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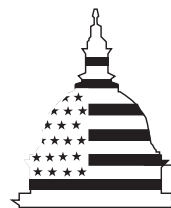
Before the Committee on Indian Affairs,
U.S. Senate

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**INDIAN
SELF-DETERMINATION
CONTRACTING**

**Shortfalls in Contract Support
Costs and Alternatives for
Funding Them**

Statement of Jim Wells, Director,
Energy, Resources, and Science Issues
Resources, Community, and Economic
Development Division



G A O

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Mr. Chairman and Members of the Committee:

Two months ago, the President of the United States visited the Oglala Sioux Tribe in South Dakota, stressing Native Americans' need for economic empowerment. This historic visit is another step—the first of which was taken in 1975 with the passage of the Indian Self-Determination and Education Assistance Act (the act)—toward recognizing the potential for tribes' self-determination through economic development. The act, as amended, provides that tribes shall have the opportunity to assume the management of federal Indian programs and that they shall receive contract support funds to cover their costs for contract management and administration.¹ However, during our review of contract support costs for tribal self-determination contracts, many tribal officials told us that they have diverted funds from economic development opportunities to cover shortfalls in federal funding.

For example, for fiscal year 1998, the Bureau of Indian Affairs (BIA) and the Indian Health Service (IHS) calculated that they owed the Oglala Sioux an additional \$1.5 million in contract support funding that they were unable to provide because of limited appropriations. For all tribes with self-determination contracts, the shortfall in funding for allowable contract support costs totaled \$95 million in fiscal year 1998.² Contract support costs are intended to cover the expenses tribes incur (e.g., for financial management and accounting, some training, and program startup costs) in managing contracted programs such as social services, hospitals and clinics, road maintenance, law enforcement, and forestry.

In 1998, a year of concern and controversy over contract support costs culminated in a statutorily imposed 1-year moratorium for fiscal year 1999 on all new contracting under the Indian Self-Determination Act. This moratorium was prompted by concerns over sustained increases in tribes' allowable contract support costs (that is, the tribes' costs that BIA and IHS determine are eligible for reimbursement), increases in the shortfall between these costs and the funding available for them, and litigation over such shortfalls. Because of a lack of progress in resolving this issue during

¹Throughout this testimony, the term "tribes" will refer to both tribes and tribal organizations eligible to contract for programs under the act. Also, the term "contracts" will refer to contracts, grants, self-governance agreements, cooperative agreements, or annual funding agreements that are entered into under the act, as amended, and receive contract support funds.

²Tribal contractors and IHS are currently engaged in litigation to determine whether, for Indian self-determination contracts, the funding for tribal contract support costs is limited to the amount appropriated.

1999, the Senate Committee on Appropriations has proposed extending the moratorium for another year.

Because of congressional concerns over ever-increasing contract support costs and shortfalls in funding these costs, the Subcommittee on Interior and Related Agencies, Senate Committee on Appropriations, and the Senate Committee on Indian Affairs asked us to review various aspects of these costs in our June 1999 report.³ We testified last month on our report before the House Committee on Resources.⁴ Our testimony today further discusses the issues surrounding Indian contract support costs. In particular, we will discuss (1) the different categories of contract support costs; (2) the extent of, and reasons for, increases in contract support costs over the last several years; and (3) four alternatives for funding these costs.⁵

In summary, BIA and IHS commonly refer to three categories of contract support costs: (1) indirect costs, (2) direct contract support costs, and (3) startup costs. Indirect costs are costs for a tribe's common support services, such as accounting. Direct contract support costs are costs for activities that are program-related but for which the tribe does not receive program funds, such as workers' compensation. Finally, startup costs are costs for one-time expenses incurred in beginning a program, such as the costs of computer hardware and software.

Tribes' allowable contract support costs tripled from 1989 through 1998, increasing from about \$125 million to about \$375 million.⁶ This increase occurred for two principal reasons. First, the total costs of tribally contracted programs—upon which contract support costs are based—have increased. Second, the total cost to tribes of administering their self-determination contracts has increased. Although the amounts appropriated for contract support costs have increased over the past decade, they have not increased as fast as the support costs, resulting in funding shortfalls. For fiscal year 1998, for example, the shortfall between

³Indian Self-Determination Act: Shortfalls in Indian Contract Support Costs Need to Be Addressed (GAO/RCED-99-150, June 30, 1999).

⁴Indian Self-Determination Contracting: Shortfalls and Alternatives for Funding Contract Support Costs (GAO/T-RCED-99-271, August 3, 1999).

⁵The June 1999 report also addressed how the tribes have been affected by funding shortfalls for contract support costs and whether the act's provisions for contract support costs have been implemented consistently. The report contained two recommendations to make BIA's and IHS' payment of contract support costs more consistent.

⁶Dollar figures used throughout this testimony have been adjusted to constant 1998 values.

appropriations (almost \$280 million) and allowable contract support costs (about \$375 million) was about \$95 million. Projections of future contract support costs are difficult to calculate because the number of programs for which tribes will choose to contract in the future is uncertain, as is the amount of funding they will receive.

The impasse over whether to provide full funding for contract support costs or limit these costs continues in the Congress. To assist the Congress in its deliberations over how to resolve the impasse over contract support costs, we present four alternative funding approaches, each of which can be considered individually or combined with the others. These alternatives range from providing appropriations sufficient to fund tribes' allowable contract support costs each year to amending the act to remove the provision for funding contract support costs separately from and in addition to a program's direct costs and instead provide a single, consolidated contract amount. Each of the alternatives has advantages and disadvantages. Three of the four alternatives have the advantage of controlling future increases in contract support costs. A disadvantage of these same three alternatives is that they would require legislative changes to the act's funding provisions.

Background

Before 1975, Native Americans and Alaska Natives depended on the federal government to provide them with such services as law enforcement, social services, natural resource management, hospital care, and other health services like dental and mental health care. This began to change in 1975 when the government announced a policy of self-determination for tribal governments. The federal government's self-determination policy allows tribes to take over the management and administration of programs previously managed by the government on their behalf. As part of the government's policy, tribes receive funding for the programs they contract to manage as well as funding to cover the costs of their contract management and administration. These latter costs, referred to as contract support costs, are the necessary and reasonable costs tribes incur in establishing and maintaining the support systems needed to administer their contracts.

Tribes enter into self-determination contracts with two agencies: (1) BIA, which is the primary federal agency with responsibility for administering Indian policy and discharging the federal government's trust responsibility for American Indians and Native Alaskan villages, and (2) IHS, which is responsible for delivering health services to American Indians and Alaska

Natives. If a tribe chooses not to contract for a BIA or IHS program, the agencies continue to provide the service to the tribe. In fiscal year 1997, tribes contracted for programs worth about \$546 million, excluding such programs as education and construction; BIA's budget that year totaled \$1.7 billion. Tribes contracted for IHS programs worth \$719 million in fiscal year 1998, and IHS' total budget for that same year was over \$2 billion.

Categories of Contract Support Costs

BIA and IHS developed implementing guidelines that specified the types of costs that will be reimbursed under the act. In policy and practice, the agencies commonly refer to three categories of contract support costs. Table 1 defines and provides examples of these cost categories.

Table 1: Categories of Contract Support Costs, Definitions, and Examples

Cost category	Definition	Examples
Indirect costs	Costs incurred for a common or joint purpose benefiting more than one cost objective ^a and not readily assignable to the cost objectives specifically benefited, without effort disproportionate to the results achieved.	Indirect costs (often thought of as overhead costs) typically include those incurred for financial and personnel management, property and records management, data processing and office services, utilities, janitorial services, building and grounds maintenance, insurance, and legal services. ^b
Direct contract support costs ^c	Costs of activities that are not contained in either the indirect cost pool or the direct program funds.	Direct contract support costs can include training required to maintain the certification of direct program personnel, and costs related to direct program salaries, such as unemployment taxes, workers' compensation insurance, and retirement costs.
Startup costs	One-time costs incurred to plan, prepare for, and assume the operation of the program, function, service, or activity that is the subject of the contract and to ensure compliance with the terms of the contract.	Startup costs can include the costs of purchasing computer hardware and software, providing required training and staff development, establishing required administrative and management systems, and purchasing equipment and furniture to support the administrative unit.

^aA cost objective is a grouping of costs for functions for which cost data are needed and costs are incurred.

^bAccording to the Office of Management and Budget's Circular A-87, Cost Principles for State, Local, and Indian Tribal Governments, "There is no universal rule for classifying certain costs as either direct or indirect under every accounting system." The types of costs classified as indirect may vary by tribe depending on each one's circumstances.

^cAs discussed in ch. 4 of our June 1999 report, the agencies have inconsistent policies on the payment of direct contract support costs.

Sources: Office of Management and Budget Circular A-87, Cost Principles for State, Local, and Indian Tribal Governments; BIA; and IHS.

In 1996, BIA and IHS issued joint regulations for implementing the act, as amended, as it applies to self-determination contracts. These regulations describe the three types of costs identified in table 1 as costs for which tribes can request reimbursement in their contract proposals.

Tribes' indirect cost rates are negotiated using guidance published by the Office of Management and Budget. This is the same guidance used by other groups, such as state and local governments and nonprofit agencies. The Department of the Interior's Office of Inspector General negotiates the majority of these rates. The Department of Health and Human Services' Division of Cost Allocation also negotiates some rates, predominately for tribal organizations. A number of legal challenges have dealt with the rate-setting process and the funding for contract support costs. A 1997 court decision—*Ramah Navajo Chapter v. Lujan*—may require a change in the Inspector General's method of calculating indirect cost rates; we do not address this issue in our testimony because the settlement discussion is ongoing.⁷

Past Increases in Contract Support Costs Likely to Continue

As tribes' funding for contracted programs has increased over the past decade, so has the funding for contract support costs. In the past decade, the total dollars that BIA and IHS have provided to tribes for self-determination contracts has more than doubled, from about \$800 million in fiscal year 1989 to about \$1.9 billion in fiscal year 1998.⁸ Tribes' contract support costs have also increased for these programs; the amount of contract support funding for tribes' administrative and other management costs has increased from about \$125 million to about \$375 million. Although appropriations from the Congress and the payments from these two agencies for contract support have increased, they have not been sufficient to cover tribes' allowable costs identified by BIA and IHS. In fiscal year 1998, the Congress appropriated almost \$280 million to fund almost \$375 million in tribes' allowable contract support costs, resulting in a shortfall of about \$95 million.

The exact amount of future contract support costs is difficult to predict but will likely increase beyond the \$375 million calculated for fiscal year 1998. The extent of future increases will depend on the (1) amount of future appropriations BIA and IHS receive for contracted programs, (2) extent to which tribes choose to contract for new programs in the

⁷112 F. 3d 1455 (10th Cir. 1997).

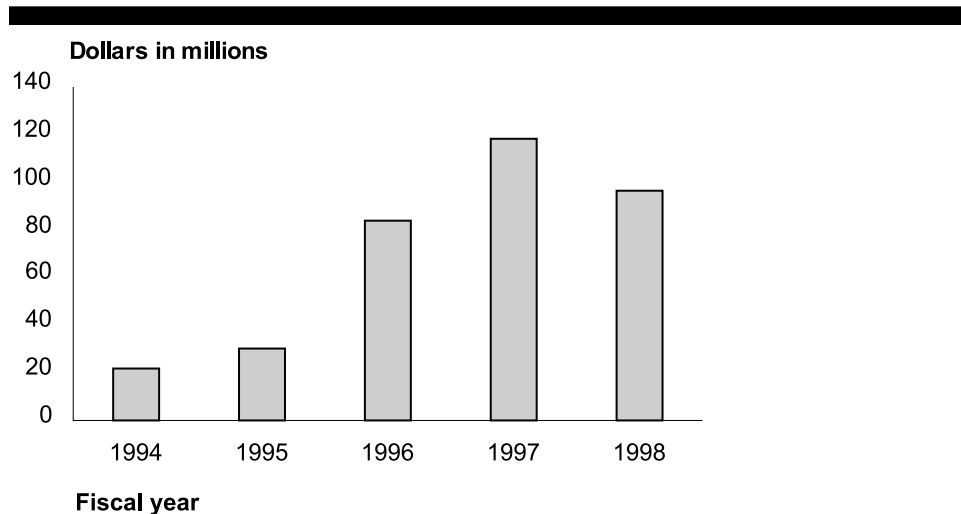
⁸Because BIA could not provide us with fiscal year 1998 contracting data, this information is based on fiscal year 1997 contracting data expressed in constant 1998 dollars.

future, and (3) future changes in tribes' costs of administering contracts. Currently, tribes receive funding through self-determination contracts equal to about half of BIA's and IHS' total appropriations; the other half is being used by BIA and IHS themselves to provide services to tribes. If the half now being used by BIA and IHS were contracted by tribes in the future and if indirect cost rates were to stay about the same, then contract support costs could double—from the fiscal year 1998 amount of about \$375 million to about \$750 million.

Alternatives for Funding Contract Support Costs

Shortfalls in contract support funding have persisted for the past decade, with the most dramatic shortfalls occurring in the last 5 years. Figure 1 shows that funding shortfalls grew from about \$22 million in fiscal year 1994 to about \$95 million in fiscal year 1998, peaking at about \$120 million in fiscal year 1997.

Figure 1: Shortfalls in Contract Support Funding for BIA and IHS, Fiscal Years 1994-98



In response to the need for a permanent solution to the current funding impasse, we are presenting four alternatives for funding contract support costs. We discuss the advantages, disadvantages, and cost implications of each. In discussing the costs of each alternative, we address costs starting in fiscal year 1998. We do not address the additional funding that would be necessary if prior years' shortfalls were to be covered or BIA and IHS were

to change their methods for determining direct contract support costs.⁹ The cost estimates we provide are illustrative rather than actual because they involve two major assumptions. First, using the agencies' estimated funding level for new contracts for fiscal year 2000, we assume that \$17.5 million would be the annual cost of supporting new contracts. Second, using fiscal year 1998 appropriations of about \$280 million, plus the agencies' fiscal year 1998 shortfall estimate of about \$95 million for existing contracts, we assume that \$375 million would be the cost of fully funding the existing contracts the first year under an alternative funding method. Finally, we are not able to estimate the costs of changes to existing contract costs because of the ever-changing nature of tribes' indirect cost rates and direct cost bases.

Alternative 1: Fully Fund Contract Support Costs

The first alternative for congressional consideration is to make appropriations sufficient to fully fund (i.e., at 100 percent of allowable costs) tribes' allowable contract support costs (this alternative assumes that BIA and IHS would request the full amount of tribes' allowable costs). Under this alternative, BIA and IHS would continue to identify tribes' allowable costs as they do now, by using tribes' indirect cost rates, and would pay direct contract support costs in a consistent way. The agencies would identify and request the funds necessary to support new contracts.

Advantages and Disadvantages

The first alternative has the advantage of fulfilling the provisions of the act that allow tribes to receive funding for their allowable contract support costs. By fully funding these costs, the Congress and the funding agencies would eliminate funding shortfalls as well as the potential for lawsuits stemming from such shortfalls. This alternative would be advantageous to tribes because it would help ensure that they receive the allowable support funds for the BIA and IHS programs they contract. As tribes contract for more programs, they may need to build up their administrative systems to properly administer and manage their contracts.

The primary disadvantage of this alternative is that its implementation would require the Congress to fully fund all allowable contract support costs, which would likely continue to increase each year. It is difficult to predict future contract support costs for several reasons, including the difficulty of determining how many tribes will enter into new contracts

⁹In 1998, the Congress included language in the Omnibus Consolidated and Emergency Supplemental Appropriations Act for fiscal year 1999 (P.L. 105-277, section 314, 112 Stat. 2681-288, Oct. 21, 1998) that limited the obligation to fund contract support costs to the amounts the Congress appropriated for that purpose in fiscal years 1994 through 1998. This provision is currently being challenged by tribal contractors.

during a given year. As BIA and IHS transfer more and more programs to tribes, the agencies' administrative costs should decrease, and some of this funding could become available to offset increases in contract support funding. Nevertheless, most of the funding for the increased allowable costs would have to be provided through federal appropriations.

Another disadvantage of this alternative, in terms of cost-efficiency, is that it would not provide tribes with incentives to limit the growth of contract support costs and, particularly, of indirect costs. Although tribes must justify their indirect cost rates through the standard rate negotiation process and, under the law, should not receive duplicate funding for the same task from program funding and contract support funding, the current method of funding indirect costs could encourage tribes to classify as many costs as possible as "indirect" to receive more funding.

Cost of the First Alternative

Because the need for contract support funding will, in all probability, continue to increase each year, the "full funding" alternative will involve ever-increasing amounts of funding. The cost of this alternative would be about \$375 million the first year, including the fiscal year 1998 funding shortfall, and would increase by the amount paid for new and expanded contracts and an undetermined amount for changes to existing contracts due to changes in indirect cost rates or program funding.¹⁰ The incremental cost of this alternative for the first year would be \$95 million, the amount of the shortfall for fiscal year 1998.

Alternative 2: Amend the Act to Eliminate the Provision for Full Funding of Contract Support Costs

A second alternative is for the Congress to amend the act to eliminate the provision for fully funding allowable contract support costs and, instead, provide funding strictly on the basis of annual appropriations.¹¹ This alternative would eliminate the expectation of full funding as well as the potential for lawsuits stemming from funding shortfalls. Under this alternative, BIA and IHS would continue to identify tribes' allowable costs, using their indirect cost rates, in the agencies' budget requests.

Advantages and Disadvantages

This alternative has the advantage of limiting the growth of contract support funding; funding amounts would be established by the amount the Congress appropriates each year. At the same time, this alternative would

¹⁰We assume that in the second year of contracting under this alternative, the funding for existing contracts would increase by \$17.5 million and another \$17.5 million would fund additional new and expanded contracts.

¹¹This alternative may not be necessary if federal courts determine that the requirement for contract support funding under the act is limited to the amount actually appropriated. Cases presently before the Court of Appeals for the Federal Circuit are considering this issue.

allow the Congress to fund contract support costs at whatever level it deems appropriate. The Congress has appropriated increased amounts for contract support; in fiscal year 1989, it provided about \$100 million; in fiscal year 1998, it provided about \$280 million. If adopted, this alternative would eliminate the expectation, created by the 1988 and 1994 amendments to the law, that full contract support funding would be available, when, in fact, appropriations and funding have been limited and shortfalls have occurred.

A disadvantage of this alternative is that it might discourage tribes from entering into new self-determination contracts. The current policy fosters self-determination by encouraging tribes to assume managerial responsibility for federal programs that the government previously managed on their behalf. Yet, as the Senate authorizing committee has explicitly stated, assuming responsibility for these programs was not intended to diminish tribes' program resources.¹²

Another disadvantage of this alternative for tribes is that funding for their contract support costs would be subject to the uncertainties of the appropriations cycle. Unless the Congress decides to appropriate amounts sufficient to fully fund tribes' contract support costs every year, this alternative would produce shortfalls between the amounts provided and those identified as allowed for contract support. Appropriations could fluctuate from year to year, and this could negatively affect tribes' ability to plan and budget for administering their programs.

Cost of the Second Alternative

The cost of this alternative would depend on the annual appropriations provided by the Congress for contract support. For fiscal year 1998, \$280 million was provided.

Alternative 3: Amend the Act to Impose Limits on Indirect Cost Rates

A third alternative would be to amend the act to limit the amount of funding tribes could receive for contract support by limiting the amount of indirect costs they can receive. For example, one way to limit funding would be to establish one indirect cost rate—such as the current aggregate rate of 25 percent—as a flat rate that would apply to all tribes.

Advantages and Disadvantages

Like the second alternative, this one has the advantage of imposing limits on the growth of funding for contract support costs and of eliminating the expectation created by the law's current language that such costs would

¹²S. Rep. No. 103-374 at 9 (1994).

be fully funded.¹³ An advantage of this alternative for tribes is that their contract support costs would be funded on a consistent basis and they could better anticipate their annual contract support funding. All tribes would receive funding, and they would receive it at the same rate.

However, a disadvantage of this alternative to tribes is that it would ignore differences among individual tribes' actual indirect costs, which make up the majority of contract support costs and vary widely among tribes. By ignoring these differences, this alternative could provide a windfall for tribes that have low indirect cost rates while placing those with high rates at a disadvantage, depending on the specific rate limit that would be applied. Currently, if the Congress were to impose a flat 25-percent rate based on total direct costs, more tribes would receive reduced funding than increased funding for indirect costs. For example, if a tribe had a 30-percent rate before this fixed rate was set, it would receive 5 percent less for indirect costs each year. On the other hand, a tribe that had a 15-percent rate before the establishment of a fixed 25-percent rate would receive 10 percent more each year than it would have done otherwise. While this alternative would provide an incentive for tribes with high indirect cost rates to lower their indirect costs, BIA and IHS would have to redistribute funding among tribes, which could cause financial and administrative disruption for those that would lose funding.

Cost of the Third Alternative

The cost of this alternative would depend on the type of rate limit established. If, for example, the Congress chose a flat rate of 25 percent, this alternative would cost about the same as the current method costs, about \$375 million, for the first year. This amount would be higher or lower depending on the rate chosen by the Congress.

Alternative 4: Amend the Act to Replace the Current Funding Mechanism With a Consolidated Contract Amount

A fourth alternative would be to amend the act to eliminate the current funding mechanism, which provides contract support funding over and above direct funding for the program, and replace it with one that would combine the current categories of contract costs into one contract amount from which both direct and indirect costs would be recovered. The revised contract amount would consist of the sum of (1) a program's dollars; (2) the allowable indirect costs; and (3) any allowable direct contract support costs. Upon consolidation into a single contract amount, these

¹³The idea of imposing a cap on indirect cost rates is similar to the approach used to limit the growth of indirect costs at colleges and universities. Beginning in fiscal year 1992, a 26-percent cap was imposed on federal reimbursements to universities for certain indirect costs associated with the performance of federally funded research, as we reported in a previous review of such costs. See University Research: Effect of Indirect Cost Revisions and Options for Future Changes (GAO/RCED-95-74, Mar. 6, 1995).

cost categories would lose their individual identities and would thereafter simply make up the contract total. This method was tried before but failed because of funding shortfalls. BIA tried to create a single contract amount in the mid-1980s.

Advantages and Disadvantages

An advantage of this alternative for both the government and tribes is that it would provide for the full recovery of indirect costs, although the amount of funding provided might not increase. At the same time, this alternative would remove any incentive for tribes to increase their indirect costs to receive more funding each year. Funding would no longer be provided over and above a program's direct funding, so once the consolidated contract amount had been set, any increases in indirect costs would leave less money to spend for the program. Tribes would thus have an incentive to reduce their indirect costs as much as possible to make more money available for direct program expenditures. In keeping with the purpose of the act, tribes would decide how much funding to spend on program costs and how much to spend on administrative, or indirect, activities. Under this alternative, the spotlight would no longer be on the sufficiency of contract support funding but on the sufficiency of direct program funding. That is, funding debates would center on whether the funds provided for a particular program would be sufficient to achieve its intended purpose.

A disadvantage of this alternative for tribes is that if their indirect cost rates increased over the years, the contract amounts would not automatically increase. Changes in indirect cost rates—whether upward or downward—would no longer affect the amount of funding a tribe would receive because contract support would no longer be funded separately from program amounts. Thus, tribes would bear the responsibility for managing indirect costs prudently, to retain as much funding as possible for program services.

Cost of the Fourth Alternative

The Congress could fund this alternative in one of two ways. First, when the existing contract funding is consolidated, the funding could be combined at the current funding level, which would perpetuate the current funding shortfall. This option would cost \$280 million annually for existing contracts but would not differ from the previous failed attempt by BIA. The incremental costs of consolidating the funding at this amount would be zero. Or, second, the contract funding could be consolidated at the level identified by BIA and IHS as the amount of tribes' allowable contract support costs. For fiscal year 1998 funding, the consolidated amount would be about \$375 million, or \$95 million more than the \$280 million

appropriated. As under the other alternatives, funding for contract support costs would continue to be needed for new contracts. But under this alternative, future increases in contract support costs would be slowed for existing contracts because the funding mechanism would no longer provide amounts for contract support over and above the amounts for program services. Thus, if the Congress decided to increase the funding for a particular program, this decision would not create a corollary obligation to increase the funding for contract support.

Mr. Chairman, this concludes my statement. We would be pleased to respond to any questions that you or other members of the Committee may have at this time.

Contact and Acknowledgments

For information about this testimony, please contact Chet Janik at (202) 512-6508. Individuals making key contributions to this testimony included Susan Iott and Jeff Malcolm.

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