BACKGROUND

The Department of Defense (DoD) is under substantial pressure to manage its resources more effectively in order to free resources that can be used to fund weapon system modernization and quality of life improvements. Its strategy for accomplishing this reallocation has several components, including efforts to establish priorities and to improve efficiency. Core defense functions, which include intelligence, strategic defense, applied research and development, and the provision of operational forces, assume the highest priority. To perform these core functions, DoD must rely on a support infrastructure—a set of activities that are not directly part of the defense mission, but facilitate the realization of that mission. As illustrated in Figure 1.1, approximately 60 percent of DoD’s 1997 obligation authority funded infrastructure activities. Personnel costs account for at least half of those infrastructure costs. Because these activities consume such a large proportion of the defense budget and are less directly related to the defense mission, they have become a natural focus of DoD cost-cutting efforts.

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1 DoD’s 1993 Report on the Bottom-Up Review identified seven categories of infrastructure: logistics, medical, personnel, training, acquisition management, installation support, and force management.

2 Infrastructure is not a formal DoD budget category, and hence these estimates are approximate. See GAO/NSIAD-96-176 for a discussion of infrastructure costs.
By reducing costs in infrastructure areas, DoD hopes to limit the impact of budget cuts on directly mission-related activities. DoD has identified competitive sourcing as one of the most promising avenues for reducing these infrastructure costs.

### Competitive Sourcing in DoD

Competitive sourcing is a general term describing a process through which managers consider both internal and external service providers to determine who can provide a given level of service at the

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3Indeed, the 1996 Future Years Defense Program (FYDP) reflected a reduction of approximately 25 percent in infrastructure expenditure. However, GAO/NSIAD-98-294 argues that these anticipated reductions were exaggerated and they have been revised downward in the 1997 and 1998 FYDP.

4Other potentially important sources of infrastructure savings include large-scale restructuring of activities such as base closures and realignments, reductions in military construction costs, and process reengineering. See GAO/NSIAD-96-131 for a discussion of potential savings opportunities for DoD in the infrastructure area.
lowest cost. Potential service providers include government employees within the organization (in-house providers), government employees in another organization (inter-service support providers), and private contractors.

It is important to distinguish the term competitive sourcing from the term outsourcing. Outsourcing refers to a process through which the provision of a service is contracted out to the most efficient external service provider. From the perspective of a government organization, an external provider may be either a private-sector entity or another government organization. Competitive sourcing, on the other hand, also considers how efficiently the in-house provider can provide the service. In other words, outsourcing is a more restrictive type of competitive sourcing that does not directly consider the possibility of in-house provision.

The federal government makes a distinction between activities that are inherently governmental and those that are commercial. Inherently governmental activities are “so intimately related to the public interest as to mandate performance by Federal employees.” So long as they are classified as such, inherently governmental activities cannot be contracted to an external private-sector provider. Inherently governmental activities involve policy determination or the direction and control of government resources (including federal employees). Activities not inherently governmental are considered commercial.

Commercial activities are subject to a series of rules and procedures set forth in U.S. Office of Management and Budget (OMB) Circular A-76. Every five years the A-76 program requires all government

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5Competitive sourcing could also refer to the purchase of a good, but the current policy debate as well as this paper focuses on the acquisition of services.


7A complete description of functions considered to be inherently governmental can be found in OMB Circular No. A-76—Revised Supplemental Handbook (March 1996), Appendix 5.

8The term “A-76” is often used as an adjective to describe rules, procedures, and processes related to the circular. The A-76 process attempts to balance the interests of the private sector (which believes that the government should not compete with its citizens) with those of federal employees (who believe they have a right to keep their jobs
agencies, including the DoD, to review commercial functions being performed in-house. Agencies can, however, exempt functions from the review process for reasons listed in OMB Circular A-76. For example, the function may be exempt if it is critical to the national defense, involves the provision of health services to government employees, or if there is no private sector provider for the service.

At the beginning of this review process, the government must develop a formal document called the performance work statement (PWS) that describes, from a customer perspective, the work required. Ideally, the PWS describes the required output and level or quality of service, rather than the manner in which the service is to be provided.

The PWS forms the basis of a competitive-bidding process through which the government compares potential private sector providers with the in-house provider. The in-house provider as well as the hopeful external providers submit detailed plans describing how they will accomplish tasks described in the PWS, along with an estimate of the cost of doing so. The bids are supposed to incorporate opportunities for improving the efficiency of the work process while meeting the requirements of the PWS. The in-house bid is called the most efficient organization (MEO).

After all bids are submitted, contractor costs are formally compared with the MEO costs. The contract cost includes the contract price (or bid) plus estimates of government contract monitoring and administrative expenses, and one-time transition costs. Contract costs also include the tax benefit that accrues to the government from having the service performed by a for-profit entity if the contractor is a for-profit organization. The MEO costs include estimates of the costs of operating the MEO and one-time transition costs. Starting in 1996, the MEO costs also have included a general and administrative

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10The PWS is sometimes referred to as the Statement of Work (SOW).
11The details of this process are described in OMB Circular No. A-76—Revised Supplemental Handbook (March 1996).
overhead charge equal to 12 percent of direct personnel costs.\textsuperscript{12} The government first compares all external bids, and then compares the best of those to the MEO bid. Generally speaking, if the best contract bid is more than 10 percent below the MEO cost, the function will be contracted out.\textsuperscript{13} Otherwise, the in-house organization wins the competition and must implement changes represented in the MEO.

\textbf{A-76 as a DoD Cost Saving Strategy}

DoD believes that A-76 competitions can generate substantial cost savings. The 1995 Commission on Roles and Missions of the Armed Forces gave special emphasis to expanded outsourcing of support services, advocating aggressive pursuit of this strategy. DoD plans to compete over 200,000 positions between FY 1997 and FY 2005 and expects savings of approximately $9 billion from those competitions, which are being programmed into service budgets.\textsuperscript{14} These broad savings projections are based on an assumption that DoD will save between 20 and 30 percent on each billet competed.\textsuperscript{15}

Excitement about the A-76 cost comparison process as a means of generating cost savings has been propelled by analyses conducted by the Center for Naval Analyses (CNA). Examining a set of completed DoD A-76 competitions, CNA has estimated that such competitions generated savings of approximately 30 percent per year (on average) for the government over the contract term: 38 percent for activities that are outsourced and 20 percent for activities that remain in house.\textsuperscript{16}

In spite of past outsourcing efforts, there are still between 260,000 and 360,000 military and civilian positions eligible for an A-76 com-

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{12}Prior to this, installations had complete flexibility in determining the estimated level of those overhead costs, and in most cases estimated them at zero.
\item \textsuperscript{13}This 10 percent margin is designed to ensure that the government does not outsource a function in order to achieve marginal savings.
\item \textsuperscript{14}See GAO/NSIAD-99-46.
\item \textsuperscript{15}See GAO/NSIAD-99-66.
\item \textsuperscript{16}See Tighe et al., 1996.
\end{itemize}
\end{footnotesize}
petition. For this reason, the notion of saving 20 to 30 percent on each billet is compelling.\footnote{Robbert, Gates, and Elliott (1997) report that DoD-wide, 636,846 positions (302,956 of them military) categorized as commercial activities remained in-house at the end of FY 1994. For 268,044 (72,540 military) of these positions, there was no national defense reason for in-house performance. More recently, the Office of the Secretary of Defense for Acquisition and Technology (Installations) compiled service and agency responses to a call for reevaluation of commercial activities (Defense Reform Initiative Directive #20). Responding to this directive, OSD, the services, and agencies identified as of FY 1998, 618,506 military and civilian positions in commercial activities that are exempt from competitive sourcing for various reasons, and 283,594 that are not. Subsequent reevaluations by some components have raised the pool that is subject to competition to about 358,000. These numbers reflect interpretation on the part of the services in terms of which activities are classified as “commercial activities” and which commercial activities are exempt from the A-76 process for national defense reasons (Moore et al., 1997).}

**Limitations on Possible Cost Savings from A-76**

There are, however, reasons to believe that the current expectations of potential savings from the A-76 process are overly optimistic\footnote{See GAO/NSIAD-99-46 for a detailed discussion of these concerns.} with regard to the process of conducting these competitions as well as the savings that will be generated from those that are completed.

The savings estimates generated by analysis of historical data have not been properly adjusted to account for practical aspects of implementation. In particular, savings are attributed to each billet slated for competition. However, historically, more than 40 percent of initiated competitions have been cancelled before completion (see Robbert, Gates, and Elliott (1997), Keating (1997)).\footnote{In defending the savings estimates, many have argued that the cancellation rate will decline because of increased high-level support for the A-76 process. We do not mean to suggest that the cancellation rate will remain at historically high levels. At the same time, there are many reasons for cancellation, and it is unlikely that the rate will fall to zero.} We have no data on the savings generated by cancelled competitions, but it is likely that those savings are low. When a competition is cancelled, the activity normally remains in house, and the in-house management is under no obligation to implement the MEO or otherwise improve efficiency. Moreover, Keating (1997) finds that competitions involving a large number of civilian billets are also the most frequently cancelled and subject to the longest delays.
According to Tighe et al. (1996), these large competitions are precisely the types that have generated the largest percentage savings. Therefore, even if completed competitions yield savings on the order of 30 percent, the expected savings generated by each initiated competition are far less.

The number of positions scheduled for competition between FY 1997 and FY 2003 is more than twice the number competed by DoD between FY 1978 and FY 1996. Serious questions have been raised as to whether the DoD components can in fact identify the expected number of positions for competition in the first place, and whether the competitions can be completed in the anticipated time frame.

There are also concerns that the savings estimates for completed competitions fail to capture some important costs, particularly initial investment costs to conduct the competition and implement the contract or MEO (e.g., separation payments, hiring costs).

In spite of concerns over DoD’s ability to achieve planned savings through the A-76 process, these savings have been programmed into DoD component budgets. OSD officials reported that “if the savings do not occur as quickly as planned, the components will have to absorb the shortfalls in their operations and maintenance accounts or shift money back from planned modernization.”

OBJECTIVES AND APPROACH

The purpose of this analysis is to develop a better understanding of the sources of efficiency improvement generated through the A-76 process, how those improvements are achieved, and whether they could be achieved outside of an A-76 competition. We focused our analysis on the use of personnel before and after A-76 competitions. At least half of DoD’s overall infrastructure costs are personnel costs. Because A-76 competitions involve service activities, more than half of the costs of these activities probably are labor costs. Moreover, our sponsor for this research, the Deputy Assistant Secretary of Defense for Civilian Personnel Policy, has a special interest in the costs

\footnote{See GAO/NSIAD-99-46, p.7.}
and efficiencies of in-house workforces relative to external alternatives.

Our investigation explored four general questions:

• How big are the projected personnel cost savings?
• How are the projected personnel cost savings achieved?
• Are those savings real and enduring?
• Could the personnel cost savings be achieved outside of the A-76 process?

In order to examine these and other questions, we conducted a series of detailed case studies of recently completed and implemented A-76 competitions. The case studies involved detailed document reviews of the PWS, MEO, and, for outsourced activities, the contract file. We also gathered as much information as possible on current personnel. In addition, we conducted a series of semistructured interviews with various participants in all stages of the A-76 process and the contract or MEO implementation.

SCOPE

The results presented in this report are based on six case studies at four installations in three services (Army, Navy, and Air Force), and should be interpreted with appropriate caution. The number of candidate sites was limited because there was little A-76 activity in the early to mid-1990s. The installations we visited were among the select few that had actually completed A-76 competitions, and in many cases were breaking new ground—either in their service or in their command. These installations probably faced certain advantages and disadvantages that would not exist for installations conducting studies today; specifically, they likely had more resources available to complete the study but less experience with the process. It is also possible that some of the issues raised in these case studies are specific to the downsizing environment in which DoD currently finds itself.

This report refers in several places to policies and procedures promulgated by OMB or the Office of the Secretary of Defense (OSD).
While we have made every effort to capture the latest policies and procedures, changes are continually occurring, prompted by ongoing high-level executive and congressional interest in competitive sourcing. Readers should consult primary sources to obtain the most current policies and procedural guidance.

ORGANIZATION OF THE REPORT

In Chapter Two, we present our methodology, describing our initial hypotheses, the sites we visited, our information-gathering process, and the analytical approach. In Chapter Three, we present the main results related to the four basic research questions. We also discuss other issues that arose during our site visits. Chapter Four presents recommendations and conclusions. Appendix A includes our interview protocols; Appendix B summarizes the source of cost savings from each case study; Appendix C analyzes the contractor-government wage differences; and Appendix D discusses some of our concerns with the savings calculations in A-76 studies.