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PRIVATIZATION AND COMPETITION

Comments on H.R. 716, The Freedom from Government Competition Act

Statement of
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Privatization and Competition: Comments on H.R. 716, the Freedom From Government Competition Act

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to assist the Subcommittee in its consideration of H.R. 716, the Freedom From Government Competition Act. The bill would require that the government procure from the private sector, with some exceptions, the goods and services it needs to carry out its functions. As you know, we testified in June on S. 314, the Senate companion bill to H.R. 716, and my remarks today closely parallel our statement before the Senate Committee on Governmental Affairs.¹ Specifically, I will discuss H.R. 716 as a potential vehicle for competitive contracting, using the results of our recent work on privatization initiatives at the state and local government levels.

We reported in March 1997 on the major lessons learned by, and the related experiences of, state and city governments in implementing privatization efforts.² Our report, done at the request of Representative Scott Klug, examined the privatization experiences and lessons learned by the states of Georgia, Massachusetts, Michigan, New York, and Virginia, as well as the city of Indianapolis. While not done across the board each of these governments made extensive use of privatization—primarily contracting out governmental functions—over the last several years, tailoring their approaches to their particular political, economic, and labor environments. On the basis of our literature review, the views of a panel of privatization experts, and our work in the six governments, we identified six lessons that were generally common to all six governments. In general, the governments found that they needed to

- have committed political leaders to champion the privatization initiative;
- establish an organizational and analytical structure to implement the initiative;
- enact legislative changes and/or reduce resources available to government agencies in order to encourage greater use of privatization;
- develop reliable and complete cost data on government activities to assess their performance, support informed privatization decisions, and make these decisions easier to implement and justify to potential critics;
- develop strategies to help their workforces make the transition to a private-sector environment; and lastly,

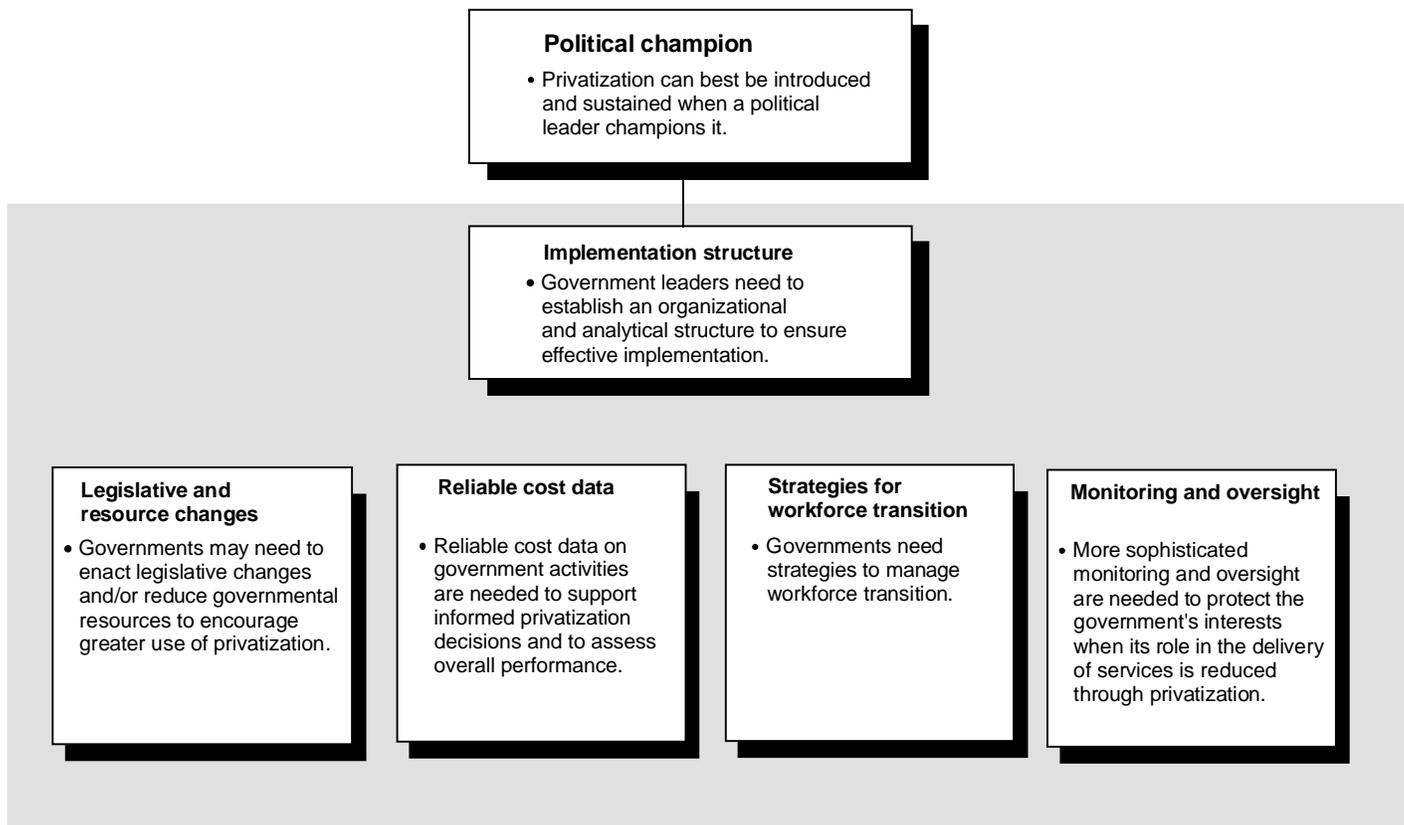
¹Privatization and Competition: Comments on S. 314, the Freedom From Government Competition Act (GAO/T-GGD-97-134, June 18, 1997).

²Privatization: Lessons Learned by State and Local Governments (GAO/GGD-97-48, Mar. 14, 1997).

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- enhance monitoring and oversight to evaluate compliance with the terms of the privatization agreement and evaluate performance in delivering services to ensure that the government's interests are fully protected.

Figure 1: Lessons Learned From Our Review of State and Local Privatization Efforts



Implementation

Source: GAO analysis.

H.R. 716 Provides a Tool but Not a Substitute for a Political Champion

The history of government reform has demonstrated that new policies, whether based in law or in administrative directives, are not self-implementing. In our work on state and local privatization initiatives, we reported that reforms such as privatization are most likely to be sustained when there is a committed political leader to champion the initiative. In the six governments we visited, a political leader (the governor or mayor), or in one case, several leaders working in concert (state legislators and the governor), played a crucial role in fostering privatization. These leaders built internal and external support for privatization, sustained momentum for their privatization initiatives, and adjusted implementation strategies when barriers to privatization arose.

H.R. 716 does not, and probably cannot, provide for effective political leadership. It has been executive branch policy for more than 30 years to encourage competition between the federal workforce and the private sector for providing commercial goods and services. However, this policy has been embodied only in an administrative directive, Office of Management and Budget (OMB) Circular A-76. While we have consistently endorsed the concept of encouraging such competition, its effectiveness in practice has been questioned both in the executive branch and in dozens of congressional hearings.

H.R. 716 would give the force of law to general reliance on the private sector for commercial goods and services, and thus would provide a stronger foundation, but not a substitute, for political leadership.

H.R. 716 Would Establish a Flexible Implementation Structure

To implement their privatization initiatives, the governments we visited reported the need to establish an organizational and analytical structure. A key aspect of this structure is an office to guide and support the privatization initiative and provide the analytical framework to evaluate the costs, benefits, and risks of privatizing a particular activity. Many of the frameworks established by the six governments shared common elements, such as criteria for selecting activities to privatize, methods for cost comparisons, and procedures for monitoring the performance of privatized activities.

Responding to the need for such a centralized structure, H.R. 716 requires OMB to issue regulations and to establish a new “Center for Commercial Activities,” which is given responsibility for

- implementing the requirements of the legislation;

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- ensuring compliance by agencies; and
- providing guidance, information, and assistance to both private and public sectors.

OMB is given wide latitude as to what regulations it will issue and what they will contain. This grant of broad authority affords OMB flexibility in implementing the legislation. However, given the wide latitude that OMB is afforded by the bill, issues will inevitably arise during implementation that will have to be dealt with by OMB. These issues could include such questions as

- Whether government corporations, federally funded research and development centers, state governments, or even the U.S. Postal Service should be included within the definition of “private sector sources” and thus eligible to compete for the government’s contracts.
- Whether public buildings would need to be sold to the private sector in order to house federal employees.
- How OMB will incorporate congressional views when significant or highly sensitive conversions are proposed.

Given concerns such as these, Congress will need to oversee OMB’s performance of its responsibilities. The strategic and annual performance plans and annual report that OMB is to produce under the Government Performance and Results Act, provide a mechanism for such accountability. OMB could include in its strategic plan an objective and strategy for implementing the bill’s requirements.³ The strategy could be developed in consultation with Congress and could describe major priorities as well as specific milestones for implementing the bill’s provisions. In addition, OMB through its annual performance plan could provide a schedule for changing current policies and systems that would be necessary to accomplish the bill’s purposes. Such a schedule would provide greater direction for agencies as they go through the process of identifying potential activities to be included in their annual performance plans. It could also provide a firm basis for Congress to assess OMB and agency activities as they relate to the bill’s requirements.

To effectively carry out the role envisioned for it under the bill, OMB will require additional resources or will need to reallocate existing resources from other mandated responsibilities. We reported in 1995 that we were concerned about OMB’s capacity to carry out its already numerous

³The Results Act: Observations on the Office of Management and Budget’s July 1997 Draft Strategic Plan (GAO/AIMD/GGD-97-169R, Aug. 21, 1997).

management responsibilities, which have been expanded significantly in recent years.⁴ Such a plan might be an appropriate vehicle for addressing such resource issues.

**Implementation of H.R. 716
Would Be Helped by
Integrating It With
Agencies' Strategic and
Performance Planning
Activities**

The experiences of other governments as well as of major private firms indicate that, when the outsourcing of functions is contemplated, answers to fundamental questions about the purpose and mission of an organization should precede any major outsourcing activities. The bill has significant implications for the ongoing implementation of the Results Act; the Act focuses on what activities the government should or should not be performing from the perspective of overall contributions to missions and goals, while the bill addresses how and by whom those activities should be performed. Under the provisions of the Results Act, agencies are required to set their strategic direction through multiyear strategic plans, develop annual goals, and report on performance against those goals. Agency strategic plans and performance measures are intended to provide Congress with a vehicle for asking fundamental questions about federal functions and their performance. In our recent reports on the implementation of the act, we have found that many agencies are not yet well positioned to specify their plans and strategies in terms of tangible results.⁵

If enacted, the bill's implementation will occur as agencies are going through their first cycle of planning, measuring, and reporting on program performance, as called for under the Results Act. The bill would amend the Results Act by requiring, among other things, that agencies include in the annual performance plans and reports that they submit to Congress (1) inventories of functions that are and are not subject to the Freedom From Government Competition Act's provisions and (2) a schedule for converting to private sector performance those functions capable of, but not currently, being performed by the private sector. Requiring agencies to specify the activities they would perform directly, and those they would convert to private sector performance, is consistent with the Results Act's strategic planning requirements.

If Congress chooses to enact H.R. 716, an opportunity exists to further integrate implementation of the bill's provisions with the Results Act. A

⁴Office of Management and Budget: Changes Resulting From the OMB 2000 Reorganization ([GAO/GGD/AIMD-96-50](#), Dec. 29, 1995).

⁵Managing For Results: Critical Issues for Improving Federal Agencies' Strategic Plans ([GAO/GGD-97-180](#), Sept. 16, 1997); The Government Performance and Results Act: 1997 Governmentwide Implementation Will Be Uneven ([GAO/GGD-97-109](#), Jun. 2, 1997).

key provision of H.R. 716 requires OMB to create a methodology for making determinations on what types of activities should and should not remain in government. This provision, if integrated with the strategic planning and annual performance planning requirements of the Results Act, could avoid the potential situation of agencies inadvertently replacing unneeded federal functions with unneeded private sector contractors—a concern we have expressed regarding Department of Defense depots.⁶ By making clear that, as part of their strategic planning and performance measurement activities, agencies should review potential outsourcing candidates in light of their contribution to mission accomplishment, the bill could reduce the possibility of such an outcome.

Incentives May Be Needed for Implementing Change

Encouraging the magnitude of change that this bill contemplates will require incentives if it is to be effective. We believe that integrating the bill's requirements with those of the Results Act is one of the best incentives Congress could use to ensure successful implementation. The Act should, if successfully implemented, expand opportunities for congressional oversight of agency performance, including, for example, closer scrutiny of agency budget requests for specific activities in the context of expectations about program performance. Another incentive could be to allow government agencies to use savings gained from eliminating duplication and unnecessary non-core functions to further improve operations or satisfy other priorities such as modernization.⁷ However, such proposals need to be carefully examined as they raise questions of congressional oversight and the allocation of scarce financial resources.

State and local governments that we reviewed used incentives to accomplish their goals. In Virginia, officials said department managers were allowed to retain savings garnered through privatization and restructuring for use in productivity and technology improvements.⁸ This practice, according to the Director of Virginia's Commonwealth Competition Council, provided the incentive needed and helped solve the question often asked by managers of "what's in it for me"? In Indianapolis' managed competition process, if the public sector won a competition and

⁶Defense Depot Maintenance: Privatization and the Debate Over the Public-Private Mix (GAO/NSIAD-96-148, Apr. 17, 1996).

⁷See for example: DOD High-Risk Areas: Eliminating Underlying Causes Will Avoid Billions of Dollars in Waste (GAO/T-NSIAD/AIMD-97-143).

⁸S. 959, Workforce Transition Act of 1995, Chapter 811 of the Acts of Assembly, Commonwealth of Virginia.

the union-management team performed the activity at the desired level of performance for less than it had bid, the team would receive a share of the savings at the end of the year. The city, after tracking performance over a period of years, could place a moratorium on bidding for areas for which city employees had demonstrated performance excellence and in which they had consistently outbid private competitors. In addition, Indianapolis built community support by taking some cost savings achieved through outsourcing and managed competitions and allocated it to hiring additional police, lowering tax rates, and increasing infrastructure projects. According to the Deputy Mayor, this approach built community support and provided further incentives for managed competition and outsourcing.

In contrast, Georgia's Governor instituted a budget redirection program that required all agencies to prioritize their current programs and activities and identify those programs that could be eliminated or streamlined. The agencies were required to make at least 5 percent of their total state-funded budgets available for redirection to higher priorities. According to a Georgia Privatization Commission official, agencies were given a 6-month notice that their budgets would be cut by 5 percent. State officials said these budget cuts required managers to rethink how they could perform the same activities for a lower cost. This action provided the incentive for agencies to contract out more activities, such as vehicle maintenance and management services for a war veterans facility.

The Relationship of H.R. 716 to Other Relevant Laws Is Unclear

In our state and local work, we found that all five states and the city of Indianapolis used some combination of legislative changes and resource cuts as part of their privatization initiatives. These actions were taken to encourage greater use of privatization. Georgia, for example, enacted legislation to reform the state's civil service and to reduce the operating funds of state agencies. Virginia reduced the size of the state's workforce and enacted legislation to establish an independent state council to foster privatization efforts. These actions, officials told us, reduced obstacles to privatization and sent a signal to managers and employees that political leaders were serious about implementing it.

While providing a statutory basis for competitively contracting out government functions, H.R. 716 has implications for certain existing laws. As currently drafted, the bill is broad in its application, and how it will relate to existing laws and policies is not entirely clear. For example, H.R. 716 prohibits agencies from beginning or carrying out any activity to

provide any products or services that can be provided by the private sector, and it prohibits agencies from providing any goods or services to any other governmental entity. This could conflict with the “Economy Act of 1932” (31 U.S. 1535-1536), which authorizes interagency orders for goods and services, as well as with the General Services Administration’s (GSA) authority to provide agencies with goods and services. GSA was created, and still exists, to provide goods and services to agencies, such as office space, consolidated purchasing, air fare contracts, and excess property disposal. Its role under H.R. 716 is unclear.

In addition, the bill does not contain language limiting judicial review of management actions taken under its provisions. The possibly unintended effect of subjecting management decisions to judicial review could slow implementation and increase costs due to litigation.

Reliable and Complete Cost Information Needed for Privatization Decisions

In the governments we visited, reliable and complete cost data on government activities were deemed essential in assessing the overall performance of activities targeted for privatization, in supporting informed privatization decisions, and in making these decisions easier to implement and justify to potential critics. Most of the governments we surveyed used estimated cost data because obtaining complete cost and performance data, by activity, from their accounting systems was difficult. However, Indianapolis, and more recently Virginia have used activity based costing (ABC)⁹ to obtain more precise and complete data on the cost of each separate program activity.

H.R. 716 Requires Cost and Past Performance Information in Making Privatization Decisions

A notable feature of the draft legislation is the provision describing the criteria that are to be used in contracting for goods and services. The legislation requires OMB to prescribe standards and procedures that are to include the analyses of all direct and indirect costs, and to be performed in a manner consistent with generally accepted cost accounting principles as well as with past performance of sources. We have found in the past that the widespread absence of this type of information has compromised effective public-private comparisons. This provision of the bill is

⁹ABC is a methodology that assigns costs to products or services based on the resources they consume. It assigns functional costs, direct and indirect, to the activities of an organization and then traces activities to the product or service that caused the activity to be performed. ABC gives visibility to how effectively resources are being used and how all relevant activities contribute to the cost of a product or service. Such information may be key to making decisions about whether to restructure or privatize an activity. See Glossary: Terms Related to Privatization Activities and Processes (GAO/GGD-97-121, July, 1997).

consistent with current efforts aimed at improving federal financial management.

In the past, when competitive contracting has been done at the federal level under the provisions of Circular A-76, the absence of workload data and adequate cost accounting systems has made the task all the more difficult. Given that most agencies do not have cost accounting systems in place at this point, the bill's requirement to use past performance and cost data will be difficult for many federal activities to meet.

Efforts are under way to develop the type of cost and performance data that would be necessary to compare public versus private proposals, as could occur under the provisions of H.R. 716. The Federal Accounting Standards Advisory Board (FASAB) has developed standards that are designed to provide information on the costs, management, and effectiveness of federal agencies. These standards require agencies to develop measures of the full costs of carrying out a mission or of producing products and services. Such information, when available, would allow for comparing the costs of various programs and activities with their performance outputs and results. To help agencies meet these standards, the Joint Financial Management Improvement Program (JFMIP) plans to issue guidance to facilitate the acquisition and development of managerial cost accounting systems needed to accumulate and assign cost data consistent with governmentwide data.¹⁰

H.R. 716 Recognizes Federal Workforce Transition Needs

We found that governments we visited needed to develop strategies to help their workforces make the transition to a private-sector environment. Such strategies, for example, might seek to involve employees in the privatization process, provide training to help prepare them for privatization, and create a safety net for displaced employees. Among the six governments we visited, four permitted at least some employee groups to submit bids along with private-sector bidders to provide public services. All six governments developed programs or policies to address employee concerns with privatization, such as the possibility of job loss and the need for retraining.

¹⁰The JFMIP is a joint cooperative undertaking of the Office of Management and Budget, the General Accounting Office, the Department of the Treasury, and the Office of Personnel Management, working in cooperation with each other and with operating agencies to improve financial management practices throughout the government. An exposure draft of the system requirement was issued in April 1997, and final issuance is projected for later this calendar year.

The bill's findings section states that it is in the public interest for the private sector to utilize government employees who are adversely affected by conversions of functions to the private sector. The legislation does not create any new benefit or competitive job right that does not already exist. It does, however, assign to the Director of OMB the function of providing information on available benefits and assistance directly to federal employees. This would be a new and possibly burdensome function for OMB—a function that probably could be better handled by the Office of Personnel Management, which already has responsibility and experience in this area.

Competitive Contracting Helped Attain Employee Cooperation

Involving employees in the privatization process by letting them compete for the right to provide the service was a strategy used by state and local governments to gain employee cooperation during the privatization process. H.R. 716 neither encourages nor prohibits public-private competitions. However, it does give implicit authority to OMB to implement such a program, by requiring that the implementing regulations include standards and procedures for determining whether it is a private sector source or an agency that provides certain goods or services for the best value. While the question of how such determinations would be made is left up to OMB, competitive contracting has been the traditional method for making such determinations both at the federal level and the state and local level.¹¹

Effective Monitoring and Oversight of Contractor Performance Are Essential

When a government's direct role in the delivery of services is reduced through privatization, we found that, at least among the state and local governments we visited, the need for aggressive monitoring and oversight grew. Oversight was needed not only to evaluate compliance with the terms of the privatization agreement, but also to evaluate performance in delivering goods and services in order to ensure that the government's interests were fully protected. Indianapolis officials said their efforts to develop performance measures for activities enhanced their monitoring efforts. However, officials from most governments said that monitoring contractors' performance was the weakest link in their privatization processes.

¹¹Under competitive contracting, also referred to as managed competition, a public-sector agency competes with private-sector firms to provide public-sector functions or services under a controlled or managed process. This process clearly defines the steps to be taken by government employees in preparing their own approach to performing an activity. The agency's proposal, which includes a proposal for cost-estimation purposes, is useful in competing directly with private-sector offers.

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The essential foundation for effective oversight is good cost and performance data. H.R. 716's analytical requirements call for the consideration of all direct and indirect costs, qualifications, and past performance as well as other technical considerations. These requirements, along with the authority and flexibility given to OMB in implementing the legislation, provide the necessary foundation for effective performance monitoring and oversight, but they do not resolve capacity problems.

Converting government activities to private-sector performance will increase the contracting workload on federal agencies. Conversion to contract performance requires considerable contract management capability. An agency must have adequate capacity and expertise to successfully carry out the solicitation process and effectively administer, monitor, and audit contracts once they are awarded. In past reports on governmentwide contract management, we identified major problem areas, such as ineffective contract administration, insufficient oversight of contract auditing, and lack of high-level management attention to and accountability for contract management.¹² Some federal agencies have recognized the problem and have taken actions intended to improve their contract management capacity. The Department of Energy (DOE) and The National Aeronautics and Space Administration (NASA) provide examples of the challenges agencies face in overseeing contractors.

DOE—the largest civilian contracting agency in the federal government—contracted out about 91 percent of its \$19.2 billion in fiscal year 1995 obligations. We designated DOE contracting in 1990 as a high-risk area, vulnerable to waste, fraud, abuse, and mismanagement, because DOE's missions rely heavily on contractors and DOE has a history of weak contractor oversight; however, it has been working to improve its contract management practices. As we recently reported in our high-risk report on DOE,¹³ changing the way DOE does business has not come easily or quickly. DOE has taken various actions in the past to improve its contracting, and a recent contract reform effort that has received high priority and visibility appears promising; however, much remains to be done to ensure effective oversight of contractors.

¹²Government Earns Low Marks on Proper Use of Consultants (GAO/FPCD 80-48, June 16, 1980); Civilian Agency Procurement: Improvements Needed in Contracting and Contract Administration (GAO/GGD-89-109, Sept. 5, 1989); and Federal Contracting: Cost-Effective Contract Management Requires Sustained Commitment (GAO/T-RCED-93-2, Dec. 3, 1992).

¹³Department of Energy Contract Management (GAO/HR-97-13 Feb. 1997).

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NASA's contracting reforms demonstrate what can be accomplished when an agency places high priority on contractor oversight. NASA spends about 90 percent of its budget on contracts with businesses and other organizations. NASA's procurement budget is one of the largest among federal civilian agencies, totaling about \$13 billion annually in recent years. NASA first identified its contract management as vulnerable to waste and mismanagement in the late 1980s. Since then, it has grappled with a variety of contract management problems. NASA has made considerable progress in developing ways to better influence contractors' performance and to improve oversight of field centers' procurement activities. It has, for example, established a process for collecting cost, schedule, and technical information for all major NASA contracts to assist management in the tracking of contractor performance, and it also has restructured its policy on award fees to emphasize contract cost control and the performance of contractors' end products.

In conclusion, Mr. Chairman, striking a proper balance between the public- and private-sector provision of goods and services to the American people is among the most enduring issues in American politics and public policy. The Freedom From Government Competition Act would redirect current policy, which does not now have the weight of legislative authority and significantly affect the operation and management of the federal government. We believe that Congress is the proper forum to address such fundamental questions, and we hope that our testimony today has been helpful by raising some issues for the Subcommittee to consider in its deliberations on the proposed act.

That concludes my prepared statement. I would be pleased to answer any questions the Subcommittee may have.

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