early 1990s, DSCP competitively bought the services of a private contractor, Merck-Medco Managed Care, to buy and distribute prescriptions to the Department of Defense's (DoD) 7.2 million eligible active-duty service members, retirees, and dependents. This outsourcing contract resulted in significant quality and customer service improvements, as well as reductions in the costs of medicine to the military customers by 30 to 70 percent—prices lower than those paid by regional hospitals. The savings to the government is at least 40 percent.

Two three-state regional pilots were conducted in 1993, and the program expanded to over a dozen states in 1995. The national contract was signed in 1997. Responsibilities of the DSCP contractor include receiving prescriptions, certifying beneficiaries' eligibility, making sure that participants are taking the right drugs in the right amounts, monitoring drug interactions, verifying prescriptions, and dispensing and mailing the drugs. The firm also runs a customer service center. DSCP developed an automated system to monitor contractor compliance with all contract requirements, but is not otherwise involved in drug delivery.

*Savings and service improvements:* The National Mail Order Pharmacy saves money and time for military service members and their dependents, and frees up DoD funds to improve other health programs. The program gives DSCP an opportunity to serve a whole new class of customers while reducing beneficiaries' co-payments—$23 million on 1.3 million prescriptions in FY 1999, while saving DoD an estimated $55 million. DSCP monitors drug prices continuously and sends Merck-Medco an automated pricing file each month to ensure that DoD is getting the best possible prices. DSCP sold more than $4.8 billion in supplies worldwide in 1999, while reducing the inventory it held by 19 percent over 1998. The center's staff has also been reduced from 7,000 in 1993 to 2,900 in 2000.

The service received by the military personnel and their dependents has also improved a great deal. Before the mail order program, those eligible for DoD drug benefits had to drive great distances to military pharmacies or retail drug stores, where they paid co-payments of 15 percent to 25 percent of the commercial cost of pharmaceuticals. However, under the mail order pharmacy, active-duty members pay no co-payments and their dependents pay a fixed charge of $4, while retirees and their dependents pay a fixed charge of $8 per prescription. Further, beneficiaries can get up to a 90-day supply of drugs (as opposed to a 30-day limit imposed by retail pharmacies), and the drugs are mailed to their homes, making it easier for many personnel.

*Conclusions*: As a result of implementing this new service, inventories were reduced by 19 percent and staffing was reduced by 58 percent. Apart from the savings and service improvements the program provided, it has demonstrated innovative contracting and transitioned DCSP into a supply chain and relationships manager—rather than buyer and distributor.

### 2. Air Force's Hunley Park Military Family Housing Renovation[11]

When the Air Force inherited Charleston Naval Base from the Navy in 1996, it also received the responsibility of the Hunley Park military family housing renovation project. The houses required extensive renovation, including asbestos remediation and underground utility work. Congress allocated $7.4 million to help begin the renovation in November 1997, and wanted the money spent by March 1, 1998. Many of the previous Air Force housing projects resulted in cost overruns. Additionally, the contracts usually involved schedule slips. These issues forced the Air Force to develop a new contracting strategy to avoid the problems

and complete the project within the mandated time schedule. The Air Force's normal approach, which typically required 180 days just to develop a design, would not work. Instead, they formed an integrated project team to manage the contracting and other aspects of the project concurrently, rather than having the various phases laid out end to end over the period of a year. The design phase, with the help of this innovative approach, took only two months instead of the normal six months, reducing the completion time by 66 percent.

The acquisition team required all the bidders to provide evidence of past performance in whole-house renovation and underground utility upgrades. The "best value" approach was used, trading off price with past performance. This resulted in the lowest bidder being eliminated because of a limited experience base. The contract was eventually awarded to H&N Constructors, a small firm in Louisville, Kentucky.

One of the common problems in the past was costly renovation contract modifications caused by unforeseen problems encountered during construction. Instead of trying to define the scope of the project without knowing all of the potential problems that can cause modification, the team decided that the contract should require the contractor to experiment with just a few homes first. The prototyping revealed the actual condition of the houses and how much material and equipment would be required to finish the project. After the prototyping, the team let the future occupants tour the houses and make suggestions. This acquisition innovation (i.e., user reviews of prototype) added up to a total cost increase of just $35,000 or 0.06 percent, a mere fraction of a typical renovation project overrun. According to interviews with current occupants, they are truly satisfied with the renovated houses.

*Conclusions:* This project shows how performance-based service contracting can save significant amounts of time and money, even when the winner of the contract isn't the lowest-price bidder. They used performance-based contracting and prototyping and took user feedback, all of which proved to be useful strategies for the outsourcing project. The decrease from cost overruns alone saved at least 5 percent.

### 3. The Navy's Sailor Assisted Move (SAM) Program[12]

Traditionally, the Military Traffic Management Command awarded contracts to the lowest bidder without performance considerations. Additionally, they would divide up service members' moving business evenly among all the qualified carriers. DoD surveys indicated that more than 75 percent of the personnel moving were unhappy with the existing system. Additionally, 25 percent experienced property loss or damage during the moves, more than twice the rate outside the military. Moving is big business in the military—military services pay commercial carriers more than $1.2 billion annually to move 650,000 military personnel. DoD is the single largest customer in the property shipment industry, accounting for more than 15 percent of the industry's business.

In contrast to the traditional approach, the SAM program allows sailors to choose their own moving companies based on their own or others' experience with the firms. During the move, sailors can check on the status and location of their household goods and alter delivery plans as needed. In addition, for the first time service members receive full-value protection against property loss and damage. Additionally, they can be reimbursed by directly negotiating with the carrier in just two weeks—compared to depreciated reimbursement of damage after several months, when military legal officials filed claims for damage under the old system. Letting sailors choose firms based on their track records adds a vital performance piece to the deal. The carriers are also happier with the system that rewards high performance and eliminates paperwork and bureaucracy.

In customer surveys, 95 percent of SAM customers reported satisfaction with their moves, compared to 23 percent under the traditional moving program. In 1999, during the second year of the program, SAM attracted about 25 percent of the sailors eligible to participate, a 1,500 percent increase over participation in 1998. In addition to improved customer satisfaction, damage claims under SAM dropped from one in every four moves to one in 12; and, according to the Navy, the dollar value of an average claim has dropped 50 percent, from $550 to $224. The potential savings are huge. In

1996 alone, service members filed more than $100 million in damage claims under DoD's traditional moving program, about 10 percent of program costs.

*Conclusions:* Letting the sailors choose contractors based on performance records and shifting to a competitive best-value (vs. "lowest bidder") approach improved performance and decreased costs significantly. Savings from damage costs alone are 87 percent. There was a 300 percent customer satisfaction improvement, and a 66 percent reduction in the number of damage claims.

**4. The Navy Marine Corps Intranet (NMCI)[13]**
The NMCI is a comprehensive, enterprise-wide contracting-out initiative that will make the full range of network-based information services available to sailors and Marines for day-to-day activities and in war. When the actual costs figures are used, from the initial rollout of NMCI seats (desktop computer workstations) at seven sites, the average cost per seat before NMCI was about $3,545 per year, and the cost of an average NMCI seat is $4,179. Although the NMCI cost is 18 percent higher, the price of an NMCI seat includes capabilities that were not available in the pre-NMCI environment, such as compliance with DoD mandates, records management, public key infrastructure, and information security upgrades. If the pre-NMCI estimates are adjusted to reflect these added capabilities, the original seat cost would increase to at least $4,286—more than 2 percent higher than the NMCI seat cost. The decision to undertake the NMCI initiative was not based solely on cost; rather, it focused on performance improvements (including security) that the Navy would not be able to provide through the traditional information technology approach. In addition, the Navy and Marine Corps are obtaining all the benefits of a state-of-the-art, fully integrated information system.

*Conclusions:* Cost-benefit analysis is a necessary tool and a significant part of agency decisions. The contracting in this case resulted in capability and performance improvements too costly or not possible for the Navy to achieve itself—and the competitive outsourcing controlled the costs.

**Strengths of Outsourcing:**

- Outsourcing is more efficient (and reduces costs significantly) because:
  - It harnesses competition and brings the pressure of the marketplace to bear on the inefficient producers.
  - It permits better management control by freeing government managers of most of the distracting influences of overtly political organizations and civil service constraints.
  - Managers can see more directly the costs and benefits of their decisions.
- Outsourcing enables the government to take advantage of specialized skills, new technology, and innovation that are lacking in its own organization.
- Outsourcing can reduce dependence on a single supplier (i.e., the government), and the potential for future competition provides a continuing incentive for higher performance at lower cost.

**Weaknesses of Outsourcing:**

- Outsourcing can limit the flexibility of government in responding to emergencies if not provided for in advance, via the contract.
- Contracting processes can be complex, time-consuming, and costly if proper management and a standardized process are not provided.
- Outsourcing can cause personnel disruptions and transition problems if not planned well.

## Lessons Learned and Recommendations

1. **Use performance-based contracting** instead of contracts based on fixed costs. Performance-based contracts do not list tasks but state the results sought or problems to be solved. This takes the performance risk off the government and shifts it to the contractor, and decreases the likelihood of cost overruns. Contracts prepared this way contain performance measures agreed upon by both parties.
2. **Choose contractors according to "best value"** by trading off performance and price instead of simply awarding to the lowest bidder. Issues

such as past performance, culture clash, training needs, metrics and control, and the level of relationship between the parties must be carefully considered. The organization should build relationship management capabilities to develop trust between themselves and the outsourced firm.

3. **Use prototyping and pilot implementations** for outsourcing projects to make an estimation of total costs, scope of the project, necessary supplies and equipment, and to foresee problems that are likely to be faced during the implementation. Obtain user feedback along the way and incorporate lessons learned into the implementation. (Whenever possible, use competitive prototypes.)

4. **Apply integrated (with "bundled" functions) outsourcing.** Outsourcing should be done in an integrated (multifunction) way for improvements in efficiency and performance. Make the outsourcing decisions by contracting similar functions (or functions that can be done by the same contractor) to the same contractor instead of to a number of them. An effective and closely integrated management of services is essential to applying these principles. In addition to savings from economies of scale and from integrating the tasks of different functions, having larger bids also attracts a larger number of and more qualified contractors, decreasing the resulting bid. It also allows the winner to re-engineer the multiple functions for far better performance and significant additional cost savings. In addition, it should be noted that bundling need not reduce the amount of small business contracts, and would even improve it, if it is made a subcontracting requirement of the winning bidder. The key in making bundling decisions is to look at similar samples in the industry.

5. **The larger the award, the greater the savings.** The quantitative benefits of larger-sized awards for outsourcing would be very similar to those shown in Table 5 (namely, larger percent savings with larger size awards, and far fewer awards with very little savings).

6. **Success requires strong managerial support, skill, and knowledge.**[14] In a study on information technology (IT) outsourcing, it was found that management played a key role in the success of the contracts. Overall, the benefits of IT outsourcing are many: cost savings, greater access and flexibility in using appropriate technology, and utilization of skilled IT personnel. But in order to obtain these benefits, management at the top needs to be supportive and involved in the process; managers must allocate the necessary amount of time and resources at all stages of the process; managers need strong, continually updated procurement skills and knowledge; and frequent communication must occur within the partnership of agencies and their service providers.

# Competitive Sourcing

## Definition

"Competitive sourcing" assumes a competition for work between the government and the private sector, and can result in activities being performed either by government (in-house) or by contract personnel depending upon who wins the competition. Competitive sourcing differs from outsourcing in that outsourcing assumes that the in-house (i.e., within government) workload will be contracted out to the private sector. It also differs from privatization, in which the government transfers the ownership of its equipment and facilities involved in performing the function to the private sector.

Privatization and contracting out policies are subject to the theoretical assumption, *a priori,* that private sector service delivery is always less costly and is always of an equal or better quality than public sector service delivery. Public-private competition ("competitive sourcing") makes no such ideological value judgment, but rather treats the question as an empirical one subject to testing. Public-private competition is predicated on the notion that it is not the ownership of the service delivery (public or private) that leads to improved service quality and lower service costs, but rather the presence and degree of competition.[15]

## Various Forms

The type of public-private competition that covers most federal government work is governed by OMB Circular A-76. Depot competitions are excluded from A-76, but generally follow a similar process (see Case 5 below regarding a maintenance depot public-private competition). Other approaches are possible, such as using the normal Federal Acquisition Regulations for competition (i.e., "FAR-Based"), and there are many state and local approaches. These latter forms of public-private competition are often ad hoc approaches (public sector service delivery is simply compared to private sector delivery), or utilize informal bidding (public sector submits informal bids). An example of a local and state approach with a less formal bidding process is the competitive sourcing of the road and repair work in Indianapolis (explained in Case 1).

## A-76 Process

In 1966, OMB issued Circular A-76: Performance of Commercial Activities, which established the policy for acquiring commercial activities. In 1979, OMB issued procedures for A-76 cost comparison studies to determine whether commercial activities should be performed by government, by another federal agency, or by the private sector.[16] The objective of A-76 is to provide a "fair" public-private competitive sourcing process, seeking to determine the most cost-effective method of obtaining services that are available from the commercial market. Because the A-76 process is very complicated and presents a considerable administrative burden, many circulars have been issued since 1966 that simplify the cost comparison procedures, provide options for "reinventing government" operations, and identify potential positions to be "studied" (the term-of-art used to describe the public-private competition process). OMB is currently revising the circular in an effort to streamline the process and make it more equitable. Their goal is to have the new circular approved and released in the second quarter of 2003.

At present, an A-76 study requires an agency to develop a performance work statement (PWS) to identify the work to be done; to prepare a government in-house cost estimate based upon a Most Efficient Organization (MEO) that can accomplish the work; to solicit bids to perform this work from the private sector; and to compare this estimate with the lowest or best-value offer from the private sector. The government converts to performance by the private sector if the offer is lower than the in-house estimate either by 10 percent of direct personnel costs or by $10 million over the length of the specified performance period. The time period established for cost comparisons is 24 months for a single function and 48 months for multifunction competitions.

It is important to note that the government's bid of the MEO is almost always significantly less than its current (monopoly-based) costs. The presence of competition creates the previously missing incentive to significantly improve processes to lower costs while increasing performance.

Agencies are supposed to submit a list of non-inherently governmental activities (commercial activities inventories) that are being performed by government employees. Such activities are suitable for competitive sourcing or outsourcing. Inherently governmental functions cannot be competed and must be performed by the government.

There are also functions that are not inherently governmental, but may (under special conditions) be considered as such because of the way in which the contractor performs the contract or the manner in which the government administers contractor performance. Examples include services that involve feasibility, efficiency, and cost analysis; services that involve reorganization, regulations, and planning; contractors providing technical evaluation of contract proposals or providing assistance in development of statements of work; and contractors providing inspection services.

Under the Clinton administration, OMB estimated savings of roughly $9.2 billion in DoD operating costs between 1997 and 2005 and $2.8 billion in annual recurring savings after 2005 that resulted from A-76 studies.[17] The Bush administration is taking steps to achieve even larger savings and management reforms. They have proposed that (for the overall federal government) over 400,000 positions (i.e., 50 percent of all non-inherently governmental positions identified) should be competitively sourced by 2005, and agencies are reviewing positions to determine their exact number.

## Case Studies

### 1. Road Repair Work in Indianapolis[18]

In 1992, Mayor Stephen Goldsmith, a believer in free markets, decided to privatize some of the public operations in the city of Indianapolis. To avoid the expected reaction of the employee unions to possible layoffs, Goldsmith decided to organize a public-private competition instead of firing the employees precipitously. One issue raised with the public-private competition was whether such a competition would be fair. A second issue was the difficulty in determining the full costs of current public operations. In addition to finding solutions to these problems, the mayor's office had to decide which of the operations (among trash pickup, wastewater treatment, and street repairs) to initially compete and how to organize the competition.

Among several options, filling potholes was chosen for public-private competition because of its high public visibility. First, cooperation with the union and employees was obtained. To provide fair bidding, private sector consultants were brought in to help public employees prepare bids. Cost determination was one of the most difficult steps during the bid preparation. To ensure the highest level of accuracy, activity-based costing (ABC) was used to determine cost figures. Employee timesheets, interviews to determine the time required for each task, and market price for the materials were used. Historical averages were used to estimate the quantity (number of potholes to be filled) in order to determine total costs. Senior management cost was not considered, as top management would remain public to monitor performance. Public employees prepared a bid of $301 per ton of asphalt put down after performing detailed studies to decrease the labor and equipment cost (i.e., to get the MEO). They cut costs from $407 to $301, a 25 percent cost reduction.

Only the threat of competition removed some of the slack that existed as part of the costs of the job.

Middle managers who were not essential and held positions used solely for political patronage were laid off to reduce the cost of management. An independent committee was established to evaluate the bids. However, there was an unexpected problem in the bidding process: The work to be done was not adequately described—it was not clear whether the job was simply to fill in the potholes or repair the whole road. As a result, there was a vast difference between the public bids and the lowest private bid. The work was awarded to the public workers; and subsequent competitions focused on much clearer performance specifications.

*Conclusions:* The threat of competition cut costs by 25 percent in this case. Among the initial challenges were a lack of government cost data and difficulty in determining the job-based cost. Resistance was dealt with by cooperating with the union and by ensuring a level playing field. One of the problems during competition was a poorly prepared performance work statement.

**2. The Navy's Public-Private Competition[19]**

After the election of Ronald Reagan in 1980, strengthening national defense and increasing government's reliance on private goods and services were two of the government's top priorities. By 1984, the Navy introduced several elements of a Navy Industrial Improvement Program; the most important was a program authorized by Congress in 1984 to test public-private competition for the Navy's multibillion-dollar overhaul and repair work.

The Navy's shipbuilding contractors had cost problems on new ship constructions because of the high inflation rates in the 1970s. This was compounded by unrealistic schedules and planning mistakes, which resulted in an inability to cover costs. These factors seriously crippled the United States shipbuilding industry at the end of the 1970s. The Navy's trend was toward using private sector capacity more widely; however, the projects given to the private sector did not have motivating contracts for the contractors. Also, there was dissatisfaction among private shipbuilding employees because of their lower salaries and benefits compared to those of public employees. Project orders specified the work to be performed, the anticipated cost, and schedule of performance; but unlike normal commercial contracts, these cost-based, percent-of-cost fee contracts did not specify any incentives or penalties to motivate adherence to these terms.

Consequently, in the 1980s, senior Navy leadership started to discuss taking advantage of the excess capacity of the private sector compared to the full loading of public shipyards. The eight public shipyards, five of which were built in the 1800s, were devoted exclusively to the overhaul and repair of naval vessels. In 1982, the Undersecretary of the Department of the Navy commissioned an in-depth study by a team of two management consulting firms on how to improve the naval shipyards' performance and costs. By 1984, most of the team's 130 recommendations were approved, one of which was to test the recommendation that the naval shipyards be required to compete with the private sector for scheduled overhaul and repair work.

The test programs started in 1985. The competition program not only included overhauls and repairs, but also ship alterations and the Naval Sea Systems Command's Nuclear Propulsion Directorate. In the test competitions, the contract would not be awarded simply to the lowest bidder; instead, performance would also be carefully assessed and both sectors would be required to submit fixed-price incentive-fee bids, with a target price and a ceiling price above which the shipyard would absorb all the costs. The competition process involved a lot of learning, especially for the public employees (who obtained private consultant help in preparing bids), and for the Navy management (regarding how to ensure a fair comparison). There were complaints and investigation requests after the first contracts, on which the General Accounting Office (GAO) prepared reports and basically upheld the Navy's decisions to award one overhaul to a private yard and one (at a significantly higher cost) to the public yard. The Navy then ran a competition for another ship; a public yard (Charleston) won with a bid of $112 million (14 percent less than its previous, similar overhaul cost of $130 million).

*Conclusions:* The Navy solved most of its problems with the naval shipyards and maintenance in the early 1980s using competitive sourcing based on best value. The incentives created by the competitive environment allowed them to achieve both greater control and significant cost reductions, without sacrificing performance.

### 3. Services at Fort Rucker Aviation Training Base

Fort Rucker, the Army's main aviation training base, has been using competitive sourcing for its pilot training and aircraft maintenance services since the 1980s. Three examples of the public-private competitions (described below) brought between 20 and 40 percent savings, with equal or higher performance.

- In 1991, the Army competed some of the services at its Fort Rucker base using the A-76 process. A large training services unit (providing audiovisual support to trainers) was contracted out. Savings from the original baseline were about 40 percent. The in-house bid would have produced a savings of 17 percent, although that was not enough to retain the work. All 72 government employees were retained in place, though some were downgraded.[20]
- Another public-private competition at Fort Rucker was for the director of logistics (for base support functions that employed about 400 people). It was competed in 1991, about seven years after the announcement date. The work remained in-house, and there was a 20 percent savings from the original baseline cost.[21]
- A more recent competition[22] (in 2001) at Fort Rucker resulted in contracting out despite some strong objections. The savings realized were 30 percent. The Army awarded the company a $44.6 million contract to perform services at Fort Rucker, which would eliminate 338 federal civilian jobs at the base. The employees at the base urged the Army not to proceed with the contract award on the grounds that the contractor's bid was based on outdated cost estimates and contractor labor costs. The contractor's bid relied on data from 1997, when the base first started studying whether contractors could perform the job at a lower cost. The contractor bid did not take into account additional services and new buildings built since then. However, the contract was awarded, and revisions to cost calculations made. The private bid came in $10 million under that of the federal workers and, even after the revisions, the contract was awarded and the appeal rejected.

*Conclusions:* In the recent competitions at Fort Rucker, the competitions still took two to four years, and some of the earlier ones took even longer—primarily to overcome Army, union, and congressional opposition. Clearly, this time period needs to be shortened. Nonetheless, the competitions resulted in significant savings in spite of the process problems.

### 4. Six DoD Cases Examined by RAND[23]

RAND examined six competitive sourcing competitions (one for the Army, one for the Navy, and four for the Air Force) to determine their expected savings, whether the savings were real and enduring, and how they were achieved. The expected personnel cost savings were found to range from 34 percent to 59 percent of the baseline personnel costs. The savings were found to be real and enduring for the three contractor awards. They could not be fully verified for the three in-house awards (due to the lack of cost visibility on government full costs). The cases covered base operating support (2), missile maintenance (1), aircraft maintenance (2), and telecommunication maintenance and operations (1).

RAND concluded that the labor savings came from three major factors:

- Using fewer workers—contributing factors included civilianization, multiskilling (cross-training, combining job series), organizational restructuring, reduced work scope, and labor availability/increased work intensity
- Downgrading positions and paying lower wages for lower-skilled jobs
- Capital-labor substitution

These savings were found to be real and enduring. For the private contractors, the difference between the contractor bid and the actual contract payment is a good indicator of whether the savings were realized as expected. This difference was at most a 2.5 percent increase in the payment (and was actually a decrease of 13 percent in one case). For the public sector the difference between personnel slots in the MEO bid and current staffing is an indication of whether savings endure over time. The differences are small, indicating that savings endured. To get an actual cost comparison, the government would need to move to a method (such as activity-based costing) that would provide full-cost visibility.

### 5. Organizational and Intermediate Maintenance of Navy Aircraft[24]

The Navy competitively sourced its personnel and equipment for the organizational (O) and intermediate (I) level maintenance of the TA-4J aircraft. The award was made to the private sector. The analyses of performance and cost data show a 33 percent reduction in costs at the same level of performance.

The analysis of cost was done by comparing direct maintenance man-hours per flight hour (DMMH), which shows the amount of resources used to complete the task. The performance analysis compared full mission capable rate (FMC)—the percentage of time the aircraft is ready—mission capable rate (MC)—the percentage of time the aircraft can fly and complete the mission—and not-mission-capable rate (NMC)—the percentage of time the aircraft cannot perform the mission. All three of these performance measures remained essentially the same.

Thus, there is a significant difference between DMMH (costs) in favor of the contractor, while differences between MC, FMC, and NMC rates (performance measures) are not significant when the in-house and contractor performance are compared. However, on this program the transition from in-house to contractor was not well planned and it took about two years for the contractor to reach the previous performance of the in-house workforce. Yet, when the contractor subsequently turned over the task to another contractor, there was no such drop in performance as the personnel stayed the same and only the management changed in this case—clearly, the initial transition was not well handled by the Navy.

Finally, since the contractor provided an equivalent flight hour with a 34 percent reduction in direct maintenance man-hours (an obvious resource and cost savings), some of these savings could instead be used to improve performance even further. Competition leads to a gain in efficiency. How this gain is divided between performance gains and cost reductions depends on how the contract is written. One other conclusion from this case is that if the transition period is not smooth, both performance and savings can suffer.

### 6. Defense Finance and Accounting Service (DFAS) Studies

During the period 1995–2001, DFAS ran nine competitive sourcings for a variety of finance and accounting functions.[25] They varied in size from 84 man years to 650 man years—for a baseline total of 2,929 man years. The vast majority of these competitions were won by the in-house MEO. The savings ranged from 20 percent to 69 percent, with an average of 32 percent, with seven of the nine falling in the range of 25 percent to 39 percent.

What is particularly important about these studies is the fact that when competition is introduced, even when the award goes to the in-house organization, there is likely to be a savings in the range of 30 percent.

## Aggregated Results of DoD Competitive Sourcing

Table 2 summarizes the average expected savings from DoD competitive sourcing studies completed (i.e., the comparison between the prior in-house costs and the winning bid).

***Realized savings:*** There are two studies that examine the actual (realized) savings from the DoD competitive sourcings after the work has been completed: one from the Center for Naval Analysis (CNA) and one from RAND.

The CNA study[26] on actual realized savings and their comparison with expected savings is illustrated in Table 3.

"Effective costs" exclude cost changes that would have occurred whether or not the function was competed (such as one-time cost increases caused by an increase in workload). Thus, comparison of costs before the competition and the effective costs after the competition gives a good measure of the results of competition. Effective costs are 98 percent of expected costs, which shows that expected costs are generally a good estimation of later realized costs. The "observed" costs include the effects of added workloads and scope. It is observed that even with this added work, there was still a 24 percent savings relative to the in-house baseline without the added work.

**Table 2: Average Expected Savings from DoD Competitive Sourcing Studies**

| Time period | Agency | Number of Competitions | Average Percent Savings | Source |
|---|---|---|---|---|
| 1995–1998 | DoD total | 53 | 42% | GAO report Jan. 1999 |
| 1994–1998 | Air Force | 44 | 42% | CNA report Nov. 1998 |
| 1994–1998 | Navy | 3 | 37% | CNA report Nov. 1998 |
| 1995–2000 | DFAS | 9 (2,929 FTEs) | 32% | DFAS report 2000 |
| 1975–2001 | DoD total | 2,287 (98,348 FTEs) | 33% | CNA report 2001 |
| 1997–2001 | Army | 105 (10,791 FTEs) | 39% | Department of Army report 2001 |
| 1998 | DoD | 5 (1,840 FTEs) | 47% | RAND report 2000 |

**Table 3: Actual Realized Savings from CNA study**

| Time period | Agency | Number of Competitions | Savings | | |
|---|---|---|---|---|---|
| | | | Expected | Effective | Observed |
| 1988–1996 | DoD | 16 | 35% | 34% | 24% |

## Analysis of Case Results

For the competitive sourcing initiatives described above, the average savings of the cases is 33 percent—and the savings are expected to be between 25 percent and 43 percent, 95 percent of the time. Also, for those limited cases where performance improvements were quantified, the performance improvement averaged 109 percent.

To achieve an optimum implementation strategy, it is important to define the Performance Work Statement, or PWS, clearly and completely. A successful example is the application in DFAS: introducing a two-team and three-stage methodology to PWS and MEO development, establishing a new process to enhance and potentially speed up competition, instituting an executive steering group to provide oversight, and involving all DFAS business partners in the process. The strategies were seen to be effective in making the process less complicated and effective.[27]

## Effects of Competitive Sourcing on the Workforce

One of the greatest concerns about competitive sourcing is that no matter who wins—the public or private sector—there will be a significant number of public employees forced out of work. In contrast, actual results show that the number of civil employees laid off is in the single-digit percentages, even when the private sector wins. A GAO study[28] examining the effects of competitive sourcing initiatives on the workforce for three large competitive sourcing cases (with one in-house win and two contractor wins) found that very few of the employees were involuntarily separated (only 8 percent), while the actual government workforce reduction was quite significant (1,079 military were reassigned, and 348 civilian positions remained from the original 1,111 civilian positions). The remaining civilians were either transferred (27 percent) or voluntarily retired or separated (65 percent). The study also found that 26 percent of those who voluntarily separated or retired took jobs with the contractor.

### Strengths and Weaknesses of Competitive Sourcing

**Strengths**

- Competitive sourcing introduces competition (vs. prior monopoly), which promises to raise performance and significantly lower costs.
- Competitive sourcing allows historic government workforce an opportunity to bid to retain the work (vs. outsourcing or privatization).

**Weaknesses**

- The current process (A-76) is both time-consuming and expensive—as well as very complex (and not based on "best value").
- Competitive sourcing will have an impact on government workforce (both in morale and in limited involuntary separations).

An earlier CNA study found that DoD personnel programs were very effective in minimizing involuntary job loss. Even though 40 percent of the employees at depot facilities were targeted for Reduction in Force (RIF)—involuntary separation—many found other jobs through DoD job placement services, some voluntarily retired, and others voluntarily separated to take jobs with the winning contractor. As a result, only 3.4 percent were actually RIFed.[29]

## Findings from Competitive Sourcing Initiatives

1. **Trend of savings:** When the historical trends of overall DoD-expected savings from competitive sourcing between 1975 and 2001 are examined, it is evident that savings are increasing with the improvement in implementation;[30] specifically, average savings before 1994 are around 31 percent, while average savings from competitions since then are around 42 percent. Similarly, a Department of the Army (DA) independent study found that, for these same time periods, savings improved significantly—from 28 percent to 39 percent.
2. **Performance improvements:** Performance is found to improve, or at least stay the same, after the competitions (as long as this is a consideration in the process). Note that in some cases implementation during the transition period is somewhat problematic because of lack of training and support. This results in performance being lower during the first year compared to subsequent years.
3. **Average time to complete studies (competitions) decreased over time:** Average time to complete competitions declined from 51 months before 1994 to 18 months for single functions, and 30 months for multiple functions.[31] The decline in completion time contributed to implementation effectiveness and the increasing trend in percent savings. However, it is still far too long.
4. **Percent contractor wins increased over time:** Between 1978 and 1994, roughly half of competitions were won by private sector contractors, while for competitions held after 1995, about 60 percent were won by contractors.[32]
5. **Winners:** Savings from contracting decisions (i.e., private sector awards) are generally higher than in-house decisions, as seen in Table 4. However, savings from both public and private sector wins are significant, and getting larger with learning.
6. **Savings/size relationship:** As shown in Table 5, average savings are significantly larger for bigger competitions; yet they are still important even for small ones. The percent savings and savings per personnel billet increase noticeably as the size of the function increases.[33]

   Although average percent savings are smaller for the very small competitions, and regulations don't obligate competition (especially for 1–10 billets), 82 percent of studies completed had less than 45 billets, and 73 percent had less than 25 billets.[34] In DoD between 1978 and 1994, half the competitions were for 14 or fewer positions.[35] Notice also (from Table 5) that while average savings are still significant, small competitions are more likely to produce no savings than are large competitions; and the larger ones (over 250 people) will always have savings.

   Finally, although A-76 processes are not normally required for functions with 10 or fewer

**Table 4: Savings from Contracting Decisions**

| Time Period | Agency | Number of Competitions | Contracting Decision | Percent Savings | Source |
|---|---|---|---|---|---|
| 1978–1994 | DoD | 2,131 (82,000 FTEs) | Contractor<br>In-house | 40%<br>20% | CNA report |
| 1997–2001 | DA | 105 (10,291 FTEs) | Contractor<br>In-house | 51%<br>22% | DA report 2001 |

**Table 5: Saving vs. Size of Competed Effort**

| Size (number of personnel) | Total Studies | Average Percent Savings[39] | Percent with 0 Savings[40] |
|---|---|---|---|
| 1 to 10 | 796 | 22% | 37% |
| 11 to 30 | 633 | 29% | 14% |
| 31 to 45 | 142 | 32% | 9% |
| 46 to 75 | 94 | 30% | |
| 76 to 100 | 42 | 34% | 3% |
| 101 to 150 | 36 | 42% | 4% |
| 151 to 200 | | | 9% |
| 201 to 250 | 31 | 41% | 5% |
| >251 | | | 0% |
| **Total** | **1774** | **34%** | |

personnel, one study[36] found that 858 functions (around 40 percent of all the competitions in that database) with 1–10 personnel were competed using the full A-76 process. Clearly, this was both expensive and time consuming, but may have been the only way (politically) to get it done.

7. **Savings/number of bidders relationship:** This is an area of some controversy, since one RAND study[37] found that competition effectiveness was greatest when there were a few very qualified bidders (e.g., 3–6), and it fell off as the numbers became very large. Another study[38] (by CNA) found that savings continue to increase with the number of bidders, and as the number of bidders gets larger (after around 17 bidders), the increase slows down. However, in the CNA study the median number of bidders was four, so the data may not be too inconsistent (although this is an area requiring further research). Clearly there have been many examples of fierce competition when there were only two bidders for a significant contract (for example, for the DoD purchase of jet engines).[41]

8. **Sustaining savings:** Multiple studies found that savings from A-76 competitions were sustained over time. Nine of the 14 competitions analyzed by CNA (where data existed) showed no significant increase in realized ("effective") costs over the first solicitation period bids.[42] Similarly, a RAND study[43] found that savings are endured over time. (Evidence of sustained savings was more apparent for the cases where the private sector won because the costs were measurable; but the head counts for the public sector ended close to the MEO's bid, so it is believed that the costs were sustained).

9. **A credible threat of competition can result in significant (about 20–25 percent) savings:** One example is competition of road repair work in Indianapolis. In-house cost was decreased easily by 25 percent while preparing the bid. Also, according to bidding behavior simulation,[44] 22 percent savings are expected if no contractor bidding is actually performed, but only if the in-house team is facing the threat of competition. This indicates the effect of maintaining a credible potential for competition on savings, as well as the existence of slack (easily removable extra costs) as big as 22 percent (on average) for the non-competed, in-house functions.

10. **Savings by function:** When savings by function group are analyzed,[45] savings are found to be significantly higher for research, development, test, and evaluation (RDT&E) support functions

(69 percent), followed by real property maintenance, installation services, and intermediate maintenance. Essentially, the more a process can be "reengineered" for productivity gains, the greater the savings potential from competition. But even simple functions show gains as a result of the competitive pressure.

11. **Effect on Government Workforce:** A number of studies have shown that the effect of competitive sourcing on the government workforce is considerably less than has been expected. In fact, even when the winner of the competition is the private sector (replacing the prior government performers), the involuntary separations are in single-digit percentages. The vast majority of the government workers have either found other government work or gone to work for the contractor.

## Recommendations

1. **Establish an effective training system to:**

- Inform government managers that increased efficiency does not mean decreased effectiveness, and that the target of the reforms is to improve both effectiveness and efficiency.
- Inform managers in developing Performance Work Statements and Most Efficient Organizations.
- Inform managers to make better cost estimations, and assessments of actual costs and savings.

2. **Establish a system to facilitate tracking cost and performance.** Cost information should be presented using an appropriate (and consistent) activity-based accounting method that considers all relevant costs. Government management should be able to isolate a particular unit or activity within government and identify all reasonable costs associated with that activity. This is important for establishing a level playing field for industry and government competition comparisons—as well as for post-award tracking.

3. **Build an independent research unit.** There is an urgent need to collect data and analyze realized savings as well as other effects of competitions. This data and analysis, which is critical for making effective strategic decisions, is largely missing today.

4. **Create incentives and alignment of goals with mission.** As for every organizational reform, leadership and support from all levels of management are critical for a successful competitive sourcing effort. To ensure support, management should align goals of the program with the organization's mission.

5. **Subject in-house wins to recompetition every five years if performance or cost standards are not met (as is done with private sector wins).** The option of competition should always be kept open.

6. **Make comparisons, but trade off performance against cost.** Choose the party offering "best value" instead of merely choosing the lowest bidder.

7. **Shift to a Federal Acquisition Regulation-based approach,** which will be fairer than the current A-76 process as all parties will compete under the same set of well-known rules. According to GAO observations, most of the appeals after the competitive bidding process are related to compliance with A-76 regulations.[46]

8. **Shorten the competition time.** The requirement should be to complete the process in less than 12 months—outsourcing the award if it takes longer. To achieve this shortened cycle will undoubtedly require process simplification (an obviously desirable feature, in any case).

9. **Limit the process to functions that have more than 10 billets.** Competing larger projects/jobs brings more savings than competing smaller ones for which the long and costly competitive sourcing process may not be worth the results.

10. **Require senior leadership approval to cancel competitions.** Cancellations deteriorate savings a great deal and discourage future bidders. (Note that when a competition is cancelled, there is no requirement for the in-house organization to implement the MEO.)

11. **Bundle similar and small functions in one competition.** Bundling similar functions increases the size of the competition (and thus increases savings) and attracts more qualified and a larger number of bidders. More importantly, bundling similar functions creates synergy from reengineering, and increases

efficiency and effectiveness by enabling better utilization of workforce, cross training, and multitasking. Additionally, to address the issue of small business involvement, contractors competing should be obligated to have a certain percentage (around 20 percent) of their subcontracts as small businesses.

# Privatization

## Definition

Privatization is the process of transferring an existing public entity or enterprise to private ownership. It can be done with or without competition. It differs from "outsourcing" in that the management and the workforce—and often the equipment and facilities—remain the same as before, except that they are now private employees (and private equipment and facilities); it differs from "competitive sourcing" in that there is no option of the work staying in the government.

## Various Forms

- *Full privatization:* A government agency is sold completely, including all the capital assets as well as the transfer of the workforce. The property, employees, and management are all private.
- *Partial privatization:* The equipment and facility remain government-owned but the workforce is privatized (i.e., government-owned and contractor-operated). This can also be considered a form of public-private partnership.
- *"Privatization-in-place":* The work remains at the prior facility, and can be both "full" privatization (i.e., labor and equipment), or "partial" privatization (i.e., labor only). This arrangement preserves jobs and may guarantee workload, although civil servants transition to contract labor. Kelly Air Force Base and McClellan Air Force Base are two examples of privatization-in-place, and are explained in Case 4 below.
- *Employee Stock Ownership Plan (ESOP):*[47] This is a form of full privatization. In these initiatives, the operation is transferred to a private firm owned by the former government employees. The employees essentially transform governmental services into a profit-making ESOP company (among other forms, ESOPs can also be nonprofit, or linked in partnerships with a private firm). These ESOPs provide former government workers with the opportunities that a new business can offer, and enable a smooth transition from government employment. But while an ESOP may develop worker support for privatization, it is not a preferred model of privatization in that unless the former government service is in real demand in the open market, the model lacks the element of competition. The privatization of the Office of Personnel Management's Background Investigation Unit is an example of an ESOP, which is explained in Case 1 below.
- *Transitional Benefit Corporation Model (TBC)*[48]*:* The TBC model transfers underutilized government assets to the private sector, allowing for more efficient use of real estate, equipment, and even intellectual property. The TBC model occurs under the legal and business framework of a nonprofit umbrella structure, which oversees the gradual transfer of government employees and property to the private sector. The TBC model is beneficial in that it allows government employees to retain their public benefits, while improving costs and efficiency through the maximum utilization of workload and assets. However, like the ESOP, the TBC does not have the benefit of competition during the transfer process; therefore, incentives to

improve costs and performance are present only when the TBC competes for additional work in the outside marketplace.

## Case Studies

### 1. Office of Personnel Management's Background Investigation Unit ESOP[49]

Federal agencies rely on the Office of Personnel Management (OPM) to conduct background investigations and training. In response to a decision to close its Background Investigation Unit, OPM proposed to privatize that operation through an employee stock ownership program, or ESOP. Since there is also a strong commercial market in this business, the ESOP had to become competitive. This effort has saved OPM over $75 million during its first five years.[50] In addition, the employees have received bonuses and stock options. The transition was transparent to the using agencies.

OPM used a sole-source, three-year contract (with two options years) initially to help ensure that the U.S. Investigations Services, Inc. (USIS) got off to a good start. USIS was awarded the contract again in 1998, and also entered into a contract with DoD for $200 million. By bringing in commercial business, USIS has continued to grow, with over 1,000 employees in 2000. The ESOP shares were recently bought by an investment firm for $545 million, which will be distributed among the 3,600 current employees, 1,400 former employees, and other shareholders.

*Conclusion:* The investigation unit of OPM was a good candidate for an ESOP-type privatization as the services it provides are in demand outside of government. The potential of the privatized organization to be a strong commercial enterprise in the competitive market is one of the criteria for deciding which federal organizations are good candidates for an ESOP.

### 2. Indianapolis International Airport[51]

As a result of falling revenues and increased expenses, the Airport Authority Board looked for better ways to manage the Indianapolis airport system. They resolved that through privatization they could cut operating costs, improve customer service, attract added revenue to the airports, and make the airport more competitive with lower per-passenger costs. In 1995, the Airport Authority chose a private contractor after receiving several proposals. The contractor hired the full airport staff and estimated that the costs of operating the airport would fall by 25 percent (without any performance reduction). The agreement made Indianapolis International Airport one of the largest privately managed airports in the United States.

*Conclusion:* During the first year of operations, the contractor was able to decrease the per-passenger cost from an average of $6.70 to $3.87. This savings, along with a 50 percent increase in per-passenger concessions and parking revenue, led the airport to reduce landing fees by 70 percent. A reduction in landing fees will benefit the city by potentially attracting more business to the airport, meeting their goal of making the airport more competitive in the region. After seven years of managing the airport, the contractor generated $34 million in non-airline revenue. Rather than charging the airlines more for the use of the airport, the contractor generated money for the airport through increased food, retail, and cargo sales.[52]

### 3. British Telecom: An International Privatization Case[53]

Great Britain's efforts to privatize British Telecom (BT) in the 1980s involved a publicity campaign to counter public and employee opposition. This campaign promoted the purchase of shares in the denationalized company by small investors and BT employees.[54] In 1984, BT was publicly sold—nearly 2 million people attempted to purchase shares—with 90 percent of their employees purchasing shares.

This privatization resulted in significant performance improvements. Long waiting lists for phone installation were eliminated, the number of public phones increased by 83 percent after 15 years,[55] and the call-failure rate of 1 in 25 was improved to 1 in 200 (an 800 percent improvement). In addition to these improvements in customer service, privatization still allowed BT to fulfill the requirement of maintaining costly emergency phone needs and public phones in rural communities. The government allowed BT to introduce pricing that was based on the competitive market, with adjustments for maintenance costs and reasonable profit.

One of the reasons for the success of the BT privatization was the element of competition introduced by government regulation, as well as license requirements for increased performance. Once privatization was realized, with the significant number of citizen and employee stockholders, reversing the process was not politically feasible. This successful case of privatization in Britain provided the necessary incentive for the rest of Europe to follow suit. The results of privatization in 1998 were noticeable; in Western Europe, countries with competitive telecommunications have local business rates that are 27 percent lower than in monopoly countries; calls to the United States from Western Europe average 22 percent lower with international competition allowed; and Internet costs are 34 percent lower in countries with competition.[56] Thus, even with criticisms of competition being slow to start (BT did not compete in an open market until seven years after competing in a duopoly), the benefits of competition are measurable for consumers.

### 4. Kelly and McClellan Air Force Bases[57]

Privatization-in-place was employed by the Air Force as a remedy for excess labor and facilities at Air Logistics Centers attempting to avoid job losses while increasing efficiency. Previously, Air Logistics Centers were operating at less than 50 percent capacity. As a result, the Base Realignment and Closure Commission (BRAC) recommended closure of these facilities. Instead, President Clinton decided to privatize these centers at the Kelly and McClellan Air Force Bases, allowing the more than 25,000 civilian employees to stay on as private employees. This decision to use privatization-in-place served to avoid politically sensitive layoffs while still maintaining surge capacity for emergency situations (as long as the excess capacity is funded, or if the privatized facility is able to bring in other work).

A GAO study[58] estimated that the potential savings from the logistics center closures could be as high as $206 million, well above the savings of $70 million estimated by the BRAC. The GAO study based that estimate on the assumption that the closing depots' work would be transferred to the three remaining Air Force depots, since the privatization-in-place plan does not solve the excess capacity problem at the other depots. The GAO estimated that the greater savings resulting from the transfer of work will occur when the remaining depots reduce excess capacity from 46 percent to 8 percent, economies of scale and other efficiencies are employed, and the hourly rates of those at the receiving locations are lowered by an average of $6. But even given these GAO figures, privatization-in-place was considered a more attractive option than the full transfer of work to another facility, considering the political ramifications of the latter. Also, even if the work had been transferred, it would still be performed without any competition (i.e., on a monopoly basis by the government). However, with the privatization approach, if the contractor performed poorly or costs rose, the government could then run a competition for its work, allowing other private or government sources to bid.

Recent contracts indicate that in these two cases the privatization-in-place plans were successful. Two contracts, worth a combined $11.8 billion, were competitively won for work performed out of Kelly by private companies working in partnerships with the Tinker and Hill Air Force Bases.[59] The Air Force expects that overall savings from the consolidation of depot work will be worth $2.6 billion over the course of roughly 15 years.[60] However, because of the success of the privatized depots, concerns remain about the "50-50" law imposed by Congress to ensure that only 50 percent of depot work is contracted out, as it hinders the Air Force from operating with efficiency and flexibility.

### 5. Naval Air Warfare Center Takeover by the City of Indianapolis[61]

In the mid-1990s, a series of base closures nationwide galvanized Indianapolis officials to work to save the 2,800 jobs at the Indianapolis Naval Air Warfare Center (NAWC), a large contributor to the local economy. In a solution that benefited the city, the workers, and the Navy, city officials decided to competitively contract with a private firm to operate the center, bringing in outside work in addition to performing the services needed by the Navy. The deal allowed the jobs to remain in the city, but technically skilled workers would be private rather than government employees. This is an example of partial privatization, where the civilian workforce becomes a private workforce under the new contractor, but remains in the government-owned facility; and the contractor is free to add new capital equipment (over which it will retain ownership).

*Results:* Because 98 percent of the original NAWC employees chose to work for the new contractor, there was a smooth transition in providing the services that the Navy required. In addition, the cost savings planned will greatly benefit the Navy; the contractor has committed to reducing the rates it charges the Navy by 15 percent over the next five years. After that time, the company will have to compete with other firms for Navy contracts to ensure that costs remain low.

As for the city of Indianapolis, the privatization move allowed it to keep the jobs important for the local economy, and the contractor planned to increase employment at the site to 3,000 by 2002. The city also receives more than $3 million annually in taxes on property that was previously tax-exempt. Thus the plan at NAWC enabled a skilled workforce to keep their jobs, performing additional work in the private sector while providing the public sector with lower cost services.

### 6. United States Enrichment Corporation (USEC)

In the 1940s, the United States government created the United States Enrichment Program (in the public sector) for the provision of enriched uranium for nuclear weapons. In 1996, Congress passed the USEC Privatization Act, which required that the United States Enrichment Corporation would be sold either to a third party or as a public offering. The act established four criteria necessary for the sale: the United States Treasury would receive the net present value of USEC; USEC would be protected against foreign ownership; protections would be in place for public health, security, and the environment; and domestic utility industry demands would be reasonably met. To satisfy these criteria and to ensure that the privatization process was accomplished in the best public interest, the Treasury coordinated the input from government agencies, outside financial advisors, bidders, unions, and other affected parties. After the consultation process, the Treasury decided on the public offering, which was expected to result in fewer layoffs, less initial debt, and higher proceeds.[62]

*Results:* The public offering of USEC resulted in a net revenue for the government of $1.38 billion, with 100 million shares offered at a price of $14.25 per share.[63] The Treasury continued to monitor the company through a "post-closing" agreement, which limited layoffs, plant closings, and executive compensation for the two years following the sale. The government also remained involved with the company after the sale through the investment of research and development (R&D) funds to aid in research to lower production costs, ensuring that the company would be better able to compete with foreign companies.[64] By 2000, the Treasury testified before Congress that it was satisfied with the sale and the status of USEC and had decided to remove its extensive oversight and allow the company to function as a fully private entity.

### Strengths and Weaknesses of Privatization

**Strengths**

- If competition is introduced, customers receive better prices and higher performance for private services formerly provided by government monopolies.
- Government assets can be converted into revenue through sales to private firms.
- Excess capacity of government facilities can be addressed through privatization-in-place, maintaining jobs and, if competition is introduced, using facilities more effectively.

**Weaknesses**

- Where there were once public monopolies, privatization may produce private monopolies, not competition.
- Governments can maintain control over newly privatized firms, preventing open market competition.

## Lessons Learned and Recommendations

1. **Privatization introduces savings and quality improvements** (as long as competition is maintained). Expected savings from the cases ranged from 15 to 25 percent and, for the limited cases that have been analyzed, the savings were, in fact, realized.

2. **Competition is key.** Expected savings from sole-source privatization are lower than savings from privatization with competition for the award. Privatization with subsequent competition is expected to yield significantly more savings and performance improvements.

3. **Privatize services in demand.** Agencies that provide services that are in demand in both the public and private sectors, such as the investigative services of OPM, are good candidates for privatization (and for building ESOPs). The newly private entity should be self-sustaining, and should not need the government to subsidize it in order to stay afloat.[65]

4. **Consider change management issues.** It is important in cases where the government's existing workforce is retained under new (private sector) management (such as ESOPs or privatization-in-place) to give special consideration to change management and competitive incentives, as culture clash is likely. Private consultants can be used in implementing and establishing change.

5. **Government should strictly maintain open market competition and fair prices after privatization occurs.** The British Telecom privatization was a big success, with the help of supportive regulations; other European governments that failed to maintain a truly competitive market after privatizing services were less successful. One of the government's principal roles in the implementation of privatization is to make and enforce the rules and regulations that keep the market open and competitive.

6. **Government needs to monitor (but not control) newly privatized entities to ensure full public benefit.** The Treasury practiced continuous oversight of the United States Enrichment Corporation for the two years following the sale to ensure that it remained a benefit to the public. The government invested R&D funds to help the company in the competitive enrichment market. However, after two years, the Treasury reached the decision to allow the company to act fully private, in contrast to some of the European models in which the government remained intertwined with the private company.

7. **Privatization-in-place allows addition of private work to lower costs of public work.** The privatization of the Indianapolis Naval Air Warfare Center demonstrated how a contractor could utilize skilled former Navy employees for private enterprise, which enabled the firm to commit to charging lower rates to the Navy.

8. **Privatization of assets and operations that are not inherently governmental can result in large revenues for the public.** Private firms worldwide are able to enrich uranium and make a profit. With no justifiable reason for the United States government to perform such work, the Treasury was able to bring in $1.38 billion in revenue from the sale of USEC. Other government assets (like helium) offer similar possibilities for privatization revenue.

# Public-Private Partnerships

## Definition

Public-private partnerships (PPP), also referred to as public-private ventures, allow the public and private sectors to share the costs, risks, benefits, and profits. Public-private partnerships take many forms, between the range of fully public and fully private operations.[66] In PPP initiatives, production work, facilities management, and the investment of capital are functions that can be shared between public and private entities to obtain efficiency and cost savings. One of the key elements of a PPP is the allocation of risks between the public and private sectors. When using other strategies, the government assumes only recipient risks; in PPPs, it has to assume both recipient and sourcing risks. When used appropriately, PPPs can enable the government to take advantage of privately owned infrastructure, technology, financing, or capabilities. To be truly effective, a PPP must operate in a competitive environment; otherwise the incentives for high performance at low cost will be missing.

## Private Financing

Private financing is the use of private funds (rather than public funds) to provide a public good. Private financing, as a form of public-private partnership, is utilized by government entities to enlist the investment of private firms in order to afford to finance a project. The firm benefits from the partnership with revenue from the project, and the government benefits in various ways: sharing the revenue, decreasing its costs, and having the facility or service offered by the private firm available. The VA Medical Center took advantage of private financing to construct a needed energy facility (Case 3), as did the state of Virginia in authorizing the construction of a private toll road to ease traffic congestion (Case 4).

## Case Studies

### 1. Army Partnerships: Three Cases

In 2002, the Army considered a more effective use of its valuable property through public-private partnerships. Army repair depots were operating at 77 percent capacity, and the Army had to increase its budget for the depots by 34 percent from FY 2002 to FY 2003.[67] The Army planned to focus its personnel only on tasks essential to war-fighting, and to privatize those functions that are non-essential to the mission or that detract from the mission, such as property maintenance. The Army estimated that it could save over $600 million a year by moving many of the approximately 11,000 civilian and military depot personnel into private jobs, and from the for-profit use of the excess capacity of their facilities.[68] Partnerships with private firms already existed at the Red River, Tobyhanna, and Anniston Army Depots.

The results of a RAND study[69] in 2002 found that the Army could improve its "readiness posture" by removing the distraction of maintenance from its war focus. Additionally, facilities would be better prepared in the case of emergency, because the Army could not afford the upgrade money, and private investment in the maintenance of these facilities could improve them. The study recommended that the Army use its property to save costs and

attract revenue by converting its five repair depots into entities called Federal Government Corporations (FGCs). These FGCs would operate with the flexibility of a private company regarding their finances, personnel, and other operations; however, they would need to balance that flexibility with congressional oversight in order to be effective and to address inevitable political concerns.[70]

***Aberdeen Test Center***

The Army plans to open Aberdeen Test Center (ATC) in Maryland to outside academic and private entities for research use, and estimates savings of $1 million to $3 million per year in revenues.[71] The partnership, referred to as the National Testing, Training and Technology Company ($NT^3C$), will be set up by 2004 if the Army and Congress complete authorizing legislation. $NT^3C$ will be a "limited liability company" with private and academic partners, enabling the partners to share liability through the pooling of their capital and expertise.[72] The potential partners the ATC is pursuing are those interested in testing vehicle and communication products.

Currently, the ATC operates with 25 percent of its funding from the Army and 75 percent from test customers. By forming this new company, the ATC hopes to continue to obtain private funding needed to maintain a state-of-the-art test facility for optimum military tests. The private uses of the facility will also help to lower overhead costs and offer the highly skilled workforce more frequent testing experience. Of course, it will have to offer competitive prices and performance to attract private activities.

***Sharing Production at Anniston and Letterkenny Depots[73]***

In 1997, the Anniston Depot partnered with a private firm to upgrade 62 Fox reconnaissance vehicles.[74] The company used the depot for production, and then paid the depot for tasks such as welding, grinding, cleaning, and painting. As of 1998, the depot had received $1 million for work done on the first eight vehicles. According to depot personnel, the partnership has also resulted in lower total costs for the combined work while the core depot capabilities remained intact; and the contractor invested $450,000 in facility upgrades.

In 1993, a work-sharing partnership was also developed at Letterkenny Army Depot to efficiently construct the Paladin, a self-propelled Howitzer. By using government facilities and contractor components, $15 million in savings resulted, as well as $3.4 million in contractor investments to renovate the facilities.

***Armament Retooling and Manufacturing Support (ARMS) Act[75]***

In 1992, the Armament Retooling and Manufacturing Support (ARMS) Act authorized the Army to invest funds in its ammunitions plants in order to attract private tenants. The ARMS Act predicted that by repairing, refurbishing, and upgrading ammunitions plants, the Army would be able to reduce maintenance costs, create jobs, and encourage private use of the facilities while retaining core manufacturing capabilities.

*Results:* Between 1993 and 1999, the government saved $103 million and 5,133 jobs were created as a result of the ARMS program. The number of tenant employees, 90 percent of whom are commercial, grew by 30 percent from 1994 to1999. There are still concerns about the program regarding the unclear roles and responsibilities between the public and private partners in the management of the Army ammunition plants. Additionally, some of the facilities discontinued the ARMS program before the benefits could be realized. Overall, though, it is clear that the program has succeeded in lowering facility costs, encouraging more private tenants, creating jobs, and bringing in revenue to cover the costs of facility improvements.

### 2. Indianapolis Wastewater Treatment (White River Environmental Partnership)[76]

In the early 1990s, the city of Indianapolis had to deal with tremendous deficits and impending infrastructure improvement costs for its water system. To handle these issues, city officials decided to develop a public-private partnership; a private organization would manage the two publicly owned Advanced Wastewater Treatment (AWT) facilities that served the city. In 1993, the city signed a contract with the White River Environmental Partnership (WREP), a consortium of three companies, one of which was the parent company to the Indianapolis Water Company. Knowing that it was the first major city

to contract wastewater facilities, the city used independent consultants to carefully plan and conduct the competitive bidding process before the WREP was chosen.

*Results:* By 1999, the WREP partnership had generated over $72 million in savings for the city. WREP reduced staff levels from 328 in 1993 to 157 in 1998. In anticipation of layoffs, the city transferred 67 of the staff to other city jobs, 43 found jobs through an outplacement system funded by the WREP, 10 found jobs on their own, and five retired (there is no information on the remaining 46 employees laid off). The union admits that the environment for members at the AWT facilities has improved; wages and benefits are 9 to 28 percent higher than for other city employees, accidents are down 84 percent, and grievances are fewer. Performance has also improved as water quality violations have fallen 86 percent; thus, the WREP exceeded city performance measurements. Due to the success of this partnership, the city granted the WREP a 10-year extension to the contract in 1997, projecting future savings of $189 million as a result of the move away from city management.

### 3. VA Medical Center, Mountain Home, Tennessee[77]

In an effort to take advantage of its property holdings to attract revenue, the Department of Veterans Affairs (VA) developed an enhanced-use leasing arrangement whereby private firms could finance, develop, manage, and profit from VA property. This arrangement was authorized in 1991 and, since then, has enabled the VA to enter into PPPs involving diverse projects, including office buildings, senior residential facilities, homeless shelters, and health care support facilities. This lease allows for private investment and use of VA properties in return for various benefits such as a share of revenue, services, and facility use, All proceeds related to the lease, after costs are reimbursed, go straight into medical care appropriations; this creates incentives for managers to make the most productive use of property in order to improve the core functions of the agency.

In 2001, the VA opened the Mountain Home Energy Center, a facility financed, developed, and operated by a private contractor to provide energy for the James H. Quillen VA Medical Center and for non-VA customers. The facility was designed not only to meet the regular energy needs of the VA, but also to meet 100 percent of its emergency power needs, an improvement over its previous capabilities. The lease requires fixed terms for the VA to purchase energy for 35 years; yet there was built-in flexibility allowing the VA to adjust for future needs. Overall, the partnership resulted in savings for the VA of $35 million, with $11.5 million in discounted recurring costs and $17.5 million in life-cycle costs. The private lessee was to profit by selling excess energy to non-VA customers, and the VA would receive a percentage of that revenue, estimated at $5 million.

### 4. Dulles Greenway

The concept of a privately financed toll road developed in response to increasing strain on current highways and a lack of state resources to improve them. The states authorized the creation of these roads by transferring control over the property and rights of the private entity to collect tolls, generally for a temporary period of time. This transaction balances risk between public and private entities.[78] In the late 1980s, the state of Virginia faced a $7 billion deficit for transportation needs, yet it needed to build a highway to give residents of Loudoun County access to expanding employment opportunities located in northern Virginia and Washington, D.C. To solve this problem, the state authorized the development of private toll roads in 1988, and by 1990, granted the partnership Trip II the authority to build the Dulles Greenway, a completely private venture that would be returned to public ownership in 2036.

The Dulles Greenway is a 14.1-mile extension to the state-owned Dulles Toll Road. It opened in 1995 as the first private toll road to be built in the state since 1816, and one of the first national roads to be financed, built, and operated with private money since the 19th century. When the road opened September 1995, ridership was a disappointment; only about 10,500 vehicles per day used the extension after the first six months.[79] The project originally estimated ridership based on the economic growth of the late 1980s, and did not include the proper level of risk when developing its financing plan, thus causing serious financial problems with much lower than expected revenue.[80] As

### Strengths and Weaknesses of Public-Private Partnerships

**Strengths**

- PPPs allow the government to finance facilities or services needed, but which it could not afford to publicly fund.
- PPPs make the most productive use of valuable government assets by bringing in revenue, reducing overhead costs, and providing investments for facilities; and can be used to address excess capacity.

**Weaknesses**

- Authority can be blurred and roles made unclear between public and private partners.
- The government assumes a greater portion of risk compared to other forms of privatization.

a result, the project barely met operating costs, and by 1996, Greenway owners began to default on their loans and were on the verge of bankruptcy. Rather than acting as a partner to support this project, the state expanded a free road competing for ridership, and state officials were said to be ambivalent about the private project.[81]

In 1999, the project received a private refinancing package of $360 million in insured bonds, and was able to repay its initial creditors and expand the road. Ridership then quadrupled from 10,500 weekday commuters in 1995 to nearly 44,000 by 1999.[82] With this increase in ridership along with an increase in toll charges (except for passengers using the electronic system), the project was able to afford expansion. Without needing state money to finance the project, the Greenway was able—with private financing—to complete the first five miles of a six-lane widening project in 2001.[83]

## Lessons Learned and Recommendations

1. **Competition is critical.** Once again, incentives are required to create the motivation for a PPP to achieve lower costs and higher performance (otherwise, it is simply a public-private monopoly).
2. **Significant savings and increased revenues result.** Examples demonstrate the savings to public services, lower-cost facility maintenance, and decreased excess capacity, as well as revenues resulting from PPPs.
3. **Performance improvements can result.** The WREP partnership in Indianapolis improved water standards, by multiple measures, over the previous city management. The Mountain Home Energy Center provided the VA Medical Center with 100 percent of its emergency energy needs.
4. **Underutilized, costly-to-maintain facilities are potentially valuable assets for PPP initiatives.** The Army now recognizes that its depots and ammunitions plants, which are both valuable and underutilized, can operate at lower costs and greater capacity with the influx of private tenants and production. The VA developed enhanced-use leases to make more productive use of its property assets and to raise funds for its core functions.
5. **Balance is needed between government oversight and flexible, local control over initiatives.** Partnerships can blur the lines of authority between public and private entities. The RAND recommendations for the ARMS program and the results of the VA Medical Center partnership illustrate the need for a balance between flexibility in operations and government oversight and accountability.
6. **Efficiency can result from the sharing of production.** The Army's Aberdeen Test Center, Letterkenny Depot, and Anniston Depot utilize facilities to share the production of goods with private partners, resulting in lower overhead costs, investments in facilities, and more efficient use of its workforce.
7. **Understanding market demand for new product/service is vital.** Though the Dulles Greenway eventually recovered financially and has increased ridership, it nearly went bankrupt in failing to adequately predict the number of riders, the marketing needed, the toll that customers were willing to pay, and subsequent revenue that would result.
8. **Private financing can be utilized to fund projects the government cannot afford.** Virginia

authorized the private Dulles Greenway to pay for needed infrastructure that the state could not afford with its huge deficits. The VA Medical Center used private financing to build an energy facility to improve capabilities. Projects providing public services with private financing, building, and operations are widely being used, enabling infrastructure to be improved without raising taxes or draining scare government resources.[84]

# Government Entrepreneurship ("Franchising")

## Definition

Government entrepreneurship is the development of separate fee-for-service entities operating within a governmental agency. These entities compete to sell services to other government agencies and often contract with the private sector to provide the services offered, while a core staff of government employees retains managerial control over the operation.

The term "franchising" is often used in place of "entrepreneurship." In this context it does not refer to the traditional franchise arrangement wherein a private business is given a license to operate a service on government land (e.g., a gas station or a fast food outlet) or to provide a service government traditionally provided.

## Various Forms

Within the federal government, entrepreneurship has taken several forms. Under the 1994 Government Management and Reform Act (GMRA), franchises were allowed to form in order to eliminate the monopoly of administrative services offered to the government. These "enterprises" or "franchises" were expected to operate within a competitive environment and offer better services for lower costs. Previously, cross-servicing agreements enabled agencies to charge fees to other agencies for services provided, but the 1994 law allowed the formation of separate franchise funds to operate with more financial freedom and act more like private businesses. Government agencies now have the ability to choose among the service providers or retain an in-house arrangement in order to obtain the best services based on quality, cost, and other factors.

In addition to franchises, entrepreneurship in government can take the form of long-term Government-Wide Acquisitions Contracts (GWACs) for IT products, where the sponsoring enterprise assembles an acquisition contract that other agencies can use for a fee. The Clinger-Cohen Act of 1996 allowed for the formation of these IT GWACs.

## Case Studies

### 1. Franchise Fund Pilot Program

Six franchise funds were established as a pilot program through the 1994 GMRA. These funded pilot programs act as internal entrepreneurs and are authorized to provide their customers—other government agencies—with administrative support services. The goal of this program was to lower the unit cost of administrative services by introducing competition and economies of scale, and eliminating duplicated services. The pilot program also established several operating criteria, including competition, transparent pricing, full cost recovery, surge capacity, performance measurements, and benchmarks against competitors.

In 2002, John Callahan reported on the achievement of the GMRA experiment.[85] He assessed the overall program to be a success; however, this conclusion is reached by measuring only the limited available data that compares the first two full years of operation: FY 1997 and FY 1998. In these two years, the funds generated $600 million in rev-

enues. For the funds with available data, the growth in revenues averaged 128 percent, with a low of 1 percent to a high of 468 percent. The vast majority of this business (from 50 percent to 95 percent) was handled by private contractors, yet the services were managed and monitored by the government employees who have the organizational knowledge to meet the needs of their customers. In addition to financial strength, the funds demonstrated their ability to compete—four franchises competed for a total of 60 bids and won 43 to 100 percent of the competitions. Finally, savings were achieved for customers of four funds. The results are given in Table 6 below for five franchises; two of them are described in more detail below.

***Federal Occupational Health***

The Federal Occupational Health (FOH) fund was created in the Department of Health and Human Services (HHS) to provide basic occupational health services to locations across the country, ranging from physical and mental health care to workplace safety training and hazard protection. The agency manages the subcontracting service providers—84 "core" government employees oversee the tasks of over 1,600 contracted employees. These core employees, similar to those in other funds, have developed essential managerial and marketing skills to provide high-quality, customer-focused services, often custom-tailored to fit the customers' needs. This attention to the customer has paid off—the FOH received 88 to 92 percent "excellent" or "good" responses on five measures of customer satisfaction. However, some fund managers were concerned that with these marketable customer skills, their core staff would move to private industry for better pay.

As a measure of the fund's overall success, the FOH managed to achieve a 10 percent growth in revenue from FY 1996 to FY 2001 (from $84.9 million to $93.6 million). In addition to creating revenue growth, the FOH worked with HHS to intelligently manage risk. One of the potential disadvantages of the franchise structure is that, similar to PPP initiatives, the government assumes a higher level of risk. While the FOH aggressively sought new customers, offering such quick services as the anthrax inoculation needed by the U.S. Army, the franchise was careful not to take on risks that could have been too great. HHS turned down a proposal by the FOH to manage environmental cleanup of a contaminated U.S. Navy site, citing the potential for FOH to incur costly legal liability for the site. The FOH has also considered its strengths in competing for services, moving more toward reasonably priced, quality services and away from lower-quality and lower-priced services.

**Table 6: Characteristics of Franchise Funds, FY 1997–FY 1998**[86]

| Franchise Fund | Year Started | Service Efficiency | Revenue Growth | Full-Time Employees | Percent Business Private Contractor | Competitive Bidding |
|---|---|---|---|---|---|---|
| Department of the Treasury | 1996 | 7–27% support cost reductions | $37–$80 million | 84 (120 FTEs) | 84% | 10 bids, 50% won |
| Department of Health and Human Services | 1997 | Reduced clinical training costs | $81–$82 million (by FY01, $93.5 M) | 103 (90 FTEs) | 87% | 21 bids, 43% won |
| Department of Veterans Affairs | 1996 | 83% unit rates decreased | $59.2–$88 million | 433 (546 FTEs) | 50% | 25 bids, 100% won |
| Department of the Interior | 1996 | n/a | $3.4–$19.3 million | 12 (58 FTEs) | 85% | 4 bids, 50% won |
| Environmental Protection Agency | 1996 | 9.6–20% cost savings in business units | $104–$111 million | 65 (59 FTEs) | 95% | None |

***Treasury Franchise Fund***

The Treasury Franchise Fund (TFF) was designated as a way for the Treasury Department to provide a wide range of administrative services, from accounting and auditor training to mail and messenger services. The TFF has a core staff of 490 employees, with subcontractors performing the majority of the services (and receiving 83 percent of the revenue). The TFF was designed with strict rules:

- Operating costs cannot be subsidized.
- Quarterly statements must be issued.
- Annual audits must be conducted.
- Benchmarks are used to measure service performance.

But given this strict financial and performance scrutiny, the business units within the TFF act as fairly self-sustaining units, as separate private entities would.

By FY 2000, the TFF had met all of its benchmarks of performance, including measures of customer service, financial self-sufficiency, and competitiveness. Compared to the FOH, the TFF has achieved an even greater growth in revenue, from $38 million in FY 1997 to $165 million in FY 2000 (an increase of 334 percent). Additionally, the TFF exceeded its customer service approval rating of 80 percent in both 1999 and 2000. High customer approval may in part be attributed to the fact that customers of TFF have reduced administrative costs from 7.3 percent of the budget to 5.5 percent. But, given these successes, the TFF has concerns that its temporary pilot status, as well as impending retirements of its core staff, will impede its future success.

With this initial success, the Treasury decided in 2000 to launch a new advertising brand called FedSource, with the three franchises under TFF combining to market their services. They currently maintain a website advertising their services, which is indistinguishable from that of a private company. Other enterprises have followed this marketing strategy; in 2002, GovWorks was created as a trademarked brand for an enterprise operating within the Department of the Interior.

## 2. Government-Wide Information Technology Acquisition Contracts[87]

In 1996, Congress passed the Clinger-Cohen Act, which replaced the 1965 Brooks Act and enabled agencies to assemble long-term, government-wide acquisition contracts, or GWACs, for IT products and to charge fees for their use. The goal of this enterprise was to offer agencies a faster, cheaper alternative to competing sources and writing their own contracts, thereby saving those administrative costs.

The National Institutes of Health's Information Technology Acquisition and Assessment Center (NITAAC) stepped up to the challenge and awarded Indefinite-Delivery, Indefinite-Quantity (IDIQ) contracts. These contracts enable companies to constantly bid for every order through a faster purchasing cycle, rather than opening a lengthy competition process for each order. NITAAC's IDIQ initiative successfully attracted the business previously lost within its own department.

In 1996, the Department of Transportation formed a franchise called the Transportation Administrative Services Center (TASC) to handle administrative services for a fee. With a focus on providing good service to customers at a fair price, TASC offered a GWAC called Information Technology Omnibus Procurement (ITOP), which by 1999 was used by more than four agencies to make 250 orders worth $851 million. The process benefited the agencies involved by saving them time; the normal contracting process took approximately one year, while with ITOP it took a mere six to eight weeks. By charging fees of 1 percent to 2.75 percent, ITOP generated income of roughly $20 million from the orders. To attract more customers, fees are set in a range based on the amount of work the customer is willing to perform. The success of the first ITOP allowed for an ITOP II, a $10 billion multi-agency pact awarded in 1999.

Thus government entrepreneurs took advantage of the loosening of government restrictions on the procurement process by creating contracts for agencies to share—saving both time and money. Once again, entrepreneurs succeeded by seizing an opportunity and focusing on customer service demands.

### 3. The Forest Service[88]

After staff and budget cuts in the 1990s left the Forest Service short on skilled staff, the agency experimented with a plan to create competitive, self-supporting enterprises within the agency. Unlike other government businesses that are hesitant to provide services core to their missions, the Forest Service enterprises utilize the expertise of its staff to provide trail services and tree assessments for timber yields, along with more administrative services like workers' compensation claims. In the first year, workers' compensation services resolved eight cases that saved the Forest Service $244,000 (as much as $4 million over the course of the employees' lives). One employee was able to save his job by capitalizing on his skills as a tree measurer and sell his services as an entrepreneur.

In order to give these enterprises the freedom to take risks and act independently, the Forest Service had them report to a separate department called the "reinvention laboratory," established with the mission of fostering innovation. Because these enterprises must cover all overhead costs, along with salaries and benefits, the laboratory provides them with advisory financial services. With this help, the enterprises are able to keep close watch over their finances, calculating their true costs and knowing where they can cut costs (e.g., several offices moved to lower-cost rental space). In addition to financial help, the laboratories have supported employees through the difficult transition from bureaucrat to entrepreneur, and have enlisted the support of local managers as well as the union located in the forest area served by the enterprises (called Region 5).

After four years, Region 5 fostered the growth of 18 enterprises. Through the financial and managerial support of the laboratory, most of the enterprises were able to cover their costs within the first year. Additionally, employees gained valuable marketing, accounting, and innovative skills through the experience.

### 4. e-Payroll for the Federal Government

In 2002, the Office of Personnel Management (OPM) started a program called the e-Payroll initiative, which consolidates the entire federal payroll operations into the hands of four agencies, including two franchises: the Department of Agriculture's National Finance Center and the Interior Department's National Business Center. Government agencies must decide which of the four agencies they will pay to operate their payroll systems. The idea behind the initiative is that by taking advantage of economies of scale, agencies will be able to lower their current costs of cutting checks (costs which average between $32 to $663 per payee, annually).

A 2001 analysis for OMB[89] reported that the e-Payroll initiative could greatly reduce costs and avoid expensive system improvements with the consolidation of the payroll system. The problems they identified with the current system included a lack of standardized payroll processes; software systems 13 to 35 years old supporting 80 percent of payroll transactions; and potential systems infrastructure improvements that could cost up to $200 million per system. To remedy these problems, the report recommended the following:

- Designate OPM to manage payroll policy and operations, allowing for a centralized analysis of processes and better decision-making capabilities.
- Standardize federal payroll policies and processes. This would create cost savings through easier consolidation, and provide more timely and improved financial information for managers to use.
- Consolidate systems, allowing for a choice among two to three providers. This would reduce costs through economies of scale, and avoid large-scale system improvement costs associated with having 14 providers. Consolidation also reduces the number of government employees devoted to non-core missions.
- Integrate human resources and payroll processes, reducing redundancies and lowering overhead.

OPM has adopted many of these suggestions, including the consolidation of providers down to four agencies. It estimates that costs of migration of payroll systems to the four providers will be $40 million this fiscal year and $50 million next fiscal year.[90] Technology replacements for the four systems will occur in 2005. While this plan will likely result in savings from consolidation and cost avoidance, it lacks a key element: competition. Since

### Strengths and Weaknesses of Government Entrepreneurship

**Strengths**

- Franchising provides administrative services to government agencies in a competitive environment, thus improving performance and lowering costs
- Franchising enables government agencies to acknowledge the true costs of their services, and subsequently adjust to save costs

**Weaknesses**

- Funds are relatively independent from political oversight and accountability to Congress.
- There is a potential for the agency to lose sight of its core functions.
- There is a tendency not to use competition, and thus lose the incentive for higher performance at lower costs.

agencies are assigned to a service provider, there is no strong incentive for costs to remain low, and the initial savings realized may not last.

## Lessons Learned and Recommendations

1. **Government "customers" save money and receive quality services.** Much of the cost savings is due to the ability of franchises to aggregate the service needs of smaller agencies and then use economies of scale to charge lower prices for them.[91]
2. **Fees paid to enterprises can provide full cost coverage.** With financial help from the reinvention laboratory, Forest Service franchises charged fees that reflected true hourly rates of their staff, and most were able to cover costs within a year. Within one year of the formation of the six government franchises, three had plans in place for full cost recovery.
3. **Employees develop strong managerial and customer-service skills.** By having to compete with other enterprises, employees must maintain a strong focus on customer service and meeting demand, and have the skills to market the services and the financial know-how to cover the costs of operations. While these highly qualified employees contribute to the success of the enterprises, managers worry that these skilled individuals will be lost to higher paying jobs in the private sector.
4. **"Franchise funds" maintain the role of government as "manager" while allowing private contractors to be the "provider."** Close to 80 percent of federal "franchise" revenues go competitively to private firms,[92] while government workers with organizational knowledge are able to maintain control over the operations and meet the needs of customers. The fact that the majority of funds go into private companies counters the criticism by private contractors that government businesses unfairly favor the government.
5. **An event or opportunity is often necessary to enact change.** The Forest Service used impending staff and budget cuts to gain support for enterprises as a "do or die" solution. NITAAC and TASC took advantage of the Clinger-Cohen Act to develop the successful shared-IT acquisition contracts.
6. **Strong leadership and support at the top is necessary for success.** A business unit within the Treasury Franchise Fund was forced to shut down after failing to cover costs in 2000 and 2001. The unit succeeded in 1998 and 1999, but after a leadership change in the Treasury Department led to a lack of support and a more micromanaging style overseeing the unit, the unit had a high turnover of staff and failed to perform.[93] On the other hand, the leadership and support given by the reinvention laboratory was crucial for the success of the Forest Service enterprises, having offered financial advice and obtained the support of the regional managers and union.[94]
7. **Services in demand need to be identified.** The Forest Service staff decided to offer workers' compensation services when they saw claims falling through the cracks. The IT GWACs were a response to the lengthy procurement process that agencies were willing to pay fees to circumvent.

8. **The focus must be on the primary mission and political accountability of the agency.** Enterprises need to be monitored to ensure that the core mission of the agency is not compromised. As Congress loses budgetary control with the increase of franchises, there is concern about the level of political accountability that remains. Some of these concerns will be addressed, as OMB now requires agencies to report the number of employees funded by fee-for-service agreements, and is moving to make the interagency contracts open to competition more frequently.[95]

9. **Maintaining competition among franchises will be key to long-term efficiency**. While the OPM e-Payroll initiative will likely result in savings in the near future, because agencies are assigned to one of the four franchise providers, the project will not have the future benefit of competition.

# Contractors in Security Operations: A Special Case

Although not a distinctive sourcing strategy, the use of contractors in security operations (including on or near the battlefield) poses some unique issues that are addressed here.

## Definition

Using contractors in security operations has developed as a method to achieve more cost effectiveness in the military, to compensate for military personnel cuts, to utilize the technological expertise of contractors, and to allow for flexibility from congressional troop limits. Contractors on the battlefield are not considered combatants, but rather civilians accompanying the force. Contractors provide the military with a wide variety of services, ranging from logistics support (i.e., maintenance, housing, food, and basic health care), recruitment and training, the development and operation of new technology, security services for State Department personnel, and even military operations.[96]

These contracts are basically a form of contracting-out for services (as described in the introduction in "Understanding Sourcing Options"). However, because of the risks involved to individuals and corporations performing the services, they have many unique requirements. Nonetheless, the overriding consideration is that they, like other contracting-out activities, receive their maximum benefits—in performance improvements and cost reductions—through the presence of competition; and they can be acquired and terminated as the services are needed (rather than hired as permanent government employees—military or civilian).

Overall, an estimated 1,000 U.S. companies now provide support of all sorts for the armed services.[97] It is clearly a growing trend. In the 1991 Persian Gulf war there were 10,800 contractor employees (making up 2 percent of those deployed), while in the mobilization in preparation for the 2003 Persian Gulf conflict there were 25,000 contractor employees (making up 11 percent of the deployment).[98] The positions are frequently filled and directed by former military officers and enlisted personnel. Nonetheless, it is a requirement that contractors send employees who will be stationed for 30 days or more near the front lines to Fort Benning, Georgia, for training and equipment (including seminars on the region they are going to, and all required documentation and equipment).[99]

## Various Forms[100]

**Theater support contractor**s provide services to deployed forces that meet the immediate needs of the operational commander, conducted under the authority of the theater principal authority responsible for contracting (PARC). Examples of services provided include construction, port operations, transportation, and security.

**External support contractors** provide support to deployed forces that augment the shortage of military capabilities through contracts that are administered by organizations other than the PARC. Many external contractors work within a pre-arranged umbrella contract called the Logistics Civil Augmentation Program (LOGCAP), in addition to the Air Force Contract Augmentation Program (AFCAP). Much of this base operating support is provided to peacekeeping deployments.

**Systems contractors** provide support to material systems by enhancing their readiness, and by offering mission-enhancing and mission-essential maintenance and operation services. Many of these contractors contribute sophisticated technical expertise to operate some of the equipment used by the military.

## Case Studies

### 1. Logistics Civil Augmentation Program (LOGCAP): Two Cases

Since 1992, the Army has used LOGCAP to hire contractors to provide logistics and engineering support to contingency operations. The U.S. Army Materiel Command centrally manages and administers the contract, which involves worldwide and regional planning before the contractors begin. The Army's principle is to use the LOGCAP contract as a last resort measure, such as lack of host nation support, and to allow military units to fulfill their primary obligations (without exceeding troop ceilings).[101] From 1992 to 1995, LOGCAP provided logistics support in the form of construction, food supply, maintenance, and transport services for seven major operations in Somalia, Rwanda, Haiti, Saudi Arabia/Kuwait, Italy, and Bosnia.

#### *Brown & Root in Bosnia*

In 1992, the Army contracted with Brown & Root Services (BRS)—after a competition with three other companies—to provide logistics services at military bases and camps in Bosnia. The logistics services provided included basic life support, engineering, and maintenance work for Operation Joint Endeavor.[102] Both the Army and BRS claim that by not having the military perform the support services, the contract saved the government 30 percent in costs.[103] BRS hired about 6,700 workers, and paid them at lower local wages to perform the tasks that would have normally required 8,500 troops (a personnel reduction of 21 percent).[104] Freed from much of the logistics activity, the units then had more troops available for combat and humanitarian operations.

In spite of these very significant benefits, in reviewing the operations of BRS in the Balkans, a GAO study[105] concluded that the Army needed to provide more continuous oversight of the contractor to ensure that costs were controlled. Between 1995 and 2000, private contractors received 10 percent of the $13.8 billion spent on operations in the Balkans. Yet by 2000, the Army was only beginning to attempt to keep contractor costs down, and was exercising minimal control over the costs of recurring services. Employees were found to be frequently idle, as BRS had hired too many local employees. Part of this lack of control is attributed to the nature of the Balkans Support Contract. Because the contract is a cost reimbursement, performance-based contract, the government gives the contractors a fair amount of freedom to perform the generalized tasks required. In addition, the government civilians in charge of administering the contract rotated every six months, preventing them from developing an expertise on the contract and from building relationships with the contractors to ensure efficient operations. Finally, the study found that the government and contract personnel were never clear on how much authority the government had over the contracts, nor were they properly trained to implement such a contract.

#### *DynCorp in East Timor*[106]

In 1999, the Army called on LOGCAP to provide heavy helicopter lift support in East Timor, where a U.S. force was deployed. The former province of Indonesia had mountainous terrain and poor infrastructure that required the contracting of the helicopter service for the transport of refugees and humanitarian supplies. The Army paid DynCorp $10 million for the contract in order to free up what would have been a large U.S. military presence on the island for an indefinite period of time. The soldiers used for supervision were deployed from an Army Reserve unit, a unit under the operational control of the Army Materiel Command (AMC), the LOGCAP manager. DynCorp had to quickly complete a market survey in order for LOGCAP to estimate the costs and to ensure that the contract would be feasible. Once the contract was authorized, DynCorp and its subcontractors prepared for the helicopter mission and ground support required to replace the Navy and Marine Corps forces. After several days, a base camp was constructed to receive the helicopters and for DynCorp staff. The helicopters were able to complete more than 39 flying hours, transporting 434 passengers and over 28,000 pounds of cargo in just nine days.[107] Thus

the contractor was able to quickly respond and meet the entire needs of the Army in East Timor while allowing the U.S. military to perform important functions elsewhere.

### 2. Logistics Support for Weapons Systems: Two Cases

Because of the high skill required to maintain many of today's modern weapon systems, contractors have been increasingly involved—first, in the United States and, in growing numbers since Vietnam, on or near the front lines.

In 2002 the GAO examined a large number of contractor-supported weapon systems used by the Army and Navy.[108] The average projected cost savings were 20 percent, and significant performance benefits were also projected. The Army and Navy broadly measured the performance of the contractors between 1998 and 2001. The contractors for the Army performed "satisfactory" or above in 98 percent of 100 cases, and 93.4 percent of contractors were "satisfactory" or above for 802 cases in the Navy. However, the GAO found that costs were not adequately monitored—either before or after the contractor involvement—so demonstration of the savings was difficult.

Additionally, the study pointed out a number of areas to focus on in such contract work in the future:

- The use of contractors in support of weapons systems reduces the minimum amount of technical skills for military personnel that are required for war-fighting capability. (So care should be paid to training in this area.)
- There are concerns with contractors on the battlefield regarding their willingness to stay on or near the battlefield during hostilities, which could weaken wartime missions. (Although current experience—due to their military backgrounds—has not found this to be the case.)
- Protection of the contractors requires diverted personnel and resources. (So thorough planning is required for deploying, protecting, and managing contractors, and verifying compliance.)
- Because contracts are treated as relatively fixed obligations, there is limited flexibility with funding. This limits the transfer of funds to respond to changing needs and requirements of weapons systems. (So contractors should provide adequate flexibility.)
- DoD must assure that contractor maintenance costs for their original equipment is reasonably priced.

#### *Air Force F-117 Aircraft Support*[109]

In 1998, the Air Force entered into a contract with Lockheed Martin to provide the systems support for the operation of the F-117 fleet. The contract, called Total System Performance Responsibility (TSPR), had built-in performance measures and projections of cost savings, in addition to profit incentives for improvements in the reliability of the fleet.[110] The contract also required the company to respond to maintenance requests within 24 hours.

Within two years, savings of $30 million were achieved,[111] the majority of which derived from the reduction in personnel from 242 to 55 in the government's F-117 System Program Office. Personnel reductions were estimated to save $90 million over the life of the contract, and with other efficiencies incorporated, total savings are estimated at $170 million. In addition to cost effectiveness, the contract provided performance improvements to the fleet. All of the TSPR performance measures were exceeded. The Air Force sets a goal of keeping the number of non-mission-capable aircraft down to 7 percent of the fleet; the rate for the F-117 was 5 percent the first year, decreasing to less than 3 percent by 2001, significantly less than many (most) Air Force systems.

#### *Deployment Through Private Transportation*

The crucial mission of transferring deployed troops is increasingly performed by the private sector. During the Persian Gulf War, 85 percent of troops and cargo were transported by commercial aircraft and ships. Since then, the military has sought to reduce deployment time with upgrades; however, the military is facing shortfalls and is turning to commercial aircraft and shipping to meet transport needs.[112] The Air Force is planning to purchase, or lease, commercial jetliners from Boeing (for transportation as well as for refueling), while the Military Sealift Command charters foreign vessels

### Strengths and Weaknesses of Contractors in Security Operations

**Strengths**

- The use of contractors allows military personnel to focus on core missions and stay within troop ceilings.
- Cost savings are achieved through flexibility offered to the military in hiring contractors to provide a service when required.
- The military can take advantage of sophisticated technology offered through the private sector.
- The military can use commercial transport capabilities to meet surge requirements.

**Weaknesses**

- The potential unwillingness of contractors to work during periods of hostility can hinder the war-fighting capabilities of the deployed troops.
- The need for commanders to offer contractors protection can detract from mission.
- The vague legal status of contractors can cause difficulties.
- Commercial transport may lack the security that military transport provides for troops and cargo.

from allies. Even though the private sector is able to fulfill this important role and assist the military in meeting surge requirements, there are still concerns regarding security. A 2002 GAO study[113] found that there are serious risks posed to commercial ships and commercial seaports being used for troop deployment, as the DoD is limited in its ability to provide adequate security at various stages in transit. With an increase in reliance on commercial craft for deployment, there is greater potential for harm as these craft enter regions in close proximity to the battlefield. Therefore, the DoD needs to assess these new security risks and take appropriate measures to address them.

## Lessons Learned and Recommendations

1. **Use of contractors allows military to circumvent troop ceilings.** When Congress placed a limit of 20,000 troops to be stationed in Bosnia, the executive branch circumvented that restriction by providing another 2,000 contractors.[114] This allowed the Army to move support functions to contractors so the remaining troops could focus on peace operations. Contractors are also able to hire local citizens in a station where there are caps on the number of military and civilian personnel. This practice does raise issues as to the level of authority the executive branch assumes when working around congressional troop limits.
2. **More continuous oversight of the contractor is required to ensure that costs are controlled.** As the GAO study on contractors supporting weapons systems demonstrated, the DoD often does not maintain adequate information on the costs and performance exhibited over the course of the contract, and how it compares to initial expectations.
3. **Deployment of temporary workers is cost-effective.** Since the Gulf War, overall military forces have fallen by 500,000, but the number of regional operations has increased. To compensate for the loss of military personnel, the DoD and State Department have been using temporary, private contractors to save money and fill in workers for short-term use, allowing remaining troops to focus on fighting.
4. **Commercial transportation can compensate for low capacity in the military.** The use of private ships, aircraft, railroads, and trucking can fulfill the growing demands of the military to meet capacity requirements.
5. **More permanent government contract administrators/managers should be hired to better oversee commercial contracts.** The Brown & Root case demonstrates how a lack of consistent personnel to administer contracts lessened government control, and resultant cost effectiveness, of the contract.[115]
6. **Proximity to the battlefield can endanger contractors, even with legal protections in status.** The Geneva Convention recognizes the status of contractors as "Civilians Accompanying the Force" (CAF), yet this status is irrelevant if the enemy does not recognize it. Additionally, contractors who support weapon systems in a

hostile environment are evolving away from a purely civilian role. This highlights the need for further examination of the CAF requirements as the line between combatant and contractor blurs.[116]

7. **A high degree of planning is necessary for contractors on the battlefield to deploy and operate without detracting from combat effectiveness.** Because the commander is responsible for the contractors' safety, it is important that detailed plans are made in advance to cover the contractors' arrival, numbers, positioning on the battlefield, protection, and emergency life support needs.[117]

8. **Improved security measures are needed for future private transportation.** As the GAO study demonstrated, the DoD is lacking in adequate research, planning, and protection for the security needs of commercial ships, seaports, railroads, and port workers involved in transporting military cargo and personnel.

9. **Contractors do not have to follow military codes of conduct.** Private contractors are obligated to take orders only from their employer (the firm hired by the DoD), and are not subject to military discipline. In a case where DynCorp employees were found to be operating a sex ring for underaged women in Bosnia, employees involved were merely fired, and were not subject to any form of military (or local) discipline.[118] In addition to discipline issues, because contractors are not required to take military orders, they pose a threat to themselves and raise questions as to the level of responsibility that military personnel have over their safety.

# Findings and Conclusions

From the cases examined, one can reach two overriding conclusions:

- Competition, when properly emphasizing both performance and cost (i.e., best value), can have significant benefits—specifically, in achieving better results at lower costs, regardless of whether the winner is the public or the private sector.
- However, this is not automatically achieved. It requires the government to properly manage the winner (again, either public or private sector) and to have a credible option of reintroducing competition should performance fall off or costs rise.

It is also clear from the examples studied that there is a wide variety of forms that the shift from the "government as the doer" to the "government as the manager of the doers" can take; and that in many circumstances, there really is no single "right answer." It is simply a management judgment. However, almost any choice can have very significant benefits if properly implemented. Thus, there is a very real need for the government to educate and train acquisition personnel in this increasingly important field so that they will have the management skills and the experience to achieve the best possible results at the lowest possible costs.

## Concerns about the Changing Role of Government

As would be expected, there has been resistance to the implementation of this whole shift in the role of the government from the "provider" to the "manager of the providers." Specifically, six concerns have been raised whenever the issue comes up.

1. Performance will deteriorate (since industry will focus on profits and not public needs; and since the government is more experienced at these jobs, they will do it better).
2. Costs will be higher (since government employees are paid less than in industry and the government doesn't have to add on a "fee").
3. The promised savings (from the competitions) will not be realized over time.
4. Small businesses will be negatively impacted (since the small contracts will now be part of a much larger overall competition for the full function).
5. A large number of government employees will be involuntarily separated (as a result of their either losing the competition to the private sector or as a result of their having to become much more efficient in order to win the competition).
6. There will be a significant loss of control by government management (as a result of contracting out much of the work).

It might be noted that these six points are not listed here in priority order (in fact, the fifth and sixth items are the ones of greatest concern to the employees and to the government, respectively); but they are usually not explicitly raised—except by the politicians. Rather, when trying to argue against any form of shift of government functions,

**Table 7: Clarifying the Debate about Market-based Government**

| Common Concerns | Study Findings |
|---|---|
| Performance will deteriorate. | Performance improves significantly. |
| Costs will be higher. | Costs decrease significantly. |
| Promised savings will not be realized over time. | Promised savings are realized over time. |
| Small businesses will be negatively impacted. | Small businesses have actually benefited. |
| A large number of government employees will be separated. | Involuntary separations of government employees are few. |
| Government management has a significant loss of control. | Government actually has greater control. |

they will raise the first four points. But the last two are implicit—and the biggest barriers.

Importantly, each of these six points has a valid basis for concern, and needs to be explicitly addressed in any government decision making as it shifts work to a competitive environment. However, the reality is that when each of them is directly addressed—and in most programs, they have been—*the results indicate that these "concerns" are not based on realized results, and that the empirical data refute all six of them.* The next section will provide the findings based on the case study results.

## Findings

### 1. Performance Improves Significantly

As noted above, many of the earlier efforts at shifting the role of government were done at the local (city) level. In 1995, a survey of 100 of the largest cities in the United States was conducted with regard to their efforts at "privatization."[119] (This term is often used—although improperly—as a collective term for the various forms of shifting work from a government monopoly to a competitive environment.) Of the 66 responding cities, 82 percent reported that they were satisfied or very satisfied with privatization, and the remaining 18 percent were neutral. None said they were dissatisfied. In explaining their reasons for having decided to privatize, 54 percent replied that they had done it to reduce costs, while 30 percent did it to improve service. However, in after-the-fact reports they found an average improvement in service delivery of about 25 percent for each of the four major service areas: public works/transportation, public safety, human services, and parks and recreation.

Typical results achieved in various studies of city transportation systems give a feeling for the gains. For example, one study of Los Angeles public transportation from 1980 to 1996 showed service reliability increases of 300 percent and complaints reduced by 75 percent. Similar results in Denver, San Diego, Indianapolis, and Las Vegas showed service-level increases from 26 percent to 243 percent. It must be emphasized that for these five examples of public transportation, shifts from a public monopoly to a competitive environment not only improved performance dramatically, but also achieved savings that ranged from 20 percent to 60 percent, compared to the costs of the non-competitive services of the past. Another example is that of Indianapolis' wastewater treatment where, in the competitive environment, the city partnered with a private water supply utility. In this case, employee accidents fell by 70 percent and effluent violations fell 86 percent—and costs of the operation's partnership fell by 40 percent.

Similar results have been achieved at the federal level. For example, when the U.S. Navy changed from having all its moving being centrally controlled and allocated by the military traffic management command (in a non-competitive fashion) to allowing sailors to choose their own moving companies from the private sector (in a competitive fashion),

the customer satisfaction increased from 23 percent to 95 percent and the damage claims dropped from 1 in 4 to 1 in 12 moves. As another example, when the British privatized their telecommunications service in 1994, the call failures dropped from 1 in 25 to 1 in 200, and the number of public pay phones increased by 83 percent.

Finally, there have been many examples in the Department of Defense in recent years where they have shifted from having government workers perform equipment maintenance (known as "organic maintenance") to having the work competitively sourced in one form or another. In each case, there was a significant improvement in the availability and reliability of the systems, while at the same time there was a significant reduction in cost. As an example, when the Navy went (in competition) to a public-private partnership for the maintenance and logistics support (spare parts, etc.) of an auxiliary power unit (APU) for its carrier-based aircraft (from a prior government monopoly of this work), they found that the reliability of the APUs increased by more than a factor of 10. In addition, the mean flight hours between unscheduled removals for the P-3 aircraft improved 300 percent, for the F/A-18 aircraft by 45 percent, and for the S-3 and C-2 aircraft by 15 to 25 percent. Further, when the Navy went to war in Afghanistan, the public-private partnership was able to "surge" by 50 percent to fill all of the emergency demands. As another example, when the Navy competitively outsourced its jet trainer maintenance, its "fully mission capable rate" increased by 13 percent while the direct man-hours required for maintenance decreased by 33 percent, thus showing that the increased reliability was not achieved by increased costs, but from increased efficiency in the process.

The fact that the performance increased while costs went down in these and the other cases described in "Understanding Sourcing Options" indicates that if the contracts are focused on this combination of increased performance and lower costs, innovation within the companies will be required to improve both efficiency and effectiveness. Additionally, the examples show that companies can still make a profit while the total cost to the government goes down significantly, allowing the government to both save money and receive better services.

**2. Costs Decrease Significantly**

Many analyses of this shift from the government as the "doer" to the "manager of the doers" compare the costs as bid from the competitive environment with those which were the best estimates of the government's actual costs prior to the competition. As the performance data above indicate, even though performance improvements were sometimes the objective of the competitions, there was still a significant focus on cost reduction; and, in fact, the cost reductions were achieved. However, in most cases the government's purpose in pursuing the competition was primarily that of cost reduction. For example, in the Department of Defense there were 2,138 competitions run from 1978 to 1994 (usually between private bidders and the current government workforce—where the latter could bid their "most efficient organization," and to win, the private sector had to be 10 percent less than that). *The average cost savings projected as a result of these competitions was 31 percent* (specifically, for the Army, 27 percent; the Air Force, 36 percent; the Marine Corps, 34 percent; the Navy, 30 percent; and the Defense agencies, 28 percent.)[120]

Subsequently, the General Accounting Office performed a competitive sourcing analysis of the more recent time period from FY 1995 to FY 1999.[121] They looked at 286 "studies" (the term-of-art for these competitions) by the Department of Defense. For these, the DoD actually competed 138 between the public and private sectors, of which 40 percent were won by the private sector and 60 percent by the public sector. They also had 148 "direct conversions," of which 134 were moved from the public to the private sector (and then competed there), and the other 14 were actually conversions from the private sector back to the public sector. From these 286 efforts, the Department of Defense reported cost savings of 39 percent. The GAO concluded that they could not precisely verify the savings (partly because of the difficulty of determining the actual government baseline cost prior to the competition), but they did state that "the savings from the studies between public and private sector competitions are substantial and sustained over time."

Finally, in another analysis, based on DoD CAMIS[122] data of public/private competitions by the Department of Defense from FY 1997 through FY 2001, where there were 314 comparisons made,

the number of people required to do the work was (on average) reduced by 35 percent; yet only 40 percent of these competitions were won by the private sector. The conclusion one might reach is that when the public sector is forced to compete, they are able to do the same work just as well, or better, than before the competitions, but with significantly fewer people—in fact, frequently with 20 to 40 percent fewer people.

Interestingly, similar results in terms of the savings realized have been found at the state and even local levels, as well as on international comparisons (as seen earlier in "Understanding Sourcing Options"). For example, two studies were conducted by the auditor/controller of Los Angeles County for the 1980s time period that showed savings of 32 percent and 28 percent.[123]

Importantly, the productivity gains through this competitive process resulted, in general, from more work performed per employee per unit time, not from lower wages. A study by the National Commission for Employment Policy found no significant pattern of lower wages paid by private contractors.[124] In fact, a detailed survey of municipal privatization in Illinois found that 78 percent reported that wages were the same (40 percent) or greater (38 percent) than municipal wages paid for that same work.[125] One early study attempting to analyze this phenomenon concluded that there is no statistically significant difference between municipal and contract work with respect to salaries or the costs of fringe benefits. The study found that the observed cost difference is accounted for by productivity factors (including using lower-skilled workers for appropriate work, holding managers more responsible for the work of their employees, giving first-line supervisors more hire and fire flexibility, using incentive systems, making the work less labor intensive through capital equipment investments, and having a higher ratio of workers to supervisors).[126] In fact, in many cases the private sector will use higher-paid workers because of their greater experience, innovation, or skills. Thus, if one higher-paid worker can do the work of three lower-paid workers, the costs are still significantly less. (Unfortunately, too often the government uses individual workers' hourly pay as the measure of total cost, which is clearly not an appropriate way to measure overall productivity.)

### 3. Promised Savings Are Realized Over Time

The conclusion that promised savings are realized over time is conditioned by the potential for future competition to be maintained after the initial award. In fact, at least two studies have gone back and shown that when the public sector has won the initial competitions, there has been no effort made to reintroduce the potential for competition and, therefore, in many of those cases, the promised savings have not been realized.[127] However, when the potential for reintroducing competition was present—in order to create the necessary incentives for either the public or private sector to not only realize their promised savings but to continue to introduce productivity innovations for improved performance at a lower cost—then the promised savings have been realized (as found by not only the GAO but also a number of independent studies).

For example, the Center for Naval Analysis reviewed 16 specific competitions and found that the average expected savings (as bid by the winner, whether it be government or private) was 35 percent.[128] The actual savings (as measured after the fact) on those 16 programs was 24 percent, but that included increased scope and quantity increases to the contracts. When those changes mandated by the government were removed, then the realized savings for the same scope and quantity as had been originally contracted was 34 percent. In effect, not only did the government fully realize the savings that had been projected, but it also gained significant increases in scope and quantity for less money than had been expended originally for significantly less work.

Similarly, a RAND Corporation study of six contracts in which the expected savings for contractor wins ranged from 41 percent to 59 percent, and for the government employees' wins from 34 percent to 59 percent, found that the contractors' savings were sustained over time—but no total data was kept for the in-house wins, so direct comparisons could not be made. However, by comparing the government head counts before the competition with those promised by the government bidders (their "Most Efficient Organization" bid) and observing that the resultant head count was close to the MEO, there was some confidence that the promised reductions were realized.[129]

One area that the Department of Defense has recently been moving into is that of having contractors replace military personnel and/or civilian government workers in areas outside of the continental United States—including on the "battlefield" (see "Contractors in Security Operations: A Special Case"). For example, the firm of Brown and Root was hired to provide logistics services at a military base in Bosnia. This had a number of significant advantages. First, and most obvious, the contractor was able to do the work with 21 percent fewer laborers. Second, the contractor was able to hire workers at local salary levels (which were significantly less). Third, the contractor could hire workers as needed and could terminate them when they were no longer required. Finally, it freed up soldiers to perform war-fighting functions. Thus, the savings to the Army were quite significant—without any reduction (and in fact with some significant improvement) in reported performance.[130]

Similar realized results have been achieved at the state and local levels. For example, the Public Service Electric and Gas Company in New Jersey contracted its recycling responsibilities to another firm. The private recycling company operates as a "material recovery facility" and is allowed to charge lower fees than landfills. With mechanized recycling and the sale of processed materials, the company can offer lower rates for disposal. Overall, the realized savings are approximately 42 percent.[131] As a final example, in Chicago the job of towing scrap vehicles (formerly a government responsibility) was given to a private-sector contractor. The private-sector company actually pays the city $25 per vehicle and then sells the vehicles as scrap, providing Chicago with revenues of $1.2 million when it was previously losing money.[132]

**4. Small Businesses Have Actually Benefited**

Government at all levels, and especially the federal government, uses contracting not only to procure goods and services, but also to achieve social objectives. There are laws and regulations that provide preferences to small businesses, women- and minority-owned businesses, nonprofit corporations, and firms that hire disadvantaged individuals; restrictions to buy only American-made products; preferences to hire veterans; and many others. These can have an impact on reducing competition unless these considerations are addressed directly. Since many innovations and positive competitive pressures often come directly from small businesses, this report focuses on them. The conclusion that one can come to is that, contrary to the perceptions, small businesses have actually benefited.

Again, the finding that small businesses have actually benefited is conditional upon the fact that when the competitions are being conducted there is an explicit consideration of the potential small business impacts. Various techniques can be used to address this issue, from making the competitions specific small business set-asides, to allowing extra credit to small businesses on their bids, to requiring a significant percentage of the work to be done by small businesses through the larger prime contractor. Utilizing these and other techniques, the actual results have been quite encouraging for small businesses. When this fact is combined with the reality that advertising competitions on the Internet has significantly increased small businesses' participation (because they now have as much insight into the programs as do large companies with big marketing organizations, and because the small firms now have high visibility to the customer through their responses on the web), results for small business have been extremely positive. For example, between 1995 and 2001, the Department of Defense conducted 784 public-private competitions; 79 percent of all the contracts were awarded to small businesses.[133]

Additionally, many of the large outsourcing contracts had requirements for a significant share to go to small businesses as subcontracts. In fact, two of the largest awards of outsourcing by the Department of Defense—the Navy Marine Corps Intranet and the National Security Agency Intranet (both multi-billion dollar contracts)—each had a mandate of a 35 percent small business subcontract set-aside that the winner had to guarantee; and at least 10 percent of that subcontract effort had to be in direct-labor costs. This 35 percent requirement (of a multi-billion dollar contract) is obviously a much larger one than is typical for a government agency in direct contracting with small business, and is a large benefit to small contractors.

It must be emphasized that numerous studies show that a contracted-out activity can be made much more efficient through reengineering of a significant number of multiple functions than if each of

the small functions was separately contracted out (see Table 5, showing savings vs. size of the competitive effort.) Nonetheless, the government has traditionally found it much easier (for both internal and external political reasons) to separately contract for small awards. (Over 80 percent of the public-private competitions by the Department of Defense have been for fewer than 45 people each.) This makes no sense from either an efficiency or an effectiveness perspective. Yet it is greatly encouraged by the small-business people. The answer, from the perspective of both government and the small businesses, is to go to larger contracts but to require significant small business set-asides within them. In this way, one could satisfy the small business benefits as well as the efficiency and effectiveness associated with the potential for multi-functioned integration and economies of scale. This can be a "win-win" situation, but it does require the small business interests to recognize the value of the subcontracts, not just direct prime contracts from the government. (Legislation against "bundling" of small competitions into larger, multi-function competitions would be counterproductive to the government's interest.)

### 5. Involuntary Separations of Government Employees Are Few

The finding that only a small number of government employees will be involuntarily separated has come as somewhat of a surprise, since the above-noted figures indicate that there are labor savings of 20 to 40 percent (compared to the original government workforce), even when the government wins. However, all of the independent studies show that the vast majority of impacted employees can be well taken care of through a variety of actions. Again, this assumes consideration of this issue in the planning process associated with the competition.

In today's environment, when a military person is replaced by a contractor, that military person moves into a combat position. On the other hand, civilian employees of the government have numerous other options. In one study the GAO examined three DoD competitions[134] and found that of over 1,000 civilian positions that had to be reduced as a result of the savings on these three competitions (one in-house win and two contractor wins), 27 percent were transferred, 65 percent voluntarily retired or separated (17 percent of those who voluntarily separated or retired took jobs with the contractor) and only 8 percent were involuntarily separated. Another study led by the Center for Navy Analysis[135] found that the DoD has been very effective in minimizing involuntary job losses. They looked at competitions in large depot maintenance facilities where the promised reductions would amount to 40 percent of the employees scheduled to go. They determined that these employees either found other DoD or federal jobs, that many were hired by the winning contractor, and that others chose to retire; only 3.4 percent were actually involuntarily separated.

One specific case worth noting was an Army competition to replace an in-house group of 400 workers who were maintaining an old logistics information system written in the COBOL computer language. The Army decided to competitively outsource this work to any contractor who had an off-the-shelf commercial software package to do this work. However, they specified as a condition of the outsourcing that the winning contractor would have to hire 100 percent of the workers for at least one year, and that they would have to agree to train these workers in a modern computer language (e.g., C++). The workers would initially be utilized to maintain the old system during the transition and would, with additional training, be of much greater value to the contractor (or to any other contractor) than they would have been with their previous skills. The Army, of course, gained a much more efficient and effective logistics information system in the process. Subsequent testimony by the employees who had been hired by the winning contractor found that they were extremely pleased with the outcome of this effort. What this demonstrates is that manpower considerations can be made a major part of the competition itself, thus minimizing the negative personnel impacts.

Similar results (i.e., very few involuntary separations even though large personnel cutbacks result from the competitive sourcing process) are found in studies of competitions at the state and local levels. For example, a study of the privatization efforts in Los Angeles County[136] found that the elimination of 4,700 positions was accomplished with "only a handful of layoffs." Given the difficulty of getting rid of poor-performing government workers (at the

local, state, or federal levels), one perspective on these single-digit impacts is that the employees not shifted to other jobs or picked up by the winning contractors are most likely those at the bottom of the performance or skill rungs. Perhaps these losses are not that significant to the performance of the government functions.

Any time individuals (even a small number) must be involuntarily separated, there is a potential for personal hardships. This represents a social problem that clearly must be directly addressed; the government, however, cannot be viewed as a guarantor of permanent employment (regardless of performance) and still be expected to be efficient and effective.

**6. Government Actually Has Greater Control**
As noted above, it is essential that when the government makes an award to a performer (either public or private), it carefully monitors that performance using agreed-to metrics on both performance and cost. Government "control" after the competitive award is of such concern because many government managers feel that when they have the employees directly reporting to them, they somehow think they have more control than if they have to exercise control through a contractor. In reality, the government has very little ability to hire or fire civil service workers compared to the ability they have with contractors. In fact, the data show that there is very little cost visibility into the total cost of government work since most government organizations do not perform activities-based costing and therefore lack visibility of the indirect costs associated with their work. Additionally, changing processes within the government is extremely difficult, and innovation (as with most monopolies) tends to be stifled. Therefore, true control over change is minimized in such an environment.

Mayor Steven Goldsmith of Indianapolis asserted that he has "far more control over contractors than he ever had over his own in-house workforce; he can fire a contractor for poor performance but cannot do much with or to a malfunctioning city department."[137] He believed that this increased control was gained because governments will have to write a detailed performance specification for the contract (which they rarely do when the work is routinely done in-house), as well as because of the legendary rigidity of the civil service system (which is reinforced by union contracts, and which limits an official's managerial authority). In essence, the government managers can now utilize the competitive market to reward or replace, based on the measured performance and costs, under the contract. And with the threat of potential future competition, if the results are not the desirable ones, there is, in fact, greater control—in contrast with the government manager's lack of visibility or control in the presence of a government monopoly.

However, this obviously assumes that when the government awards a contract, it does not turn its back and walk away. Rather, the government must assume full managerial responsibility whether the work is done in-house or by a contractor.

## Recommendations on Overcoming Barriers and Moving Ahead

The empirical data are very clear in refuting the six concerns (or perceptions) with regard to the changing role of the government from "provider" to "manager of the provider." While there have been significant increases in the number of positions being shifted, and while President Bush has made clear the privatization goals of his administration, there is still significant resistance to making these changes. This resistance begins with government workers' fears about losing their jobs and with government managers' concerns about loss of control. These then are reflected by local politicians and, in turn, at the federal level in Congress, where efforts have increasingly been made to legislate against such changes. Further, such changes are strongly resisted by the federal government workers' union.[138] Since the empirical evidence is so convincing with regard to improved performance and reduced costs as a result of the presence of competitive market courses (although concerns regarding lower performance and higher costs are still raised), it is clear that more explicit attention needs to be given to the political and personal concerns of the workers and managers—along with education on what the actual results are likely to be and how they can best be achieved.

This educational process needs to be extended not just to the federal level but down to the state and local levels. A 1989 survey of city officials in cities

with populations of more than 5,000 and county officials in counties with populations greater than 25,000 found that the greatest impediment to privatization by contracting is the fear of loss of control (which was named by 51 percent of the responding officials) and that employee (and union) resistance was second (identified by 47 percent of the respondents), while "politics" was third (as named by 42 percent).[139] A similar survey of U.S. state governments in 1992 identified loss of control and labor problems as the principal impediments to contracting for services.[140] These are concerns that must be explicitly addressed from perspectives of unions, government workers, and government managers. Undoubtedly the best way to address them is with empirical data and case studies that address the key concerns (some of which are described earlier in "Understanding Sourcing Options").

Nonetheless, there are also very real procedural barriers to be overcome. The most obvious of these is the procedure for competing the public against the private sectors at the federal level. This procedure, which is contained in OMB Circular A-76, was negotiated 36 years ago between the government unions and the executive branch, and has been in existence ever since. It has a number of major shortcomings, which were highlighted in a 2001–2002 congressionally mandated Commercial Activities Panel study (headed by the GAO).[141]

- In the first place, the current process uses "low cost" as the source selection criterion, and thus eliminates the possibility of making selections on the basis of "best value," i.e., balancing performance and cost.
- Second, the comparative "studies" (competitions) take far too long (an average of 25 months from start date until tentative decision date for the DoD studies from FY 1997 to FY 2001), and they cost far too much (one 2001 estimate ranged from $1,300 to $3,700 for each position competed).
- Finally, the current process provides no guidelines for selecting and grouping functions, which is highly desirable since the more functions that can be put together (to allow reengineering of the process), the greater the potential benefits in efficiency and effectiveness.

In addition to the problems with the A-76 process, there is the critical fact that the government has very little visibility for its own initial, full-cost baseline. So there is, in effect, a "Catch-22 " built into the process. For instance, the government wants a "business case" analysis performed in order to justify the likely benefits of the competition, but since no credible baseline is available, it is impossible to generate a valid business case that would justify running the competition despite the likelihood of significant performance improvements and cost savings if the competition and management oversight subsequent to the competition are conducted properly.

What needs to be done to allow, and encourage, more of a shift in the direction of improved efficiency and effectiveness through the use of competitive market forces? First, and most obvious, is the *need for the government to develop a new competitive process that is faster, less expensive, and based upon "best value" competitions*. A November 14, 2002, draft revision of A-76 by the Office of Management and Budget[142] makes these recommendations, and goes further to recommend that each agency be forced to define those functions that are "inherently governmental"—under the assumption that all others should be subject to competition within the next five years. It also requires that *full metrics should be kept on performance and cost, regardless of whether the competitions are won by the public or private sector.* Implementation of recommendations such as these is critical. Obviously, there will be significant resistance; but if the government is to move in the direction of increased efficiency and effectiveness—in a period of declining budgets (particularly at the state and local levels, but also at the federal level)—then this resistance must be overcome.

One way to overcome resistance to this change is to increase education and training in this area. Increasing the visibility of the results achieved and the best practices for achieving them would likely garner wider acceptance and understanding of the benefits (higher performance and lower costs) realized from a shift from monopoly government performance of essential functions to government management of competitively awarded performers (either public or private). This is too important a result not to take full advantage of it.

# Endnotes

1. The Eisenhower Administration Budget Bulletin 55-4, January 1955 stated: "It is the general policy of the Federal Government that it will not start or carry on any commercial activity to provide a product or service for its own use if such a product or service can be procured from private enterprise through ordinary business channels."

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17. Clark, Frances, et al., "Long-Run Costs and Performance Effects of Competitive Sourcing," Center for Naval Analysis, February 2001.

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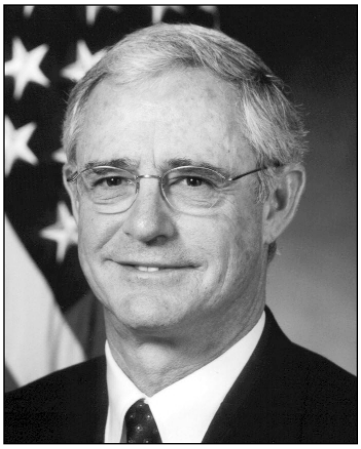
# ABOUT THE AUTHOR



**The Honorable Jacques S. Gansler** holds the Roger C. Lipitz Chair in Public Policy and Private Enterprise at the University of Maryland's School of Public Affairs. He teaches graduate courses and leads the school's Center for Public Policy and Private Enterprise, which fosters collaboration among the public, private, and nonprofit sectors in order to promote mutually beneficial public and private interests. Previously, Dr. Gansler served as the Under Secretary of Defense for Acquisition, Technology, and Logistics from November 1997 until January 2001, where he oversaw an annual budget of over $180 billion and a workforce of over 300,000. In this position he was responsible for all matters relating to Department of Defense acquisition; research and development; logistics; acquisition reform; advanced technology; international programs; environmental security; nuclear, chemical, and biological programs; and the defense technology and industrial base.

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