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# PRIVATIZATION AND COMPETITION

# Comments on S. 314, the Freedom From Government Competition Act

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# Privatization and Competition: Comments on S. 314, 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 S. 314, 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. We testified in the 104th Congress on a predecessor to S. 314.[1] The revisions incorporated in this new bill respond to a number of our suggestions, including provisions relating to the use of best value as a criterion for contracting decisions, allowing for situations where private sector sources are inadequate to meet the government's needs, and recognizing that the identification of inherently governmental functions is somewhat situational. As you know, we recently had discussions with the Subcommittee staff on S. 314 and provided some suggestions and comments. The Subcommittee has asked that today we discuss the new bill 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 recently reported 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. 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 they needed to

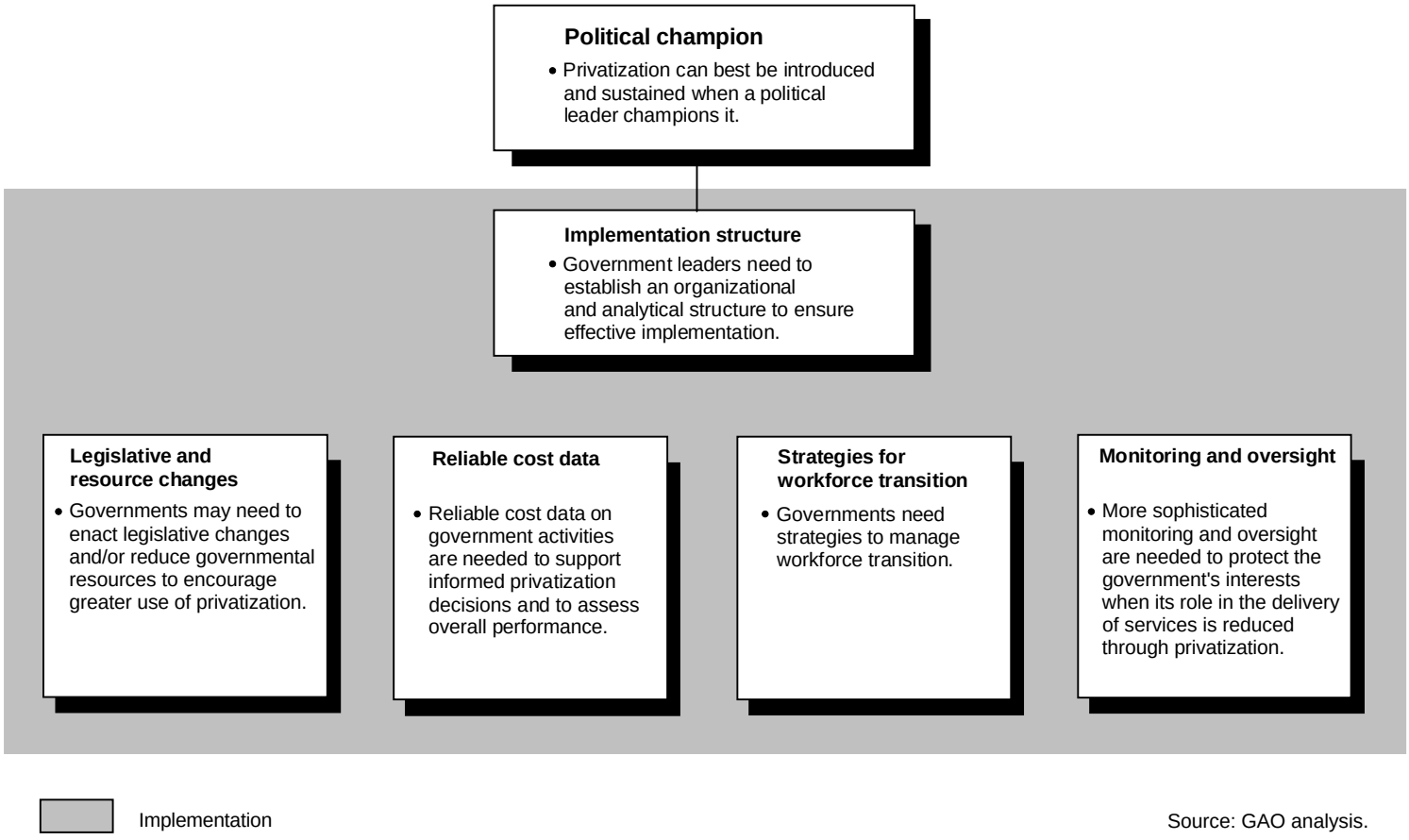
- have committed political leaders to champion the privatization initiative;
- establish an organizational and analytical structure to implement the initiative;
- enact legislative changes and/or reduce resources available to government agencies in order to encourage greater use of privatization;

[1]Federal Contracting: Comments on S. 1724, The Freedom From Government Competition Act (GAO/T-GGD-96-169, Sept. 24, 1996).

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

- develop reliable and complete cost data on government activities to assess their performance, to support informed privatization decisions, and to 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,
- 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**




Source: GAO analysis.

## S. 314 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.

S. 314 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.

S. 314 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.

## S. 314 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, S. 314 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;

- 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 or not 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 may want a mechanism to hold OMB accountable for carrying out its responsibilities. Such a mechanism could require that OMB prepare a multiyear strategic plan for implementing the bill's requirements. The plan could be developed in consultation with Congress and could describe major goals and priorities, as well as specific strategies and milestones for achieving the goals. In addition, the plan could provide an assessment of changes to current policies and systems that would be necessary to accomplish the bill's purposes. A strategic plan thus 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 tool for congressional oversight of 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 management responsibilities, which have been expanded significantly in recent years.[3] Such a plan might be an appropriate vehicle for addressing such resource issues.

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

## Implementation of S. 314 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 Government Performance and Results Act, often referred to as "GPRA" or "the Results Act," since it cuts to the very heart of questions on what activities the government should and should not be performing. Under the provisions of GPRA, 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 report on initial implementation of the act, we found that many agencies are not yet well positioned to specify their plans and strategies in terms of tangible results.[4]

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) an inventory of functions that are subject to the Act's provisions, and (2) a schedule for converting the functions identified in the performance plan. Requiring agencies to specify the activities they would perform directly, and those they would convert to private sector performance, is consistent with the Act's strategic planning requirements.

If Congress chooses to enact S. 314, an opportunity exists to further integrate implementation of the bill's provisions with the Results Act. A key provision of S. 314 requires OMB to create a methodology for making determinations as to what activities should and should not remain in government. This provision, if integrated with the strategic planning and performance reporting 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 with regard to Department of Defense depots.[5] By making clear that, as part of their strategic planning and performance measurement

[4]The Government Performance and Results Act: 1997 Governmentwide Implementation Will Be Uneven (GAO/GGD-97-109, Jun. 2, 1997).

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

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.

## The Relationship of S. 314 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, S. 314 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, S. 314 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 services to agencies, such as office space, consolidated purchasing, air fare contracts, and excess property disposal. Its role under S. 314 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 new techniques to obtain more precise and complete data on the cost of each separate program activity.

## S. 314 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. It requires OMB to prescribe standards and procedures that are to include the analyses of all direct and indirect costs, 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 consistent with current efforts aimed at improving federal financial management.

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 S. 314. 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, guidance has been issued to facilitate the acquisition and development of managerial cost accounting systems needed to accumulate and assign cost data consistent with governmentwide data.

## S. 314 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.

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. S. 314 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.[6]

[6]Under 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 bid proposal for cost-estimation purposes, is useful in competing directly with private-sector bids.

## 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 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.

The essential foundation for effective oversight is good cost and performance data S. 314'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.[7] 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

[7]Government 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).

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. DOE has been working to improve its contract management practices. As we recently reported in our high-risk report on DOE,[8] 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.

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.

[8]Department of Energy Contract Management (GAO/HR-97-13 February 1997).

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