COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-158685

NOV 5 1976

The Honorable Morris K. Udall
House of Representatives

Dear Mr. Udall:

This is in response to your letter of August 30, 1976, written jointly with the Honorable Christopher J. Dodd, regarding actions of the Office of Management and Budget (OMB) designed to greatly expand the amount of contracting out of functions now performed in-house by civil service employees.

To obtain the information you required, we have contacted representatives of OMB, the Civil Service Commission and other organizations.

Many of your questions concern the reasonableness of estimates of future events. While we have endeavored to respond in a useful manner, estimates of this nature are not precise and could vary significantly, depending upon the assumptions made. Each estimate, therefore, could be considered reasonable if the assumptions are accepted. For example, the Government cost factor for retirement benefits of 24.7 percent of current payroll costs, is only as good as the projections of many future events such as (1) pay increases of Government employees, (2) interest rates applicable to pension fund assets, and (3) rates of inflation. There is no single right answer for these multiple projections.

Outlined below are our answers to the six questions contained in your letter.

<u>Question 1.</u> Is the assumption that retirement costs to the Government are higher than 7 percent reasonable?

<u>Response</u>:

The annual retirement costs to the Government are higher than 7 percent of payroll costs regardless of whether reference is being made to net Government outlays from the retirement fund, the Government's contributions to the retirement fund, or the Government's annual share of the value of currently accruing benefit rights earned by active employees during the year. In actuarial terminology, the value of benefit rights earned annually by employees covered under a retirement system is referred to as "normal cost." Normal costs estimated on a dynamic basis take into consideration (1) projected rates of inflation, (2) interest earnings on the pension fund assets, and (3) estimated wage increases. A more detailed discussion of the many factors involved in this matter is presented in Enclosure I.

Question 2. Are the cost factors developed by the Civil Service Commission at OMB's request for the retirement system reasonable?

Response:

We believe the Civil Service Commission's estimate of 31.7 percent of current payroll costs as the dynamic normal cost for the retirement system is reasonable, provided one accepts the economic assumptions used in calculating the cost. The Government's cost factor of 24.7 percent was derived by subtracting employees' contributions of 7 percent from the 31.7 percent normal cost.

Question 3. Are the methods to estimate future "dynamic" costs, such as wage increases, or benefit increases, or interest and inflation rates, as recommended by the actuaries board of the Civil Service Retirement System, reasonable, and why, or why not? Are the empirical analyses of past and future trends correct?

Response:

The economic assumptions used by the Commission's Chief Actuary in calculating the 31.7 percent dynamic normal cost for the retirement system were prescribed by OMB.

The assumptions were (1) future real annual pay increases of 1 percent, (2) real annual interest on fund investments at a rate of 2 percent, and (3) an annual inflation rate of zero percent. The Commission's Chief Actuary told us that using assumptions of a 5 percent general annual increase in pay, 6 percent interest rate, and 4 percent inflation rate would produce essentially the same normal cost as the assumptions prescribed by OMB. According to the Actuary, any combination of rates in which the annual pay and interest rates are 1 percent and 2 percent, respectively, above the assumed inflation rate would produce essentially the same normal cost estimate.

In making its interest rate assumption of 2 percent (6 percent minus inflation of 4 percent), OMB used a table (taken from U. S. Treasury reports) showing annual interest rates on 3-5 year Government bonds. The table covered a period of 28 years (1947-1974). Each year's rate was adjusted for inflation and expressed as an estimated "real" interest rate. Using these adjusted rates, OMB computed an average real interest rate of 1.58 percent for the 13 year period from 1952 to 1964, omitting the last 10 years, on the basis that they were not normal years. This rate was then rounded to 2 percent and used in OMB's assumptions. However, in our opinion, it is unsound to ignore the total experience available, particularly that pertaining to recent years. If OMB's assumption had been based on experience for all 28 years, the average real interest rate would have been 1 percent.

OMB's assumption that future annual pay would increase at a "real" rate of 1 percent was based on a study of private sector real wage rate increases between 1955 and 1962. We believe that it would have been more appropriate to base the assumption on historical experience within the Government. While we did not analyze Government experience over the long run, recent real wage rate increases within the Government, particularly for white collar employees, have been near zero percent.

It should be noted that decreasing the assumed pay rate increase to zero, and the average interest rate to 1 percent will increase the normal cost factor to approximately 37 percent and the Government's share to about 30 percent.

Estimates of the dynamic normal cost of the retirement system can vary considerably depending upon the assumptions made regarding future real wage increases and real interest rates. By their very nature, the validity of these economic assumptions cannot be judged on the basis of their precision or accuracy, but rather should be considered in terms of their reasonableness. OMB believes that their economic assumptions, by ignoring recent experience, favor an estimate of retirement costs on the low side.

Question 4. Are the actuarial models of the retirement system, on which the "dynamic" normal costs were calculated reasonable?

Response:

We discussed the models used to calculate normal cost with the Commission's actuary and perused the input data used for the calculations. We did not find any flaws in the method of calculations; different normal costs based upon different economic assumptions were consistent with each other. We did not, however, completely evaluate the computer program because of its complexity and the substantial period of time that would be required.

The computer program is based upon a large amount of statistical data accumulated over a number of years and was written about 10 years ago. The careers of 100,000 hypothetical Government employees in about 75 categories are modeled over a period of 50 years. For each year, the program provides for computing how many employees in each category shift to other categories during the next year and the effects on retirement benefit costs. Factors considered and processed include such things as the probability of death at a given age, promotion, and retirement. For each year in the 50 year period the program provides for computing the salaries and benefits, and processing the data to arrive at the dynamic normal benefit cost factor.

Composite Retirement Cost Rate

The 24.7 percent Government retirement cost rate for civil service employees is a composite rate applicable to the overall workforce, including engineers, secretaries, unskilled laborers, etc. We believe OMB should give consideration to developing a series of rates tailored to apply to each type of activity that is a candidate for contracting out such as guard services, grounds maintenance, and food service since it is improbable that pension cost factors are the same for all occupations. Under such a system, more accurate cost comparisons should be achievable.

Social Security as a Part of the Cost of Contracting Out

In making cost comparisons to determine whether activities should be performed in-house or contracted out, it is very important that proper consideration be given to costs under both alternatives. Therefore, we believe that Social Security costs for private sector employees should also be computed on the dynamic normal basis as are retirement costs for civil service employees. The current employer Social Security contribution is 4.95 percent of an employee's wages up to an annual ceiling of $15,300. This amount, together with the employee's contribution, may be insufficient to cover the full cost of employee benefits accruing under the system. Since there is a possibility that some portion of any additional costs will eventually be borne by the Federal Government, we believe that consideration should be given by OMB to developing a factor for cost comparison purposes that could be applied to labor costs of private sector employees to reflect the full annual accrual of retirement benefits of employees under the Social Security system on a dynamic basis.

OMB has stated that social security costs should not be considered because benefits paid are financed by earmarked contributions of employers and employees. OMB states, further, that there are no contributions to the Social Security trust fund from the general fund of the Treasury.

The Social Security Administration acknowledges that contributions to the Social Security trust fund are not adequate to finance future liability for benefits. Estimates of the unfunded liability range to the trillions of dollars. Government funding of this liability is a distinct possibility, if not a liklihood.

We recognize that it will be difficult to develop a reasonably accurate rate to reflect the potential social security costs that are likely to be borne by the Government. However, similar difficulties are inherent in the calculations of civil service retirement costs, i.e., numerous assumptions have to be made. It is our position that cost comparisons are meaningless if similar costs are not included in both computations.

<u>Question 5.</u> Should the completion of an adequate cost comparison analysis be required before every contracting out action, rather than in selected cases now? Are the criteria used to determine whether such studies should be made now sufficiently detailed to protect the Government?

<u>Response:</u>

As you know, A-76 does not require that a cost comparison be made before a contracting out action below certain dollar thresholds. The Commission on Government Procurement addressed this issue and made certain recommendations to revise A-76 in this regard (see Enclosure II) which our Office fully supports. We believe that implementation of the five recommendations advocated by the Commission on Government Procurement should be pursued. OMB feels it has not yet developed enough information on agency implementation of A-76 to establish target dates for taking a position on these recommendations.

<u>Question 6.</u> Is the five-function increase in contracting out mandated in OMB's July 27, 1976, memorandum reasonable or even achievable within the

near future, and is the private sector capable of providing the services as identified in the agency reports due August 23, 1976? Are these services proper ones to be obtained by Government through contracting out?

Response:

The OMB staff would not make the agencies' responses to the July 27, 1976, OMB memorandum available to us for evaluation. As of October 15, 1976, we formally requested the Director of OMB to instruct his personnel to provide the required information. A copy of my request is enclosed (see Enclosure III).

In his response dated October 26 (Enclosure IV), the Director advised that the data will not be made available until after it has been presented to the President and he has made his decisions on the proposed actions. We are in disagreement with this view and will pursue the matter further.

We plan to closely monitor any major developments concerning Government contracting out of functions previously performed in-house and expect to be reporting to the Congress on this matter from time to time.

A number of other Congressmen and Senators have requested a similar evaluation of the recent actions of the Office of Management and Budget concerning contracting out vs in-house production. We will, therefore, be in touch with your office to arrange for copies of this letter to be provided to those individuals.

If you have any further questions, please let us know.

Sincerely,

Elmer B. Staats

Comptroller General
of the United States

Enclosures

Enclosure I

Comments on The Government's
Retirement Costs

Question (1): Is the assumption that retirement costs to the Government are higher than 7 percent reasonable?

Response:

In discussing the Government's annual costs (expressed as a percentage of total annual payroll) of the civil service retirement system, annual costs may be expressed as:

(1) total annual benefit payments by the Government to former employees and survivors of former employees minus contributions by current employees to the Civil Service Retirement and Disability Fund; or

(2) total annual Government contributions (deposits) to the retirement fund; or

(3) the Government's share of the value of currently accruing pension benefits earned by active employees during the year.

When discussing the Government's retirement costs as an element of current annual employment costs, we believe the appropriate reference is to the Government's share of the value of currently accruing pension benefits ((3) above). Reference to annual benefit payments ((1) above) would be inappropriate because such payments are related to prior service by employees and thus reflect past, not current, employment costs. The following table shows net Government outlays for fiscal years 1970 through 1975. The table also shows that retirement costs computed on this basis amounted to 13.1 percent of the payroll in 1975.

Civil Service Retirement Fund Benefit and Expense Payments

	Fund expenses and benefit outlays 1/ (millions of $)	Outlays as a percent of payroll
1970	$1,012	3.9
1971	1,310	4.8
1972	1,867	6.4
1973	2,449	8.0
1974	3,453	10.6
1975	4,673	13.1

1/ Net of contributions by current employees.

Reference to the Government's total annual contributions to the retirement fund ((2) above) is also inappropriate because such contributions represent costs related to both past and current employment. Under civil service retirement laws the Government is required, annually, to make the following payments to the retirement fund:

- --contributions in amounts which match employees' contributions,
- --some of the interest on the system's unfunded liability,
- --an amount equal to the current benefits payments attributable to credit for military service, and
- --installments to finance increases in the system's unfunded liability resulting from (1) new or liberalized benefits, (2) extension of coverage to new groups of employees, or (3) employee pay increases.

The following table summarizes the Government's payments to the fund for fiscal year 1970 through 1975 and shows that retirement costs computed on this basis were 18.8 percent of the payroll in 1975.

Civil Service Retirement Fund Annual Government Payments
(In Millions)

	1970	1971	1972	1973	1974	1975
Agency 1/ contributions	$1,738	$1,914	$2,060	$2,141	$2,291	$2,495
Interest on the unfunded liability	-	264	585	952	1,374	2,261
Military service payments	-	13	29	71	129	205
Installment payments	215	496	547	737	1,024	1,746
TOTAL	$1,953	$2,687	$3,221	$3,901	$4,818	$6,707
Total as a percent of aggregate pay	7.6	9.8	11.0	13.0	14.7	18.8

1/ Government agencies are required to match employees' contributions of 7 percent of annual salary.

The ultimate cost of any retirement system can be determined only as actual expenditures emerge throughout the life of the system. By the very nature of a retirement system's obligations, there is a timelag between the accrual of benefit rights and the payment of benefits. Under the civil service system, an employee's benefit rights accrue during his years of service. That is, each year of service by an employee has an associated retirement value. Therefore, it is sound accounting practice, as well as an encouragement to fiscal and budgetary discipline, for an employer to recognize the annual accrual of retirement benefit liabilities as an annual cost of employment.

In actuarial terminology the value of benefit rights earned (accruing) annually by employees covered under a retirement system is referred to as the "normal cost" of the system and is frequently expressed as a percentage of the total payroll. Normal cost can be calculated on either a "static" or "dynamic" basis. Under the static basis, no consideration is given to future general pay increases or cost-of-living annuity adjustments while under the dynamic basis consideration is given to such increases.

The law requires that the pay of Federal employees be adjusted periodically to maintain comparability with their counterparts in the private sector. Benefits payable at retirement depend, in large part, on an employee's average salary during his 3 highest paid years. Furthermore, the annuities of civil service retirees must be adjusted to reflect increases in the Consumer Price Index. Pay and annuity adjustments have occurred frequently and in large amounts. Since 1969, Federal white-collar pay rates have increased 58 percent and annuity adjustments have totaled 72 percent. When such future increases are ignored in computing normal cost (as is the case when the static basis is used) retirement costs currently being accrued are significantly understated.

On November 11, 1975, in testifying before the Subcommittee on Retirement and Employee Benefits, House Committee on Post Office and Civil Service, we stated that the preferable approach to retirement funding would require cost recognition and funding on a "dynamic" basis with full consideration of the effect of pay increases and cost-of-living adjustments on ultimate annuity payments.

Enclosure II

Recommendations from Commission on Government Procurement

Recommendation 22:

Provide through legislation that it is national policy to rely on private enterprise for needed goods and services, to the maximum extent feasible, within the framework of procurement at reasonable prices.

Recommendation 23:

Revise BOB Circular A-76 to provide that Federal agencies should rely on commercial sources for goods and services expected to cost less than $100.000 per year, without making cost comparisons, provided that adequate competition and reasonable prices can be obtained.

Recommendation 24:

Base cost comparison on:

(a) Fully-allocated costs if the work concerned represents a significant element in the total workload of the activity in question, or if discontinuance of an ongoing operation will result in a significant decrease in indirect costs.

(b) An incremental basis if the work is not a significant portion of the total workload of an organization, or if it is a significant portion in which the Government has already provided a substantial amount.

Recommendation 25:

Increase the BOB Circular A-76 threshold for new starts to $100,000 for either new capital investment or annual operating cost.

Recommendation 26:

Increase the minimum cost differential for new starts to justify performing work in-house from the 10 percent presently prescribed to a maximum of 25 percent. (Of this figure, 10 percent would be a fixed margin in support of the general policy of reliance on private enterprise. A flexible margin of up to 15 percent would be added to cover a judgment as to the possibilities of obsolescence of new or additional capital investment; uncertainties regarding maintenance and production cost, prices, and future Government requirements: and the amount of State and local taxes foregone.) New starts which require little or no capital investment would possibly justify only a 5 percent flexible margin, while new starts which require a substantial capital investment would justify a 15 percent flexible margin, especially if the new starts were high-risk ventures.

Enclosure III

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-158685

OCT 15 1976

The Honorable James T. Lynn
Director, Office of Management
and Budget

Dear Mr. Lynn:

At the request of Congressman Udall and Congressman Dodd, we are studying aspects of the Government's policies for contracting out of in-house functions. At the President's request, on July 27, 1976, you asked Federal departments and agencies to identify five additional in-house functions to be contracted out, and to revise procedures to increase the scope of contracting out by each department or agency. You asked for the responses by August 23, 1976.

In order to carry out the requested study, we require copies of all replies by agencies and departments to your July 27 letter. Members of my staff have sought informally to obtain these replies, but your staff has been unwilling to accede to our requests. As you know, 31 U.S.C. §54 requires all departments and establishments to furnish GAO with all required information, and to permit access to any books, documents, papers, and records.

I would appreciate your directing your staff to provide us the requested information immediately. In addition, we would like to be apprised of any events relating to the issue of contracting-out occurring subsequent to the replies in question.

Sincerely yours,

(SIGNED) ROBERT F. KELLER

ACTING Comptroller General
of the United States

cc: Congressman Morris K. Udall
Congressman Christopher S. Dodd

RMG:cbc

Enclosure IV

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

OCT 26 1976

Your Ref: B-158685

Honorable Elmer B. Staats
Comptroller General
of the United States
Washington, D.C. 20548

Dear Mr. Staats:

This responds to Mr. Keller's letter of October 15 concerning the Government's policies for contracting out of in-house functions.

As you know, Mr. Lynn's memo of July 27 was written pursuant to a Presidential directive and the agencies' responses thereto constitute their recommendations to the President on the subject of his management initiatives. Although the Office of Management and Budget has substantially completed its review of the agency submissions, those submissions have not yet been presented to the President. We expect to forward this material to the President early in November.

Until the President completes his review, the dissemination of the agency proposals outside of the Executive branch would clearly be inappropriate. To my knowledge, 31 U.S.C. 54 has never been construed to authorize the Comptroller General access to agency recommendations and advice prior to Presidential action thereon.

I wish to assure you of OMB's cooperation in your study and of our willingness to make relevant material available to you as soon as the President has completed his action.

Sincerely yours,

Paul H. O'Neill
Acting Director

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-158685 NOV 5 1976

The Honorable Christopher J. Dodd
House of Representatives

Dear Mr. Dodd:

This is in response to your letter of August 30, 1976, written jointly with the Honorable Morris K. Udall, regarding actions of the Office of Management and Budget (OMB) designed to greatly expand the amount of contracting out of functions now performed in-house by civil service employees.

To obtain the information you required, we have contacted representatives of OMB, the Civil Service Commission and other organizations.

Many of your questions concern the reasonableness of estimates of future events. While we have endeavored to respond in a useful manner, estimates of this nature are not precise and could vary significantly, depending upon the assumptions made. Each estimate, therefore, could be considered reasonable if the assumptions are accepted. For example, the Government cost factor for retirement benefits of 24.7 percent of current payroll costs, is only as good as the projections of many future events such as (1) pay increases of Government employees, (2) interest rates applicable to pension fund assets, and (3) rates of inflation. There is no single right answer for these multiple projections.

Outlined below are our answers to the six questions contained in your letter.

Question 1. Is the assumption that retirement costs to the Government are higher than 7 percent reasonable?

Response:

The annual retirement costs to the Government are higher than 7 percent of payroll costs regardless of whether reference is being made to net Government outlays from the retirement fund, the Government's contributions to the retirement fund, or the Government's annual share of the value of currently accruing benefit rights earned by active employees during the year. In actuarial terminology, the value of benefit rights earned annually

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by employees covered under a retirement system is referred to as "normal cost." Normal costs estimated on a dynamic basis take into consideration (1) projected rates of inflation, (2) interest earnings on the pension fund assets, and (3) estimated wage increases. A more detailed discussion of the many factors involved in this matter is presented in Enclosure I.

Question 2. Are the cost factors developed by the Civil Service Commission at OMB's request for the retirement system reasonable?

Response:

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Question 3. Are the methods to estimate future "dynamic" costs, such as wage increases, or benefit increases, or interest and inflation rates, as recommended by the actuaries board of the Civil Service Retirement System, reasonable, and why, or why not? Are the empirical analyses of past and future trends correct?

Response:

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The assumptions were (1) future real annual pay increases of 1 percent, (2) real annual interest on fund investments at a rate of 2 percent, and (3) an annual inflation rate of zero percent. The Commission's Chief Actuary told us that using assumptions of a 5 percent general annual increase in pay, 6 percent interest rate, and 4 percent inflation rate would produce essentially the same normal cost as the assumptions prescribed by OMB. According to the Actuary, any combination of rates in which the annual pay and interest rates are 1 percent and 2 percent, respectively, above the assumed inflation rate would produce essentially the same normal cost estimate.

In making its interest rate assumption of 2 percent (6 percent minus inflation of 4 percent), OMB used a table (taken from U. S. Treasury reports) showing annual interest rates on 3-5 year Government bonds. The table covered a period of 28 years (1947-1974). Each year's rate was adjusted for inflation and expressed as an estimated "real" interest rate. Using these adjusted rates, OMB computed an average real interest rate of 1.56 percent for the 13 year period from 1952 to 1964, omitting the last 10 years, on the basis that they were not normal years. This rate was then rounded to 2 percent and used in OMB's assumptions. However, in our opinion, it is unsound to ignore the total experience available, particularly that pertaining to recent years. If OMB's assumption had been based on experience for all 28 years, the average real interest rate would have been 1 percent.

OMB's assumption that future annual pay would increase at a "real" rate of 1 percent was based on a study of private sector real wage rate increases between 1955 and 1962. We believe that it would have been more appropriate to base the assumption on historical experience within the Government. While we did not analyze Government experience over the long run, recent real wage rate increases within the Government, particularly for white collar employees, have been near zero percent.

It should be noted that decreasing the assumed pay rate increase to zero, and the average interest rate to 1 percent will increase the normal cost factor to approximately 37 percent and the Government's share to about 30 percent.

Estimates of the dynamic normal cost of the retirement system can vary considerably depending upon the assumptions made regarding future real wage increases and real interest rates. By their very nature, the validity of these economic assumptions cannot be judged on the basis of their precision or accuracy, but rather should be considered in terms of their reasonableness. OMB believes that their economic assumptions, by ignoring recent experience, favor an estimate of retirement costs on the low side.

Question 4. Are the actuarial models of the retirement system, on which the "dynamic" normal costs were calculated reasonable?

Response:

We discussed the models used to calculate normal cost with the Commission's actuary and perused the input data used for the calculations. We did not find any flaws in the method of calculations; different normal costs based upon different economic assumptions were consistent with each other. We did not, however, completely evaluate the computer program because of its complexity and the substantial period of time that would be required.

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Composite Retirement Cost Rate

The 24.7 percent Government retirement cost rate for civil service employees is a composite rate applicable to the overall workforce, including engineers, secretaries, unskilled laborers, etc. We believe OMB should give consideration to developing a series of rates tailored to apply to each type of activity that is a candidate for contracting out such as guard services, grounds maintenance, and food service since it is improbable that pension cost factors are the same for all occupations. Under such a system, more accurate cost comparisons should be achievable.

Social Security as a Part of the Cost of Contracting Out

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OMB has stated that social security costs should not be considered because benefits paid are financed by earmarked contributions of employers and employees. OMB states, further, that there are no contributions to the Social Security trust fund from the general fund of the Treasury.

The Social Security Administration acknowledges that contributions to the Social Security trust fund are not adequate to finance future liability for benefits. Estimates of the unfunded liability range to the trillions of dollars. Government funding of this liability is a distinct possibility, if not a liklihood.

We recognize that it will be difficult to develop a reasonably accurate rate to reflect the potential social security costs that are likely to be borne by the Government. However, similar difficulties are inherent in the calculations of civil service retirement costs, i.e., numerous assumptions have to be made. It is our position that cost comparisons are meaningless if similar costs are not included in both computations.

<u>Question 5.</u> Should the completion of an adequate cost comparison analysis be required before every contracting out action, rather than in selected cases now? Are the criteria used to determine whether such studies should be made now sufficiently detailed to protect the Government?

<u>Response:</u>

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If you have any further questions, please let us know.

Sincerely,

Elmer B. Staats

Comptroller General
of the United States

Enclosures

TO THE READER:

SEVERAL PAGES OF THE FOLLOWING MATERIAL MAY BE ILLEGIBLE BECAUSE OF THE POOR QUALITY OF THE COPY SUBMITTED FOR MICROFILMING

Enclosure I

Comments on The Government's Retirement Costs

Question (1): Is the assumption that retirement costs to the Government are higher than 7 percent reasonable?

Response:

In discussing the Government's annual costs (expressed as a percentage of total annual payroll) of the civil service retirement system, annual costs may be expressed as:

(1) total annual benefit payments by the Government to former employees and survivors of former employees minus contributions by current employees to the Civil Service Retirement and Disability Fund; or

(2) total annual Government contributions (deposits) to the retirement fund; or

(3) the Government's share of the value of currently accruing pension benefits earned by active employees during the year.

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Civil Service Retirement Fund Benefit and Expense Payments

	Fund expenses and benefit outlays 1/ (millions of $)	Outlays as a percent of payroll
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1973	2,449	[illegible]
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1975	4,673	13.1

1/ Net of contributions by current employees.

Reference to the Government's total annual contributions to the retirement fund ((2) above) is also inappropriate because such contributions represent costs related to both past and current employment. Under civil service retirement laws the Government is required, annually, to make the following payments to the retirement fund:

- --contributions in amounts which match employees' contributions,
- --some of the interest on the system's unfunded liability,
- --an amount equal to the current benefits payments attributable to credit for military service, and
- --installments to finance increases in the system's unfunded liability resulting from (1) new or liberalized benefits, (2) extension of coverage to new groups of employees, or (3) employee pay increases.

The following table summarizes the Government's payments to the fund for fiscal year 1970 through 1975 and shows that retirement costs computed on this basis were 18.8 percent of the payroll in 1975.

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(In Millions)

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Military service payments	-	13	29	71	129	205
Installment payments	215	496	547	737	1,024	1,746
TOTAL	$1,953	$2,687	$3,221	$3,901	$4,818	$6,707
Total as a percent of aggregate pay	7.6	9.8	11.0	13.0	14.7	18.8

1/ Government agencies are required to match employees' contributions of 7 percent of annual salary.

The ultimate cost of any retirement system can be determined only as actual expenditures emerge throughout the life of the system. By the very nature of a retirement system's obligations, there is a timelag between the accrual of benefit rights and the payment of benefits. Under the civil service system, an employee's benefit rights accrue during his years of service. That is, each year of service by an employee has an associated retirement value. Therefore, it is sound accounting practice, as well as an encouragement to fiscal and budgetary discipline, for an employer to recognize the annual accrual of retirement benefit liabilities as an annual cost of employment.

In actuarial terminology the value of benefit rights earned (accruing) annually by employees covered under a retirement system is referred to as the "normal cost" of the system and is frequently expressed as a percentage of the total payroll. Normal cost can be calculated on either a "static" or "dynamic" basis. Under the static basis, no consideration is given to future general pay increases or cost-of-living annuity adjustments while under the dynamic basis consideration is given to such increases.

The law requires that the pay of Federal employees be adjusted periodically to maintain comparability with their counterparts in the private sector. Benefits payable at retirement depend, in large part, on an employee's average salary during his 3 highest paid years. Furthermore, the annuities of civil service retirees must be adjusted to reflect increases in the Consumer Price Index. Pay and annuity adjustments have occurred frequently and in large amounts. Since 1969, Federal white-collar pay rates have increased 58 percent and annuity adjustments have totaled 72 percent. When such future increases are ignored in computing normal cost (as is the case when the static basis is used) retirement costs currently being accrued are significantly understated.

On November 11, 1975, in testifying before the Subcommittee on Retirement and Employee Benefits, House Committee on Post Office and Civil Service, we stated that the preferable approach to retirement funding would require cost recognition and funding on a "dynamic" basis with full consideration of the effect of pay increases and cost-of-living adjustments on ultimate annuity payments.

Enclosure II

Recommendations from Commission on Government Procurement

Recommendation 22:

Provide through legislation that it is national policy to rely on private enterprise for needed goods and services, to the maximum extent feasible, within the framework of procurement at reasonable prices.

Recommendation 23:

Revise BOB Circular A-76 to provide that Federal agencies should rely on commercial sources for goods and services expected to cost less than $100,000 per year, without making cost comparisons, provided that adequate competition and reasonable prices can be obtained.

Recommendation 24:

Base cost comparison on:

(a) Fully-allocated costs if the work concerned represents a significant element in the total workload of the activity in question, or if discontinuance of an ongoing operation will result in a significant decrease in indirect costs.

(b) An incremental basis if the work is not a significant portion of the total workload of an organization, or if it is a significant portion in which the Government has already provided a substantial amount.

Recommendation 25:

Increase the BOB Circular A-76 threshold for new starts to $100,000 for either new capital investment or annual operating cost.

Recommendation 26:

Increase the minimum cost differential for new starts to justify performing work in-house from the 10 percent presently prescribed to a maximum of 25 percent. (Of this figure, 10 percent would be a fixed margin in support of the general policy of reliance on private enterprise. A flexible margin of up to 15 percent would be added to cover a judgment as to the possibilities of obsolescence of new or additional capital investment; uncertainties regarding maintenance and production cost, prices and future Government requirements; and the amount of State and local taxes foregone.) New starts which require little or no capital investment would possibly justify only a 5 percent flexible margin, while new starts which require a substantial capital investment would justify a 15 percent flexible margin, especially if the new starts were high-risk ventures.

WASHINGTON, D.C. 20548

B-158685

OCT 15 1976

The Honorable James T. Lynn
Director, Office of Management
and Budget

Dear Mr. Lynn:

At the request of Congressman Udall and Congressman Dodd, we are studying aspects of the Government's policies for contracting out of in-house functions. At the President's request, on July 27, 1976, you asked Federal departments and agencies to identify five additional in-house functions to be contracted out, and to revise procedures to increase the scope of contracting out by each department or agency. You asked for the responses by August 23, 1976.

In order to carry out the requested study, we require copies of all replies by agencies and departments to your July 27 letter. Members of my staff have sought informally to obtain these replies, but your staff has been unwilling to accede to our requests. As you know, 31 U.S.C. §54 requires all departments and establishments to furnish GAO with all required information, and to permit access to any books, documents, papers, and records.

I would appreciate your directing your staff to provide us the requested information immediately. In addition, we would like to be apprised of any events relating to the issue of contracting-out occurring subsequent to the replies in question.

Sincerely yours,

(SIGNED) ROBERT F. KELLER

Acting Comptroller General
of the United States

cc: Congressman Morris K. Udall
Congressman Christopher S. Dodd

RMG:cbc

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

OCT 26 1976

Your Ref: B-158685

Honorable Elmer B. Staats
Comptroller General
of the United States
Washington, D.C. 20548

Dear Mr. Staats:

This responds to Mr. Keller's letter of October 15 concerning the Government's policies for contracting out of in-house functions.

As you know, Mr. Lynn's memo of July 27 was written pursuant to a Presidential directive and the agencies' responses thereto constitute their recommendations to the President on the subject of his management initiatives. Although the Office of Management and Budget has substantially completed its review of the agency submissions, those submissions have not yet been presented to the President. We expect to forward this material to the President early in November.

Until the President completes his review, the dissemination of the agency proposals outside of the Executive branch would clearly be inappropriate. To my knowledge, 31 U.S.C. 54 has never been construed to authorize the Comptroller General access to agency recommendations and advice prior to Presidential action thereon.

I wish to assure you of OMB's cooperation in your study and of our willingness to make relevant material available to you as soon as the President has completed his action.

Sincerely yours,

Paul H. O'Neill

Paul H. O'Neill
Acting Director